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ITALY: MACRO FISCAL ASSESSMENT

AN ANALYSIS OF THE NOVEMBER 2007 UPDATE OF THE STABILITY PROGRAMME

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 30 November 2007.

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 (DG ECFIN) of the European Commission, was finalised on 22 January 2008. 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 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.

The analysis takes into account (i) the Commission services' autumn 2007 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. Technical issues are explained in an accompanying "methodological paper" prepared by DG ECFIN.

Based on this technical analysis, the European Commission adopted a recommendation for a Council opinion on the programme on 30 January 2008. The ECOFIN Council is expected to adopt its opinion on the programme on 12 February 2008.

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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

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 2007-2011, was submitted on 30 November 2007. 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.

Real GDP growth in Italy has been below the euro area average since the 1990s and potential growth is estimated to have fallen from above 2% in the early 1990s to around 1½% over the last 15 years. On the positive side, Italy has enjoyed robust employment growth since the turn of the century and its unemployment rate has fallen substantially, also reflecting the impact of labour market reforms. But, while there remains a long way to go before Italy catches up with the EU average in terms of employment rates, the combination of dynamic employment growth and sluggish GDP growth highlights Italy's productivity problem. Notwithstanding the recent recovery, medium-term prospects for the Italian economy remain challenging under the strain of major structural weaknesses feeding into low productivity growth, a steady loss of external competitiveness and, until recent years, a positive inflation differential with the euro area average. A public debt-to-GDP ratio above 100% and the still relatively weak, though improving, budgetary position increase economic uncertainty and generate a high cost of debt service, making Italy vulnerable to increases in interest rates. They also prevent more productive uses of public resources and limit the ability of fiscal policy to allow automatic stabilisers to work effectively. Further containing the structural primary expenditure ratio, following its recent stabilisation, and increasing potential growth, also through an improvement of the quality of public finances, are key to rapidly reducing the debt ratio and putting public finances on a sustainable path.

The macroeconomic scenario underlying the programme envisages that real GDP growth will slow down from 1.9% in 2007 to 1.5% in 2008. This would be followed by a mild but steady acceleration throughout the remainder of the programme period, whereby growth is expected to reach 1.8% in 2011. This scenario appears to be rather favourable, in particular as recent developments point to a real GDP growth in 2008 clearly below that of the programme. The programme’s projections for inflation also appear to be on the low side for 2008 and plausible thereafter. Domestic demand is expected to continue being the main driver of growth, but both private consumption and gross fixed capital formation will slow down in 2008. The latter would resume pace in the following years. After being neutral in 2007, the contribution of net exports to real GDP growth is projected to be very mildly positive in the subsequent years, on the back of a recovery of both exports and imports. Inflation prospects, and the underlying moderation in unit labour cost growth, appear to be consistent with a containment of the competitiveness losses of the Italian economy. Although the projected output gap remains slightly negative, the observation of a broader set of economic indicators suggests that the economy is in neither good nor bad (i.e. “neutral”) economic times in the near term.

For 2007, the general government deficit is estimated at 2.4% of GDP in the 2007 update of the stability programme, against a target of 2.8% of GDP set in the previous update. In the Commission services' autumn 2007 forecast, the deficit was expected at 2.3% of GDP. These lower deficit projections are essentially explained by the 1 pp. of GDP positive base effect from the better deficit outturn in 2006 and the 1.8 pp. higher nominal

GDP growth in 2007 vis-à-vis the 2006 programme, partly offset by around 0.9% of GDP of additional expenditure adopted in the course of 2007. In light of more recent information, the 2007 deficit could turn out substantially lower than estimated in the autumn forecast.

Budgetary implementation in 2007 is in line with the invitation in the Council opinion on the previous update of the stability programme[1] related to the correction of the excessive deficit. However, in view of the above-mentioned additional expenditure adopted during the year, it cannot be considered fully in line with the invitation to take advantage of better-than-expected budgetary developments for deficit reduction, also expressed in the April 2007 Eurogroup orientations for budgetary policies.

The programme's budgetary strategy aims at pursuing fiscal consolidation towards the medium term objective (MTO) of a balanced position in structural terms, i.e. cyclically-adjusted and net of one-off and other temporary measures, which is planned to be reached by 2011. On the back of a similar economic outlook, deficit targets for 2008-2011 are broadly unchanged compared to the previous update. However, the projected adjustment in 2008 is around ½ pp. of GDP lower, as the unchanged nominal target is planned against a better starting position. The government deficit is targeted to narrow by only 0.2 pp. of GDP in 2008 and by around ¾ pp. per year thereafter, to turn into a balanced position in 2011. The composition of the adjustment is provided only for 2008, when the small deficit reduction is planned mainly on the expenditure side. After 2008, the programme only provides the overall size of the consolidation package that is required each year to achieve the budgetary targets from the trends under an unchanged legislation scenario, with no indication on its composition. The gross debt-to-GDP ratio, estimated at 105% in 2007, i.e. well above the 60% of GDP Treaty reference value, is planned to decline by around 10 percentage points over the programme period.

The risks to the deficit projections in the programme appear broadly balanced in 2008, but the budgetary outcomes could be worse than projected in the programme thereafter. While the likely positive outturn for 2007 would provide a favourable base effect for 2008, the 2008 budget law envisages that revenue developments over and above those needed to achieve the deficit target can be used to fund tax cuts. In light of recent economic developments, the deficit outturn in 2008 is also subject to the risk of a significantly lower GDP growth. The achievement of the 2.2% of GDP deficit target in 2008 could imply a deterioration of both the headline and structural balance relative to 2007.[2] Risks to public finances in the medium term mainly relate to the fact that the adjustment is backloaded to the years after 2008 where no information is given on its composition. In particular, appropriate measures aimed at curbing expenditure developments remain to be spelt out. Considering these risks to the budgetary targets, from 2009 onwards the evolution of the debt ratio may be less favourable than projected in the programme.

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[1] OJ C 70, 27.3.2007, p. 17.

[2] This is particularly true for the structural balance. The measure adopted on 31 December 2007 to discontinue the obligation by tax collectors to advance to government the payment of a certain amount of taxes to be collected in the following year could have a negative impact (0.3% of GDP) on the headline balance in 2007. However, it would not have any impact on the structural balance in 2007 because of its one-off nature.

In view of this risk assessment, the budgetary stance in the programme is consistent with a correction of the excessive deficit in 2007 as recommended by the Council. However, a sufficient safety margin against breaching the 3% of GDP deficit threshold with normal macroeconomic fluctuations may not be secured before 2010 and the budgetary stance in the programme may not be sufficient to ensure that the MTO is achieved by the end of the programme period, as envisaged in the programme. Unless the better-than-expected 2007 outturn is carried forward, the structural balance risks deteriorating substantially in 2008. The pace of adjustment towards the MTO implied by the programme is inadequate and should be strengthened to be in line with the Stability and Growth Pact, which specifies that, for euro area and ERM II Member States, the annual improvement in the structural balance should be 0.5% of GDP as a benchmark. Furthermore, the budgetary stance in 2008 is not in line with the April 2007 Eurogroup orientations for budgetary policies, according to which fiscal policy for 2008 ought to be carefully designed so as to accelerate the adjustment towards the MTO. From 2009 onwards, the budgetary stance in the programme should be backed up with measures. Finally, also taking into account the risks to the budgetary projections mentioned above, the debt ratio may not be sufficiently diminishing towards the reference value over the programme period.

Italy is at medium risk with regard to the sustainability of public finances. For Italy, the long-term budgetary impact of ageing 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. Yet, pension expenditure as a share of GDP remains among the highest in the EU and the projections hinge upon the full implementation of the recently adopted reforms, in particular the revision of the actuarial coefficients as of 2010, without departing from the contributory principle underlying the reformed pension system. The budgetary position in 2007 as estimated in the programme, which is better than the starting position in the previous update, contributes to offsetting the projected long-term budgetary impact of ageing but is still insufficient to fully cover future spending pressures, even when factoring in the likely better outturn. 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.

Italy’s national reform programme identifies 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. In the Commission's December 2007 Strategic Report on the renewed Lisbon strategy for growth and jobs,[3] Italy is assessed to have made good progress in implementing its national reform programme over the 2005-2007 period. Against the background of strengths and weaknesses identified and the evidence of progress made, the Commission advises the Council to recommend Italy to give the highest priority to the challenges in the areas of: the long-term sustainability of public finances; competition in product and services markets; and education, life-long learning, undeclared work and the operation of employment services, within a flexicurity approach and with a view to reducing regional disparities. In addition, Italy should also focus on the areas of: R&D;

[3] Communication from the Commission to the European Council, “Strategic report on the renewed Lisbon strategy for growth and jobs: launching the new cycle (2008-2010)”, 11.12.2007, COM(2007)803.

CO_2 emission reduction; impact assessment; infrastructure; reconciliation of work and family life; and employment of older workers.

The stability programme is fully consistent with the October 2007 implementation report of the national reform programme. Although not in a systematic way, the budgetary projections in the programme explicitly take into account the public finance implications of the structural reform actions with a direct budgetary impact envisaged in the report. The budgetary strategy in the programme is partly consistent with the country-specific broad economic policy guidelines included in the integrated guidelines and the guidelines for euro area Member States issued in the context of the Lisbon strategy in the area of budgetary policies. Italy should have pursued a more ambitious consolidation strategy given the favourable cyclical and budgetary developments. The programme reports on promising initiatives aimed at improving the quality of public finances. An ongoing spending review and the reclassification of the state budget are first steps towards a wider reform of the budgetary process. Concrete measures aimed at curbing current primary expenditure and improving its efficiency and cost effectiveness remain to be spelt out.

The overall conclusion is that the programme is consistent with a correction of the excessive deficit in 2007. The 2007 budgetary outturn is likely to outperform expectations due to the favourable cyclical and budgetary developments. This result could have been even better in the absence of the additional expenditure approved during finances, Italy is at medium risk but this assessment assumes the full implementation of the adopted pension reforms, in particular the revision of the year. In 2008, the structural balance risks deteriorating substantially, unless the better-than-projected 2007 starting position is carried forward. The planned adjustment towards the MTO is backloaded to the outer years of the programme. The programme provides no information on the composition of the fiscal consolidation strategy after 2008, which hinders its proper assessment. Appropriate measures aimed at curbing expenditure developments remain to be spelt out. In the light of these risks, the MTO may not be achieved by 2011 as planned in the programme and the debt ratio may not be sufficiently diminishing towards the 60% of GDP reference value over the programme period. With regard to the sustainability of public finances, Italy is at medium risk but this assessment hinges upon the full implementation of the adopted pension reforms.

Comparison of key macroeconomic and budgetary projections

		2006	2007	2008	2009	2010	2011
Real GDP (% change)	**SP Nov 2007**	**1.9**	**1.9**	**1.5**	**1.6**	**1.7**	**1.8**
	COM Nov 2007	1.9	1.9	1.4	1.6	n.a.	n.a.
	SP Dec 2006	*1.6*	*1.3*	*1.5*	*1.6*	*1.7*	*1.7*
HICP inflation (%)	**SP Nov 2007**	**2.2**	**1.9**	**2.0**	**2.0**	**1.8**	**1.9**
	COM Nov 2007	2.2	1.9	2.0	1.9	n.a.	n.a.
	SP Dec 2006	*2.2*	*2.1*	*1.7*	*1.5*	*1.5*	*1.5*
Output gap[1] (% of potential GDP)	**SP Nov 2007**	**-1.0**	**-0.6**	**-0.6**	**-0.6**	**-0.6**	**-0.6**
	COM Nov 2007[2]	-1.1	-0.8	-0.9	-1.0	n.a.	n.a.
	SP Dec 2006	*-0.9*	*-0.9*	*-0.8*	*-0.7*	*-0.5*	*-0.5*
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	**SP Nov 2007**	**-1.9**	**-1.3**	**-0.8**	**-0.6**	**-0.4**	**-0.2**
	COM Nov 2007	-1.9	-1.6	-1.5	-1.5	n.a.	n.a.
	SP Dec 2006	*-2.3*	*-2.0*	*-2.0*	*-2.0*	*-1.9*	*-1.8*
General government balance (% of GDP)	**SP Nov 2007**	**-4.4**	**-2.4**	**-2.2**	**-1.5**	**-0.7**	**0.0**
	COM Nov 2007	-4.4	-2.3	-2.3	-2.3	n.a.	n.a.
	SP Dec 2006	*-5.7*	*-2.8*	*-2.2*	*-1.5*	*-0.7*	*0.1*
Primary balance (% of GDP)	**SP Nov 2007**	**0.1**	**2.5**	**2.6**	**3.4**	**4.2**	**4.9**
	COM Nov 2007	0.1	2.5	2.4	2.5	n.a.	n.a.
	SP Dec 2006	*-0.9*	*2.2*	*2.8*	*3.4*	*4.2*	*5.0*
Cyclically-adjusted balance[1] (% of GDP)	**SP Nov 2007**	**-3.9**	**-2.0**	**-1.9**	**-1.2**	**-0.4**	**0.2**
	COM Nov 2007	-3.9	-1.9	-1.9	-1.8	n.a.	n.a.
	SP Dec 2006	*-5.3*	*-2.3*	*-1.8*	*-1.2*	*-0.4*	*0.3*
Structural balance[3] (% of GDP)	**SP Nov 2007**	**-2.7**	**-2.2**	**-2.0**	**-1.3**	**-0.5**	**0.2**
	COM Nov 2007	-2.7	-2.0	-2.0	-1.9	n.a.	n.a.
	SP Dec 2006	*-3.9*	*-2.5*	*-1.9*	*-1.2*	*-0.4*	*0.3*
Government gross debt (% of GDP)	**SP Nov 2007**	**106.8**	**105.0**	**103.5**	**101.5**	**98.5**	**95.1**
	COM Nov 2007	106.8	104.3	102.9	101.2	n.a.	n.a.
	SP Dec 2006	*107.6*	*106.9*	*105.4*	*103.5*	*100.7*	*97.8*

Notes:

[1]Output gaps and cyclically-adjusted balances from the programmes as recalculated by Commission services on the basis of the information in the programmes.

[2]Based on estimated potential growth of 1.5%, 1.6%, 1.5% and 1.7% respectively in the period 2006-2009.

[3]Cyclically-adjusted balance excluding one-off and other temporary measures. According to the most recent programme and the Commission services' autumn forecasts, one-off and other temporary measures are: 1.2% of GDP in 2006, deficit-increasing; 0.2% of GDP in 2007, deficit reducing, and 0.1% of GDP per year, all deficit reducing, from 2008 onwards.

Source :

Stability programme (SP); Commission services' autumn 2007 economic forecasts (COM); Commission services' calculations

1. INTRODUCTION

The Italian authorities submitted the ninth update of the stability programme in the original language on 30 November 2007[4], covering the period from 2007 to 2011.

The programme is published under the responsibility of the Ministry of Economy and Finance. It is not adopted by the government and is presented to Parliament for information only. However, 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 adopted on 28 June 2007 and successively updated in connection with the presentation of the draft of the 2008 Budget Law at the end of September. The programme incorporates the first version of the 2008 draft Budget Law, which was adopted by government on 29 September, and does not take account of the amendments incorporated in the final version of it.

This assessment is structured as follows. Section 2 discusses key challenges for public finances in Italy, with a particular focus on the need to contain public expenditure while at the same time enhancing its quality. Section 3 assesses the plausibility of the macroeconomic scenario underpinning the public finance projections of the stability programme against the background of the Commission services' economic forecasts. Section 4 analyses budgetary implementation in the year 2007 and the medium-term budgetary strategy outlined in the new programme. Taking into account risks attached to the budgetary targets, it also assesses the appropriateness of the fiscal stance and the country's position in relation to the budgetary objectives of the Stability and Growth Pact. Section 5 reviews recent debt developments and medium-term prospects, as well as the long-term sustainability of public finances. Section 6 discusses the quality of public finances and structural reforms, while Section 7 analyses the consistency of the budgetary strategy outlined in the programme with the National Reform Programme and its implementation reports and with the broad economic policy guidelines. The annexes provide a detailed assessment of compliance with the code of conduct, including an overview of the summary tables from the programme (Annex 1) and selected key economic indicators of past economic performance (Annex 2).

2. THE CHALLENGE FOR FISCAL POLICY IN ITALY: CONTAINING EXPENDITURE AND ENHANCING ITS QUALITY

With a budget deficit still at double-digit levels at the beginning of the 1990s, meeting the Maastricht criteria on the fiscal front and maintaining fiscal soundness thereafter represented a major challenge for Italy. Yet, a considerable policy effort, supported by the reduction of the cost of servicing the debt originating from the sharp fall in interest rates, allowed Italy to bring the deficit down to 1.7% of GDP in 1999 and put the debt on a downward path. Starting from this, optimism prevailed that the debt ratio could continue shrinking rapidly thanks to savings from the steady decrease in interest rates and by maintaining a stable primary surplus at around 5% of GDP. Unfortunately, these hopes did not materialise as lack of commitment towards fiscal consolidation resulted in rising primary expenditure and untimely tax cuts. By 2005, the primary surplus was almost fully eroded and the public debt ratio started rising again. Even though the

[4] The English translation was submitted on 13 December 2007.

underlying situation of public finances has recently improved to comply with the Council recommendation under Article 104(7) of July 2005, fiscal consolidation continues to represent a key challenge for Italy. Italy is the only Member State that still has a public debt above the nominal GDP level and the related interest expenditure absorbs an amount almost twice as high as in the rest of the euro area.

In last year's assessment of the stability programme update of December 2006, the Commission services identified three important challenges for Italy’s fiscal policy, none of which could be met without achieving first a resolute and durable fiscal consolidation. First, it is crucial to ensure the long-term sustainability of public finances, particularly in light of the heavy pressure stemming from a rapidly ageing population. Second, in an economic policy strategy aimed at addressing the structural weaknesses of the Italian economy and enhancing its efficiency, a wisely conducted fiscal policy can help reduce economic uncertainty, create more favourable conditions for investment and make room for enhanced expenditure on knowledge, human capital and infrastructure. Finally, in the context of EMU, fiscal policy has an important role as a stabilisation tool.

The present section addresses the question of how fiscal consolidation can be achieved on a durable basis so that fiscal policy can meet the above challenges. It is argued that, with a tax burden that is perceived as very high in relation to the scope and quality of public services supplied, curbing growth of primary expenditure is the only means to pave the way for sound and sustainable public finances without increasing the tax burden much further. But within a much needed comprehensive strategy aimed at addressing the structural weaknesses of the economy and raising its growth potential, the containment of public expenditure must go hand in hand with action to enhance its efficiency and cost effectiveness.

After a first subsection illustrating public finance developments in Italy during EMU years, the second subsection focuses on patterns and trends of primary expenditure. Two items of public spending that have represented a source of budgetary slippages over the recent past - compensation of employees and health care expenditure – are examined in greater detail. Various aspects of quality of public expenditure are briefly reviewed in the subsequent section. The conclusive subsection draws some policy lessons.

2.1. Fiscal consolidation in Italy: an unfinished agenda

In Italy, the impressive budgetary adjustment that was achieved during the 1990s and that led to the adoption of the euro was reversed in the following years (see Table 1 at the end of this section):[5] already in 2000, in spite of buoyant real GDP growth (3.6%), the deficit decreased to 0.8% only thanks to one-off measures[6] worth 1.3% of GDP. Then, in 2001, the deficit rose above the 3 percent of GDP Treaty reference value and has remained above that threshold over 2003-2006, despite sizeable deficit-reducing one-offs measures. In 2005, when GDP stagnated, the deficit attained 4.2% of GDP and the primary surplus was almost fully eroded, 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, after decreasing by almost 18 pp. of GDP between 1995 and 2004. In 2006, a significant

[5] For an analysis of budgetary developments in Italy from the ‘90s up to 2004, see also Daniele Franco (2005), "Il consolidamento interrotto", in Guerra M. C. and A. Zanardi (eds) *La finanza pubblica italiana Rapporto 2005*, Il Mulino, Bologna.

[6] Essentially UMTS licence proceeds.

budgetary adjustment was achieved when excluding one-offs, thanks to the improved economic conditions and the implementation of a budgetary strategy aimed at addressing the excessive deficit by 2007, in compliance with the Council recommendation under Article 104(7) of July 2005. However, the adjustment has been largely revenue-based: the tax burden increased by 1¾ pp. of GDP, to 42¼% of GDP.

In structural terms, the deterioration of public finances is just as evident (Figure 1). The structural primary balance steadily deteriorated between 1997 and 2003. It was only thanks to the increase in structural revenue recorded in 2005-2006 that it rose from around zero over 2003-2004 to around 2% of GDP in 2006, leading to a structural deficit below 3% of GDP (Figure 2).

Figure 1 – Structural deficit and interest expenditure

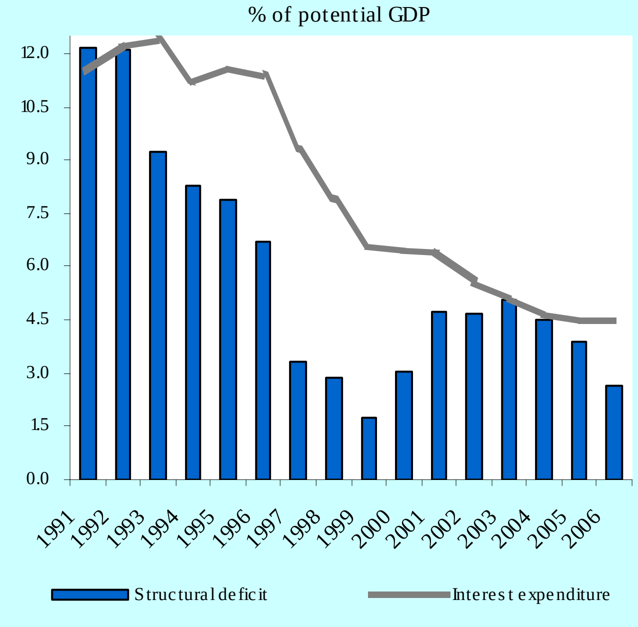
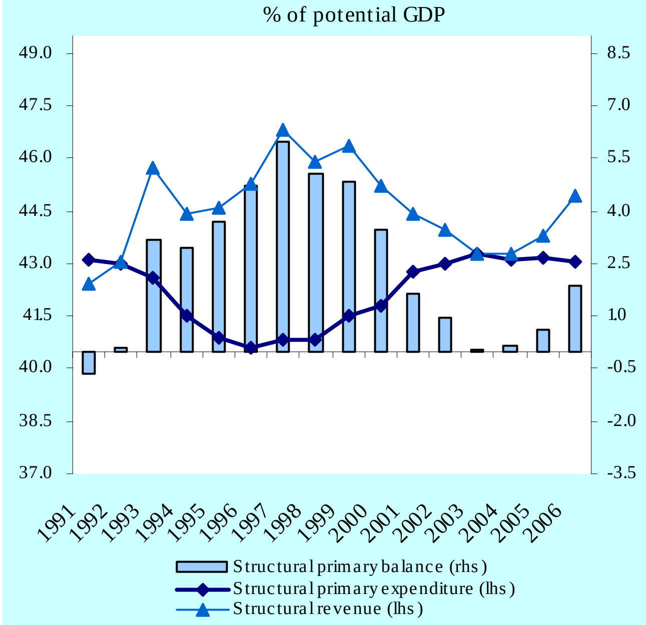


Figure 2 – Revenue and primary expenditure developments in structural terms



Source: Commission services' calculations

On the revenue side, developments over the past decade have been uneven. In the run-up to the euro, discretionary measures gradually led the revenue-to-GDP ratio to peak at just below 48% of GDP in 1997. The revenue ratio started decreasing in 2000, when significant tax cuts were granted on the basis of favourable revenue projections. Based on the optimistic assumption that real GDP growth in the following years could grow faster than the planned increase in real primary expenditure, the 2001 budget law introduced additional measures aimed at further lowering the tax burden. As a result, in both 2000 and 2001 the revenue ratio (excluding one-offs) decreased by around one percentage point of GDP. Permanent revenue decreased further in 2002 and 2003, offset by sizeable one-offs. Revenue developments reverted in 2005, when sizeable discretionary measures were adopted to address the deteriorating fiscal situation. In 2006, permanent revenue as a share of GDP recorded a 1½ pp. rise, supported by buoyant corporate income tax and VAT revenue.

On the expenditure side, current primary expenditure has been increasing steadily since 1995, at an average annual nominal rate close to 5%, i.e. more than 2% in real terms, so well above potential growth. Capital expenditure, excluding one-offs, has recorded an average annual increase of 6% since the trough recorded in 1997; in 2006 it was at around 4% of GDP. On the other hand, after falling sharply between 1993 and 1998, interest expenditure as a share of GDP has continued declining in the euro area years, by 3.3 percentage points between 1998 and 2006. Taken together, about ¾ of the fall in the interest expenditure ratio during the euro area years were offset by the rise in the primary expenditure ratio, excluding one-offs.

Today, interest rate developments are no longer supportive of a reduction in the cost of the debt service. Further major savings cannot even be expected from a restructuring of the debt, which has already been carefully managed to lengthen its average residual maturity. The scope for sales of financial assets and other operations on assets and liabilities is more limited than over the past decade, when they allowed a decline in the debt-to-GDP ratio of more than 11 percentage points. In addition, if Italy is to regain external competitiveness, future price developments could affect nominal GDP growth and thus the debt ratio. In these conditions, interest expenditure savings can only originate from a substantial fiscal retrenchment that increases the primary surplus and leads to the reduction of the debt ratio. With a tax burden that is above the euro area average and perceived as very high curbing growth of primary expenditure appears a necessary condition to achieve this goal. The analysis above warns against discretionary tax cuts that are not matched by a substantial and durable reversal of primary expenditure dynamics. Any untimely tax cuts would risk jeopardising the fiscal consolidation efforts and prevent a durable reduction in the debt ratio, as they did in the recent past.

In what follows, trends and patterns of primary expenditure in Italy are examined in greater detail and are contrasted with those in the euro area, as a way to help identify which items and functions exhibit trends that are not consistent with the underlying economic and financial conditions and/or absorb resources that could be better re-allocated in order to support potential growth.

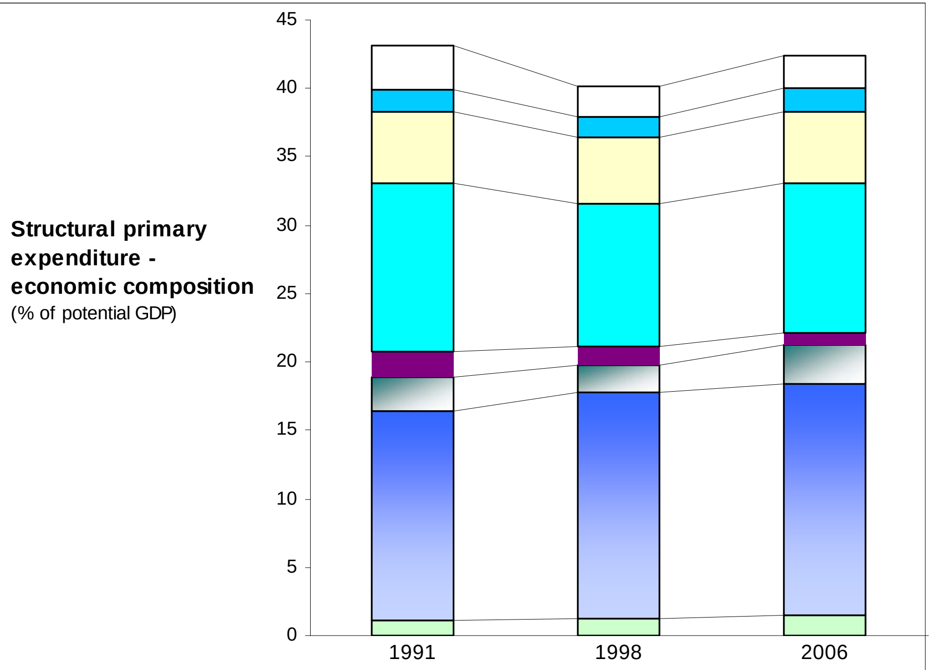
2.2. A focus on public primary expenditure

2.2.1. The economic composition of public primary expenditure

The level of primary expenditure in Italy is broadly in line, if only slightly below, the euro area average. In 2006, total primary expenditure accounted for more than 43% of GDP.[7] The current component accounted for just below 40% of GDP, like in the euro area. In terms of trends, Italy's primary expenditure during the euro area years grew faster than potential GDP: it increased its share in the latter by more than 2 pp. percentage points, compared to a reduction by almost one percentage point for the rest of the euro area. This is hardly consistent with Italy's much higher level of debt and the related higher cost of the debt service requirements.

[7] Excluding the around 2% of GDP of capital expenditure accrued as a result of court rulings and the cancellation of the railway's company debt related to the high speed project (Ferrovie dello Stato – RFI/TAV) (see Footnote 14).

Figure 3 - Developments of primary expenditure by economic composition



	1991	1998	2006
Gross fixed capital formation	3.2	2.3	2.4
Other capital expenditure	1.6	1.4	1.8
Intermediate consumption	5.2	4.8	5.2
Compensation of employees	12.4	10.5	10.9
Subsidies	1.8	1.3	0.9
Social transf. in kind supplied to households via market producers	2.5	2.0	2.8
Social benefits other than social transfers in kind	15.3	16.6	16.9
Other current expenditure	1.1	1.2	1.5

Source: Commission services

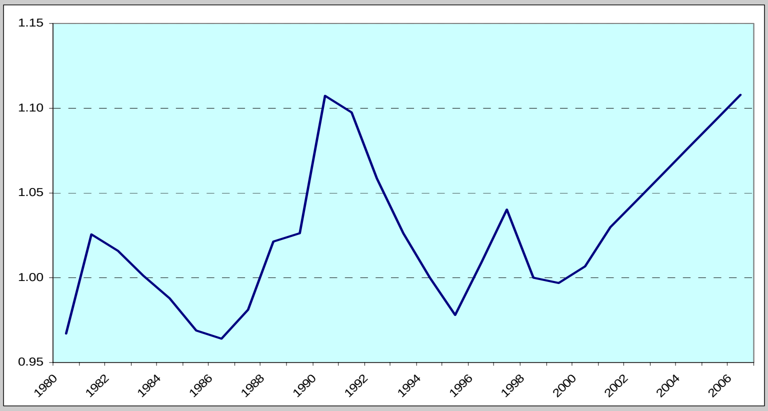
The expansion of primary expenditure after the euro adoption was due to both a recovery in capital expenditure and a steady increase in current expenditure (Figure 3). Within current expenditure, the largest rise was recorded in "social transfers in kind supplied to households via market producers", essentially related to expenditure on health care. Intermediate consumption and compensation of employees were both around ½ pp. of GDP higher in 2006 relative to 1998. In particular, after the considerable wage restraint in the 1990s to help meet the Maastricht criteria, growth of the latter item has been particularly strong since the year 2000, well above inflation and economy-wide productivity[8] (see Box 1).

[8] Commissione Tecnica per la Finanza Pubblica (2007), *Libro Verde sulla Spesa Pubblica – Spendere meglio: Alcune Prime Indicazioni*, Ministry of Economy and Finance, Rome.

Box 1. Public employment and wages

The strong increase in expenditure on compensation of employees along with a steady increasing workforce since the euro adoption (0.5% per year on average - excluding the compulsory military service) contrasts with the trend in the euro area, where the share of public wages in GDP has been decreasing since the mid 1990s, driven in particular by wage restraint and the reduction of the public sector workforce in Germany. In terms of full-time equivalent employees (FTE), the cumulative increase over 1999-2006 was around 37%, or 4% on average per year, much higher than inflation and economy-wide labour productivity, as well as of wages in the private sector (see Figure). These trends are particularly worrying, even though the comparison of wage trends in the public and the private sectors must take account of composition effects, i.e., changes in the composition of the workforce by age, skill and type of contract.

Wages per employee (FTE): public/private ratio (1998 = 1)



Collective bargaining in the public sector is, in principle, regulated by the framework set for the overall economy by the July 1993 Protocol, which established a two-tier system: the first, national level with the main purpose of maintaining the purchasing power of wages; and a second, decentralised level aiming at distributing productivity gains to workers. In practice, the application of this framework in the public sector is hampered by a number of specific features. First, the funds that are expected to be required to cover wage agreements and/or their renewal are allocated through the Budget Law, even before the national and branch agreements are stipulated, but they normally prove insufficient to meet their actual cost. Second, given the limited or no fiscal autonomy by the single administrations, these funds also include the second tier of bargaining. Third, there is no accepted method to measure productivity in the public sector. Finally, in the bargaining process the public employer and the trade unions have often been defending the same interests, with only the Ministry of Economy and Finance acting as a counterpart. In this context, the biggest wage increases in the public sector have been obtained through the second tier of bargaining, at the level of single administrations, or have been granted through career progression, particularly at management level, with little relationship with performance or local labour market conditions. In addition, there have been persistent delays in the renewal of public contracts, which also entailed the granting of a pay premium to workers to compensate them for the long waiting times*.

As for the public workforce, the Green Book on public expenditure** points to evidence of an insufficient mobility of staff and an inefficient allocation of public employees across functions and across the territory, with instances of over-staffing. With a view also to containing expenditure, reiterated budgetary provisions aimed at freezing public employment turn-over have been stipulated, but they have hardly been followed through. In February 2007, the government and the main Italian trade unions signed a memorandum on the re-organisation of the public administration, signalling the intention to modernise the Italian public sector and improve its performance. The agreement foresees important changes, including the introduction of performance-based remuneration, merit-based career advance and the reduction of the workforce by limiting new hires. New evaluation systems to be introduced by collective bargaining are to become the basis for differentiating pay levels at decentralised level. On the other hand, the agreement foresees restrictions on the use of external consultants and a reduction in the use of atypical contracts.

* Dell'Aringa, C. (2006), *Una Regia Nazionale per la PA*, available at http://www.lavoce.info/index.php and Golino *et al*. (2007), *Le retribuzioni dei dipendenti pubblici. Tendenze e confronti con il settore privato*.

** Commissione Tecnica per la Finanza Pubblica (2007), op.cit in Footnote 8.

As already noted above, capital expenditure developments have been rather volatile over the last 15 years. The share of capital expenditure in GDP in the '90s declined by almost 2 percentage points, from over 5¼% at the end of the 1980s to 3½% in 1997. The drop, which affected in particular non-residential construction investment, was mainly due to the following two factors: the widespread judicial anti-corruption investigations that led to a slowdown in central and local government decisions concerning building permits, and the policy effort to meet the euro deficit convergence criteria. Capital expenditure started its recovery in 1998 and, net of one-off measures, its share in GDP returned to about 4½% over 2001-2003. Structural capital expenditure was reduced again in 2004, to support the renewed consolidation effort. The volatility of capital expenditure coupled with a steadily increasing current primary expenditure highlights the fact that the burden of fiscal consolidation has been borne by the former, as well as by taxpayers, given the unpopularity of current expenditure reductions. This contributed to the impoverishment of infrastructure endowment of the country.

2.2.2. The functional composition of primary expenditure

Like in the rest of the euro area, most of the Italian budget is absorbed by expenditure on social protection: in 2005[9], it accounted for around 42% of total primary expenditure, or 18% of GDP (as against 44% and 19¾% respectively in the rest of the euro area in 2004). Spending on pensions, by definition a rigid item of expenditure, is by far the largest component of total social protection spending. It accounts for 82% of the total reflecting a combination of high benefit rates and a long average time spent receiving a pension. In the other countries of the euro area, pensions account for a lower share of total social protection spending, as unemployment, family and social assistance benefits are more developed. Pension spending is very high compared to that in the other euro area countries even when allowance is made for the age structure of the population, i.e., after adjusting for the share of the elderly in total population. The relative importance of the other functions of primary expenditure is about the same in Italy as in the rest of the euro area, with the exception of expenditure on health care and on public order and safety that represent a higher share of primary expenditure (more than 15.5% and 4.5% in Italy vs. 14% and 3.5% in the rest of the euro area, respectively). The opposite is true for spending on education and housing and community amenities.

Witnessing the high rigidity of expenditure, the ranking in terms of the share in the different functions in general government primary expenditure was only slightly different at the beginning of the 1990s (Figure 4). In the first half of the 1990s, pushing in the opposite direction as the consolidation efforts, pension spending was still increasing at a fast pace. After 1995, expenditure on social protection has remained broadly stable as a share of potential GDP, at just below 18%, thanks to a succession of pension reforms. As a result of sizeable containment measures, general government expenditure on health declined in real terms between 1990 and 1995 but steadily increased thereafter. By contrast, expenditure on education now weighs less than at the beginning of the 1990s. General public services displayed an increasing trend since 1995 while economic affairs witnessed a decreasing trend since the beginning of the 1990s, also reflecting the decreased involvement of the government in the economy after major privatisations were carried out.

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[9] This analysis is based on data available up to 22 January 2008, i.e. data on functional expenditure up to 2005 for Italy and 2004 for the rest of the euro area aggregate. On 7 February 2007, the Italian statistical office published updated data for Italy for the period 2000-2006..

Box 2. Health care expenditure developments

Broadly in line with the average for the euro area, Italy spends around 9% of its GDP on health care, of which over two thirds weigh on the general government accounts. From a qualitative point of view, overall performance looks satisfactory: Italy's health outcome indicators are situated in the medium-to-high end of cross-country comparisons*.

According to the 2006 projections by the Ageing Working Group of the Economic Policy Committee, public health care expenditure is expected to increase less than in the EU as a whole in the long term. Nevertheless, the recent dynamics of health care expenditure raise concern, as since 2000 public health spending outturns have always overtaken the official projections. There is also indirect evidence of an inefficient use of resources. With regions in charge of providing health care services, the cost of these services varies substantially across regions, and in a way which does not appear directly correlated to their quality. Health care outcomes also differ widely as suggested by substantial inter-regional migration for hospital and specialist services. Indicators point to inefficiencies in all parts of the country, but particularly in the South, *e.g.* inappropriate use of hospital services or excessive procedures and drug prescriptions.** Thus, public health care spending represents the most critical and emblematic sector for fiscal federal relations. In this context, a draft Framework Law was adopted in July 2007 aimed at creating a more coherent fiscal federalism framework. It envisaged a new system of financing of local authorities (regions, provinces and municipalities), with increased own resources and national tax sharing, but also equalisation arrangements between regions to allow comparable levels of public services across the national territory. For the definition of the financial transfers from the central government, a gradual passage from a system based on historical spending to one based on standard costs is envisaged.

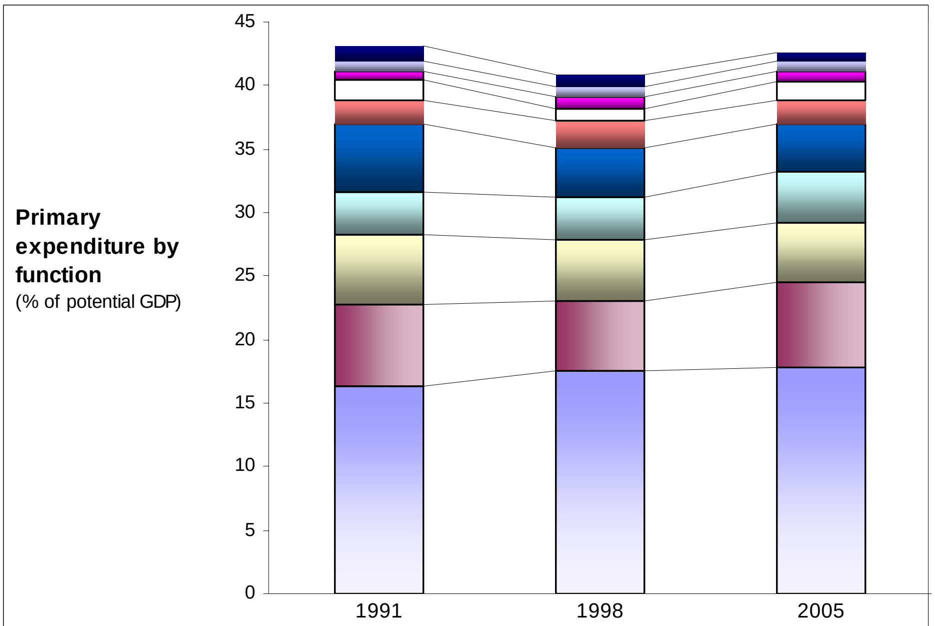
Similar legislation aimed at enhancing regions' accountability entered into force already in 2001, but was never consistently implemented and was eventually suspended in 2004. In order to control expenditure developments, the government has signed successive Health Pacts with the regions, setting expenditure caps and regulating its distribution. The substantial rise in expenditure on pharmaceutical products that was recorded after drugs co-payments were abolished at the national level in 2001 has been tackled through specific caps and the exercise of monopsony power by the central government. However, health spending continued to exceed the set targets. Regions incurring health deficits just blamed the need to satisfy national standards of care, as defined in the menu of minimum required levels of care (*Livelli Essenziali di Assistenza* - LEA) and demanded, and generally obtained, additional *ex post* transfers from the State.

In line with a further revision of the Health Pact, the 2007 budget law involved substantial additional public resources, but also prolonged a key innovative measure introduced by the 2006 budget law, which requires deficit regions to increase their two chief taxes (IRAP and the surcharge on personal income tax). Regions incurring high structural deficits were granted special long-term state "loans", but were also required to engage in correction plans aimed at identifying and tackling each single expenditure item that is out of control on the basis of best practice and standard costs (for more details, see the relevant box in the programme update). Some patient co-payments ("ticket") have been re-activated to stem excessive demand, just to be suspended a few months later. Finally, there is the intention to better define the menu of "essential" services (*LEA*), so as to quantify their cost.

The expenditure control mechanisms are starting to bear fruit: in particular, pharmaceuticals' expenditure is being contained and regions with high structural deficits have undertaken correction plans. A consistent implementation of these mechanisms may reflect an actual stronger commitment to improve the budgetary process in this area; it remains to be seen, however, whether the correction plans will end up in ex-post central government transfers to the deficit regions, as it has happened in the past.

* OECD (2007), *Economic Survey of Italy*, OECD, Paris.
** Commissione Tecnica per la Finanza Pubblica (2007), *op.cit.* in Footnote 8, and OECD (2007) , *op.cit.* above.

Figure 4 – Developments of primary expenditure by function in Italy



	1991	1998	2005
Housing and community amenities	1.2	1.0	0.7
Environment protection	0.7	0.8	0.7
Recreation, culture and religion	0.7	0.9	0.8
Defence	1.5	1.0	1.5
Public order and safety	2.0	2.0	1.9
Economic affairs	5.2	3.9	3.7
General public services	3.4	3.4	4.1
Education	5.5	4.7	4.6
Health	6.5	5.5	6.7
Social protection	16.3	17.6	17.8

Source: Commission services

2.3. The quality of public expenditure

In a broad-based definition of the quality of public finances that includes all fiscal policy dimensions, Italy's persistent fiscal imbalances and a composition of public expenditure heavily biased towards a high cost of the debt service and high pension spending are an indication that the quality of the Italian public finances needs improving.

Efficiency and effectiveness of public expenditure are two important aspects of the quality of public finances. Unfortunately, the adequate measurement of public sector efficiency, particularly when it concerns services provision, is a difficult empirical issue and the literature on it, particularly when it comes to aggregate and cross-country data, is scarce.[10] Still, the available evidence suggests that there is indeed scope for enhancing the quality of public expenditure in Italy. According to two composite indicators trying to relate the composition of public expenditure to the achievement of the strategic goals

[10] Afonso, A., Ebert, W., Schuknecht, L. and Thöne, M. (2005), *Quality of Public Finances and Growth*, Working Paper Series, No 438, European Central Bank, Frankfurt.

of government intervention, Italy ranks at the bottom among the 15 old Member States.[11] The first indicator aims at measuring the contribution of public expenditure to long-term growth in different countries on the basis of the *ex-ante* impact of each expenditure category as derived from a literature review.[12] The second indicator, used in Afonso *et al*. (2005), aims at measuring the efficiency of the public sector in reaching a range of objectives of government intervention. It is calculated as the ratio of various performance indicators to measures of relevant expenditure for each indicator. Italy's performance in some areas as measured by internationally-comparable indicators is disappointing, given the amount of resources devoted to them: for example, while Italy spends comparatively high amounts per student up to upper secondary education, a still large share of pupils does not complete this level of education and their performance scores on the OECD PISA literacy survey is significantly lower than the OECD average; Italy also scores relatively high in terms of poverty rates, in spite of a level of social protection expenditure that is around the EU average. Furthermore, based on the analysis of national data sources, the Green Book on public expenditure points to an inefficient allocation of resources in some major areas (justice, public employment, tertiary education, local governments, health care), particularly by comparing inputs and outcomes across different public entities performing the same functions.

Fiscal governance aspects are also important, as they create the appropriate framework conditions for fiscal policy to achieve its goals. In Italy, a deficit of effective fiscal rules and institutions, or lack of commitment towards implementing them, has been a major reason for the accumulation of fiscal imbalances. The weakness of the budgetary procedures is another important factor. Recent action by the government is aimed at introducing some forms of performance-based budgeting but, more importantly, the medium-term budgetary framework needs to be improved so as to steer fiscal policy towards a longer time perspective. To this purpose, medium-term budgetary targets for the main expenditure items should be made explicit in order to create appropriate incentive mechanisms for a better planning of public spending.

Finally, the quality of public finances can also be assessed in terms of the degree to which it contributes to provide a smooth functioning of labour, product and services markets so as to contribute to the overall adaptability to shocks. In this light, recent trends in the Italian wage setting for the public sector do not set a good example. Similarly, the inefficient functioning of the judicial system is a major factor hampering a favourable business environment.

2.4. Conclusions

The level of public expenditure in Italy is only slightly higher than in rest of the euro area, but the steady increase in its primary component over the past decade is not consistent with the need to rapidly reduce a public debt-to-GDP ratio still above 100%, while avoiding further excessive increases in the tax burden. In particular, some items of public expenditure highlight the need for more effective control mechanisms at local level, whereas others – namely public sector wages – exhibit trends that are unrelated to

[11] European Commission (2004), *Public finances in EMU – 2004*, European Economy No. 3. 2004. Office for Official Publications of the EC. Luxembourg. http://ec.europa.eu/economy_finance/publications/publication469_en.pdf

[12] European Commission (2002), *Public finances in EMU – 2002*, European Economy 2002. Office for Official Publications of the EC. Luxembourg. http://ec.europa.eu/economy_finance/publications/publication1662_en.pdf

the underlying economic conditions. Furthermore, the composition of public expenditure is biased towards a high cost of the debt service and high pension spending, which takes its toll on more productive expenditure as well as other social spending and largely contributes to the overall high rigidity of Italy’s public spending. There is also evidence that there is large scope for improving the quality of services provided.

Fiscal policy in Italy thus faces a double challenge: that of curbing growth of public expenditure while at the same time enhancing its quality. This can only be achieved by substantially improving the effectiveness and cost efficiency of public spending.

In 2007, the Italian government took several initiatives and actions aimed at raising expenditure control. After almost seven years of legislative vacuum in the area, a draft Framework Law on fiscal federalism was presented to Parliament with the aim to provide an institutional setting suitable to increase local government accountability and thus curb expenditure dynamics at local level, including in the area of health care. The above-mentioned blueprint for public administration reform agreed in February 2007 with the trade unions could potentially contribute to containing expenditure on compensation of employees, by introducing concepts like performance-based remuneration, merit-based career advance and the reduction of the workforce by attrition. The Green Book on public expenditure witnesses the government’s awareness of the need to tackle the current expenditure trends. This recognition is substantiated in a pilot spending review currently underway in five ministries, which in December 2007 resulted in an interim report with some broad indications of policy action. Finally, significant reflection and action on how to improve the budgetary process have been initiated by the Italian authorities. Specifically, a new functional classification for the budget has been prepared and is being tested in the 2008 budgetary session; and proposals have been put forward by the budget commissions of Parliament to streamline the budget approval process (for a more detailed account, see Section 6).

It is now crucial that all these initiatives are followed by concrete action. A resolute expenditure-based adjustment is not only key to achieving a durable fiscal consolidation, but would also make additional resources available for more productive uses with a view to addressing the structural weaknesses of the country. It also represents a necessary condition to avoid increasing further the tax burden. The analysis in this section warns against discretionary tax cuts that are not matched by a substantial and durable reversal of primary expenditure dynamics. Any untimely tax cuts would entail a stronger fiscal effort in the future, that is, a further burden transferred on the younger generations and a persisting environment of uncertainty that hampers growth. In addition, the history of Italy's repeated spending slippages highlights the need to substantially improve fiscal governance. In particular, the medium-term budgetary framework needs to be strengthened so as to make the expenditure targets explicit and binding. Expenditure management must become more flexible and result-oriented. For example, in the area of health care, the state financing of less efficient regions should be made conditional upon a significant improvement in the management of resources. With particular reference to the wage behaviour in the public sector, it is important that it recovers a path that is more responsive to the underlying economic conditions and consistent with the needed fiscal consolidation. With public sector employees representing over one fifth of the total wage and salary earners in the economy (in full-time equivalent terms), the wage behaviour in this sector risks entailing demonstration effects in the private sector, leading to more widespread wage pressures and thus harming the competitiveness of the country.

Table 1: Italy - General government account 1995-2006

in % of GDP	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
REVENUE												
Current taxes	40.6	41.4	43.0	42.0	42.3	41.5	41.2	40.6	40.0	40.0	40.5	42.3
Capital taxes	0.6	0.3	0.7	0.4	0.1	0.1	0.1	0.2	1.3	0.6	0.1	0.0
Other revenue	3.9	3.8	3.9	3.8	4.0	3.7	3.6	3.5	3.4	3.6	3.4	3.3
Total revenue	**45.1**	**45.5**	**47.6**	**46.2**	**46.4**	**45.3**	**44.9**	**44.4**	**44.8**	**44.2**	**44.0**	**45.6**
One-off revenue	*0.5*	*0.2*	*0.8*	*0.3*	*0.0*	*0.0*	*0.4*	*0.4*	*1.5*	*1.0*	*0.3*	*0.7**
Total revenue excl. one-offs	*44.6*	*45.3*	*46.8*	*45.9*	*46.4*	*45.3*	*44.5*	*44.0*	*43.3*	*43.3*	*43.7*	*44.9*
EXPENDITURE												
Current primary expenditure	36.4	37.2	37.6	37.3	37.6	37.2	37.5	38.1	38.8	39.0	39.6	39.5
Capital expenditure	4.5	3.7	3.4	3.8	3.9	2.6	4.2	3.6	4.3	3.9	4.1	6.0
Primary expenditure	**40.9**	**40.9**	**41.0**	**41.1**	**41.5**	**39.8**	**41.7**	**41.7**	**43.1**	**42.9**	**43.6**	**45.5**
Interest expenditure	11.6	11.5	9.3	7.9	6.6	6.3	6.3	5.5	5.1	4.7	4.5	4.6
Total expenditure	**52.5**	**52.5**	**50.3**	**49.0**	**48.1**	**46.2**	**48.0**	**47.2**	**48.3**	**47.7**	**48.2**	**50.1**
One-off capital expenditure	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*-1.2*	*-0.2*	*-0.8*	*-0.2*	*-0.3*	*-0.2*	*1.9**
Capital expenditure excl. one-offs	*4.5*	*3.7*	*3.4*	*3.8*	*3.9*	*3.7*	*4.3*	*4.5*	*4.5*	*4.2*	*4.3*	*4.1*
Primary expenditure excl. one-offs	*40.9*	*40.9*	*41.0*	*41.1*	*41.5*	*41.0*	*41.9*	*42.6*	*43.4*	*43.3*	*43.9*	*43.6*
Total expenditure excl. one-offs	*52.5*	*52.5*	*50.3*	*49.0*	*48.1*	*47.3*	*48.2*	*48.1*	*48.5*	*48.0*	*48.5*	*48.1*
Balance	**-7.4**	**-7.0**	**-2.7**	**-2.8**	**-1.7**	**-0.8**	**-3.1**	**-2.9**	**-3.5**	**-3.5**	**-4.2**	**-4.4**
Primary balance	**4.2**	**4.6**	**6.6**	**5.1**	**4.9**	**5.5**	**3.2**	**2.7**	**1.6**	**1.3**	**0.3**	**0.1**
Total one-offs	*0.5*	*0.2*	*0.8*	*0.3*	*0.0*	*1.2*	*0.6*	*1.2*	*1.7*	*1.3*	*0.6*	*-1.2*
Balance excl. one-offs	*-7.9*	*-7.2*	*-3.4*	*-3.1*	*-1.8*	*-2.0*	*-3.6*	*-4.1*	*-5.2*	*-4.7*	*-4.8*	*-3.3*
Primary balance excl. one-offs	*3.7*	*4.3*	*5.8*	*4.8*	*4.8*	*4.3*	*2.7*	*1.4*	*-0.1*	*0.0*	*-0.1*	*1.3*
Debt	**121.2**	**120.6**	**118.1**	**114.9**	**113.7**	**109.1**	**108.7**	**105.6**	**104.3**	**103.8**	**106.2**	**106.8**
in % of potential GDP												
Current primary expenditure	*36.4*	*36.9*	*37.4*	*37.1*	*37.6*	*37.9*	*38.3*	*38.5*	*38.7*	*38.9*	*39.0*	*39.0*
Primary expenditure	*40.9*	*40.6*	*40.8*	*40.9*	*41.5*	*40.6*	*42.6*	*42.1*	*43.1*	*42.8*	*43.0*	*45.0*
Primary expenditure excl. one offs	*40.9*	*40.6*	*40.8*	*40.9*	*41.5*	*41.8*	*42.7*	*43.0*	*43.3*	*43.1*	*43.2*	*43.1*
p.m. Output gap	*-0.1*	*-0.8*	*-0.3*	*-0.5*	*0.0*	*1.9*	*2.1*	*1.0*	*-0.2*	*-0.4*	*-1.5*	*-1.1*

p.m. Real GDP growth	*2.8*	*0.7*	*1.9*	*1.4*	*1.9*	*3.6*	*1.8*	*0.3*	*0.0*	*1.2*	*0.1*	*1.9*

* In 2006, one-off revenue and expenditure are increased by 0.3% of GDP (with 0 effect on total one-offs) to correct both figures from the officially estimated permanent impact of the ECJ's ruling on VAT (see Footnote 14). As explained in Footnote 14, it is likely that this amount will be revised substantially downwards.

Source: Commission services' calculations

3. MACROECONOMIC OUTLOOK

This section assesses the plausibility of the macroeconomic scenario (economic activity, labour market, costs and prices) underpinning the public finance projections of the programme. It also examines whether good or bad economic times in the sense of the Stability and Growth Pact prevail. Finally, it describes macroeconomic vulnerabilities and how they are expected to develop according to the programme.

3.1. Economic activity

The strong growth momentum created by the acceleration of GDP growth in the fourth quarter of 2006 lost vigour already in the first quarter of 2007, when real GDP grew by 0.3%. Economic growth maintained a moderate pace in the following two quarters (at 0.1% and 0.4% respectively over the previous quarters). However, thanks to the good starting position, the carry-over after the first three quarters of the year is estimated at 1.8%, non-adjusted for working days. For the fourth quarter of the year, business confidence indicators do not point to any improvement of economic prospects.

Table 2: Comparison of macroeconomic developments and forecasts

	2007		2008		2009		2010	2011
	COM	SP	COM	SP	COM	SP	SP	SP
Real GDP (% change)	1.9	1.9	1.4	1.5	1.6	1.6	1.7	1.8
Private consumption (% change)	1.9	2.0	1.4	1.8	1.7	1.8	1.8	1.8
Gross fixed capital formation (% change)	2.9	2.4	2.0	1.6	2.1	1.8	2.1	2.3
Exports of goods and services (% change)	2.9	2.0	2.8	2.8	3.1	3.5	3.8	4.1
Imports of goods and services (% change)	2.3	1.8	3.2	2.5	3.4	3.1	3.3	3.4
Contributions to real GDP growth:								
- Final domestic demand	1.9	2.0	1.5	1.4	1.7	1.5	1.6	1.6
- Change in inventories	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
- Net exports	0.2	0.0	-0.1	0.1	-0.1	0.1	0.1	0.2
Output gap[1]	-0.8	-0.6	-0.9	-0.6	-1.0	-0.6	-0.6	-0.6
Employment (% change)	0.9	0.8	0.7	0.7	0.7	0.8	0.8	0.8
Unemployment rate (%)	5.9	6.0	5.7	5.7	5.5	5.5	5.4	5.2
Labour productivity (% change)	1.1	1.1	0.8	0.8	0.9	0.8	0.9	1.0
HICP inflation (%)	1.9	1.9	2.0	2.0	1.9	2.0	1.8	1.9
GDP deflator (% change)	2.6	2.6	2.4	2.4	2.0	1.8	1.8	1.6
Comp. of employees (per head, % change)	2.4	2.4	3.7	4.3	2.3	2.1	2.1	2.1
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	-1.6	-1.3	-1.5	-0.8	-1.5	-0.6	-0.4	-0.2

Note:

[1]In percent of potential GDP, with potential GDP growth according to the programme as recalculated by Commission services.

Source :

Commission services' autumn 2007 economic forecasts (COM); Stability programme (SP)

For 2007, the macroeconomic scenario of the update assumes real GDP growth to average 1.9%. In 2008, economic growth is projected to slow down to 1.5%. This would be followed by a mild but steady acceleration throughout the remainder of programme period, whereby real GDP growth is expected to reach 1.8% in 2011. In the Commission services' recalculations, the projections of the programme imply that a slightly negative output gap will remain stable throughout the programme period.

Domestic demand is expected to continue being the main driver of growth. Both private consumption and gross fixed capital formation will slow down in 2008. The latter would resume pace in the following years. After being neutral in 2007, the contribution of net exports to real GDP growth is projected to be very mildly positive in the subsequent years, on the back of a pick-up of both exports and imports.

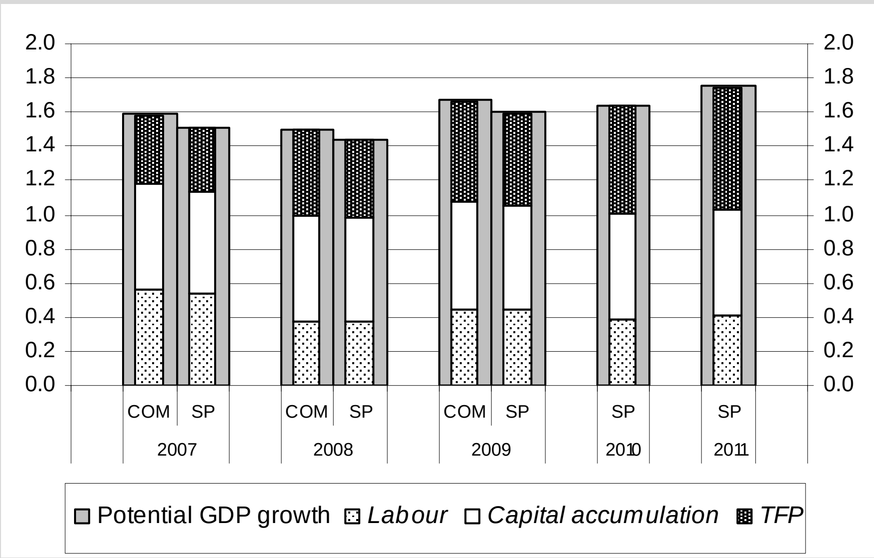
Italy's macroeconomic outlook in the programme implies an improvement on past economic trends. In particular, the average real GDP growth over the period 2006-2011 would be around 1.7% per year, which compares with a dismal 0.7% over the five-year period 2001-2005 (see Annex 2).

The profile of economic growth between 2007 and 2009 is in line with the autumn 2007 forecast. However, indications coming from business confidence indicators and the high oil prices suggest that risks to both projections are now tilted towards a significantly lower real GDP growth in 2008. In addition, the external assumptions underpinning the programme's macroeconomic scenario are somewhat more favourable than in the Commission services' autumn forecast, in particular as regards the exchange rate and oil prices in 2008. According to a sensitivity analysis presented in the programme, the impact of using the Commission services' assumptions would have a negative impact on real GDP growth in 2008 in the order of 0.1-0.2 pp. For 2010, the projected real GDP growth in the programme is broadly in line with the estimated potential growth in the Commission services' autumn forecast over the period 2007-2009, but slightly exceeds it in 2011.

Box 3: Potential growth and its determinants

The graph below 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 broadly in line with, if only slightly lower, those of the Commission services' autumn 2007 forecast up to 2009. In 2011, potential GDP growth is estimated to reach 1.8%.

Potential growth and its determinants



The drivers of potential growth in the programme scenario are broadly in line with those according to the Commission services' autumn 2007 forecast. Compared to the period 2001-2005, when the sharp slowdown in TFP growth implied that this factor hardly contributed to potential growth, TFP growth is expected to recover and thus bring a higher contribution to potential growth. This would be thanks to product and services markets reforms and the unfolding of the positive effects of an ongoing restructuring process in the tradable sector, which are expected to spur the capacity to innovate of firms.

The composition of growth is also slightly different in the programme. In 2007, the programme posts lower imports and exports' growth than the Commission services' forecast. In 2008 and 2009, growth of exports in the programme outpaces that in the autumn forecast, whereas the opposite is true for imports' growth. Within domestic demand, the more sustained pace of private consumption growth in 2008-2009 in the programme is compensated for by more subdued investment growth.

Overall, in the light of the above assessment and taking into account currently available information, the programme's macroeconomic assumptions appear rather favourable in 2008 and plausible thereafter.

The output gap recalculated by the Commission services on the basis of the data in the programme is higher than that estimated on the basis of the autumn 2007 forecast. The difference is quite significant in 2008 and 2009, at more than ¼ pp.

3.2. Labour market and cost and price developments

The programme projects a steady growth of employment, at around ¾% over 2009-2011. These projections imply a moderation of the employment content of growth from the high values recorded in the first half of the decade. As a consequence, labour productivity growth will stabilise at just below 1% between 2008 and 2010 and at 1% in 2011. The picture changes slightly when productivity is calculated on the basis of the projected total hours worked rather than head-count employment. As hours worked per person keep following their secular downward trend, productivity growth is slightly higher under this scenario, and reaches a peak of 1.3% in 2011. The unemployment rate is expected to continue decreasing to below 6% in 2008 and to 5.2% in 2011.

Up until 2009, the growth projections for both headcount employment and the unemployment rate are broadly in line with those of the Commission services. So are the projections of productivity.

The programme projects consumer price inflation in 2007 at 1.9% and at 2% in 2008, in line with the autumn forecast. However, developments in consumer price inflation in recent months have implied a higher inflation rate in 2007 (2.0%) and suggest that risks are now seriously tilted towards a higher inflation rate in 2008. HICP inflation is then projected to remain stable in 2009 and to dip to 1.8% in 2010 and to be at 1.9% in 2011. On the other hand, after peaking at 2.6% in 2007, inflation measured by the GDP deflator would progressively slow down over the programme period, to reach 1.6% in 2011, presumably under the effect of the containment of labour cost growth, and also driven by a projected normalisation in the export deflator. Based on the assumption of a stable nominal effective exchange rate and oil prices (Brent) at US$ 72 per barrel from 2008 onwards, the programme projects positive, albeit shrinking, terms of trade over the 2008-2011 period.

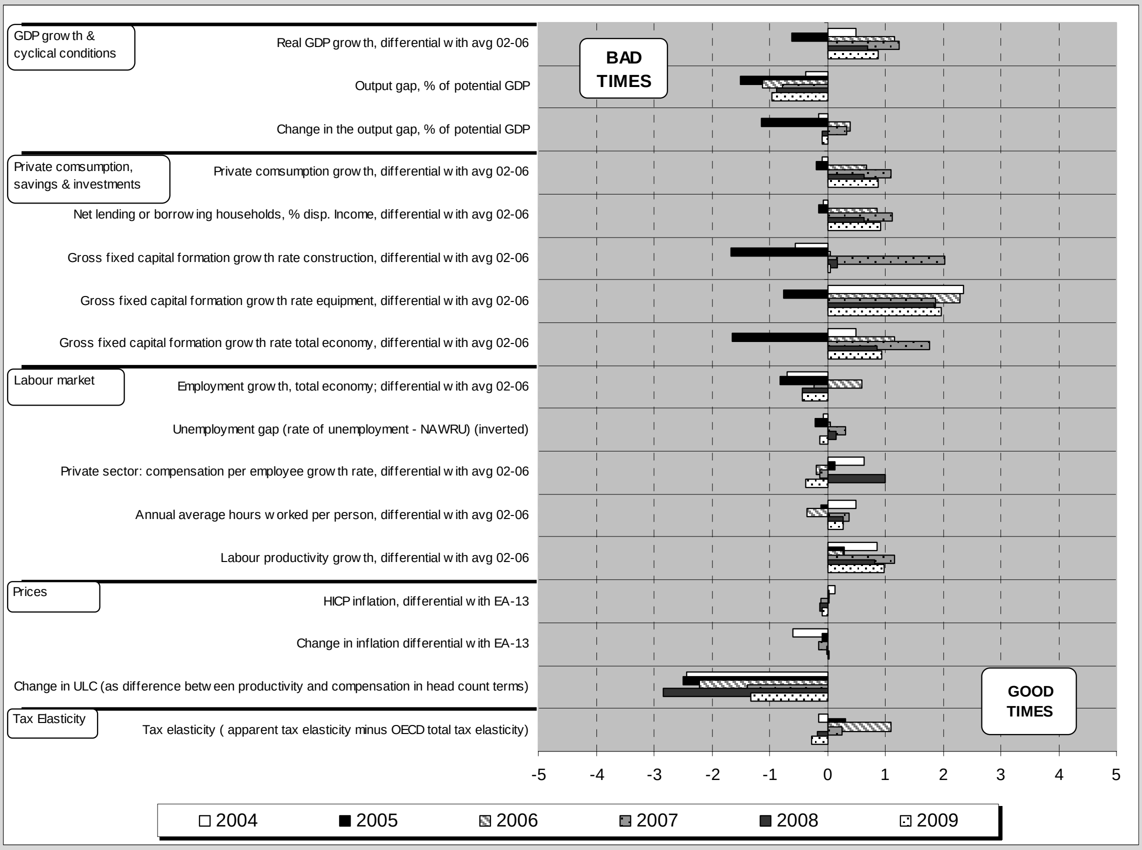
Growth in compensation of employees will be moderate in 2007, while it is expected to accelerate considerably in 2008, to 4.3%, under the impact of the scheduled contract renewals in both the public and the private sectors. Compensation of employees is expected to slow down markedly in 2009, to 2.1%, and to maintain that pace until the end of the programme period. On the back of a rather stable productivity growth, real unit labour costs are set to accelerate in 2008 and to slow down thereafter. Compared to the Commission services' forecast, the acceleration in compensation of employees projected in the programme for 2008 is more marked, and so is the resulting acceleration in unit labour costs. This does not seem to be consistent with the expected parallel pick up in export growth in 2008, if cost factors are believed to be the main determinant of competitiveness. From 2009, slowing unit labour cost growth appears to be consistent with a containment of the competitiveness losses of the Italian economy, taking into account that in the eight years since euro adoption nominal unit labour costs in Italy increased by more than 10% relative to the rest of the euro area.

Box 4: Good or bad economic times?

According to the code of conduct, the assessment of whether the economy is experiencing good or bad economic times starts from the output gap, but draws on an overall economic assessment, which should also take into account tax elasticities. The figure below presents a set of macroeconomic indicators drawn from the Commission services' autumn 2007 forecast. Overall, the economy seems to be in neither good nor bad (i.e. "neutral") economic times.

In particular, although the projected output gap remains slightly negative over the entire programme period, the observation of a broader set of economic indicators, including tax elasticities in the period 2007-2009, tempers the slightly negative assessment of the country's cyclical conditions.

Good versus bad times



3.3. Macroeconomic challenges

Real GDP growth in Italy has been below the euro area average since the 1990s and potential growth is estimated to have fallen from above 2% in the early 1990s to around 1½% over the last 15 years. Notwithstanding the recent recovery, medium-term prospects for the Italian economy remain challenging under the strain of structural weaknesses feeding into low productivity growth and a loss of external competitiveness. This suggests that Italy has so far found it difficult to cope with the shock of global economic integration solely via market flexibility, in the absence of monetary independence as before euro adoption. A public debt-to-GDP ratio above 100% and the still weak budgetary position increase economic uncertainty and generate a high cost of debt service, making Italy vulnerable to increases in interest rates. They also prevent more productive uses of public resources and limit the ability of fiscal policy to allow automatic stabilisers to work effectively.

The key policy challenge for Italy is to enable a swift and durable recovery in productivity growth, in a context of overall wage moderation in the private sector over a protracted period. To this purpose, there is no other choice than to enact structural reforms to improve the functioning of labour, product and services markets, including promoting innovation, the continued fostering of competition as well as a more dynamic financial market. A bargaining structure that is closer to where price and investment decisions are taken would also contribute to restoring competitiveness.

4. GENERAL GOVERNMENT BALANCE

This section consists of four parts. The first part discusses budgetary implementation in the year 2007 and the second presents the medium-term budgetary strategy in the new update. The third analyses the risks attached to the budgetary targets in the programme. The final part assesses the appropriateness of the fiscal stance and the country's position in relation to the budgetary objectives of the Stability and Growth Pact.

4.1. Budgetary implementation in 2007

Table 3 compares the 2007 revenue and expenditure targets (as a percentage of GDP) from the previous update of the stability programme with the results of the Commission services' autumn 2007 forecast. As the estimated size of one-offs has changed compared to the previous update (see below Footnote 16), the Table excludes all one-offs to allow an easy comparison. The difference between the revenue and expenditure targets for 2007 and the projected outcome is decomposed into a base effect, a GDP growth effect on the denominator and a revenue / expenditure growth effect[13]:

- The base effect captures the part of the difference that is due to the actual outcome for 2006 being different from what was projected in the previous update in the programme (either because the actual revenue / expenditure level in 2006 was different from the estimated outturn in the previous programme or because GDP turned out to be different from the scenario in the previous update of the programme). The base effect therefore also captures the effect of revisions to the GDP series.

- The GDP growth effect on the denominator captures the part of the difference that is related to current GDP growth projections for 2007 turning out higher or lower than anticipated in the previous update of the programme (therefore reducing / increasing the denominator of the revenue and expenditure ratio).

- The revenue / expenditure growth effect captures the part of the difference related to the revenue / expenditure growth rate in 2007 turning out to be higher or lower than targeted in the previous update of the programme. In particular, for revenue this would typically be due to GDP developments different from those expected in the previous

[13] A fourth, residual component is usually small, except if there are very large differences between the autumn forecast and the target (the full mathematical decomposition is in the methodological paper mentioned above).

update of the programme, or as a result of apparent tax elasticities different from the ex ante tax elasticities (or both).

Table 3: Budgetary implementation in 2007

	2006		2007	
	Planned SP Dec 2006	**Outcome** COM	**Planned** SP Dec 2006	**Outcome** COM
Revenue excl.one-offs (% of GDP)	44.6	45.2	46.2	46.2
Expenditure excl.one-offs (% of GDP)	48.9	48.5	49.1	48.6
Government balance excl.one-offs (% of GDP)	-4.3	-3.3	-2.9	-2.4
Nominal GDP growth (%)			2.8	4.6
Nominal revenue growth (%)			6.4	6.9
Nominal expenditure growth (%)			3.2	4.9
Revenue surprise compared to target (% of GDP)			**0.0**	
Of which [1]: 1. Base effect			0.6	
2. GDP growth effect on the denominator			-0.7	
3. Revenue growth effect			0.2	
Of which: due to a marginal elasticity of total revenue w.r.t. GDP larger than 1 [2]			*-0.5*	
Expenditure surprise compared to target (% of GDP)			**-0.5**	
Of which [1]: 1. Base effect			-0.5	
2. GDP growth effect on the denominator			-0.8	
3. Expenditure growth effect			0.8	
Government balance surprise compared to target (% of GDP)			**0.5**	
Of which [1]: 1. Base effect			1.1	
2. GDP growth effect on the denominator			0.1	
3. Revenue / expenditure growth effect			-0.6	

Notes:

[1]A positive base effect points to a higher-than-anticipated outcome of the revenue / expenditure ratio in 2006. A positive GDP growth effect (on the denominator) indicates lower-than-anticipated economic growth in 2007. A positive revenue / expenditure growth effect points to higher-than-anticipated revenue / expenditure growth in 2007. The three components may not add up to the total because of a residual component, which is generally small.

[2]Equal to (2)+(3). A positive sign means that the marginal elasticity of revenue with respect to GDP exceeds one.

Source :
Commission services

The 2006 update targeted the 2007 headline deficit at 2.8% of GDP. This compares with an estimated deficit outturn of 2.3% of GDP in the autumn forecast and of 2.4% in the new programme. Recent evidence on budgetary developments in 2007 suggest that the 2007 deficit could turn out even lower than the 2.3% of GDP in the autumn forecast, also because the latter incorporated almost 0.2% of GDP additional expenditure approved by the Senate in October 2007, which was later not confirmed by the Chamber of Deputies. According to ISTAT, the general government deficit in the first nine months of 2007 was around 1% of GDP, i.e. 1.9 pp. lower than the one recorded in the same period of 2006, which however included more than 1% of GDP negative budgetary impact due to Court rulings[14]. Favourable developments of both revenue and expenditure contributed to this

[14] The deficit in 2006 as a whole was significantly affected by the deficit-increasing impact of court rulings and the cancellation of the railway company's debt related to the high speed project (*Ferrovie dello Stato – RFI/TAV*). The cancellation of the railway company's debt related to the high speed project approved in December 2006 added 0.9% of GDP of one-off capital expenditure. The ruling issued in September 2006 by the European Court of Justice (ECJ) against Italy's VAT regime for company cars implied additional expenditure officially estimated in the April 2007 EDP report at 1.1% of GDP. More specifically, the Ministry of Economy and Finance's estimate of the net refunding of unduly paid VAT over the 2003 September 2006 period was around € 16 bn, of which € 11 bn (¾% of GDP) is considered to be one-off as related to the years 2003 to 2005, while € 5 bn (0.3% of GDP) is considered permanent as related to 2006. In the light of the limited reimbursement claims filed by

outturn in the first three quarters of the year. Although these data still do not reflect much of the additional 0.9% of GDP expenditure approved in the second semester of 2007 (see below) and executed in the final months of the year, the likelihood of a better-than-projected budgetary outcome for the year as a whole is corroborated by the state-sector cash borrowing requirement recorded over the whole 2007, 0.6 pp. of GDP lower than in 2006.[15] This positive result was negatively affected by the decision adopted on 31 December 2007 to discontinue the obligation by tax collectors to advance to government the payment of a certain amount of taxes to be collected in the following year. This decision increased the state-sector cash borrowing requirement by 0.3% of GDP in 2007.

Taking account of both the positive base effect from the better-than-expected 2006 deficit outturn (around 1% of GDP excluding one-offs[16]), and a nominal GDP growth at 4.6% in 2007 vs. 2.8% projected in the 2006 programme, the full implementation of the fiscal consolidation planned in the previous update could have led to overachieve the headline deficit target in the previous update by around 1¾ pp. of GDP. Instead, the autumn forecast expects the 2007 deficit to be just 0.5 pp. of GDP lower than targeted in the 2006 programme (0.7 pp. lower when excluding the additional expenditure not approved by the Chamber of Deputies mentioned above). This reflects a combination of discretionary measures, economic growth composition effects and unexpected budgetary developments, that partially offset each other. Specifically:

- Two packages were adopted in the second semester of 2007, which entailed additional expenditure by around 0.9% of GDP (1.1% in the forecast see above). The packages included a variety of measures ranging from the upward revision of minimum pensions to further capital transfers to the state-owned railway company and investments by the road maintenance company. The additional expenditure also relates to higher social benefit spending (by more than 0.1% of GDP) in the form of a lump-sum transfer targeted on low-income families, which the programme presents as a negative income tax and thus lower revenue;

- Expenditure developments that, net of the measures adopted during the year, are expected in the autumn forecast to be lower than planned in the 2006 programme by around 0.3 pp. of GDP;

- A tax-poor composition of growth, with relatively moderate wages pushing down personal income taxes and social contributions. In the autumn forecast, this factor entails around 0.3 pp. of GDP lower increase in revenue in 2007 as compared to that implied by the standard ex-ante elasticity;

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taxpayers up to now, these estimations now appear on the high side and therefore both the headline and the structural balances indicated for 2006 may have to be revised upwards.

[15] The 2006 state-sector cash borrowing requirement was not affected by the capital expenditure related to Court rulings and to the cancellation of the railway company's debt related to the high-speed project.

[16] The official estimation of the deficit-increasing impact of one-offs affecting the 2006 deficit outturn has been revised downwards to 1.2% of GDP, from the 1.4% of GDP projected in the 2006 update of the programme, essentially due to a corresponding downward revision of the negative impact of the ECJ's ruling on VAT on company cars. In line with the current update of the programme, the Commission services' autumn forecasts for the deficit in 2007, incorporates deficit-decreasing one-offs amounting to less than 0.2% of GDP, as compared to 0.1% of GDP in the previous update. This marginal increase relates to slight upward revision of revenue expected from the last instalments of non-recurrent taxes on the revaluation of companies' assets.

- The decision to scrap the harmonisation of taxation of financial assets, which was officially projected to increase revenue by almost 0.1 pp. of GDP in 2007;

- A more cautious projection of revenue developments in the autumn forecast than in the previous programme, particularly of social contributions, which entails a lower increase in revenue of more than 0.1 pp. of GDP.

Starting from the autumn forecast, which incorporates the budgetary developments mentioned above, it can be argued that, *ceteris paribus*, a deficit well below 1½% of GDP would have been within reach in 2007 in the absence of the 0.9% of GDP additional expenditure adopted during the year.

The reading of revenue developments deserves a note of clarification. Overall, the figures in the programme show no positive surprise in percentage of GDP in 2007 (see Table 3). The programme now estimates revenue as a share of GDP in 2007 to have been as expected at the time of the adoption of the 2007 budget in spite of a favourable base effect from 2006, as tax revenue net of one-offs was 0.6% of GDP higher than expected in the 2006 update of the stability programme. In this context, it seems that the measures adopted after the Council recommendation under Article 104(7) of July 2005 to widen the tax base and to fight tax avoidance/evasion have been effective.

The Council opinion of 27 February 2007 on the previous update of the stability programme included the invitation to "achieve the planned fiscal consolidation in 2007 so as to correct the situation of excessive deficit in line with the Council recommendation under Article 104(7)". Both the deficit target for 2007, at 2.4% of GDP, and the projected structural adjustment over 2006-2007, at 2% of GDP, are in line with this invitation. As mentioned above, the 2007 deficit could turn out substantially lower than the projected 2.4% of GDP. However, because of the additional expenditure adopted during the year, budgetary implementation in 2007 cannot be considered fully in line with the invitation to take advantage of better-than-expected budgetary developments for deficit reduction, also expressed in the April 2007 Eurogroup orientations for budgetary policies.

4.2. The programme’s medium-term budgetary strategy

This section describes the medium-term budgetary strategy outlined in the programme - and how it compares with the one in the previous update - as well as the composition of the budgetary adjustment, including the broad measures envisaged.

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

The outlined budgetary strategy aims at pursuing fiscal consolidation towards the medium term objective (MTO) of a balanced position in structural terms by 2011. The previous programme planned to reach the MTO in 2010. However, the structural balance presented in the previous programme was slightly different, as it still computed the output gap on the basis of a different methodology. In fact, when recalculated by the Commission services on the basis of the programme using the commonly agreed methodology, the MTO would have been attained only in 2011 also in the 2006 update.

The adjustment is back-loaded: the headline deficit is planned to decline by less than 0.2 pp. of GDP in 2008, to 2.2% of GDP, but to improve by around ¾ pp. of GDP per year in the following years to turn into a balanced budget in 2011. Following a similar path, the primary surplus is projected to increase from 2.5% of GDP in 2007 to 4.9% of GDP in 2011. As recalculated by the Commission services on the basis of the information in the programme according to the commonly agreed methodology, the structural balance is projected to improve on average by around ½% of GDP per year over the years 2008-2011. Against the background of a stable, mildly negative, output gap and broadly constant one-offs, the planned adjustment is back-loaded also when computed in structural terms. The planned fiscal policy effort is less than ¼% of GDP in 2008, but steps up to ¾% of GDP per year afterwards.

Box 5: The excessive deficit procedure (EDP) for Italy

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, so that no further steps under the EDP were deemed necessary. The communication specified that persisting implementation uncertainties required continuous monitoring. In its March 2006 meeting, the Council concurred with this assessment.

Table 4: Evolution of budgetary targets in successive programmes

		2006	2007	2008	2009	2010	2011
General government balance (% of GDP)	**SP Nov 2007**	**-4.4**	**-2.4**	**-2.2**	**-1.5**	**-0.7**	**0.0**
	SP Dec 2006	*-5.7*	*-2.8*	*-2.2*	*-1.5*	*-0.7*	*0.1*
	COM Nov 2007	-4.4	-2.3	-2.3	-2.3	n.a.	n.a.
General government expenditure (% of GDP)	**SP Nov 2007**	**50.1**	**48.6**	**48.5**	**47.9**	**47.3**	**47.0**
	SP Dec 2006	*50.7*	*49.0*	*48.9*	*48.6*	*48.0*	*47.5*
	COM Nov 2007	50.1	48.6	48.6	48.4	n.a.	n.a.
General government revenue (% of GDP)	**SP Nov 2007**	**45.6**	**46.2**	**46.3**	**45.9**	**45.8**	**45.7**
	SP Dec 2006	*45.0*	*46.2*	*46.0*	*45.9*	*45.7*	*45.4*
	COM Nov 2007	45.6	46.3	46.3	46.1	n.a.	n.a.
Structural balance[1] (% of GDP)	**SP Nov 2007**	**-2.7**	**-2.2**	**-2.0**	**-1.3**	**-0.5**	**0.2**
	SP Dec 2006	*-3.9*	*-2.5*	*-1.9*	*-1.2*	*-0.4*	*0.3*
	COM Nov 2007	-2.7	-2.0	-2.0	-1.9	n.a.	n.a.
Real GDP (% change)	**SP Nov 2007**	**1.9**	**1.9**	**1.5**	**1.6**	**1.7**	**1.8**
	SP Dec 2006	*1.6*	*1.3*	*1.5*	*1.6*	*1.7*	*1.7*
	COM Nov 2007	1.9	1.9	1.4	1.6	n.a.	n.a.

Note:

[1]Cyclically-adjusted balance excluding one-off and other temporary measures. According to the most recent programme and the Commission services' autumn forecasts, one-off and other temporary measures are: 1.2% of GDP in 2006, deficit-increasing; 0.2% of GDP in 2007, deficit reducing, and 0.1% of GDP per year, all deficit reducing, from 2008 onwards.

Source :
Stability programmes (SP); Commission services' autumn 2007 economic forecasts (COM)

The planned stance of fiscal policy as measured by the change in the primary structural balance is broadly neutral in 2008 and restrictive from 2009 onwards.

With a substantially unchanged macroeconomic outlook, the programme broadly confirms the nominal targets presented in the previous update for the 2008-2011 period, despite a better-than-targeted headline deficit in 2007. The path for the structural balance remains broadly unchanged between 2009 and 2011; however, due to the better-than-expected outcome in 2007, the structural adjustment projected in 2008 is almost ½% of GDP lower than in the previous programme.

Box 6: The budget for 2008

The 2008 draft budget was adopted by the government at the end of September 2007. While the targeted deficit of 2.2% of GDP in 2008 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 2007 forecast and the 2007 stability programme update are based. The budgetary package is composed of the State budget projecting budgetary developments based on unchanged legislation and of the budget law introducing new fiscal measures (see Section 6 for an illustration of the improvements introduced in the presentation of the State budget). The budget for 2008 was accompanied by a decree law introducing additional expenditure already in 2007 (see Section 4.1). Parliament approved the decree law on 28 November 2007 and the budget law, together with the State budget, on 21 December 2007.

For the first time in many years, the budget law increases the trend deficit based on the unchanged legislation scenario: according to the official estimation, the 2008 trend deficit would be 1.8% of GDP, but the adoption of the budget law leads to the target deficit of 2.2% of GDP.

The budget law contains around 1% of redistributive deficit-increasing measures, partly offset by around 0.6% of GDP of corrective measures with respect to the trend deficit at unchanged legislation. Overall, the net effect of these measures is to increase current expenditure by 0.5% of GDP and reduce capital expenditure by 0.1% of GDP. On the revenue side, 0.2% of GDP tax cuts are offset by tax revenue increases of a corresponding amount.

The financing of the public sector wage agreement for the period 2006-2007 absorbs the largest part of the net additional expenditure. In the official projections, the wage bill increases by around 7% in 2008 (9% over the 2007-2008 period). This increase does not include the resources needed to finance the forthcoming wage agreement for the 2008-2010 period, as they have not been identified yet. Other redistributive measures comprise cuts to local property taxes, lower revenue due to rent deductibility and the funding of the Protocol agreement on welfare of 23 July 2007, which has been translated into a law accompanying the budget (see Section 6). The budget law also envisages a reduction in the tax rates on corporate income (IRES) and of the regional tax on productive activity (IRAP). However, a widening of the tax base would lead to an overall positive budgetary impact in 2008 (See Section 6).

Main measures in the budget for 2008

Revenue measures*	**Expenditure measures****
o Corporate tax reform (0.1% of GDP)	o Higher compensation of employees (0.3% of GDP)
o Rent deductibility (-0.1% of GDP)	o Protocol agreement (0.1% of GDP)
o Cuts to local property taxes (-0.1% of GDP)	o Savings on unspent budgetary carry-overs (-0.1% of GDP)
o Annual extension of special tax provisions (-0.1% of GDP)	

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

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. 2008. Beyond 2008, the information is limited to the size of the correction required to achieve the budgetary targets relative to trends based on an unchanged legislation scenario. The specification of the composition of the budget over 2009-2011 reflects the "unchanged legislation scenario"[17] and hence is not consistent with the budgetary targets. The programme notes that the measures to achieve

[17] As in the previous updates, the 2007 update uses projections based on "unchanged legislation" rather than on "no-policy change" as in the Commission services' forecasts. The former normally results in an underestimation of expenditure trends compared to the latter. See Section 4.3 for an explanation.

the budgetary targets are defined year by year in the Budget Law, in compliance with Italy's fiscal policy legislation. This is not in line with the Stability and Growth Pact[18] and the code of conduct, which require a description of the broad measures backing the budgetary targets throughout the programme period.

Table 5: Composition of the budgetary adjustment

(% of GDP)	2006	2007	2008	2009	2010	2011	Change: 2011-2007 [3]
Revenue [3]	**45.6**	**46.2**	**46.3**	**45.9**	**45.8**	**45.7**	**-0.5**
of which:							
- Taxes on production and imports	14.8	14.6	14.4	14.3	14.2	14.2	**-0.5**
- Current taxes on income, wealth, etc.	14.5	14.9	15.0	14.9	15.0	15.0	**0.1**
- Social contributions	13.0	13.5	13.6	13.5	13.4	13.4	**-0.1**
- Other (residual)	3.3	3.3	3.2	3.2	3.2	3.2	**-0.1**
Expenditure [3]	**50.1**	**48.6**	**48.5**	**47.9**	**47.3**	**47.0**	**-1.6**
of which:							
- Primary expenditure	45.5	43.8	43.6	43.0	42.4	42.1	**-1.6**
of which:							
Compensation of employees	11.0	10.8	11.1	10.7	10.4	10.2	**-0.5**
Intermediate consumption	5.3	5.4	5.3	5.3	5.1	5.1	**-0.2**
Social payments	20.0	19.9	20.0	19.9	19.9	19.9	**0.0**
Subsidies	0.9	1.0	0.9	0.9	0.8	0.8	**-0.2**
Gross fixed capital formation	2.3	2.7	2.5	2.6	2.5	2.4	**-0.3**
Other (residual)	6.0	4.0	3.8	3.8	3.7	3.6	**-0.4**
- Interest expenditure	4.6	4.8	4.9	4.9	4.9	4.8	**0.0**
General government balance (GGB) [3]	**-4.4**	**-2.4**	**-2.2**	**-1.5**	**-0.7**	**0.0**	**2.3**
Primary balance [3]	**0.1**	**2.5**	**2.6**	**3.4**	**4.2**	**4.9**	**2.4**
One-off and other temporary measures	-1.2	0.2	0.1	0.1	0.1	0.1	**-0.1**
GGB excl. one-offs	**-3.3**	**-2.5**	**-2.3**	**-1.6**	**-0.8**	**-0.1**	**2.4**
Output gap[1]	-1.0	-0.6	-0.6	-0.6	-0.6	-0.6	**0.1**
Cyclically-adjusted balance[1]	-3.9	-2.0	-1.9	-1.2	-0.4	0.2	**2.3**
Structural balance[2]	**-2.7**	**-2.2**	**-2.0**	**-1.3**	**-0.5**	**0.2**	**2.4**
Change in structural balance		*0.5*	*0.2*	*0.7*	*0.8*	*0.7*	
Structural primary balance[2]	1.8	2.6	2.9	3.6	4.4	5.0	**2.4**
Change in structural primary balance		*0.8*	*0.2*	*0.7*	*0.8*	*0.6*	

Notes:

[1]Output gap (in % of potential GDP) and cyclically-adjusted balance as recalculated by Commission services on the basis of the information in the programme.

[2]Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures.

[3] Budgetary data provided in the SP for 2009-2011 are trends based on unchanged legislation. In order to achieve the targeted general government balances, additional measures with a cumulative positive impact of 0.4% of GDP in 2009, 0.8% in 2010 and 1.2% in 2011 are envisaged.

Source :

Stability programme; Commission services' calculations

For the entire programme period, details are only provided with respect the expected size of one-off measures. After many years of extensive reliance on such measures, the role of one-off and other temporary measures is planned to stabilise to 0.1% of GDP per year due to proceeds from the sale of real estate over the programme period.

As a result of higher transfers from the central government, the local government deficit, still on an unchanged legislation scenario, is projected to stabilise at around ½% of GDP over the whole programme period, which compares to an average annual deficit of over ¾% of GDP in the previous past five years.

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

In 2008, according to the update, the general government balance would improve by less than 0.2 pp. of GDP relative to 2007 after the negative impact (0.4% of GDP) of the measure adopted with the 2008 budget law on the trend deficit (1.8% of GDP) under the "unchanged legislation scenario" (see Box 6). The small fiscal correction is projected to come from a decrease in primary expenditure, whereas interest expenditure would marginally increase as a share of GDP and the revenue-to-GDP ratio would virtually level off, after the 0.6 pp. surge recorded in 2007. The 0.2 pp. of GDP decline in primary expenditure is driven by a reduction in subsidies (0.1 pp. of GDP), a fall in investment (0.2 pp. of GDP), which follows the projected rise of 0.4 pp. of GDP in 2007, and in the residual item "other expenditure" (0.2 pp. of GDP). These reductions would be partly offset by a 0.3 pp. of GDP increase in expenditure on compensation of employees linked to the renewal of public employment contracts. On the revenue side, a 0.2 pp. of GDP reduction in taxes on production and imports resulting from the cuts of the regional tax on productive activities (IRAP) would be compensated by: (i) 0.1 pp. of GDP higher current taxes on income and wealth as a temporary effect of the reform of the corporate income tax envisaged by the 2008 budged law and (ii) 0.1 pp. higher social contributions, mainly arising from buoyant wage developments.

4.3. Risk assessment

This section discusses the plausibility of the programme’s budgetary projections by analysing various risk factors. For the period until 2009, Table 6 compares the detailed revenue and expenditure projections in the Commission services’ autumn 2007 forecast, which are derived under a no-policy change scenario, with those in the updated programme.

The official economic growth projections up to 2009 are broadly in line with the Commission services' autumn 2007 forecast. However, risks are now tilted towards a lower real GDP growth in 2008, as also acknowledged in the programme (see Section 3). According to the sensitivity analysis undertaken in the programme, with lower real GDP growth in 2008, at 1% instead of the baseline 1.5%, the 2008 deficit would overshoot the target by 0.2 pp. of GDP, reaching 2.4% of GDP. The lower real GDP growth would also imply a small downward revision to the path of potential output and thus a marginally higher cyclically adjusted deficit. The ensuing structural adjustment would be almost nil in 2008. In the programme sensitivity analysis, a 0.5 pp. negative economic growth surprise vis-à-vis the baseline macroeconomic scenario over all the programme period would imply a delay in the achievement of the safety margin by one year (i.e. to 2010) and would prevent the achievement of the MTO by 2011. These results are confirmed in the Commission services’ simulations of the cyclically-adjusted balance under the assumptions of (i) the same sustained 0.5 percentage point deviation from the real GDP growth projections in the programme over the 2007-2011 period; (ii) trend output based on the HP-filter and (iii) no policy response (notably, the expenditure level in national currency is as in the central scenario[19]). The Commission services’ simulations also yield a negligible structural adjustment in 2008, while by 2011 the cyclically-adjusted deficit is 1 pp. of GDP higher than in the central scenario. Hence, in the case of persistently lower real growth, corrective measures of around 1% of GDP on top of those already needed would be necessary over the programme period to keep the public finances on the path targeted in the central scenario.

[19] For the years 2009-2011 it has been amended to include half of the future corrective measures needed to achieve the budgetary targets.

Table 6: Comparison of budgetary developments and projections

(% of GDP)	2006	2007		2008		2009		2010	2011
	COM	COM	SP	COM	SP	COM[1]	SP	SP	SP
Revenue [4]	**45.6**	**46.3**	**46.2**	**46.3**	**46.3**	**46.1**	**45.9**	**45.8**	**45.7**
of which:									
- Taxes on production and imports	14.8	14.7	14.6	14.6	14.4	14.6	14.3	14.2	14.2
- Current taxes on income, wealth, etc.	14.5	15.0	14.9	15.0	15.0	14.9	14.9	15.0	15.0
- Social contributions	13.0	13.4	13.5	13.5	13.6	13.4	13.5	13.4	13.4
- Other (residual)	3.3	3.2	3.3	3.2	3.2	3.2	3.2	3.2	3.2
Expenditure [4]	**50.1**	**48.6**	**48.6**	**48.6**	**48.5**	**48.4**	**47.9**	**47.3**	**47.0**
of which:									
- Primary expenditure	45.5	43.8	43.8	43.9	43.6	43.6	43.0	42.4	42.1
of which:									
Compensation of employees	11.0	10.8	10.8	11.0	11.1	10.9	10.7	10.4	10.2
Intermediate consumption	5.3	5.3	5.4	5.3	5.3	5.3	5.3	5.1	5.1
Social payments	20.0	20.1	19.9	20.2	20.0	20.1	19.9	19.9	19.9
Subsidies	0.9	1.0	1.0	0.9	0.9	0.9	0.9	0.8	0.8
Gross fixed capital formation	2.3	2.4	2.7	2.5	2.5	2.5	2.6	2.5	2.4
Other (residual)	6.0	4.2	4.0	3.9	3.8	3.9	3.8	3.7	3.6
- Interest expenditure	4.6	4.7	4.8	4.8	4.9	4.8	4.9	4.9	4.8
General government balance (GGB) [4]	**-4.4**	**-2.3**	**-2.4**	**-2.3**	**-2.2**	**-2.3**	**-1.5**	**-0.7**	**0.0**
Primary balance [4]	**0.1**	**2.5**	**2.5**	**2.4**	**2.6**	**2.5**	**3.4**	**4.2**	**4.9**
One-off and other temporary measures	-1.2	0.2	0.2	0.1	0.1	0.1	0.1	0.1	0.1
GGB excl. one-offs	**-3.3**	**-2.4**	**-2.5**	**-2.4**	**-2.3**	**-2.4**	**-1.6**	**-0.8**	**-0.1**
Output gap[2]	-1.1	-0.8	-0.6	-0.9	-0.6	-1.0	-0.6	-0.6	-0.6
Cyclically-adjusted balance[2]	-3.9	-1.9	-2.0	-1.9	-1.9	-1.8	-1.2	-0.4	0.2
Structural balance[3]	**-2.7**	**-2.0**	**-2.2**	**-2.0**	**-2.0**	**-1.9**	**-1.3**	**-0.5**	**0.2**
Change in structural balance		*0.7*	*0.5*	*0.0*	*0.2*	*0.1*	*0.7*	*0.8*	*0.7*
Structural primary balance[3]	1.9	2.7	2.6	2.8	2.9	2.9	3.6	4.4	5.0
Change in structural primary balance		*0.8*	*0.8*	*0.1*	*0.2*	*0.1*	*0.7*	*0.8*	*0.6*

Notes:

[1]On a no-policy-change basis.

[2]Output gap (in % of potential GDP) and cyclically-adjusted balance according to the programme as recalculated by Commission services on the basis of the information in the programme.

[3]Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures.

[4] Budgetary data provided in the SP for 2009-2011 are trends based on unchanged legislation. In order to achieve the targeted general government balances, additional measures with a cumulative positive impact of 0.4% of GDP in 2009, 0.8% in 2010 and 1.2% in 2011 are envisaged.

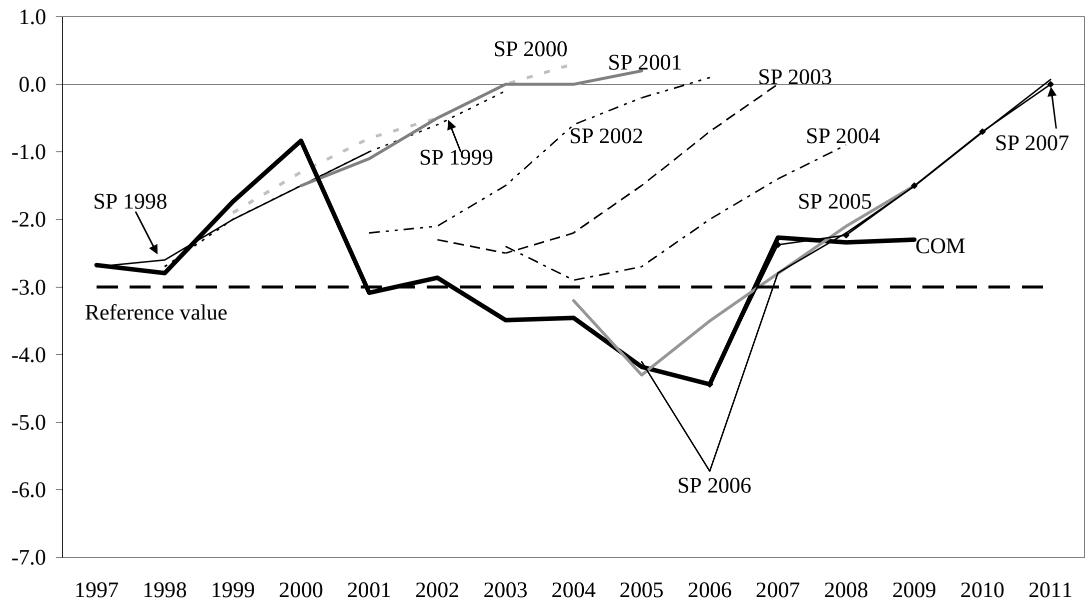
Source :

Stability programme (SP); Commission services' autumn 2007 economic forecasts (COM); Commission services' calculations

In 2008, the Commission services' autumn 2007 forecast projects the deficit marginally above the targeted 2.2% of GDP. In the absence of convincing measures aimed at containing expenditure growth and taking account that the execution of some expenditure could shift from 2007 to 2008, expenditure in the Commission services' autumn 2007 forecast is slightly more dynamic than in the programme. Moreover, there are significant risks to the budgetary execution in 2008. It is noted that a provision in the 2008 budget law foresees that better-than-expected developments of permanent revenue emerging in the mid-year review will be used to fund cuts to the personal income tax paid by employees. In view of this, the likely positive base effect from a lower deficit in 2007 (see Section 4.1) may not be fully utilised for deficit/debt reduction beyond the targets presented in the programme. Furthermore, even the achievement of the 2.2% of GDP deficit target in 2008 could imply a deterioration of both the headline and structural balance relative to 2007. This is particularly true for the structural balance. The measure adopted on 31 December 2007 to discontinue the obligation by tax collectors to advance to government the payment of a certain amount of taxes to be collected in the following year could have a negative impact (0.3% of GDP) on the headline balance in 2007.

However, it would not have any impact on the structural balance in 2007 because of its one-off nature.

Figure 5: Government balance projections in successive programmes (% of GDP)



Source: Commission services' autumn 2007 forecast (COM) and successive stability programmes

Beyond 2008, 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. Overall, the 2011 trend deficit based on unchanged legislation presented in the programme is 0.9% of GDP lower in 2011 than in 2008, as a 0.6% reduction in the revenue-to-GDP ratio would partly offset a projected 1.6% decline in the expenditure-to-GDP ratio. As also highlighted by the Economic and Financial Planning Document (DPEF) 2008-2011, trend figures based on unchanged legislation exclude the effects of events that have a high probability of occurring and are often even certain, thus understating the trend of future expenditure; "it thus creates an illusion that it will not be necessary to tap resources in order to meet the targets". The DPEF 2008-2011 thus presented a taxonomy of possible expenditure/lower revenue that are not included in the scenario based on unchanged legislation, even though they have constantly emerged in the past. According to the DPEF, to bridge the difference between the no-policy change scenario and the unchanged legislation scenario, the latter should be increased by the amount of: (i) "commitments" not yet financed by legislation, which will certainly be included in future budgets; and (ii) "customary obligations", mainly to respond to the persistent financial needs of state-owned companies, which cannot be considered as already established but are more than likely to emerge. Incorporating the DPEF estimates of these two categories of expenditure in the programme projections would increase the corrective measures needed to achieve the planned targets by 0.6% of GDP per year; i.e. to around 1% of GDP per year. This amount still disregards the resources for the next rounds of collective bargaining for the renewal of public contracts, which the DPEF includes among customary obligations, but for which no estimation is provided. The 2007 update projects compensation of employees to increase by a meagre 2.6% in nominal terms between 2008 and 2011, which compares to an average 13% rise over 2005-2008. As a result, the programme projects compensation of employees as a share of GDP to drop by 0.8 pp. of GDP between 2008 and 2011. In sum, the needed additional measures amounting to 0.4% of GDP per year in nominal terms presented in the programme is misleading, as the achievement of the planned ¾ pp. of GDP structural adjustment can be expected to require sensibly higher corrective measures each year. This appears difficult to achieve, even more so if the government's priority to contain the tax burden and then gradually reduce it reported in the DPEF 2008-2011 is confirmed.

The evaluation of one-off measures does not raise major issues, as the only temporary measures planned from 2008 onwards are sales of real estate yielding 0.1% of GDP.

Table 7: Assessment of tax projections

	2008			2009			2010	2011
	SP	**COM**	**OECD**[3]	**SP**	**COM**[1]	**OECD**[3]	**SP**	**SP**
Change in tax-to-GDP ratio (total taxes)	0.1	0.0	0.3	-0.3	-0.2	0.3	-0.1	-0.1
Difference (SP – COM)	0.0		/	-0.1		/	/	/
of which [2] *:*								
- discretionary and elasticity component	*-0.1*		/	*-0.2*		/	/	/
- composition component	*0.1*		/	*0.1*		/	/	/
Difference (COM - OECD)	/	-0.3		/	-0.4		/	/
of which [2] *:*								
- discretionary and elasticity component	/	*-0.5*		/	*-0.4*		/	/
- composition component	/	*0.3*		/	*-0.1*		/	/
p.m.: Elasticity to GDP	1.0	1.0	1.2	0.8	0.9	1.2	0.9	0.9

Notes:

[1]On a no-policy change basis.

[2]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 and variations of taxable income that do not necessarily move in line with GDP, e.g. capital gains. The two components may not add up to the total difference because of a residual component, which is generally small.

[3]OECD ex-ante elasticity relative to GDP.

Source :
Commission services' autumn 2007 economic forecasts (COM); Stability programme (SP); Commission services' calculations; 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 and 2009 in the programme are similar to the autumn 2007 forecast. Also as a result of the measures introduced in the 2008 and previous budgets, both the programme and the autumn forecast show a low elasticity, in particular in 2009. Afterwards, the tax ratio is projected to continue declining gradually in the trend scenario based on unchanged legislation. This is the result of an overall tax elasticity to GDP below that estimated by the OECD. Some negative risks to the programme's budgetary projections arise from the mentioned provision in the 2008 budget which aims at lowering personal income taxes paid by employees as from 2008, on the back of the possible better-than-expected budgetary developments. Moreover, the outcome of the substantial changes in corporate taxation is subject to significant uncertainty on both sides.

On the expenditure side, a sizeable part of the additional expenditure adopted in 2007 was presented as bringing forward expenditure that would have had to take place in 2008, with a view to containing the 2008 deficit. However, this budgetary strategy has entailed, *ceteris paribus,* an overall higher deficit/debt over 2007-2008 as lower corrective measures had to be adopted in the 2008 budget to achieve the 2.2% of GDP planned deficit target. Furthermore, the higher discretionary expenditure in 2007 can create expectations of further additional deficit-increasing measures in the future, in particular with reference to social expenditure and transfers to the state-owned railway company. The government decision, in 2006, 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. Finally, the track record points to possible expenditure overruns.

Overall, after 2008, there are risks that the budgetary outcomes will be worse than targeted in the programme.

4.4. Assessment of the fiscal stance and budgetary strategy

The table 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 and, second, the final assessment also taking into account risks.

The programme is consistent with a correction of the excessive deficit by 2007. Both the 2007 deficit, at 2.3% of GDP, and the cumulative structural adjustment over 2006-2007, almost 2 pp. of GDP, expected in the autumn 2007 forecast are in line with the goal of correcting the excessive deficit as requested by the Council. In the autumn forecast, the structural adjustment is 0.7 pp. of GDP in 2007, [20] as compared to the 1.4 pp. planned in the 2006 update. Part of it (0.3% of GDP) is due to a measure that does not improve fiscal sustainability, namely additional revenue stemming from the diversion of the severance pay scheme TFR to INPS.[21] However, recent information points to a structural adjustment in 2007 more in line with the original plans.

Table 8: Overview of compliance with the Stability and Growth Pact

	Based on programme[3] (with the targets taken at face value)	**Assessment** (taking into account risks to the targets)
a. Consistency with correction of excessive	Yes	yes

[20] The structural adjustment in 2007 includes the offsetting of the permanent impact of the ECJ's ruling on VAT on company cars recorded in 2006, which is estimated at 0.3% of GDP (see Footnote 14). A possible downward revision of the budgetary impact of the ruling would imply a different distribution of the structural adjustment over 2006-2007, with an even higher adjustment in 2006. The cumulated structural adjustment over 2006-2007 would however remain unchanged.

[21] The 2007 Budget Law laid down that employers with at least 50 employees have to divert the severance pay scheme (*trattamento di fine rapporto – TFR*) flows that employees decide not to transfer to private pension schemes towards a new scheme set up within the Italian social security institute (*Istituto Nazionale della Previdenza Sociale - INPS*). The flows accumulated into the new INPS scheme are recorded as government revenue that reduces the deficit, but the liabilities they generate for the government in the form of severance payments to employees will gradually translate into additional public expenditure. The deficit-reducing impact of this provision is projected to decrease over time, and within 8-9 years additional revenue and expenditure are expected to balance out.

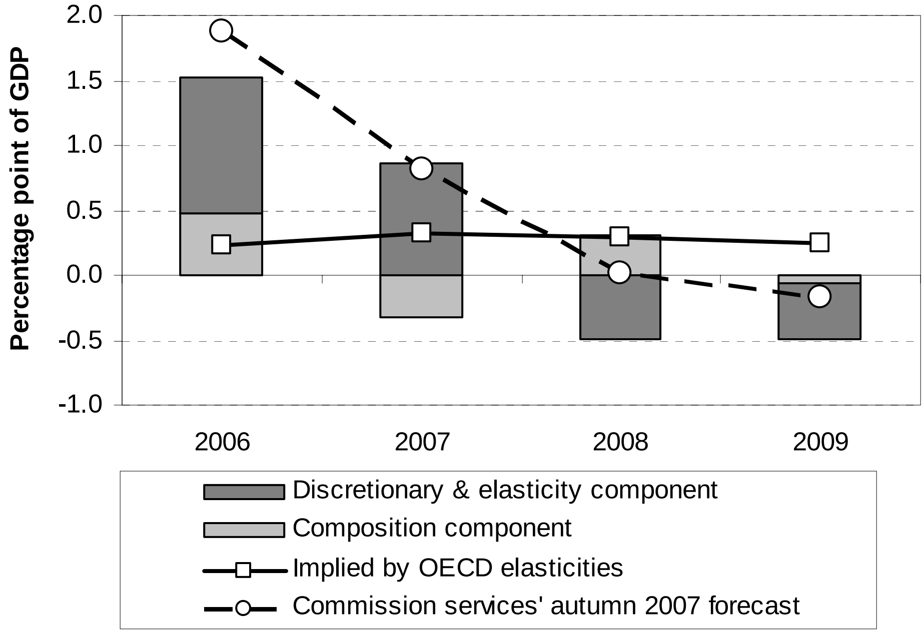
deficit by 2007 deadline		
b. Safety margin against breaching 3% of GDP deficit limit[1]	from 2009 onwards	Possibly only from 2010 or 2011, unless the better-than-projected 2007 position, which could already be close to the safety margin, is carried through to the following years
c. Achievement of the MTO	in 2011	not within programme period, unless the better-than-projected 2007 position is carried through to the following years
d. Adjustment towards MTO in line with the Pact[2]?	in line except in 2008	is clearly insufficient and should be strengthened in 2008; it should be backed up with measures from 2009 onwards

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 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 2008 and the intention to use the positive base effect from 2007 to fund tax cuts, it is difficult to assess the plausibility of the achievement of the safety margin against breaching the 3% of GDP deficit limit, planned for 2009, as well as of the MTO, planned for 2011. Although the 2007 structural position could already be close to the safety margin, it may not be provided before 2010 and the budgetary stance in the programme may not be sufficient to ensure that the MTO is achieved by 2011, as envisaged in the programme, unless the better-than-projected 2007 starting position is carried forward to the following years. As to the pace of adjustment towards the MTO implied by the programme, it is clearly insufficient and should be strengthened in 2008 to be in line with the Stability and Growth Pact, which specifies that, for euro-area and ERM II Member States, the annual improvement in the structural balance should be 0.5% of GDP as a benchmark. In particular, the structural balance risks deteriorating in 2008. The planned stance of fiscal policy is broadly neutral in 2008 and restrictive over the remaining years of the programme period. While the targets in the programme beyond 2008 taken at face value present an adjustment to the MTO that is in line with the Pact, they are, as mentioned above, not underpinned by a clear consolidation strategy. As explained in Box 4, the Commission services' calculations on the basis of the programme according to the commonly agreed methodology estimate the output gap to remain slightly negative over the entire programme period; however, looking at a broader set of macroeconomic indicators the cyclical conditions appear broadly neutral. After the high tax elasticities implied by the revenue-based adjustment in 2006-2007, mainly as a result of discretionary measures, the low tax elasticities in 2008 and 2009 essentially reflect tax cuts (see Figure 6).

Figure 6: 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' 2007 autumn forecast (for 2009, 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 and variations of taxable income that do not necessarily move in line with GDP, e.g. capital gains. The two components may not add up to the total difference because of a residual component, which is generally small.

Source:
Commission services

5. GOVERNMENT DEBT AND LONG-TERM SUSTAINABILITY

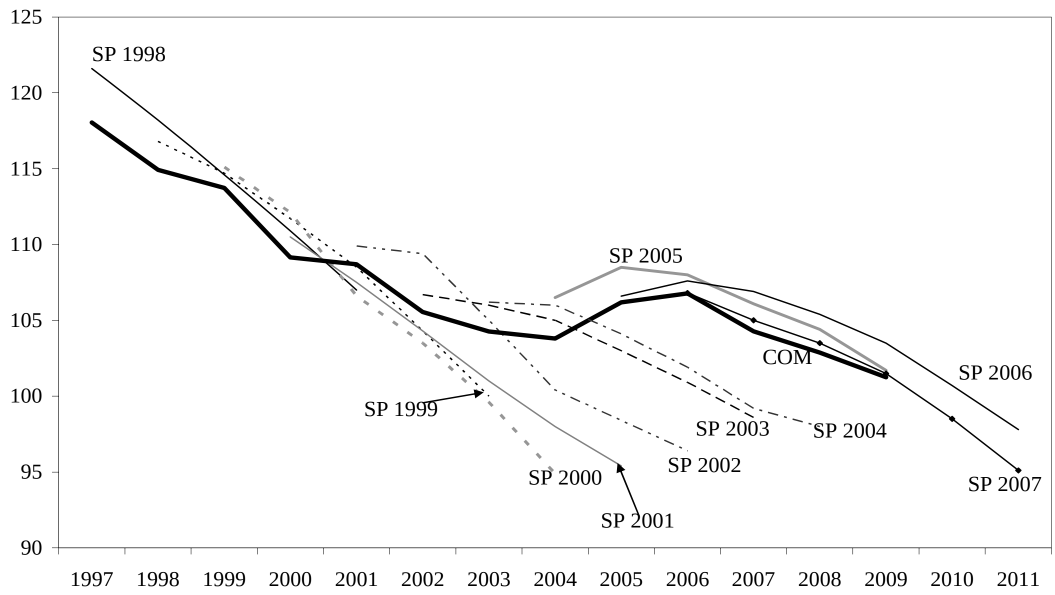
This section is in two parts. A first part describes recent debt developments and medium-term prospects, including risks to the outlook presented in the programme. A second part takes a longer-term perspective with the aim of assessing the long-term sustainability of public finances.

5.1. Recent debt developments and medium-term prospects

5.1.1. Debt projections in the programme

Figure 7 shows that the reductions in the debt ratio projected in successive updates of the Italian stability programme have clearly been missed. In particular, all the programmes submitted up until 2004 projected a debt-to-GDP ratio below 100% by 2007, whereas the current update estimates the 2007 debt-to-GDP ratio at 105%. With a shrinking primary surplus despite sizeable one-offs[22] and a sluggish real GDP growth in the 2000s, the outcome has been much worse than planned and the debt ratio has even increased in 2005 and 2006, for the first time in a decade. The new programme now projects a debt-to-GDP ratio below 100% only in 2010.

Figure 7: Debt projections in successive programmes (% of GDP)



Source: Commission services' autumn 2007 forecast (COM) and successive stability programmes

In 2007, the programme anticipates a 1.8 pp. reduction in the debt-to-GDP ratio (Table 9) thanks to the primary surplus that recovers to 2.5% of GDP after a mere 0.1% in 2006. The negative "snow-ball" effect is expected to be much more benign than in the recent past, due to a real GDP growth above potential and a substantial increase in the GDP deflator. By contrast, a sizeable stock-flow adjustment is projected in the programme also due to a net accumulation of financial assets in spite of a distribution of capital (0.2% of GDP) by a state-owned company (SACE SpA). The Commission services'

[22] Over 2002-2005 deficit-reducing one-offs amounted on average to 1.2% of GDP per year.

autumn 2007 forecast assumes that this net accumulation of financial assets will not materialise and therefore a lower debt ratio is expected compared with the programme. Recent information pointing to a substantial reduction in government liquid assets held at the Bank of Italy would support this assumption.

Table 9: Debt dynamics

(% of GDP)	average 2002-05	2006	2007		2008		2009		2010	2011
			COM	SP	COM	SP	COM	SP	SP	SP
Gross debt ratio[1]	**105.0**	**106.8**	**104.3**	**105.0**	**102.9**	**103.5**	**101.2**	**101.5**	**98.5**	**95.1**
Change in the ratio	-0.6	0.6	-2.5	-1.8	-1.4	-1.6	-1.6	-2.0	-3.0	-3.4
Contributions[2]:										
Primary balance	**-1.5**	**-0.1**	**-2.5**	**-2.5**	**-2.4**	**-2.6**	**-2.5**	**-3.4**	**-4.2**	**-4.9**
"Snow-ball" effect	**1.6**	**0.8**	**0.1**	**0.1**	**1.0**	**0.9**	**1.2**	**1.5**	**1.5**	**1.6**
Of which:										
Interest expenditure	5.0	4.6	4.7	4.8	4.8	4.9	4.8	4.9	4.9	4.8
Growth effect	-0.4	-1.9	-2.0	-2.0	-1.4	-1.5	-1.6	-1.6	-1.6	-1.7
Inflation effect	-3.0	-1.8	-2.7	-2.7	-2.4	-2.4	-2.0	-1.8	-1.8	-1.6
Stock-flow adjustment	**-0.7**	**-0.1**	**-0.1**	**0.6**	**0.1**	**0.2**	**-0.3**	**-0.1**	**-0.3**	**-0.1**
Of which:										
Cash/accruals diff.	0.0	-0.3	-0.3	-0.3	0.0	0.0	0.0	n.a.	n.a.	n.a.
Acc. financial assets	0.0	0.3	-0.1	0.5	0.1	0.4	-0.3	n.a.	n.a.	n.a.
Privatisation	*-0.6*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*
Val. effect & residual	-0.7	-0.1	0.3	0.3	0.0	0.1	0.0	n.a.	n.a.	n.a.

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.

Source:

Stability programme (SP); Commission services' autumn 2007 economic forecasts (COM); Commission services' calculations

The projected fall in the debt ratio in the programme remains moderate in 2008 (1.6 pp.). This is the result of a planned primary surplus broadly equivalent to that expected in 2007 together with a more negative "snow-ball" effect due to the lower real GDP growth and a decelerating GDP deflator. The stock-flow adjustment would affect the debt only marginally.

In 2009, the reduction in the debt ratio presented in the programme continues to be contained (2 pp.) despite a primary surplus planned at 3.4% of GDP, as the further deceleration expected for the GDP deflator would increase the negative "snow-ball" effect. Only in 2010 and 2011 would the debt ratio decline at a fast pace mainly due to a planned primary surplus well above 4% of GDP.

No privatisation proceeds are planned over the programme period, whereas privatisations and other extraordinary operations[23] had reduced the debt ratio by more than 1% on average over the 2002-2005 period.

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[23] 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.

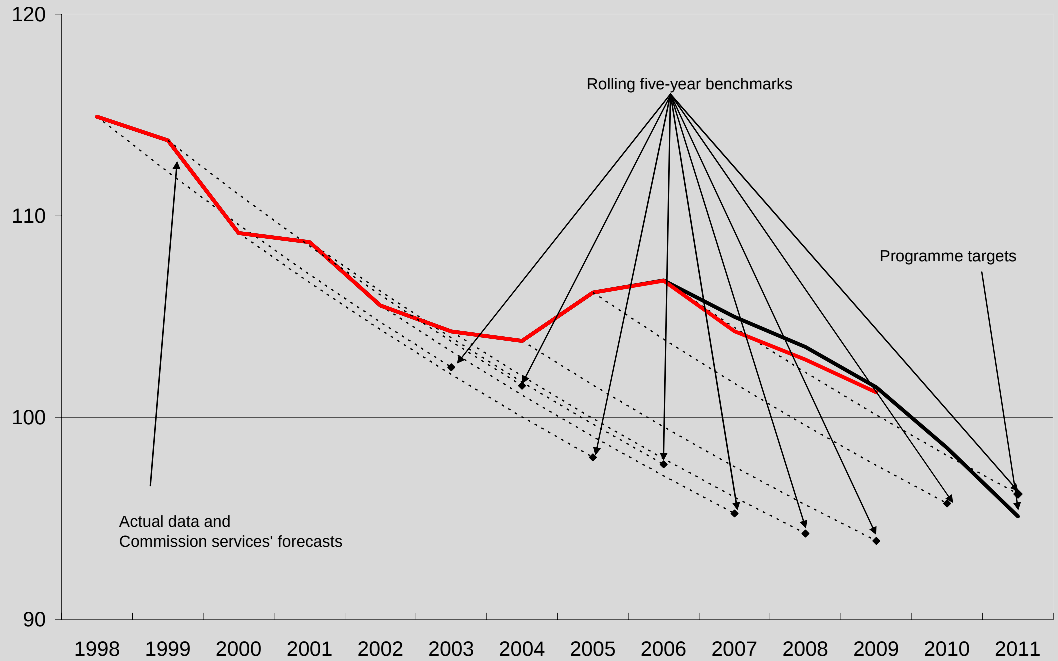
Box 7: The rolling debt reduction benchmark

The debt ratio has exceeded the 60% of GDP reference value ever since the presentation of the initial stability programme in 1998.

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 2007 forecasts until 2009 (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 2008 is compared with the value obtained for the same year by applying the formula starting in 2003. 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 the planned reduction of the debt ratio in the update at the end of the programme period (2011) is slightly more than that implied by the five-year rolling debt reduction benchmark.

Italy: rolling five-year debt 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:

$$\left(\frac{D_{t+1}}{Y_{t+1}}\right)_{benchmark} = \left(\frac{D_t}{Y_t}\right)_{benchmark} - 5\% \times \left[\left(\frac{D_t}{Y_t}\right)_{benchmark} - 60\right]$$

, 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

Positive developments of the state sector cash-borrowing requirement (see Section 4.1) suggest a 2007 debt outcome significantly below that projected in the programme and even lower than in the Commission services' autumn 2007 forecast.

For 2008, the projected reduction in the debt ratio in the programme is broadly in line with that forecast by the Commission services in autumn 2007. Both projections are subject to the risk of a lower economic growth discussed in Section 3, hence the decrease in the debt-to-GDP ratio in 2008 could be lower than expected.

For 2009, there is a more marked difference between the change in the debt ratio projected in the programme and in the autumn forecast. In the latter, the primary surplus based on the no-policy change assumption is expected stable at around 2.5% of GDP in 2009, whereas it is targeted to improve by 0.8 pp. relative to 2008 in the programme, also thanks to unspecified future deficit-reducing measures. Nevertheless, because of a better 2007 starting position in the autumn forecast, the debt-to-GDP ratios expected by the end of 2009 in the two projections are similar. Concerning the debt projections for the outer years of the programme, their achievement is conditional upon the planned budgetary adjustments leading to a balanced budget in 2011.

The risk of additional budgetary costs linked to the debt service has not significantly changed compared to the 2006 update. In particular, the average life of all government securities and their financial duration (6.78 and 4.41 years, respectively, at the end of October 2007), as well as the share of the fixed rate component (66%) have remained broadly stable. Hence, the sensitivity analysis performed in the 2007 update confirms, if not slightly reduces, the previous estimate. Even assuming a sharp and permanent 100-basis-point increase in the yield curves used in the baseline scenario, interest expenditure would increase only marginally in the first year (2008), i.e. 0.16% of GDP. The negative impact would progressively increase to 0.30% in 2009, 0.37% in 2010 and 0.43% in 2011. Because of the current volatility in financial markets, the baseline scenario uses more cautious interest rate assumptions than the current implicit rates suggest.

Taken at face value, the debt ratio would be sufficiently diminishing towards the reference value when considering the entire 2007-2011 programme period (see Box 5). However, as already mentioned above, the pace of debt reduction projected in the programme is inadequate up until 2009, due to a still low primary surplus and moderate growth. The overall sufficient debt reduction over the programme period would be largely achieved thanks to the fast reduction planned for 2010-2011 and is thus subject to the same risks highlighted in Section 4.3 for the achievement of the budgetary targets.

Finally, the debt reduction strategy based on an increasing primary surplus and with no particularly significant debt-increasing operations recorded in the stock-flow adjustment appears to be consistent with the Council recommendation of July 2005 under Article 104(7).

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

This section analyses the long-term sustainability of public finances. It uses long-term projections of age-related expenditures to calculate sustainability gap indicators and make long-term government debt projections so as to assess the sustainability challenge the country concerned is facing.

5.2.1. Sustainability indicators and long-term debt projections

Table 10 shows the evolution of government spending on pensions, healthcare, long-term care for the elderly, education and unemployment benefits according to the EPC's projections and property income received by general government according to an agreed methodology.[24] Non age-related primary expenditure and primary revenue is assumed to remain constant as a share of GDP.

Table 10: Long-term age-related expenditure: main projections

(% of GDP)	2004	2010	2020	2030	2040	2050	Change up to 50
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
- Healthcare	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
Property income received	0.6	0.6	0.6	0.5	0.5	0.4	-0.2

Source: Economic Policy Committee and Commission services.

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 pp. of GDP, due to extensive reforms enacted in the past, including the reform approved in 2004.[25] The age-related increase in health care expenditure is projected to be 1.3 pp. of GDP, lower than on average in the EU, while for long-term care an increase of 0.4 pp. of GDP is projected, close to the average in the EU.

Table 11: Sustainability indicators and the required primary balance

	2007 scenario			Programme scenario		
	S1	**S2**	**RPB**	**S1**	**S2**	**RPB**
Value	1.3	1.1	3.8	-1.2	-1.3	3.7
of which:						
Initial budgetary position (IBP)	-0.9	-0.8	-	-3.3	-3.2	-
Debt requirement in 2050 (DR)	0.7	-	-	0.6	-	-
Long-term change in the primary balance (LTC)	1.5	2.0	-	1.5	2.0	-

Source: Commission services.

Based on the long-term budgetary projections, sustainability indicators can be calculated. Table 11 shows the sustainability indicators for the two scenarios; the "2007 scenario" assumes that the structural primary balance in 2007 is unchanged for the rest of the programme period whereas the "programme scenario" assumes that the programme's budgetary plans are fully attained.

In the "2007 scenario", the sustainability gap (S2) which satisfies the intertemporal budget constraint would be 1.1% of GDP.[26] The sustainability gap is smaller than last year by almost 2 pp. of GDP, reflecting the improvement of the structural primary

[24] See the accompanying "methodological paper" for a description of the property income projections.

[25] The long-term projections do not include the most recent reform (2007), see also 'additional factors'.

[26] The sustainability gap (S1) that assures reaching the debt ratio of 60% of GDP by 2050 would be 1.3% of GDP.

balance in 2007 (2.6 pp. of GDP) compared to the structural primary balance in 2006 (0.9% of GDP as measured for the 2006/07 round of SCP assessment[27]).

The initial budgetary position contributes to the reduction of the debt ratio but is not sufficient either to cover the cost of ageing or to ensure a reduction of the debt ratio at a sufficient pace.

According to both sustainability gaps, the long-term budgetary impact of ageing is limited in particular thanks to the pension reform measures enacted in recent years.

The programme plans a structural primary budgetary consolidation of 2.4 pp. of GDP between 2007 and 2011. If achieved, such a consolidation would appreciably reduce risks to long-term sustainability of public finances by eliminating the S2 sustainability gap (“programme scenario”).

The difference between the initial budgetary position in the '2007 scenario' and the 'programme scenario' illustrates how the full respect of the stability programme targets would contribute to tackling the budgetary challenges raised by the demographic developments.

The required primary balance (RPB) is 3¾% of GDP, higher than the structural primary balance of about 2.7% of GDP today. 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 ¼% of GDP if the planned budgetary adjustment were to be postponed by 5 years, highlighting that budgetary savings can be made 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 same assumptions as for the calculations of the sustainability indicators. The long-term projections for government debt under the two scenarios are shown in Figure 8.

The gross debt ratio is currently significantly above the 60% of GDP reference value, estimated in the programme at close to 105% of GDP in 2007. According to the “2007 scenario”, the debt ratio is projected to decrease slightly, though remaining above 60%, up to the mid-2020s and thereafter increase throughout the projection period up to 2050. In the “programme scenario”, thanks to the stronger budgetary position in 2011, debt would fall below 60% of GDP in 2020 and remain below the Treaty threshold over the rest of the projection period.[28]

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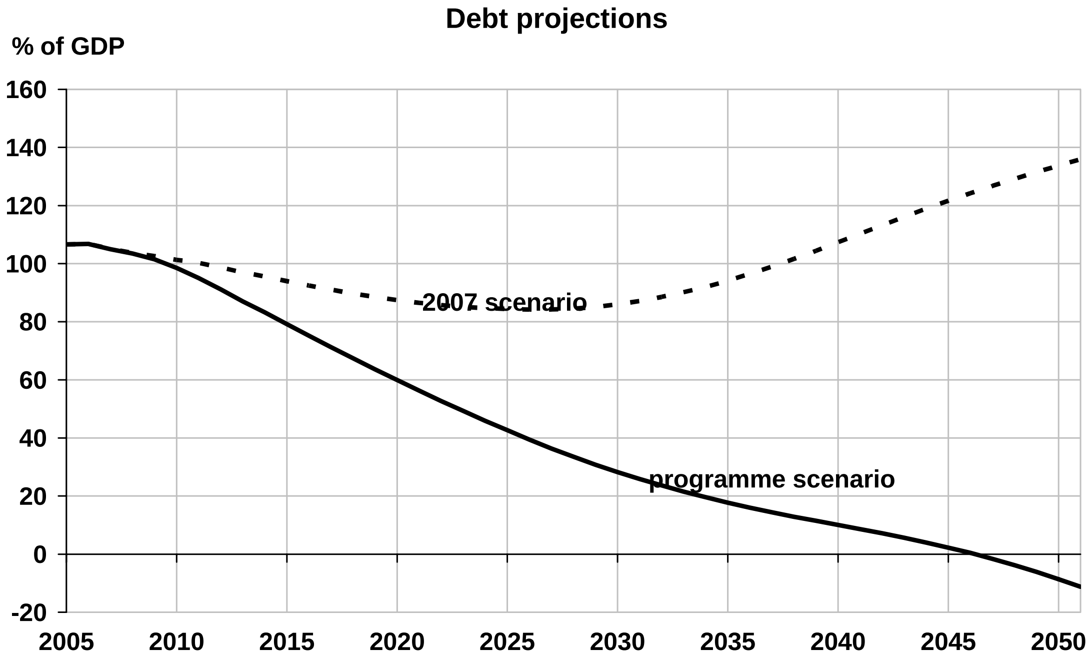
[27] In the current assessment, the structural primary balance in 2006 is 1.8 pp. of GDP, reflecting notably the better-than-expected outcome in 2006. Indeed, the nominal deficit for 2006 is -4.4% of GDP significantly better than planned a year ago (-5.7% of GDP).

[28] It should be recalled, however, that being 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 8: Long-term projections for the government debt ratio



Source: Commission services

5.2.2. Additional factors

To reach an overall assessment of the sustainability of public finances, other relevant factors are taken into account, which in addition allow to better appreciate where the main risks to sustainability are likely to stem from.

First, Italy's current level of debt is very high and 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, the pension expenditure projection of the Ageing report (2006) do not include the most recent pension reform provisions (2007 law), notably the smoothing of the sharp increase in the age condition to become eligible to a seniority pension. According to the programme, the cost of the new provision would be limited at around 0.10-0.15 pp. of GDP in 2011 and progressively becomes negligible over the long-term. However, the recent pension reform leaves several issues open, the most important one being the updating of the transformation coefficients.

The periodical updates of the actuarial coefficients in line with life expectancy represent a crucial feature of the reformed pension scheme in Italy. According to the 2006/07 update of the stability programme, the lack of periodical revisions of the actuarial coefficients would increase pension expenditure by around 1 pp. of GDP in 2035 and 2 pp. of GDP in 2050. The first update was due in 2005 but never took place. Following the current law, the adjustments should occur on a more frequent basis (3 year instead of 10 years) but the first update is due to only take place in 2010. Moreover, while the current law includes a table with revised coefficients to be applied as of 2010, this table is still subject to the decision of a Committee composed of members of the government and social partners. Any delay in implementing the revision of the actuarial updates as of

2010 or any revision to the current table which would imply a departure from the contributory principle underlying the reformed pension system could lead to a significantly higher cost of ageing over the long-term.

Third, the benefit ratio in Italy is projected to decrease relatively markedly, by around 30 pp. 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 decreases 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 risk of possible pressures on public expenditure emerging in the future.

Finally, the new discipline governing severance pay (TFR – see Footnote 21) deserves a mention in the context of the long-term sustainability of public finances. 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 (more than ¼% of GDP in 2007), but is neutral in terms of the long-term sustainability of public finances since the increase in public revenue will be matched by future social benefits. Thus, the current net gain for the general government balance will progressively vanish over time as the new system matures. In the '2007' scenario the calculations for the sustainability indicators do not take into account the future increase in TFR-related expenditure and, as such, 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. Yet, the projections hinge upon the assumption that the reforms are fully implemented, in particular that the revision of the actuarial coefficients is implemented as of 2010 as planned and without departing from the contributory principle underlying the reformed pension system.

The 2007 budgetary position in the programme, improved compared with 2006, contributes to ease the projected long-term budgetary impact of ageing but is still insufficient to fully cover future spending pressures, even when factoring in the likely better outturn. 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 is at medium risk with regard to the sustainability of public finances.

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

The analysis in Section 2 highlighted the importance of containing public expenditure and enhancing its effectiveness and cost efficiency. The medium-term economic and financial planning document of last June (DPEF), on which the stability programme update builds, largely shared this view. Accordingly, the chapter on the quality of public finances of the stability programme presents the recent Government initiatives and actions aimed at containing expenditure and improving fiscal governance, together with the planned measures that are viewed to promote economic development and social equity.

As pointed out in Section 4, according to the official estimation the 2008 budget law increases primary current expenditure by ½% of GDP relative to the trend based on unchanged legislation. Efforts to contain growth of primary current expenditure only concern some expected savings on the costs of running the state administrations, *inter alia* through a reorganisation of public procurement, some efforts to reduce the size of the central and local governments and the containment of compensation to consultants. The expected amount of savings from these measures is in the order of 0.1% of GDP. Savings at around 0.2% of GDP are planned to be achieved from capital expenditure, also thanks to the reduction of the time allowed for the appropriation of unspent amounts carried-over from previous budgets.

The programme claims that some deficit-increasing measures in the budget law favour social equity and promote economic growth. Additional expenditure includes those measures foreseen in the Implementation Report of the National Reform Programme in the context of the Lisbon Strategy (see Section 7) that have a budgetary impact in 2008. In particular, the 2008 budget law incorporates the Protocol on Welfare, Competitiveness and the Labour Market of 23 July 2007[29] that, besides revising the pension reforms, as described in Section 5, increases the amount and duration of unemployment benefits, strengthens employment services and limits the use of fixed-term contracts. These policy initiatives are potentially important steps towards improving the functioning of the Italian labour market, but only to the extent that they are carefully designed so as to "make work pay" and that they are part of a more comprehensive strategy aimed at opening up the labour market. The budgetary impact of these provisions in the Protocol is estimated to be less than 0.1% of GDP in 2008 and 2009, but to increase to 0.2% of GDP in 2010 and 2011.

On the revenue side, the reduction of housing taxation and a restructuring of companies' taxation (see Section 4) foreseen in the 2008 budget law are also presented in the Programme as promoting social equity and growth. The restructuring of corporate taxation (affecting in particular the corporate income tax IRES and the regional tax on production activities IRAP) envisages in particular a reduction of tax rates, a widening of the tax base and some simplification of payment requirements. For non-corporate firms, a flat rate tax is introduced. Overall, these measures are expected to have no budgetary impact in 2008.

The programme also reports on ongoing efforts to improve fiscal governance. First, it recalls two existing budgetary rules that are expected to allow a better control of

[29] Transposed into Law n° 247 in December 2007.

expenditure. The first rule is in fact enshrined in the Constitution and is designed to prevent the local administrations from incurring debt for any reason other than for the financing of investments. However, the programme does not report on the extent to which the concerned administrations are effectively complying with this rule. The second rule - the Internal Stability pact – consists of a series of criteria for defining specific financial targets that the local entities must meet, together with a system for sanctioning any defaulting entities. The 2008 budget law largely confirms, with some further minor changes, the revisions to it that were introduced with the 2007 budget law. The new criterion to assess the achievement of the fiscal objectives of municipalities and provinces, referring to the budget balance rather than amount of expenditure, is now being applied on a pilot basis to 11 regions. It is again noted that, while the programme briefly reports on steps to improve the Pact and compliance to its rules, it does not report on progress in implementing it.

The programme furthermore reports on steps taken towards the reclassification of the state budget, as part of the planned wider, multi-year reform of the budgetary process. The latter has been initiated by the national authorities, with the technical support of the IMF, with a view to improving the planning and management of public spending. The ongoing spending review that was mentioned in Section 2 is part of this process.

The new budget is composed of 34 "missions", which represent the main strategic objectives pursued by the public administration and can be shared by two or more ministries, and 168 "programmes", that represent standard aggregates of activity within each ministry. However, the units of budget appropriation remain the over one thousand "basic forecasting units" (*Unità previsionali di base*), which reflect the fragmented administration behind the various activities rather than the policy targets. The basic unit of budget classification will continue to be the one envisaged by the current legislation, that is, the "chapter", which can be mapped into the standard economic and COFOG functional classifications, but represents a source of rigidity for expenditure management, because items cannot easily be switched from one chapter to another.

Starting from such promising initiatives, it is important that the reform of the various stages of the budget process continues.

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

In response to the Commission's opinion expressed in its 2007 Annual Progress Report (APR), the Implementation report of the National Reform Programme (IR-NRP) of Italy, submitted in October 2007 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 2008 refers to the 2008 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.

On its part, the stability programme provides, in a separate section, detailed information on the direct budgetary costs associated with the main reforms envisaged in the NRP. The budgetary projections in the programme explicitly take into account the public finance implications of some of the actions envisaged in the IR-NRP, namely the package included in the Protocol on Welfare, Competitiveness and the Labour market mentioned in Section 6 (without however clearly distinguishing between the various measures), as well as some actions in the area of research and development. For the other areas, the 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 2008 as detailed in the stability programme is hampered by a categorization in the relevant section of the programme that 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 5.

Box 8: The Commission assessment of the October 2007 implementation report of the national reform programme

On 11 December 2007, the Commission adopted its Strategic Report on the renewed Lisbon strategy for growth and jobs, which includes an assessment of the October 2007 implementation report of Italy's national reform programme[30] and is summarised as follows.

Italy's national reform programme identifies 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 is that Italy has made good progress in implementing its National Reform Programme over the 2005-2007 period. Against the background of strengths and weaknesses identified, the Commission recommends that Italy take action in the areas of: the long-term sustainability of public finances; competition in product and services markets; education, life-long learning, undeclared work and the operation of employment services, within a flexicurity approach and with a view to reducing regional disparities.

Against the background of progress made, Italy is encouraged to also focus on the areas of: R&D; CO_2 emission reduction; impact assessment, notably on SMEs; infrastructure; reconciliation of work and family life; employment of older workers.

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.

Overall, the two programmes are fully integrated.

The tables below provide an overview of whether the strategy and policy measures in the stability programme are consistent with the broad economic policy guidelines in the area of public finances issued in the context of the Lisbon strategy for growth and jobs. The first table makes the assessment against the integrated guidelines for the period 2005-2008, adopted by the Council in July 2005. The second table makes the assessment against the country-specific recommendations / points to watch and the recommendations for the euro area, adopted by the Council in March 2007.

30 Communication from the Commission to the European Council, "Strategic report on the renewed Lisbon strategy for growth and jobs: launching the new cycle (2008-2010)", 11.12.2007, COM(2007)803.

The budgetary strategy in the stability programme is partly consistent with the country-specific recommendations / points to watch and the recommendations for the euro area.

Table 12: Consistency with the broad economic policy guidelines (integrated guidelines)

Broad economic policy guidelines (integrated 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

Table 13: Consistency with the broad economic policy guidelines (country-specific recommendations and points to watch)

Broad economic policy guidelines (country-specific recommendations and points to watch)	Yes	Steps in right direction	No	Not applicable
1. Country-specific recommendations				
– 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 finance		X		

Broad economic policy guidelines (country-specific recommendations and points to watch)	Yes	Steps in right direction	No	Not applicable
2. Points to watch				
– effective measures to improve the sustainability of healthcare provision, while preserving quality and accessibility		X		
3. Recommendations for euro area Member States				
– Make use of the favourable cyclical conditions to aim at or pursue ambitious budgetary consolidation towards their medium-term objectives in line with the Stability and Growth Pact, hence striving to achieve an annual structural adjustment of at least 0.5% of GDP as a benchmark			X	
– Improve the quality of public finances by reviewing public expenditure and taxation, with the intention to enhance productivity and innovation, thereby contributing to economic growth and fiscal sustainability		X		
Source: *Commission services*				

* * *

Annex 1: Compliance with the code of conduct

This annex provides an assessment of whether the programme respects the requirements of Section II of the code of conduct (guidelines on the format and content), notably as far as (i) the model structure (Annex 1 of the code of conduct); (ii) the formal data provisions (Annex 2 of the code of conduct); and (iii) other information requirements is concerned.

(i) Model structure

As usual, a description of the policy strategy behind the medium-term objectives, including planned developments on the expenditure and revenue side, is missing.
There is no separate section on the institutional features of public finances, but these are treated in the section on the quality of public finances.

(ii) Data requirements

Concerning gaps in the provision of compulsory data, in Table 2 "General government budgetary prospects", items 6 (Total revenue), 7 (Total expenditure) and expenditure components for the years after 2008 are not the targeted ones, but projections based on the unchanged legislation scenario (see above). Some optional data are also missing. Table 3 "General government expenditure by function" is missing. In Table 7 "Long-term sustainability of public finances", data on pension contributions are missing.

The tables on the following pages show the data presented in the November 2007 update of stability programme, following the structure of the tables in Annex 2 of the code of conduct. Compulsory data are in bold, missing data are indicated with grey-shading.

(iii) Other information requirements

The table below provides a summary assessment of the adherence to the other information requirements in the code of conduct.

The SCP…	Yes	No	Comments
a. Involvement of parliament			
… mentions status vis-à-vis national parliament.	X		
… indicates whether Council opinion on previous programme has been presented to national parliament.		X	
b. Economic outlook			
… (for euro area and ERM II Member States) uses "common external assumptions" on main extra-EU variables.		X	
… explains significant divergences with Commission services' forecasts[1].	X		
… bears out possible upside/downside risks to economic outlook.	X		
… analyses outlook for sectoral balances and, especially for countries with high external deficit, external balance.		X	
c. Monetary/exchange rate policy			
… (CP only) presents medium-term monetary policy objectives and their relationship to price and exchange rate stability.			Not applicable
d. Budgetary strategy			
… presents budgetary targets for general government balance in relation to MTO and projected path for debt ratio.	X		
… (in case new government has taken office) shows continuity with respect to budgetary targets endorsed by Council.			Not applicable
… (when applicable) explains reasons for deviations from previous targets and, in case of substantial deviations, whether measures are taken to rectify situation (+ provides information on them).	X		
… backs budgetary targets by indication of broad measures necessary to achieve them and analyses their quantitative effects on balance.		X	From 2009
… specifies state of implementation of measures.	X		
e. "Major structural reforms"			
… (if MTO not yet reached or temporary deviation is planned from			Not applicable

The SCP…	Yes	No	Comments
MTO) includes comprehensive information on economic and budgetary effects of possible 'major structural reforms' over time.			
… includes quantitative cost-benefit analysis of short-term costs and long-term benefits of reforms.			Not applicable
f. Sensitivity analysis			
… includes comprehensive sensitivity analyses and/or develops alternative scenarios showing impact on balance and debt of: a) changes in main economic assumptions b) different interest rate assumptions c) (for CP only) different exchange rate assumptions d) if common external assumptions are not used, changes in assumptions for main extra-EU variables.	X		
… (in case of "major structural reforms") analyses how changes in assumptions would affect budget and potential growth.			Not applicable
g. Broad economic policy guidelines			
… provides information on consistency with broad economic policy guidelines of budgetary objectives and measures to achieve them.	X		
h. Quality of public finances			
… describes measures to improve quality of public finances, both revenue and expenditure sides.	X		
i. Long-term sustainability			
… outlines strategies to ensure sustainability.	X		
… includes common budgetary projections by the AWG and all necessary additional information (esp. new relevant information).	X		
j. Other information (optional)			
… includes information on implementation of existing national budgetary rules and on other institutional features of public finances.	X		

Notes: SCP = stability/convergence programme; CP = convergence programme
[1]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

Table 1a. Macroeconomic prospects

	ESA Code	2006 Level	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**	***1255847.57***	**1.9**	**1.9**	**1.5**	**1.6**	**1.7**	1.8
2. Nominal GDP	**B1*g**	***1475401.69***	**3.7**	**4.6**	**4.0**	**3.4**	**3.5**	3.4
Components of real GDP								
3. Private consumption expenditure	**P.3**	***742742***	**1.5**	**2.0**	**1.8**	**1.8**	**1.8**	1.8
4. Government consumption expenditure	**P.3**	***248771***	**-0.3**	**1.6**	**0.3**	**0.0**	**0.0**	0.0
5. Gross fixed capital formation	**P.51**	***262593***	**2.3**	**2.4**	**1.6**	**1.8**	**2.1**	2.3
6. Changes in inventories and net acquisition of valuables (% of GDP)	**P.52 + P.53**	***n.a.***	**n.a.**	**n.a.**	**n.a.**	**n.a.**	**n.a.**	n.a.
7. Exports of goods and services	**P.6**	***328106***	**5.3**	**2.0**	**2.8**	**3.5**	**3.8**	4.1
8. Imports of goods and services	**P.7**	***335294***	**4.3**	**1.8**	**2.5**	**3.1**	**3.3**	3.4
Contributions to real GDP growth								
9. Final domestic demand		**-**	**1.3**	**2.0**	**1.4**	**1.5**	**1.6**	1.6
10. Changes in inventories and net acquisition of valuables	**P.52 + P.53**	**-**	**0.3**	**-0.1**	**0.0**	**0.0**	**0.0**	0.0
11. External balance of goods and services	**B.11**	**-**	**0.3**	**0.0**	**0.1**	**0.1**	**0.1**	0.2

Table 1b. Price developments

	ESA Code	2006 Level	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		***117.5***	**1.8**	**2.6**	**2.4**	**1.8**	**1.8**	1.6
2. Private consumption deflator		***117.0***	**2.7**	**1.8**	**2.0**	**1.8**	**1.8**	1.6
3. HICP[1]		***102.2***	**2.2**	**1.9**	**2.0**	**2.0**	**1.8**	1.9
4. Public consumption deflator		*122.8*	3.4	1.1	3.3	0.7	0.7	1.0
5. Investment deflator		*116.8*	2.4	3.1	1.8	1.8	1.8	1.8
6. Export price deflator (goods and services)		***125.2***	**5.2**	**6.6**	**3.9**	**3.0**	**2.4**	1.9
7. Import price deflator (goods and services)		***126.1***	**9.1**	**4.0**	**3.0**	**2.5**	**2.3**	1.9

[1] Optional for stability programmes.

Table 1c. Labour market developments

	ESA Code	2006	2006	2007	2008	2009	2010	2011
		Level	rate of change	rate of change	rate of change	rate of change	rate of change	rate of change
1. Employment, persons[1]		***24754***	**1.7**	**0.8**	**0.7**	**0.8**	**0.8**	0.8
2. Employment, hours worked[2]		*44568247*	0.9	0.8	0.5	0.7	0.7	0.5
3. Unemployment rate (%)[3]		***n.a.***	**6.8**	**6.0**	**5.7**	**5.5**	**5.4**	5.2
4. Labour productivity, persons[4]		***50733***	**0.1**	**1.1**	**0.8**	**0.8**	**0.9**	1.0
5. Labour productivity, hours worked[5]		*28*	1.0	1.1	1.0	0.9	1.0	1.3
6. Compensation of employees	D.1	***607699***	**4.6**	**3.5**	**5.2**	**2.9**	**2.9**	2.9
7. Compensation per employee		***34437***	**2.5**	**2.4**	**4.3**	**2.1**	**2.1**	2.1

[1]Occupied population, domestic concept national accounts definition.

[2]National accounts definition.

[3]Harmonised definition, Eurostat; levels.

[4]Real GDP per person employed.

[5]Real GDP per hour worked.

Table 1d. Sectoral balances

% of GDP	ESA Code	2006	2007	2008	2009	2010	2011
1. Net lending/borrowing vis-à-vis the rest of the world	**B.9**	**-1.9**	**-1.3**	**-0.8**	**-0.6**	**-0.4**	-0.2
of which :							
- Balance on goods and services		-0.8	-0.1	0.3	0.5	0.7	1.0
- Balance of primary incomes and transfers		-1.2	-1.3	-1.3	-1.3	-1.3	-1.3
- Capital account		0.1	0.1	0.2	0.2	0.2	0.2
2. Net lending/borrowing of the private sector	B.9	2.6	1.1	1.4	0.9	0.3	-0.2
3. Net lending/borrowing of general government	EDP B.9	-4.4	-2.4	-2.2	-1.5	-0.7	0.0
4. Statistical discrepancy		0.0	0.0	0.0	0.0	0.0	0.0

Table 2. General government budgetary prospects

	ESA Code	2006 Level	2006 % of GDP	2007 % of GDP	2008 % of GDP	2009 % of GDP	2010 % of GDP	2011 % of GDP
Net lending (EDP B.9) by sub-sector								
1. General government [7]	**S.13**	***-65504***	**-4.4**	**-2.4**	**-2.2**	**-1.5**	**-0.7**	0.0
2. Central government	**S.1311**	***-57782***	**-3.9**	**-2.5**	**-2.1**	**-1.9**	**-1.5**	-1.2
3. State government	**S.1312**	***-57905***	**-3.9**	**-2.3**	**-2.0**	**-1.8**	**-1.3**	-1.0
4. Local government	**S.1313**	***-16933***	**-1.1**	**-0.5**	**-0.6**	**-0.6**	**-0.5**	-0.5
5. Social security funds	**S.1314**	***9211***	**0.6**	**0.6**	**0.5**	**0.6**	**0.5**	0.4
General government (S13)								
6. Total revenue [7]	TR	***673118***	**45.6**	**46.2**	**46.3**	**45.9**	**45.8**	45.7
7. Total expenditure [7]	TE[1]	***738622***	**50.1**	**48.6**	**48.5**	**47.9**	**47.3**	47.0
8. Net lending/borrowing [7]	EDP B.9	***-65504***	**-4.4**	**-2.4**	**-2.2**	**-1.9**	**-1.5**	-1.3
9. Interest expenditure	EDP D.41	***67552***	**4.6**	**4.8**	**4.9**	**4.9**	**4.9**	4.8
10. Primary balance [2 7]		***2048***	**0.1**	**2.5**	**2.7**	**3.0**	**3.4**	3.6
11. One-off and other temporary measures [3]		***-17283***	**-1.2**	**0.2**	**0.1**	**0.1**	**0.1**	0.1
Selected components of revenue								
12. Total taxes (12=12a+12b+12c)		***432136***	**29.3**	**29.6**	**29.4**	**29.2**	**29.2**	29.1
12a. Taxes on production and imports	**D.2**	***218250***	**14.8**	**14.6**	**14.4**	**14.3**	**14.2**	14.2
12b. Current taxes on income, wealth, etc	**D.5**	***213664***	**14.5**	**14.9**	**15.0**	**14.9**	**15.0**	15.0
12c. Capital taxes	**D.91**	***222***	**0.0**	**0.1**	**0.0**	**0.0**	**0.0**	0.0
13. Social contributions	**D.61**	***192038***	**13.0**	**13.5**	**13.6**	**13.5**	**13.4**	13.4
14. Property income	**D.4**	***9076***	**0.6**	**0.6**	**0.6**	**0.6**	**0.6**	0.6
15. Other [4]		***39868***	**2.7**	**2.6**	**2.6**	**2.6**	**2.6**	2.6
16=6. Total revenue [7]	**TR**	***673118***	**45.6**	**46.2**	**46.3**	**45.9**	**45.8**	45.7
p.m.: Tax burden (D.2+D.5+D.61+D.91-D.995) [5]		*n.a.*	**42.3**	**43.0**	**43.0**	**42.7**	**42.6**	42.5
Selected components of expenditure								
17. Compensation of employees + intermediate consumption	**D.1+P.2**	***241171***	**16.3**	**16.1**	**16.4**	**15.9**	**15.6**	15.4
17a. Compensation of employees	D.1	*162999*	11.0	10.8	11.1	10.7	10.4	10.2
17b. Intermediate consumption	P.2	*78172*	5.3	5.4	5.3	5.3	5.1	5.1
18. Social payments (18=18a+18b)		***294421***	**20.0**	**19.9**	**20.0**	**19.9**	**19.9**	19.9
18a. Social transfers in kind supplied via market producers	D.6311, D.63121, D.63131	*41428*	2.8	2.7	2.7	2.7	2.7	2.7
18b. Social transfers other than in kind	D.62	*252993*	17.1	17.2	17.3	17.2	17.2	17.2
19=9. Interest expenditure	EDP D.41	***67552***	**4.6**	**4.8**	**4.9**	**4.9**	**4.9**	4.8
20. Subsidies	D.3	***13539***	**0.9**	**1.0**	**0.9**	**0.9**	**0.8**	0.8
21. Gross fixed capital formation	P.51	***33850***	**2.3**	**2.7**	**2.5**	**2.6**	**2.5**	2.4
22. Other[6]		***88089***	**6.0**	**4.0**	**3.8**	**3.8**	**3.7**	3.6
23=7. Total expenditure [7]	TE[1]	***738622***	**50.1**	**48.6**	**48.5**	**47.9**	**47.3**	47.0
p.m.: Government consumption (nominal)	P.3	*299512*	20.3	19.9	20.2	19.7	19.3	19.0

[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, item 9).

[3]A plus sign means deficit-reducing one-off measures.

[4] P.11+P.12+P.131+D.39+D.7+D.9 (other than D.91).

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

[6] D.29+D4 (other than D.41)+ D.5+D.7+D.9+P.52+P.53+K.2+D.8.

[7] Budgetary data provided for 2009-2011 are trends based on unchanged legislation. In order to achieve the net lending targeted for the general governemnt additional measures with a cumulative positive impact of 0.4% of GDP in 2009, 0.8% in 2010 and 1.2% in 2011 are envisaged.

Table 3. General government expenditure by function

% of GDP	COFOG Code	2005	2010
1. General public services	1	n.a.	n.a.
2. Defence	2	n.a.	n.a.
3. Public order and safety	3	n.a.	n.a.
4. Economic affairs	4	n.a.	n.a.
5. Environmental protection	5	n.a.	n.a.
6. Housing and community amenities	6	n.a.	n.a.
7. Health	7	n.a.	n.a.
8. Recreation, culture and religion	8	n.a.	n.a.
9. Education	9	n.a.	n.a.
10. Social protection	10	n.a.	n.a.
11. Total expenditure (=item 7=23 in Table 2)	TE[1]	n.a.	n.a.

[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	ESA Code	2006	2007	2008	2009	2010	2011
1. Gross debt [1]		**106.8**	**105.0**	**103.5**	**101.5**	**98.5**	95.1
2. Change in gross debt ratio		**0.6**	**-1.8**	**-1.5**	**-2.0**	**-3.0**	-3.4
Contributions to changes in gross debt							
3. Primary balance [2]		**-0.1**	**-2.5**	**-2.6**	**-3.4**	**-4.2**	-4.9
4. Interest expenditure [3]	**EDP D.41**	**4.6**	**4.8**	**4.9**	**4.9**	**4.9**	4.8
5. Stock-flow adjustment		**-0.1**	**0.6**	**0.2**	**-0.1**	**-0.3**	-0.1
of which:							
- Differences between cash and accruals[4]		-1.5	-0.3	0.0	n.a.	n.a.	n.a.
- Net accumulation of financial assets[5]		0.8	0.5	0.4	n.a.	n.a.	n.a.
of which:		-	-	-	-	-	-
- privatisation proceeds		0.0	0.0	0.0	0.0	0.0	0.0
- Valuation effects and other[6]		0.2	0.3	0.1	n.a.	n.a.	n.a.
p.m.: Implicit interest rate on debt[7]		**4.5**	**4.7**	**4.8**	**4.9**	**5.0**	5.1
Other relevant variables							
6. Liquid financial assets[8]		n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
7. Net financial debt (7=1-6)		n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

[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 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	2006	2007	2008	2009	2010	2011
1. Real GDP growth (%)		**1.9**	**1.9**	**1.5**	**1.6**	**1.7**	1.8
2. Net lending of general government	**EDP B.9**	**-4.4**	**-2.4**	**-2.2**	**-1.5**	**-0.7**	0.0
3. Interest expenditure	**EDP D.41**	**4.6**	**4.8**	**4.9**	**4.9**	**4.9**	4.8
4. One-off and other temporary measures[1]		**-1.2**	**0.2**	**0.1**	**0.1**	**0.1**	0.1
5. Potential GDP growth (%)		1.5	1.5	1.5	1.5	1.6	1.7
contributions:							
- labour		0.6	0.5	0.4	0.4	0.3	0.4
- capital		0.6	0.6	0.6	0.6	0.6	0.7
- total factor productivity		0.2	0.3	0.4	0.5	0.6	0.7
6. Output gap		-1.0	-0.5	-0.5	-0.4	-0.4	-0.3
7. Cyclical budgetary component		-0.5	-0.3	-0.2	-0.2	-0.2	-0.2
8. Cyclically-adjusted balance (2 - 7)		-4.0	-2.1	-2.0	-1.3	-0.5	0.2
9. Cyclically-adjusted primary balance (8 + 3)		0.6	2.7	2.9	3.6	4.4	5.0
10. Structural balance (8 - 4)		-2.8	-2.3	-2.1	-1.3	-0.6	0.1

[1]A plus sign means deficit-reducing one-off measures.

Table 6. Divergence from previous update

	ESA Code	2006	2007	2008	2009	2010	2011
Real GDP growth (%)							
Previous update		**1.6**	**1.3**	**1.5**	**1.6**	**1.7**	1.7
Current update		**1.9**	**1.9**	**1.5**	**1.6**	**1.7**	1.8
Difference		**0.3**	**0.6**	**0.0**	**0.0**	**0.0**	0.1
General government net lending (% of GDP)	EDP B.9						
Previous update[1]		**-4.8**	**-2.8**	**-2.2**	**-1.5**	**-0.7**	0.1
Current update		**-4.4**	**-2.4**	**-2.2**	**-1.5**	**-0.7**	0.0
Difference		**0.4**	**0.4**	**0.0**	**0.0**	**0.0**	-0.1
General government gross debt (% of GDP)							
Previous update		**107.6**	**106.9**	**105.4**	**103.5**	**100.7**	97.8
Current update		**106.8**	**105.0**	**103.5**	**101.5**	**98.5**	95.1
Difference		**-0.8**	**-1.9**	**-1.9**	**-2.0**	**-2.2**	-2.7

[1] The budgetary data for 2006 presented in the 2006 stability programme update did not 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 same update and approved with the final amendment to the 2007 Budget Law.

Table 7. Long-term sustainability of public finances

% of GDP	2000	2005	2010	2020	2030	2050
Total expenditure	n.a.	n.a.	n.a.	45.8	45.8	45.2
Of which: age-related expenditures	n.a.	26.2	26.0	26.4	27.9	28.7
Pension expenditure	n.a.	14.0	14.0	14.1	15.2	14.6
Social security pension	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Old-age and early pensions	n.a.	13.7	13.7	13.9	15.0	14.4
Other pensions (disability, survivors)	n.a.	0.3	0.2	0.2	0.2	0.1
Occupational pensions (if in general government)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Health care	n.a.	6.7	6.8	7.2	7.7	8.6
Long-term care *(this was earlier included in the health care)*	n.a.	0.8	0.8	0.9	1.0	1.3
Education expenditure	n.a.	4.3	3.9	3.8	3.6	3.7
Other age-related expenditures	n.a.	0.4	0.4	0.4	0.4	0.4
Interest expenditure	n.a.	4.5	4.9	3.1	1.7	0.3
Total revenue	n.a.	n.a.	n.a.	47.0	47.0	46.9
Of which: property income	n.a.	0.6	0.6	0.6	0.5	0.4
Of which : from pensions contributions (or social contributions if appropriate)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Pension reserve fund assets	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Of which : consolidated public pension fund assets (assets other than government liabilities)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Assumptions						
Labour productivity growth	n.a.	0.4	1.1	1.7	1.7	1.7
Real GDP growth	n.a.	0.0	1.8	1.5	0.9	1.1
Participation rate males (aged 20-64)	n.a.	79.2	81.1	82.4	82.6	84.0
Participation rates females (aged 20-64)	n.a.	53.6	56.8	60.4	60.6	63.8
Total participation rates (aged 20-64)	n.a.	66.4	68.9	71.5	71.7	74.1
Unemployment rate	n.a.	7.7	6.0	6.0	6.0	6.0
Population aged 65+ over total population	n.a.	19.5	20.6	23.2	27.1	33.9

Table 8. Basic assumptions

	2006	2007	2008	2009	2010	2011
Short-term interest rate[1] (annual average)	**2.8**	**4.0**	**4.3**	**4.5**	**4.7**	4.8
Long-term interest rate (annual average)	**4.0**	**4.4**	**4.7**	**5.0**	**5.1**	5.1
USD/€ exchange rate (annual average) (euro area and ERM II countries)	**1.26**	**1.35**	**1.35**	**1.35**	**1.35**	1.35
Nominal effective exchange rate	**0.6**	**2.7**	**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)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
World excluding EU, GDP growth	**5.8**	**5.5**	**5.3**	**5.4**	**5.3**	5.3
EU GDP growth	**3.0**	**2.7**	**2.6**	**2.4**	**2.4**	2.4
Growth of relevant foreign markets	**8.4**	**5.1**	**6.4**	**6.6**	**6.6**	6.6
World import volumes, excluding EU	**9.5**	**7.6**	**7.6**	**7.6**	**7.8**	7.9
Oil prices (Brent, USD/barrel)	**65.1**	**68.0**	**72.0**	**72.0**	**72.0**	72.0

[1]If necessary, purely technical assumptions.

Annex 2: Key indicators of past economic performance

This annex displays key economic indicators that summarise the past economic performance of Italy. To put the country's performance into perspective, right-hand side of the table displays the same set of indicators for the euro area.

Table: Key economic indicators

	Italy						Euro area					
	Averages			2005	2006	2007	Averages			2005	2006	2007
	'96 - '05	'96 - '00	'01 - '05				'96 - '05	'96 - '00	'01 - '05			
Economic activity												
Real GDP (% change)	1.3	1.9	0.7	0.1	1.9	1.9	2.1	2.7	1.4	1.5	2.8	2.6
Contributions to real GDP growth:												
Domestic demand	*1.7*	*2.4*	*1.0*	*0.3*	*1.6*	*1.8*	*2.0*	*2.7*	*1.3*	*1.7*	*2.6*	*2.4*
Net exports	*-0.4*	*-0.5*	*-0.3*	*-0.3*	*0.3*	*0.2*	*0.1*	*0.0*	*0.1*	*-0.1*	*0.2*	*0.2*
Real GDP per capita (PPS; EU27 = 100)	117	120	115	110	109	108	113	114	112	110	110	109
Real GDP per capita (% change)	1.0	1.9	0.1	-0.6	1.4	1.5	1.6	2.5	0.8	0.9	2.3	2.2
Prices, costs and labour market												
HICP inflation (%)	2.4	2.4	2.4	2.2	2.2	1.9	1.9	1.5	2.2	2.2	2.2	2.0
Labour productivity (% change)	0.5	1.1	-0.1	0.3	0.2	1.1	1.2	1.5	0.8	1.0	1.4	1.1
Real unit labour costs (% change)	-0.4	-1.1	0.4	0.5	0.5	-1.3	-0.5	-0.6	-0.5	-0.8	-0.9	-0.8
Employment (% change)	1.1	1.0	1.2	0.3	1.7	0.9	1.2	1.5	0.9	0.9	1.5	1.6
Unemployment rate (% of labour force)	9.7	11.0	8.4	7.7	6.8	5.9	9.1	9.8	8.5	8.9	8.3	7.3
Competitiveness and external position												
Real effective exchange rate (% change)	2.0	0.7	3.3	0.6	1.4	0.7	-1.3	-5.5	2.8	-2.6	-0.6	0.6
Export performance (% change)[1]	-5.5	-6.1	-4.9	-6.5	-3.1	-3.2	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	0.8	2.0	-0.4	-1.1	-1.9	-1.6	0.8	0.9	0.7	0.3	0.0	0.1
Public finances												
General government balance (% of GDP)	-3.2	-3.0	-3.4	-4.2	-4.4	-2.3	-2.3	-2.1	-2.5	-2.5	-1.5	-0.8
General government gross debt (% of GDP)	110.5	115.3	105.7	106.2	106.8	104.3	70.6	72.2	69.0	70.3	68.6	66.6
Structural balance (% of GDP)[2]	n.a.	n.a.	-4.5	-4.0	-2.7	-2.0	n.a.	n.a.	-2.6	-2.1	-1.1	-0.7
Financial indicators												
Short-term real interest rate (%)[3]	1.3	2.7	-0.1	-0.1	1.3	1.6	1.3	2.5	0.6	0.3	1.2	2.0
Long-term real interest rate (%)[3]	2.5	3.5	1.5	1.3	2.2	1.9	n.a.	n.a.	1.9	1.5	1.9	2.1

Notes:

[1]Market performance of exports of goods and services on export-weighted imports of goods and services of 35 industrial markets.

[2]Cyclically-adjusted balance net of one-off and other temporary measures; available since 2003.

[3]Using GDP deflator.

Source :
Commission services