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ITALY: MACRO FISCAL ASSESSMENT

AN ANALYSIS OF THE FEBRUARY 2009 UPDATE OF THE STABILITY PROGRAMME

The Stability and Growth Pact requires each EU Member State to present an annual update of its medium-term budgetary programme, called "stability programme" for countries that have adopted the euro as their currency and "convergence programme" for those that have not.

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 25 February 2009. Comments should be sent to Laura Bardone, Paolo Battaglia and Vito Ernesto Reitano (ecfin-f1-1@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' January 2009 interim 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 25 February 2009. The ECOFIN Council adopted its opinion on the programme on 10 March 2009.

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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

1. INTRODUCTION

The Italian authorities submitted the tenth update of the stability programme in the original language on 6 February 2009[1], covering the period from 2008 to 2011.

The programme is published under the responsibility of the Ministry of Economy and Finance. On 6 February 2009 the government endorsed an information note to Parliament highlighting the macroeconomic projections and fiscal targets in the programme, which have significantly changed with respect to the 2009-2011 budget adopted by the government in September and subsequently approved by Parliament by end 2008. The programme incorporates the economy recovery package contained in a decree law adopted by government on 28 November 2008.[2] It also takes into account the measures for financial stability adopted in October 2008.[3] The programme is presented to Parliament for information only.

2. MAIN CHALLENGES IN THE ECONOMIC DOWNTURN AND THE POLICY RESPONSE

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 just around 1% for the period 2003-2008. Long-standing structural weaknesses feeding into low productivity growth are at the root of Italy's external competitiveness losses, hampering the adjustment capacity of the economy. At the same time, they implied protracted subdued disposable income growth. Adding to these weaknesses, the global downturn is severely hitting the Italian economy, even though the low indebtedness of the Italian private sector and a relatively solid financial sector have so far provided some shelter from the direct impact of the financial crisis. A marked slowdown of real GDP growth was already underway in mid-2007, ahead of the euro area peers and well before the deepening of the financial crisis. It turned into recession in the second half of 2008, driven by faltering domestic demand and declining exports. All current economic indicators point to worsening conditions in Italy, most notably in terms of investment and employment growth (see Figure 1 in Annex 2). Based on the Commission services' January 2009 interim forecast, the output gap is expected to turn sharply negative in 2009 and to widen in 2010. Potential growth is estimated to erode further, to around ¾%. Hence, the Italian economy is clearly in bad times.

In this context, restoring business and consumer confidence, ensuring access to credit, in particular for SMEs, facilitating adjustment in the labour market to deal with rising unemployment and improving the conditions for productivity growth and cost competitiveness are key near-term challenges.

In the light of the very high government debt and the associated interest burden, the Italian government's response to the above challenges must be carefully balanced with the need to avoid a substantial deterioration of public finances. The recovery package adopted in November 2008 aims at supporting firms and low-income households, while accelerating public investment. Further measures were adopted in February 2009 to support demand for energy-efficient durable goods. In addition, the government adopted a number of measures to support financial stability and strengthen the system's overall ability to finance economic

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1 The English translation was submitted on 24 February 2009.

2 Decree Law 185/2008, converted into Law 2/2009.

3 Decree Laws 155/2008 and 157/2008, both converted into Law 190/2008.

activity (see Box 1). The negative budgetary impact of the recovery measures is projected to be limited, if not nil according to the programme's projections.[4] Still, the economic downturn is weighing heavily on the Italian public finances.

Box 1: Measures to help stabilise and strengthen the financial system

In October 2008 the government passed two decrees* aimed at protecting savers and maintaining adequate levels of bank liquidity and capitalisation. These allow the government, until end 2009, to inject capital into banks in situations of capital inadequacy and to guarantee new bank liabilities for up to five years. Moreover, a state guarantee for retail bank deposits was offered to supplement the Italian interbank deposit insurance scheme, which provides for coverage up to just above €100,000.

These rescue operations have been complemented by measures included in the recovery package adopted in November 2008 to strengthen the system's overall ability to finance economic activity. The Ministry of Economy and Finance has been allowed to underwrite financial instruments issued by sound listed banks that qualify as regulatory capital. The public intervention is intended to be temporary and banks availing of it must commit to lending to households and SMEs on appropriate terms and conditions. The programme estimates the possible total amount of government subscriptions of bank securities at around € 10 billion (0.7% of GDP).

* See footnote 3 in the main text.

Given the limited fiscal space and the need to quickly address the productivity and competitiveness challenges, structural measures are a particularly relevant avenue for Italy, also in the short term to support demand and promote resilience. A number of announced structural measures, if already operational in 2009, may further support the recovery and improve the resilience of the economy. These include initiatives to foster industrial innovation, promote the use of renewable sources and energy saving and reduce the administrative burden. Recent steps by the social partners to modify the wage bargaining framework, supported by fiscal incentives on performance-related pay, may lead to better alignment of wage and productivity developments. At the same time, Italy should not lose sight of the need to quickly address its long-standing productivity challenge and restore competitiveness. To this purpose, it should push ahead with the structural reform agenda, starting by strengthening the framework for competition in products and services markets, in line with the Lisbon Strategy for Growth and Jobs.

3. MACROECONOMIC SCENARIO

The Italian economy started slowing down already in mid-2007 and contracted in Q4-2007 driven by faltering domestic demand, on the back of the sharp increase of energy and commodity prices. The macroeconomic scenario has deteriorated further since mid-2008, as the global financial crisis rapidly unfolded and world trade collapsed. In both the Commission services' January 2009 interim forecast and the February 2009 update of the programme, real GDP is projected to have contracted by 0.6% in 2008 as a whole. However, after the flash estimate on quarterly data released on 13 February, real GDP is now expected to have contracted by 0.9% in 2008 as a whole. The carry-over into 2009 is estimated at -1.8% as compared with -1.4% in the interim forecast.

[4] See Section 4.2 below for details.

Table I: Comparison of macroeconomic developments and forecasts

	2008		2009		2010		2011
	COM	SP	COM	SP	COM	SP	SP
Real GDP (% change)	-0.6	-0.6	-2.0	-2.0	0.3	0.3	1.0
Private consumption (% change)	-0.4	-0.5	-0.3	-0.5	0.7	0.6	1.2
Gross fixed capital formation (% change)	-1.9	-1.8	-6.3	-6.8	-0.5	0.3	1.4
Exports of goods and services (% change)	-1.5	-1.4	-5.8	-5.0	0.9	1.3	3.5
Imports of goods and services (% change)	-2.7	-2.9	-4.3	-4.3	1.5	1.6	3.4
Contributions to real GDP growth:							
- Final domestic demand	-0.5	-0.6	-1.4	-1.7	0.4	0.4	1.0
- Change in inventories	-0.5	-0.5	-0.2	-0.1	0.1	0.0	0.0
- Net exports	0.4	0.4	-0.4	-0.2	-0.2	-0.1	0.0
Output gap[1]	0.3	0.3	-2.3	-2.3	-2.7	-2.7	-2.5
Employment (% change)	0.9	0.5	-1.4	-1.0	-0.2	0.2	0.5
Unemployment rate (%)	6.7	6.9	8.2	8.2	8.7	8.4	8.2
Labour productivity (% change)	-1.0	-1.0	-0.2	-1.1	0.5	0.2	0.5
HICP inflation (%)	3.5	3.5	1.2	1.2	2.2	1.7	2.0
GDP deflator (% change)	3.0	3.0	2.0	1.4	1.9	1.7	1.9
Comp. of employees (per head, % change)	4.1	4.3	1.9	1.5	2.1	1.9	2.0
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	-2.2	-1.6	-1.3	-1.3	-1.5	-1.1	-0.9

Note:

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

Source :

Commission services' January 2009 interim forecasts (COM); Stability programme (SP)

The profile of economic growth between 2008 and 2010 assumed in the programme is in line with the Commission services' January 2009 interim forecast, while the 1% growth projected for 2011 is close to average potential growth in the recent past. These macroeconomic projections take into account the recovery measures adopted on 28 November, in particular as regards consumption, but their expected economic impact is not quantified. Sharing the same external assumptions, the two scenarios differ on the recovery profile for some of the demand components of GDP, notably investment and exports. As for price developments, HICP inflation in 2009 is projected at 1.2% for 2009 in both scenarios, but in 2010 the programme points to a more moderate rebound of inflation.

The programme's scenario appears more favourable than that of the Commission services on employment developments in 2009 and 2010 (both when measured in headcount terms and in hours worked), as well as on the projected unemployment rate in 2010. The programme projects more moderate nominal growth of compensation of employees in 2009 and 2010. After the sharp increase estimated for 2008, unit labour cost growth is projected to decelerate in 2009 and then again in 2010 and 2011 (to 2.5%, 1.7% and 1.5% respectively). The unit labour cost projections for 2008 and 2009 in the programme are slightly higher than in the Commission services' forecast, in particular as the former expects productivity to sharply contract in 2009.

Another important difference between the two scenarios concerns the GDP deflator projection, which for 2009 is lower in the programme. This, together with higher unit labour costs, would imply a smaller gross operating surplus of the corporate sector than assumed in the interim forecast. Also the terms of trade in 2009 are expected to be less favourable in the programme (+1.8% vs. +5.8% in the interim forecast), because of the smaller reduction expected in import prices (-0.4% vs. -4.4%).

Overall, assessed against currently available information, economic growth could be even lower than projected in the programme. Also in the light of this, the 2009 projections for employment in the programme seem to be rather optimistic, in particular as concerns hours worked. By contrast, the projections for inflation appear realistic. The programme's inflation prospects and the underlying moderation in unit labour cost growth in the medium term imply some containment of the competitiveness losses that Italy has been experiencing since the late 1990s.

4. BUDGETARY STRATEGY

4.1. Budgetary implementation in 2008

The Commission services' January 2009 interim forecast estimates that the general government deficit increased to 2.8% of GDP in 2008, compared to the 2.2% deficit target in the November 2007 update of the programme (see Table 1 in Annex 2).

The higher-than-expected outcome occurred in spite of a positive base effect, as the 2007 deficit is now reported at 1.6% of GDP as against 2.4% expected in the previous programme. The better 2007 starting position was more than offset by developments in 2008, only partly related to the adverse economic conditions. Higher interest rates entailed increased debt servicing costs. A shortfall in revenue growth over and above the impact of the economic slowdown reflects the implementation of various discretionary measures, namely: the take up by employers in 2008 of the cut in the labour tax wedge (for workers on permanent contracts) foreseen for 2007, the complete abolition of the tax on primary residential property and the postponement to 2009 of some tax payment deadlines adopted with the economic recovery package at the end of 2008.

The structural deficit – that is, the cyclically-adjusted deficit net of one-off and other temporary measures – is estimated to have increased by ½ percentage point of GDP relative to 2007. This compares with a ¼ percentage point improvement planned in the November 2007 update of the programme.

4.2. Near-term budgetary strategy

The programme projects the deficit to increase to 3.7% of GDP in 2009, above the 3% of GDP deficit reference value, from 2.6% of GDP in 2008. The widening of the deficit reflects the operation of the automatic stabilisers: primary expenditure growth would largely outpace nominal GDP contraction, while revenue growth would slow down considerably.

For both expenditure and revenue, however, some intervening factors would stem the deterioration of the budgetary outcome in 2009. On the expenditure side, lower interest rates would drive interest expenditure marginally down, despite a higher debt. In addition, the projected increase in primary expenditure is rather moderate by historical standards: 3.1% versus 4.5% on average in nominal terms during the period 1999-2007. The moderation is underpinned by the expenditure-based adjustment plan outlined in the three-year fiscal consolidation package that was adopted by Parliament in the summer 2008 and confirmed in the budget for 2009 (see Box 2).

Revenue growth would slow down considerably, but by less than the tax base, also reflecting a combination of one-off and permanent discretionary measures adopted with the recovery and the three-year fiscal packages, as well as positive social contribution developments. In particular, the 2009 budget foresees a permanent increase in net revenues by around 0.3% of

GDP thanks to the so called "Robin Hood tax" on banks, insurance companies and firms in the energy sector.

The recovery package that was adopted in November 2008 in response to the European Economic Recovery Plan (EERP) is assumed to have a neutral budgetary impact, as higher expenditure and lower revenues are planned to be fully offset by one-off revenues and some permanent tax increases, mostly originating from fighting tax evasion and avoidance (Table II). The package injects new resources into the economy amounting to around 0.4% of GDP in 2009 and 0.2% both in 2010 and 2011. It includes some measures to support household disposable income and restore consumer confidence, notably a one-off cash transfer to low-income households, extensions of unemployment benefits to atypical workers and freezes on some utility tariffs. The postponement of tax payment deadlines and a reduction of the corporate income tax burden are intended to support companies. Tax relief on performance-related pay aims at fostering productivity while reducing labour costs. Finally, the government is also trying to re-allocate available EU or national funds so as to accelerate the implementation of priority infrastructural projects and extend unemployment benefit coverage. In line with the EERP, the measures are targeted and timely, provided that the planned acceleration of public investment is achieved, and most of them are temporary in nature. Thus, their reversibility is ensured, although not in full.

As a result of the above developments the planned structural balance (recalculated by the Commission services on the basis of the information in the programme) would improve by ¼ percentage point of GDP compared to 2008, slightly more than the structural primary balance. The fiscal stance planned for this year thus appears broadly neutral.

Table II. Main budgetary measures for 2009

Revenue measures[1]	Expenditure measures[2]
• Measures in response to the downturn	
• Corporate income tax relief (-0.1% of GDP) • One-off withholding tax on revaluation of company assets (+0.2% of GDP) • Intensified fighting of tax evasion / avoidance (+0.1% of GDP)	• One-off income support to households and other measures aimed at restoring consumer confidence (+0.2% of GDP)
• Other measures	
• Additional taxes on energy / banking / insurance sectors (+0.3% of GDP)	• Rationalisation in the management of resources by general government (-0.3% of GDP)

Note:
[1] Estimated impact on general government revenue
[2] Estimated impact on general government expenditure
Source: Commission services

Table III: Composition of the budgetary adjustment

(% of GDP)	2007	2008		2009		2010		2011	Change: 2008-2011
	COM	COM	SP	COM	SP	COM[1]	SP	SP	SP
Revenue	**46.6**	**46.4**	**46.4**	**46.5**	**46.8**	**46.5**	**46.8**	**46.6**	**0.2**
of which:									
- Taxes on production and imports	14.7	14.0	13.8	13.9	13.7	14.0	13.7	13.5	-0.2
- Current taxes on income, wealth, etc.	15.2	15.3	15.4	15.4	15.5	15.3	15.4	15.5	0.1
- Social contributions	13.3	13.7	13.8	13.8	14.2	13.7	14.1	14.1	0.3
- Other (residual)	3.4	3.4	3.4	3.5	3.5	3.5	3.5	3.5	0.0
Expenditure	**48.2**	**49.2**	**49.0**	**50.3**	**50.5**	**50.2**	**50.0**	**49.5**	**0.5**
of which:									
- Primary expenditure	43.2	44.0	43.9	45.6	45.5	45.3	44.9	44.0	0.2
of which:									
Compensation of employees	10.7	11.0	11.0	11.2	11.3	11.2	11.2	11.0	0.0
Intermediate consumption	5.2	5.3	5.4	5.3	5.3	5.3	5.2	5.0	-0.3
Social payments	20.0	20.6	20.5	21.5	21.5	21.6	21.5	21.6	1.2
Subsidies	0.9	0.9	0.8	0.9	0.9	0.9	0.9	0.8	0.0
Gross fixed capital formation	2.4	2.2	2.3	2.4	2.4	2.3	2.2	2.1	-0.2
Other (residual)	4.0	4.0	3.9	4.2	4.1	4.1	3.9	3.5	-0.4
- Interest expenditure	5.0	5.1	5.1	4.8	5.0	4.9	5.2	5.4	0.3
General government balance (GGB)	**-1.6**	**-2.8**	**-2.6**	**-3.8**	**-3.7**	**-3.7**	**-3.3**	**-2.9**	**-0.3**
Primary balance	**3.4**	**2.3**	**2.5**	**1.0**	**1.3**	**1.2**	**1.9**	**2.6**	**0.0**
One-off and other temporary measures	0.1	0.2	0.2	0.1	0.1	0.1	0.1	0.1	-0.1
GGB excl. one-offs	**-1.7**	**-3.0**	**-2.8**	**-3.9**	**-3.8**	**-3.8**	**-3.3**	**-2.9**	**-0.1**
Output gap[2]	1.8	0.3	0.3	-2.3	-2.3	-2.7	-2.7	-2.5	-2.8
Cyclically-adjusted balance[2]	-2.5	-2.9	-2.7	-2.7	-2.6	-2.4	-1.9	-1.6	1.1
Structural balance[3]	**-2.6**	**-3.1**	**-2.9**	**-2.8**	**-2.7**	**-2.5**	**-2.0**	**-1.7**	**1.3**
Change in structural balance		*-0.5*	*-0.4*	*0.4*	*0.3*	*0.3*	*0.7*	*0.3*	
Structural primary balance[3]	2.4	2.0	2.2	2.0	2.3	2.5	3.2	3.7	1.6
Change in structural primary balance		*-0.4*	*-0.2*	*0.0*	*0.2*	*0.4*	*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.

Source :

Stability programme (SP); Commission services' January 2009 interim forecasts (COM); Commission services' calculations

4.3. Medium-term budgetary strategy

The programme confirms the commitment to the medium-term objective (MTO) of a balanced budgetary position in structural terms, but not the 2011 target date for its achievement. The economic downturn implies a delay in the budgetary consolidation plan enshrined in the three-year fiscal package approved in the summer 2008 and broadly confirmed with the 2009 Budget Law (see Box 2). However, the pledge to the expenditure-based adjustment that was spelled out in that package is restated, in particular by broadly confirming the medium-term projections for individual spending categories and the measures for their achievement, with the above-noted deviations from the original yearly targets stemming from the implementation of the recovery package in 2009 (Section 4.2). Namely, the more marked increase in primary expenditure in 2009 than originally foreseen – 3.1% in nominal terms as compared to 2.2% mainly due to the one-off transfers to poor households adopted with the recovery package – is planned to be offset by a more moderate increase in 2010 – 0.7% vs. 1.5%. The 1% increase envisaged for 2011 is the same as originally planned.

Overall, primary expenditure is planned to increase by only 0.8% on average per year in 2010 and 2011, with the spending envelopes for those years remaining broadly unchanged compared to the three-year fiscal package. Also thanks to improved economic conditions, the primary expenditure-to-GDP ratio would gradually return to a level similar to that estimated for 2008. The revenue-to-GDP ratio is projected to increase slightly between 2008 and 2011.

Box 2: The three-year fiscal consolidation package adopted in summer 2008

The Economic and Financial Planning Document (DPEF 2009-2013) presented by the government in June 2008 was accompanied for the first time by a multi-annual fiscal consolidation package including measures aimed at achieving the MTO in 2011 (Decree Law 112/2008 converted into Law 133/2008). In so doing, the DPEF spelled out yearly targets for individual expenditure and revenue items. The budgetary adjustment hinges upon the containment of primary expenditure, particularly on compensation of employees and intermediate consumption, but also investments and capital transfers, to be realised primarily through the rationalisation of resource management by the central administration.

The bulk of the corrective measures in the package consists of:

- Ceilings to "non-obligatory" central government expenditure, i.e., both current and capital expenditure which is not allocated to compensation of employees, pensions and interest payments, but also expenditure on research and transfers to universities. Administrations are requested to better manage their resources so as to cut this expenditure relative to trend projections - based on unchanged legislation - overall by around 22% in both 2009 and 2010 and by around 40% in 2011. This would lead to expenditure savings amounting to 0.3%, 0.4% and 0.8% of GDP in 2009, 2010 and 2011, respectively. To enable this, additional flexibility in reallocating resources between spending programmes according to policy priorities is granted to line ministries.
- Cuts relative to trend projections of local administrations' expenditure (0.2% of GDP in 2009, rising to 0.3% in 2010 and 0.5% in 2011) and health care expenditure, which is also in the remit of the regions (0.1% of GDP in 2010 and 0.2% in 2011). To this purpose, the enforcement mechanisms of the Domestic Stability Pact and the health pact were further revised in the autumn.
- Additional revenue by around 0.1% of GDP in 2008, rising to 0.3% of GDP in the following years, largely through an increase of corporate taxes (the so-called Robin Hood taxes) applying to the banking, insurance and energy sectors. For banks and insurers, the increase takes the form of a reduced deductibility of interest payments. In the energy sector, the rate of corporate taxation applying to oil companies was left at 33% against a general reduction to 27.5% stipulated in an earlier provision.

As part of the planned, more general reform of the public administration, the law brought forward some provisions affecting public employment with a direct budgetary impact. These envisage in particular a partial freeze of new recruitment, with hiring limited to 10% of the expenditure savings implied by retirements in 2009. The ceiling rises to 20% in 2010 and 2011 and to 50% in 2012. Specific measures to improve cost effectiveness in the education sector are already being taken, in particular aimed at achieving a students/teachers ratio in line with European standards. Savings from these measures are expected to be in the order of no more than 0.1% of GDP by 2011.

The planned overall savings from the above measures will be partly offset by new expenditure - relative to the unchanged legislation scenario - amounting to around 0.4% of GDP each year for the renewal of public employment contracts expired at the end of 2006 and other current and capital expenditure.

After peaking in 2009, the headline deficit is planned to decline to 3.3% of GDP in 2010 and 2.9% of GDP in 2011, i.e. just below the Treaty reference value. A projected rebound in interest expenditure from 2010 implies that the primary balance is planned to improve at a faster pace.

The structural balance (as recalculated by the Commission services) would continue improving in 2010 and 2011, by a cumulative 1 percentage point of GDP. The structural primary balance would improve by more (almost 1½ point). The fiscal stance planned for 2010 and 2011 thus appears to be broadly restrictive.

4.4. Risks to the budgetary targets

The deficit outcomes could be higher than projected in the programme throughout the covered period. First, economic growth could be even lower. Second, the subdued increase in primary expenditure planned over 2010-2011 requires a consistent and strict implementation, at all levels of government, of the actions envisaged in the three-year package adopted in the summer 2008. This will not be without challenges, even though the significant progress that is being achieved to improve the fiscal framework (see Chapter 6) will provide valuable support . In particular, to be effectively implemented, the restructuring plan for the public administration will have to overcome the resistance of the main stakeholders. As for the envisaged cuts to capital expenditure, especially investment, they may be unsustainable in the medium term without increasing users' participation in costs. Finally, the ambitious cuts to local and health care expenditure may also be difficult to implement.

Another reason why the budgetary targets could be less favourable than in the programme update stems from the projections for social contributions, notably for 2009, given the rather favourable underlying assumptions for employment growth.

Finally, although planned to be fully financed, the recovery package adopted in November 2008 and the new fiscal incentives for the purchase of durable goods adopted in February 2009 might affect the 2009 budgetary outcome. Neither the programme nor the Commission services' interim forecast, which have similar projections for the 2009 deficit, includes the February 2009 measures.

5. DEBT DEVELOPMENTS AND LONG-TERM SUSTAINABILITY

5.1. Debt developments

The gross debt ratio is projected to have increased by 1.8 pp in 2008, to just below 106% of GDP, also reflecting the precautionary accumulation of liquid assets held with the Bank of Italy at the end of the year (around ½ percentage point of GDP more than at end-2007). The programme expects further increases in the debt ratio in 2009 and in 2010, to 110.5% and 112% respectively, before slightly declining in 2011. The main driver of these developments is the large debt-increasing "snow ball" effect, fuelled by the projected subdued nominal GDP growth and the planned low primary surpluses. The Commission services' interim forecast expects a less pronounced increase in the debt ratio mainly on account of higher nominal GDP growth and a smaller "stock-flow" adjustment.

At the end of 2008, the average life and financial duration of government securities (6.82 and 4.51 years, respectively) were broadly unchanged compared to a year before, while the share of the fixed-rate component was slightly higher (67.7% as compared to 67.1% at the end of 2007). Taking account of these characteristics, the sensitivity analysis performed in the programme indicates that in 2009 a permanent 100-basis-point hike in the yield curve would imply a moderate increase in interest expenditure compared with the baseline scenario (close to 0.2% of GDP). Its budgetary impact would increase to around 0.4% of GDP in 2010 and 0.5% in 2011.

The evolution of the debt ratio from 2009 onwards might be less favourable than projected in the programme, for the same reasons already mentioned in the case of the budgetary targets. The gross debt ratio could also be affected by possible capital injections into the banking sector.

Hence, it can be concluded that the debt ratio will be increasing over the programme period, moving further away from the reference value.

Table IV: Debt dynamics

(% of GDP)	average 2002-06	2007	2008		2009		2010		2011
			COM	SP	COM	SP	COM	SP	SP
Gross debt ratio[1]	**105.3**	**104.1**	**105.7**	**105.9**	**109.3**	**110.5**	**110.3**	**112.0**	**111.6**
Change in the ratio	-0.4	-2.8	1.6	1.8	3.6	4.6	1.0	1.5	-0.4
Contributions[2] *:*									
1. Primary balance	**-1.4**	**-3.4**	**-2.3**	**-2.5**	**-1.0**	**-1.3**	**-1.2**	**-1.9**	**-2.6**
2. "Snow-ball" effect	**1.4**	**1.2**	**2.7**	**2.6**	**4.7**	**5.6**	**2.5**	**2.9**	**2.3**
Of which:									
Interest expenditure	4.9	5.0	5.1	5.1	4.8	5.0	4.9	5.2	5.4
Growth effect	-0.9	-1.5	0.6	0.6	2.1	2.1	-0.4	-0.4	-1.1
Inflation effect	-2.6	-2.3	-3.1	-3.0	-2.2	-1.5	-2.1	-1.9	-2.0
3. Stock-flow adjustment	**-0.4**	**-0.5**	**1.2**	**1.7**	**-0.2**	**0.3**	**-0.3**	**0.5**	**-0.1**
Of which:									
Cash/accruals diff.	0.2	0.3	0.2	0.1	-0.5	-0.5	-0.3	n.a.	n.a.
Acc. financial assets	0.0	-0.7	1.0	0.6	0.4	0.4	0.0	n.a.	n.a.
Privatisation	-0.4	-0.2		-		-		-	-
Val. effect & residual	-0.6	0.0	0.0	0.9	0.0	0.4	0.0	n.a.	n.a.

Notes:

[1]End of period.

[2]The snow-ball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator). 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' January 2009 interim forecasts (COM); Commission services' calculations

5.2. Long-term sustainability

This section presents sustainability indicators based on the long-term age-related government spending as projected by the Member States and the EPC in 2006 according to an agreed methodology.[5]

Table 4 in Annex 2 shows that age-related spending is projected to rise by 2.3% of GDP between 2010 and 2050, below the EU average. Sustainability indicators for two scenarios are presented in Table 5 in Annex 2. Including the increase of age-related expenditure and

[5] Economic Policy Committee and the European Commission (2006), 'The impact of ageing on public expenditure: projections for the EU-25 Member States on pensions, health care, long-term care, education and unemployment transfers (2004-50)', *European Economy – Special Report* No. 1/2006. European Commission (2006), The long-term sustainability of public finances in the European Union, European Economy No. 4/2006. European Commission (2008), *Public finances in EMU – 2008*, *European Economy* No. 4/2008.

assuming that the structural primary balance remains at its 2008 level until 2050, the sustainability gap (S2)[6] would amount to 1.9% of GDP, about ¾ percentage point higher than in last year's assessment, which is due to a deterioration in the estimated structural primary balance in the starting year. The starting budgetary position is just sufficient to stabilise the debt ratio over the long term but would not contribute to offsetting the projected long-term budgetary impact of ageing.

While the "2008 scenario" already reflects the weakening of the budgetary position in response to the current economic crisis, the "programme scenario", which is based on the end-of-programme structural primary balance, would reduce the gap. If the budgetary consolidation planned in the programme were achieved, risks to long-term sustainability of public finances would be mitigated. Based on the assumptions used for the calculation of the sustainability indicators, Figure 4 in Annex 2 displays the projected debt ratio over the long term.

For an overall assessment of the sustainability of public finances, other relevant factors are taken into account, as shown in Table 6 in Annex 2.

In sum, 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, pension expenditure as a share of GDP remains among the highest in the EU and the projections hinge upon the assumption that the adopted reforms are fully implemented, in particular that revised actuarial coefficients are applied as of 2010 in full consistency with the contributory principle underlying the reformed pension system. The budgetary position in 2008 as estimated in the programme, which is worse than the starting position of the previous programme, would be sufficient to stabilise the current debt ratio but would not contribute to offsetting the projected long-term budgetary impact of ageing. Moreover, the current level of gross debt is well above the Treaty reference value. Achieving and maintaining high primary surpluses over the medium term would contribute to reducing the medium risks to the sustainability of public finances.

Additional reform measures could be considered in the area of pensions, notably a further increase in retirement age, in particular for women. The reformed pension system sets different age requirements for men and women to be entitled to a retirement pension – 65 and 60 respectively. A recent decision by the European Court of Justice[7] ruled that the gender difference in retirement age provided for in the Italian public pension scheme is at odds with the EU principle of equal treatment stipulated in Article 141 EC. The Italian government will have to take appropriate measures to adjust its public pension system to EC requirements, and could use this opportunity to harmonise the retirement age for men and women for both the public and the private pension scheme. This would allow reallocating social expenditure so as to put in place a more comprehensive and uniform unemployment benefit system that ensures appropriate work incentives and effective activation policies. The existing unemployment benefit system in Italy combines a variety of schemes applying different eligibility conditions, amounts and durations of treatment. Non-permanent workers are hardly entitled to any protection. The recovery package extends benefit payments to some categories of non-permanent workers, but does not modify the existing system. A more complete overhaul of the unemployment benefit system is highly desirable.

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6 The S2 indicator is defined as the change in the current level of the structural primary balance required to make sure that the discounted value of future structural primary balances (including the path of property income) covers the current level of debt.

7 ECJ C-46/07 of 13 November 2008.

6. INSTITUTIONAL FEATURES OF PUBLIC FINANCES

In a broad-based definition of the quality of public finances that includes all fiscal policy dimensions, Italy's fragile budgetary position and a composition of public expenditure heavily biased towards the cost of the debt service and pension spending are indications that the quality of the Italian public finances needs improving. There is also evidence that there is large scope for improving the quality of services provided.

The programme reports on the significant progress that has been achieved in recent years to improve the fiscal framework. A well-designed and functioning fiscal framework is a key pre-condition for a credible medium-term strategy of expenditure-based adjustment underpinned by enhanced cost-effectiveness and efficiency of public expenditure. The three-year fiscal package adopted in summer 2008 (see Box 2) strengthens the medium-term fiscal framework by spelling out detailed yearly caps for individual expenditure items and backing them up with measures. In so doing, the new approach makes the adjustment strategy more credible and overcomes the main weakness identified in past Commission's assessments of stability programme updates, i.e., the lack of indications on the broad measures to achieve the budgetary targets beyond the year covered by the budget law.

Several other initiatives were introduced to improve budgetary institutions. The structure of the state budget was rationalised by introducing a programme-based classification that allows better allocating resources in line with government policy objectives. In order to enable the administrations to better manage their resources, enhanced flexibility is allowed to line ministries to reallocate resources between spending programmes according to priorities. A pilot spending review exercise was conducted in five ministries to assess cost-effectiveness of public expenditure and there is now the intention to make this an integral part of the budgetary process. Enforcement mechanisms in the Domestic Stability Pact, governing fiscal relations between different levels of government, as well as those related to the health spending of regions have been strengthened. Finally, important steps are being taken to improve the efficiency and cost-effectiveness of the public administration, *inter alia* by promoting a more rational use of available resources and better rewarding merit.

Going forward, a major challenge for fiscal governance is to design a new framework for fiscal federalism that ensures the accountability of local governments and fosters efficiency. On 22 January 2009, the Italian Senate approved a draft Delegation Law that sets out the main principles of fiscal federalism in Italy. Within the existing structure of sub-national governments, it envisages more autonomy for regions and municipalities in collecting and spending tax revenue, while foreseeing solidarity mechanisms. The draft bill is now being examined by the Lower Chamber. The bill will empower the Government to adopt, within 24 months, one or more enacting decrees (*Decreti Attuativi*) to complete and specify the fiscal federalism framework. A provision of the draft act foresees that the implementation of fiscal federalism must be consistent with Italy's commitments under the Stability and Growth Pact but it is too early, at this stage, to quantify the budgetary impact of fiscal federalism.

7. ASSESSMENT

This section assesses the planned budgetary strategy outlined in the programme, taking into account risks, in the light of: (*i*) the adequacy of the recovery package in response to the Commission Communication of 26 November 2008 on the European Economic Recovery Plan (EERP) as agreed by the European Council in December 2008 and the overall fiscal stance; (*ii*) the criteria for short-term action laid down the above mentioned Commission Communication; and (*iii*) the objectives of the Stability and Growth Pact.

The economic recovery package adopted by the government in November 2008 aims at supporting firms and low income households, while accelerating public investment. Further measures were adopted in February 2009 to support demand for energy-efficient durable goods. The measures are targeted and timely, provided that the planned acceleration of public investment is enacted. Most of them are temporary in nature, thus their reversibility is ensured, although not in full. In any case, the budgetary impact of the measures is, according to official projections, offset by one-off revenues and some permanent tax increases, mostly originating from fighting tax evasion and avoidance. Overall, the package represents an adequate response to the economic downturn in view of the limited fiscal space. In particular, given the already very high debt ratio, any large budgetary deterioration could elicit a reaction from the financial markets, causing a further widening of the already significant spreads between Italian and German bonds. This would result in higher interest rates for the entire economy, outweighing the benefits from the fiscal stimulus. In addition, the Italian economy has experienced competitive losses since the late 1990s mainly due to poor productivity developments and this affected the current account with the rest of the world, which has been negative since 2002. A higher government deficit might lead to a widening of the current account deficit and generate external imbalances.

Given the limited fiscal space and the need to quickly address the productivity and competitiveness challenges, structural measures are a particularly relevant avenue for Italy, also in the short term to support demand and promote resilience. A number of announced structural measures, if already operational in 2009, may further support the recovery and improve the resilience of the economy. These include initiatives to foster industrial innovation, promote the use of renewable sources and energy saving and reduce the administrative burden. Recent steps by the social partners to modify the wage bargaining framework, supported by fiscal incentives on performance-related pay, may lead to better alignment of wage and productivity developments. These measures are related to the medium-term reform agenda and the country-specific recommendations proposed by the Commission on 28 January 2009 under the Lisbon Strategy for Growth and Jobs. More decisive and timely action is needed to improve the conditions for productivity growth, in particular to strengthen the competition framework in products and services markets.

The economic downturn implies a delay in the budgetary consolidation plan enshrined in the three-year fiscal package, even though the pledge to the expenditure-based adjustment that was spelled out in that package is restated, in particular by broadly confirming the medium-term projections for individual spending categories and the measures for their achievement. After being expansionary in 2008, the overall fiscal stance appears to be broadly neutral in 2009-2010. In particular, the structural balance according to the Commission services' interim forecast would improve by nearly ¾% of GDP over the two years, also thanks to lower interest expenditure. The primary structural balance is expected to remain unchanged in 2009 and to improve by ½% of GDP in 2010.

A reduction of the headline deficit below 3% of GDP by 2011, as envisaged in the programme, will require strong commitment to fiscal discipline and standing ready to adopt additional measures if necessary. The debt ratio could be further affected by possible capital injections into the banking sector. Hence, it can be concluded that the debt ratio will be increasing over the programme period, moving further away from the reference value.

ANNEX 1. SPECIAL TOPIC: TAXATION AND THE LABOUR MARKET

1. INTRODUCTION

Improving the quality of public finances has become a new focal point for EU policy makers, not only for its role in the achievement of sustainable fiscal positions but also to support the macroeconomic goal of sustained economic growth, as confirmed also in the context of the renewed Lisbon strategy for growth and jobs. The quality of public finances is a multidimensional concept that encompasses aspects such as fiscal governance, the structure and composition of expenditure, the efficiency of public services and the structure and efficiency of the tax system. For Italy, given the steady upward trend in primary expenditure as a share of potential GDP over the past decade and the large scope for improving its composition and efficiency, fiscal governance and the quality of public spending are clearly the priority. Accordingly, in their assessment of the November 2007 stability programme update for Italy, the Commission services identified a double challenge for fiscal policy in Italy: that of curbing growth of public expenditure while at the same time improving its effectiveness and cost efficiency. In its opinion on that stability programme update, the Council invited Italy, *inter alia*, to focus on improving the quality of public finances, with particular attention to the composition and efficiency of expenditure. The expenditure-based adjustment that is enshrined in the three-year fiscal consolidation package adopted in the summer 2008 (see Box 2 in the main body of the text of this macro-fiscal assessment) and the various initiatives taken recently to improve the fiscal framework (see Chapter 6) are important steps to respond to these concerns. Still, within a much needed comprehensive strategy to address the structural weaknesses of the Italian economy and raise its growth potential, the taxation system also plays an important role. In particular, while in the medium term the overall tax burden in Italy is set to remain relatively high so as to allow reducing the elevated government debt ratio, there may be scope for revenue-neutral and efficiency-enhancing tax reforms that help boost employment and growth.

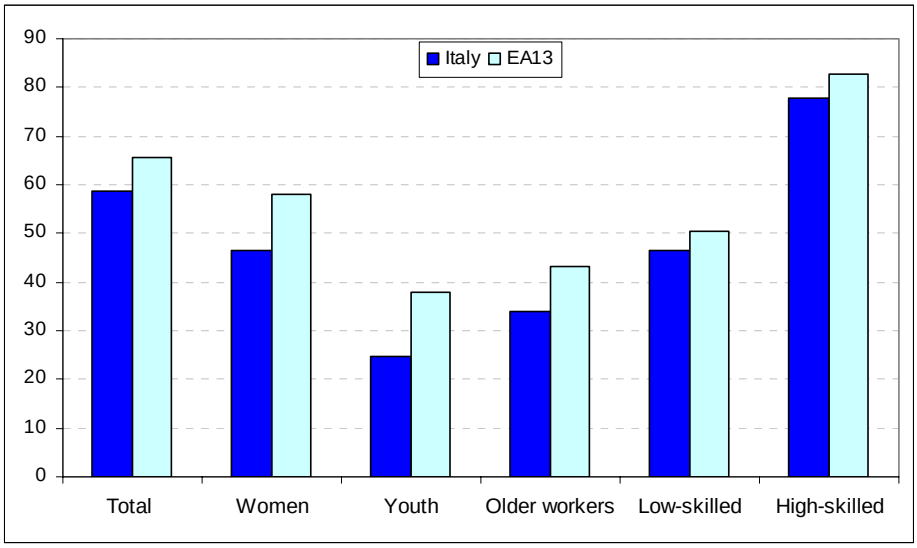
This Annex analyses the question of the structure and efficiency of the Italian tax system from the angle of the labour market. Starting from an overview of the labour market situation in Italy and a brief summary of the theoretical and empirical discussion of how taxation can affect the labour market, the analysis provides a dynamic picture of the structure and level of taxation in Italy, with special focus on taxation of labour, and its interaction with social transfers. The potential distortive effects of the tax-benefit system on labour market outcomes are discussed in the light of the available empirical evidence.

2. THE ITALIAN LABOUR MARKET

Despite considerable progress over the past decade, the employment rate, or the proportion of people of working age who are employed, in Italy continues to be one of the lowest in the euro area and the EU as a whole. Less than 59% of people of working age have a job, compared with around 66% in the euro area (Figure 1) and over 75% in the best performing EU countries (i.e., Denmark and the Netherlands). Given an unemployment rate of 6.1% at end 2007, its lowest level since 1981 and over 1 percentage point below the euro area average, the difference between the overall employment rate in Italy and the euro area is due to low participation.

The employment gap between Italy and the euro area is particularly high – in the order of 10 percentage points or more – at both ends of the age spectrum. There are age-specific barriers to employment and participation affecting young people and older workers that go beyond the scope of this analysis – namely, in the case of young people, they mainly have to do with an under-performing education and school-to-work transition system, whereas in the case of older workers they also relate to the still generous pension system. With an unemployment rate of young adults (aged 15 to 24 years) that is four times that of adults aged 25 to 54, insufficient labour cost flexibility may also be a problem.

Figure 1: Employment rates by population group in Italy and the euro area - 2007



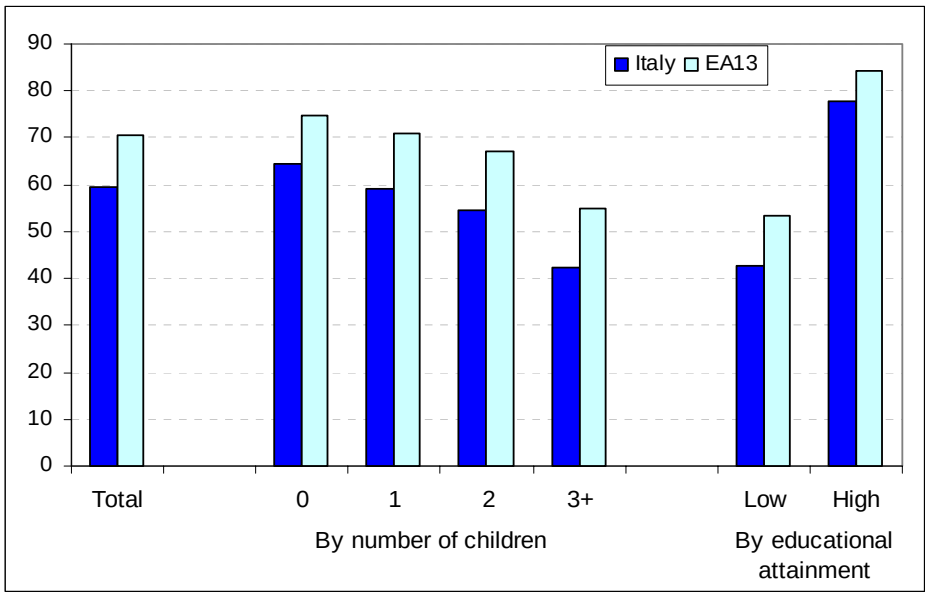
Source: Eurostat

Focusing on prime-age persons, Italy's employment gap is predominantly driven by women: with only six out of ten of them in work, Italy is the worst EU performer after Malta. Again, this is first and foremost the result of extremely low participation.

Figure 2 takes a closer look at the labour market situation of prime-age women (i.e. aged 25 to 54 years) by distinguishing between childless women and mothers, and comparing women with different skill levels (as proxied by their educational attainment). As in other countries, the employment rate is much higher among women with tertiary qualification than among low-educated women. Parenthood also reduces the proportion of women taking up employment, the more the higher the number of children (and the lower their age). Interestingly, however, in Italy the employment rate among childless women of prime working age is by itself already low compared to that for the euro area average. By educational attainment, the employment gap with the euro area is particularly large for women with less than upper secondary education. Fewer than one in two "low-skilled" prime-age women in Italy have a job, with the benefit of education becoming progressively more evident as the number of dependent children increases. The policy implication of this observation is that promoting family-friendly policies is important to encourage and help women, particularly those with low earnings potential, to enter the labour force. Obviously, this is not the only relevant policy for governments wishing to raise female employment rates. Expanding employment opportunities and increasing financial incentives for low-educated women appear to be at least as important.

Figure 2: Female employment in Italy and the euro area - 2007

Percentages of prime-age women.



Source: Eurostat

Labour supply decisions of individuals are rooted in the functioning of markets but they also reflect individual preferences and social norms. Women's labour supply decisions typically take account of the degree of income sharing with the other members in the household and are thus often taken from within a household context. It is therefore important to examine how employment and non-employment are distributed across working-age households. Unlike in many other countries in the EU, one-earner households with children in Italy are more common than two-earner couples with children. This poses a policy problem to the extent that people living in these households are exposed to a higher risk of poverty than elsewhere in the euro area.

Two other aspects of the Italian labour market that raise particular concern, and which are to a large extent inter-related, have to do with the persistently high regional dispersion in employment and participation and the high share of the underground economy. While the northern regions display employment and activity rates in line with, or higher than, the rest of the euro area, the southern regions show stagnating activity and high unemployment rates (Table 1). This is particularly true for women and young people. Central regions lie in between these two extremes. As for the underground economy, the Italian statistical office (ISTAT) estimates that in 2005 the share of irregular workers in total employment amounted to around 12%. Non-regular work is more widespread in the South: according to ISTAT, in 2005 it accounted for over 19% in that area, as against around 10% in the Centre and 8% in the North.

Table 1: Main labour market indicators 2007 - Euro area vs. Italy and its macro-regions

	Euro area	**Italy**	***North west***	***North east***	***Centre***	***South***
Activity rate*	71.1	63.0	*69.0*	*70.3*	*66.1*	*53.0*
Employment rate*	65.7	58.7	*66.0*	*68.0*	*62.0*	*46.7*
Unemployment rate**	7.4	6.1	*4.2*	*3.2*	*6.1*	*11.8*

*Percentage of population 15-64. **Percentage of the labour force.
Source: Eurostat and Istat

The sharp regional differentiation in labour market conditions, also as concerns the incidence of irregular work, suggests that the level of labour costs in the Southern regions may be too high. Although the two-tier system of collective bargaining established in 1993, currently in the process of being revised by the social partners, contributed to increasing wage dispersion across sectors and between the North and South of Italy, the widening of the wage spectrum is still insufficient to reflect the productivity and labour market conditions differentials across regions.[1] Relatively high labour costs weigh on the competitiveness of firms and discourage labour demand in the country's southern regions and encourage undeclared work. In turn, low labour demand discourages labour supply and human capital accumulation.[2] An important factor that hampers labour cost adjustment in the South is its heavy reliance on relatively attractive public jobs.[3] This implies a vicious circle in which it is expensive for private employers to offer jobs as attractive as those offered by the public sector, thus discouraging the development of market activities.[4]

3. TAXATION AND THE LABOUR MARKET: THE POTENTIAL LINKS

Taxes have an impact, either directly or indirectly, on labour market outcomes. The present analysis considers possible mechanisms by which taxation *directly* influences the rate of return from employers' decisions to hire and workers' decisions to enter the labour market, undertake training (with a view to increasing earnings potential) and increase hours of work. The focus is, therefore, on taxation of labour, broadly defined, also taking account of its interaction with the benefit system.

Taxes on labour such as personal income taxes and employers' and employees' social contributions can potentially have adverse effects on labour utilisation by affecting both labour supply and demand. In particular, to the extent that taxes and social contributions translate into higher labour costs, as wage earners succeed in shifting the tax burden onto employers, they can result in lower labour demand. By contrast, if taxes are reflected in lower take-home pay, they can influence the decision on whether to enter the labour market and/or how much labour to supply by those in employment. This is all the more true the lower the perceived benefit of paying taxes and social contributions, as would be the case when public

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[1] According to the results of the Household Survey of the Bank of Italy, earnings in the private sector in the South were around 15% lower than in the Centre-North, comparing workers with the same characteristics. Taking account of the different cost of living between the two macro-regions, the earnings gap would be smaller. At the same time, the productivity lag of the Southern regions remains significant, at around 20% compared with average labour productivity in the Centre-North, and hardly unchanged since 2000 (Bank of Italy, 2007 Annual Report).

[2] On the other hand, reservation wages are estimated to be roughly 10 per cent lower in the Southern regions than in the Northern and Central regions (see P. Sestito and E. Viviano, Reservation Wages: Explaining Some Puzzling Regional Patterns, Banca d'Italia, Temi di discussione, no. 696, December 2008).

[3] The share of public employment in the total workforce is higher in the Southern regions. As public wages are virtually uniform in nominal terms throughout the territory, and work opportunities in the private sector are better in the North, public employment is clearly more attractive in the South relative to alternative opportunities.

[4] See Alesina, A., Danninger, S. and M. Rostagno (2001), *Redistribution through Public Employment: the Case of Italy*, IMF Staff Papers, Vol. 48, No 3, IMF, Washington. The authors argue that public employment in Italy is used as a subsidy from the North to the less wealthy South, with both the size of public employment and the level of wages being used as a redistributive device.

spending is perceived to be inefficient and the social protection system inadequate.[5] Depending on whether the income or the substitution effect prevails, a change in the combination of taxes and social benefits could result in higher or lower labour supply. Empirical evidence tends to find a negative impact of labour taxes on labour supply, although with different magnitudes for different groups of workers, reflecting the elasticity of their labour supply curve. The effect seems largest for older workers, potential secondary earners within households and lone parents. In general, the incidence of taxes - i.e. who actually bears their burden - will be determined by the elasticities of labour supply and labour demand. The latter depend on various factors, such as the degree of competition in the product market, the workers' preferences for consumption and leisure, the elasticity of substitution between labour and capital and the bargaining strength of employers and employees. Labour market institutions matter as well: in the presence of wage floors created by statutory minimum wages or contractual minima and high benefit replacement rates, the tax burden may not be easily shifted onto wages, thereby transferring the depressing impact of the tax wedge onto labour demand, affecting in particular low-paid labour.

A high tax burden on labour can also create an incentive to resort to the shadow economy. When arranged in the hidden economy, the market value of the labour services is fully reaped by both the worker and the employer, while if those same services were arranged in the official economy, a large part of that value would go away in payroll and personal income taxes.

Finally, there are also other aspects of taxation, not directly related to the level of the tax burden, which can impinge on the labour market. These relate to the efficiency of the tax administration and collection and the transparency and clarity of the tax code. In Italy, tax evasion and avoidance are a well-known problem. In addition, the proliferation over time of tax allowances and tax rebates for specific spending items, together with the lack of an automatic adjustment of the personal income tax brackets to targeted inflation, have come at the cost of the simplicity and transparency of the system. Finally, frequent changes in taxation create a climate of instability. All this hampers economic activity and, as a consequence, employment growth in the regular economy.

Overall, it can be argued that a relatively high tax burden on labour may have contributed to unsatisfactory employment and growth in Italy, as in other EU countries. In this context, revenue-neutral tax reforms that shift the tax burden away from labour to other tax bases can be an important element to help improve labour market outcomes and foster growth. European Commission (2008)[6] discusses the potential in terms of employment gains and growth of a tax shift from labour to consumption, typically in the form of a reduction of payroll taxes or social contributions financed by an increase in VAT. The analysis confirms that this can be a potentially useful instrument for governments to improve the structural conditions for increasing employment growth in Europe. However, with consumption taxes being less progressive than personal income taxes, or even regressive, such a shift would

[5] Social contributions could have a smaller impact on labour supply than other taxes because they are directly related to the future benefits people receive. In particular, to the extent that the link between contributions and benefits is actuarially fair, the contributions would not be perceived as a tax. The shift from a defined-benefit system to a notional defined-contribution system in Italy may thus contribute to alleviating the perceived tax burden on labour supply.

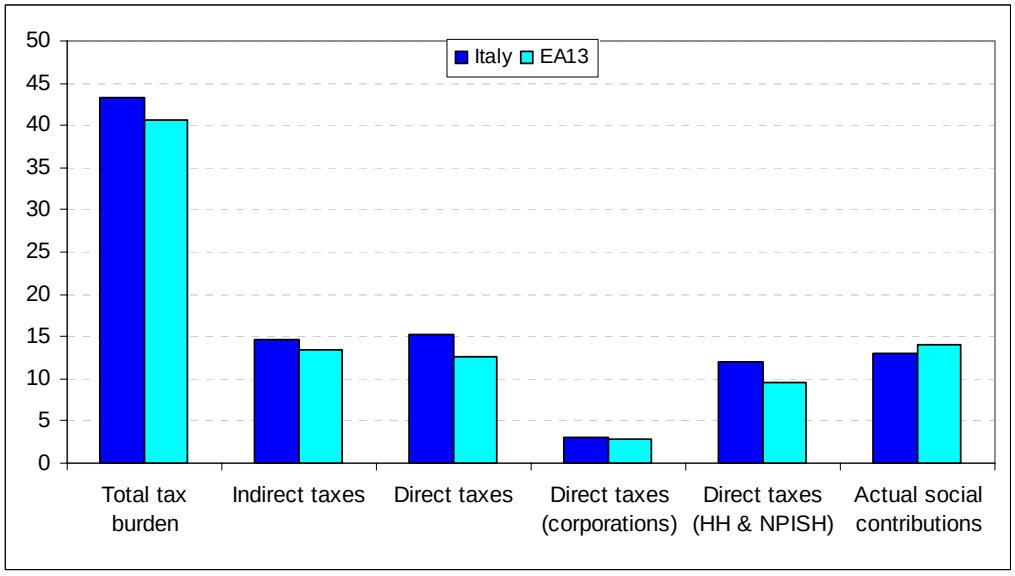
[6] European Commission (2008), *Public Finances in EMU – 2008*, EUROPEAN ECONOMY, No. 3. Office for Official Publications of the EC. Luxembourg.

reduce the progressivity of the system and thus imply a significant trade-off between efficiency and equity objectives that limits the extent to which governments can use it. Johansson *et al.* (2008)[7] extend this type of analysis by considering other tax bases. They conclude that recurrent taxes on residential property are the least distortive tax instrument in terms of long-run GDP per capita. However, the scope for switching revenue towards them is generally limited both because these taxes are currently levied by sub-national governments and, as the Italian experience shows, because these taxes are particularly unpopular. There may also be gains, both in terms of quantity and quality of labour supply, from reducing the progressivity of the personal income tax schedule, but again entailing a potential trade-off between growth-enhancing strategies and distributional concerns.

4. THE STRUCTURE OF TAXATION IN ITALY

The tax burden in Italy is high by international standards. In 2008, the total tax-to-GDP ratio (including actual social contributions) stood at 43% in Italy, the fourth-highest in the EU and 3 percentage points higher than the euro area average. It has remained above the 40% mark since the early 1990s (Figure 3), with a peak at 43.7% in 1997, reflecting strong public finance consolidation in the run-up to the euro and the need to reduce the very high government debt ratio.

Figure 3: The tax mix in Italy and the euro area. Percentages of GDP - 2007



Source: Ameco database

In 2007, direct taxes represented a relatively large share of total taxes in Italy: 35% as against 31% for the euro area, while the share of social contributions was lower in Italy than in the euro area (respectively 30% and 35% of total taxes)[8]. Indirect taxes accounted for around the

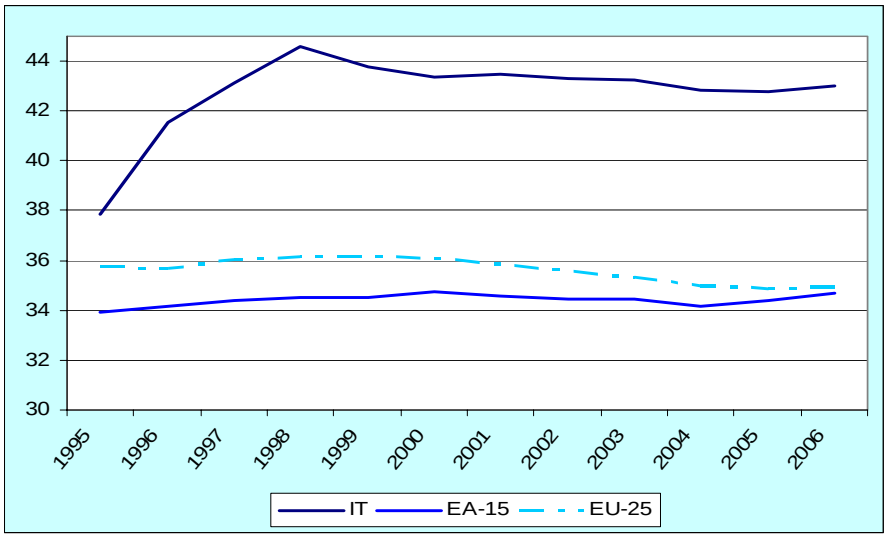
[7] Johansson, A., Heady, C., Arnold, J., Brys, B. and L. Vartia (2008), *Tax and economic growth*, Economics Department Working Paper No. 620, OECD, Paris.

[8] The structure of tax revenues was affected by an important tax reform in 1998: the elimination of employers' compulsory health care contributions and local income taxes, which were partly compensated by an increase in indirect taxes (in particular other taxes on production, through the introduction of the Regional Tax on Productive Activities – IRAP).

same share (34%). The high revenue from direct taxes is mainly due to the personal income tax, which, at almost 12% of GDP, stood two percentage points higher than the euro area average. As to the composition of indirect taxes, VAT and excise duties are well below the average for the euro area, but are counterbalanced by somewhat higher indirect taxes on products and production.

By economic function, Italy imposes a particularly high tax burden on labour income, both in comparison with the euro area and the EU as a whole. In 2006, the implicit tax rate (ITR)[9] on labour – i.e., the sum of all direct and indirect taxes and social contributions levied on employed labour income as a percentage of total compensation of employees from national accounts (increased by the part of IRAP related to labour costs) – stood over 4 percentage points above the euro area average and was second only to Sweden within the EU-27. In contrast to the experience of most Member States, from 1995 and 2006 the ITR on labour has increased markedly in Italy, from around 38% of total labour income in 1995 to 43% in 2006.

Figure 4: The Implicit Tax Rate on Labour



Source: European Commission (2008)

As for the burden of taxation on the other economic functions, Italy also displays an above-average implicit tax rate on capital – i.e., the ratio between revenue from all capital taxes and aggregate capital and savings income in the economy. It should be stressed, however, that the analysis of the ITR on capital is greatly complicated by the interlocking effects of various tax measures, the business cycle, the financial market consequences of euro adoption, as well as by statistical issues. In particular, in the calculations used here, receipts from taxes and social contributions levied on the self-employed, a relatively large group in Italy, are booked as capital taxes.[10]

[9] European Commission (2008), *Taxation Trends in the European Union – Data for the EU Member States and Norway*, Office for Official Publications of the European Communities, Luxembourg.

[10] Except for taxes (and the corresponding income) of 'continuous and co-ordinated collaborations' that are allocated to the labour category. An alternative methodology for calculating the ITRs on labour has been suggested by the Italian authorities that allocates a larger part of self-employed income and taxes to the labour category. The resulting implicit tax rate on labour for Italy would be lower than the one calculated with the common methodology.

Table 2: The Implicit Tax Rate on labour, capital and consumption - 1995-2006

	Labour			Capital			Consumption		
	2006	Change 1995-2006	Ranking	2006	Change 1995-2006	Ranking	2006	Change 1995-2006	Ranking
Italy	43	5.2	2	34.4	6.8	7	17.2	-0.2	25
EA-15	39	0.8		31.9	6.8		19.4	0	
EU-27	36.7	-0.2		33.3	7.5		19.9	-0.1	

Note: Averages for EA 15 and EU27 are GDP-weighted.
Source: European Commission (2008b)

Finally, despite the 1997 increase in the VAT rate from 19% to 20% and the abolition of the 16% intermediate rate, the implicit tax rate on consumption, at around 17% in 2006, is the second-lowest in the euro area after Spain. Indeed, Italy scores very poorly with respect to a measure of "VAT reduced rate and base indicator" developed by the European Commission, indicating an erosion of the tax base either by exemption or reduced rates, poor compliance and/or poor tax administration.[11] A major explanation for Italy's poor performance with respect to this measure lies in the extensive application of reduced rates to widely consumed goods and services such as food, transport, books and periodicals, pharmaceuticals, public facilities, hotel and restaurant services and residential housing.[12] Tax evasion and avoidance certainly also play a big role. In 2003/2004, the non-declared tax base was estimated to account for more than 30% of the total theoretical tax base and the evaded/avoided VAT was estimated at more than 3% of GDP[13].

5. TAXATION OF LABOUR IN ITALY

The labour tax wedge

The implicit tax rate on labour is a summary measure approximating the ex-post *average* effective tax burden on labour income in the economy. As such, it can hide important variation in effective tax rates across different household types or at different wage levels. At the micro level, a useful alternative measure of the tax burden on labour is the tax wedge, i.e., the difference between the cost of employing someone and the disposable income from work. In Figure 5, the tax wedge is measured with respect to the earnings of a single person without children at the average wage (AW) in 2007. Also on account of this measure, Italy remains in the higher group regarding taxation of labour, even though its position in the ranking is a bit more favourable (within the euro area, it comes fifth after Belgium, Germany, France and

[11] The indicator is calculated as the difference between the standard VAT rate and the VAT component of the ITR on consumption. It aims at giving a snapshot of the extent to which a given VAT system approximates a "pure" consumption tax, characterised by a flat rate and the widest possible tax base (i.e. the entire value of private consumption without exemptions). The higher the value of the indicator, the higher the share of private consumption that is spared from taxation at the standard rate. Italy scores the highest value of the indicator among EU-27 countries. See European Commission (2008), *Taxation Trends in the European Union (op. cit.).*

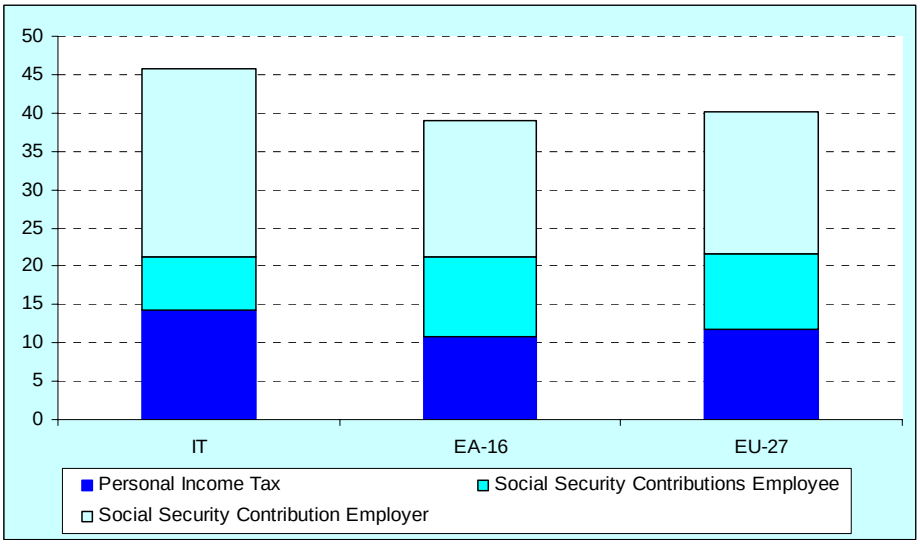
[12] The favourable treatment of housing is likely to have a significant impact on revenues. However, housing taxation should probably be rather attributed to capital stock taxes.

[13] Marigliani, M. and S. Pisani (2007), *Le Basi Imponibili IVA. Aspetti generali e principali risultati per il periodo 1980-2004*, No 7, Documenti di lavoro dell'Ufficio Studi, Agenzia delle Entrate, Ministero dell'Economia e delle Finanze.

Austria). However, unlike the ITR on labour, this measure does not include the part of IRAP that falls on labour.[14] CNEL (2008) estimates that the inclusion of IRAP would increase the tax wedge by as much as 3 percentage points, to around the same level as in Austria.[15]

Figure 5: The tax wedge on labour for the average wage worker and its components

Single person without children, 100% of AW



Note: Unweighted arithmetic averages for EA-16 and EU-27

Source: OECD, Taxing wages report

Econometric analysis by the OECD (2006)[16] confirms that a high tax wedge is an important determinant of aggregate employment rates. Various government actions intended to reduce it prove that this problem is well recognised. As general cuts in social contribution rates are expensive and would risk undermining the contributory principle of the reformed pension system, the Italian government has generally favoured targeted rate reductions in favour of groups with particular labour market problems – namely, workers in disadvantaged regions, women or young workers. The latest such reductions were introduced with the 2007 and 2008 budget laws, which stipulated reductions in the tax wedge by allowing part of the labour cost borne by employers to be deducted from the tax base of IRAP. The deductions were targeted to the workforce on permanent contracts, personnel involved in R&D and apprentices, and were higher for women, low-skilled workers and firms located in the South. Given the variation in the amount of these deductions (and the fact that they cannot be used in cases where other tax credit schemes are already in use), it is difficult to estimate the impact of this provision on the measured tax wedge. The Bank of Italy estimates that between 1999 and 2007, the proportion of the tax wedge (including the IRAP base) borne by employers was reduced by between 2.4 and 2.8 percentage points of total labour cost, depending on the regional location and other characteristics of the productive activity. In 2007 alone the reduction of the tax wedge ranged between 0.3 and 0.7 percentage points of the total labour

[14] See Footnote 7. Although not actually levied on wages and salaries as such, the fact that the tax base of IRAP is calculated as the difference between the value of production and production inputs *excluding* personnel costs and interest costs means that IRAP falls on both labour and capital. It is therefore allocated to the ITR on labour and capital, but since it is an indirect tax is not included in the calculations of the tax wedge.

[15] Consiglio Nazionale dell'Economia e del Lavoro - CNEL (2008), Rapporto sul Mercato del Lavoro 2007, Rome.

[16] OECD (2006), *Employment Outlook*, Paris

cost for a single worker without family dependants, depending on the city of residence. However, also due to the delayed take up by employers of this tax wedge reduction scheme, it is not yet possible to measure its total impact on the labour market.

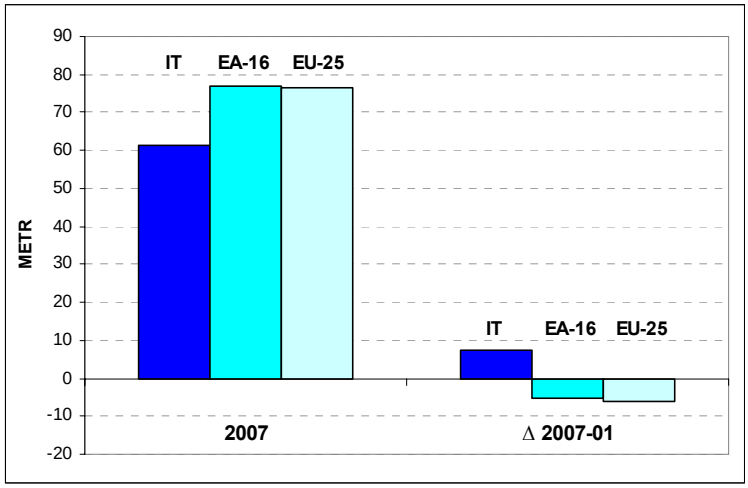
By the same 2007 Budget Law, a smaller share of the reduction of the tax wedge charged to workers was operated via a re-modulation of the personal income tax and a new bracket structure for family cash transfers, benefitting workers with family dependants, for whom income tax cuts more than offset the impact of the fiscal drag. With a spouse and two dependent children, the reduction amounted to between 1.2 and 2 points, depending on the city of residence (considering only regional capitals). In terms of total revenue, in the official estimates the reduction was largely compensated for by increases in contributions to be paid in respect of non-regular employment and the self-employed, for whom social insurance coverage is rather limited, and in the regional and local surcharge tax.

Financial incentives to work: marginal effective tax rates

The interaction of the tax and benefit systems can create financial disincentives to work for certain groups, affecting labour force participation, hours worked and employment. One method commonly used for monitoring the potential impact of tax and benefit policies on labour supply is the computation and comparison of tax burdens and benefit entitlements for a number of typical households moving from one labour market situation to another. This is the approach followed in the calculation of Marginal Effective Tax Rates (METRs), measuring the effective tax rate implied by a given labour market change.

Figure 6: The unemployment trap - 2007 and changes 2001-2007

One-earner household with 2 children, 67% of AW level



Note: Unweighted arithmetic averages for EA-16 and EU-27

Source: Joint European Commission-OECD project, using OECD Tax-Benefits models.

In Italy, while the overall level of taxation on labour is quite high, changes in the combination of tax and benefits associated with the transition from unemployment to work do not create a major unemployment trap (Figure 6).[17] If any, the trap is relevant only for a limited amount of

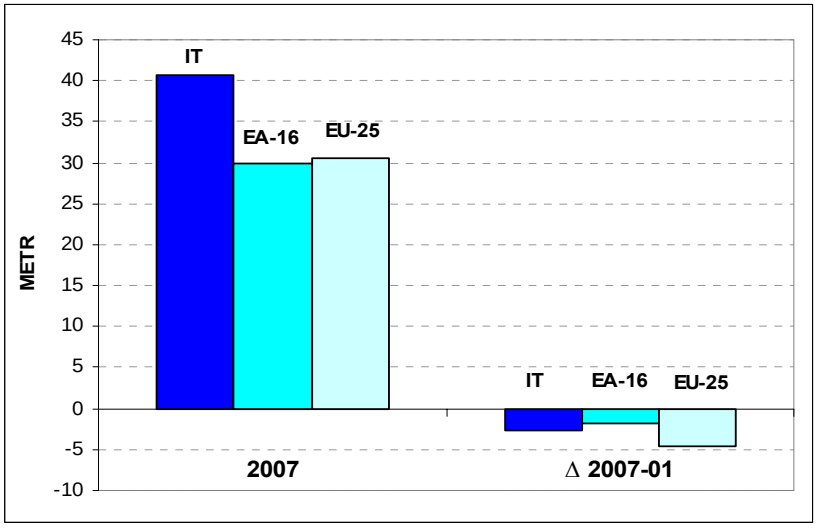
[17] See also Sestito (2005), *Indicators and policies to make work pay: an Italian perspective*, European Economy, Special Report No. 2.

time, as the ordinary unemployment benefit has rather stringent time limits. The increase in the METRs facing unemployed workers between 2001 and 2007 should be seen in the light of the very low level of coverage of unemployment benefits at the beginning of this decade.

However, labour supply disincentives are not completely irrelevant in Italy. The Italian unemployment benefit system is a complex one, with a variety of different schemes applying different eligibility conditions, amount and duration of treatments. The unemployment trap indicator displayed in Figure 6 relates to the ordinary unemployment benefit, which is much less generous than other existing schemes.[18] Looking ahead, as part of a necessary transition from a security-on-the-job regime to employment security within a flexicurity framework, as also underlined in a "Green paper on the future of welfare"[19] published in July 2008 by the Ministry of Labour, there is increasing pressure to extend (and harmonise) unemployment benefits and the social safety net. In this context, Italy will need to pay particular attention to the design of such benefits in order to limit their budgetary cost and the employment disincentive effects associated with a more generous welfare system, while ensuring appropriate activation and retraining policies.

Figure 7: The inactivity trap - 2007 and changes 2001-2007

2-earners household with 2 children; 67% of APW



Note: Unweighted arithmetic averages for EA-16 and EU-27

Source: Joint European Commission-OECD project, using OECD Tax-Benefits models

The Italian tax and benefit system appears more problematic with respect to a potential secondary earner in a household where a principal earner is already present. Although the tax system is not based upon the household, there are tax rebates for dependent persons in the households. The latter are defined as individuals lacking a large enough income and therefore include not only children but also a non-working spouse. It follows that second earners are effectively taxed more heavily than single earners. Thus, paid work for a secondary earner is

[18] Workers on permanent contracts in specific – mainly manufacturing – sectors incurring an involuntary and temporary reduction of hours worked can access CIG (*Cassa Integrazione Guadagni*) payments, financed by specific contributions. In case of industry- or firm-specific crisis, the government can grant laid-off workers access to the CIGS (or extraordinary CIG) for up to 2 years; CIGS is mainly funded through general tax revenues.

[19] Available in Italian on the website: http://www.lavoro.gov.it/NR/rdonlyres/B8453482-9DD3-474E-BA13-08D248430849/0/liboroverdeDEF25luglio.pdf

often unattractive, especially for potential low-wage earners in the presence of young children or elderly dependants to be cared of (Figure 7).

The combination of such a system with the lack of affordable and good-quality care services most likely contributed to depressing female labour market participation in Italy, thus helping to explain why Italy has low female employment rates in couples. In this context, redesigning the tax system in order to strengthen the support to working mothers, and at the same time fostering the development of affordable and high-quality care services, would clearly contribute to addressing the low female participation in Italy. This issue is receiving some attention, at least in the academic debate. For example, starting from the assumption that women have a more elastic labour supply than men, Alesina *et al.* (2007)[20] argue that women's labour income should be taxed less to achieve optimal taxation and change the allocation of family chores so as to allow women to work more in the market. The resulting increase in female labour supply and employment would eventually make up for the revenue loss generated by the scheme. Apparently simple, the implementation of such a proposal would pose some difficult issues, primarily related to its underlying assumption on the elasticity of women's labour supply: is the elasticity of labour supply of single women comparable to that of married women with children? In other words, should gender-based taxation be applied only to married women or singles as well? More fundamentally, it could be argued that gender-based taxation violates the principle of equality of treatment and could end up stigmatising the role of women in the labour market.[21] An alternative proposal, also discussed by Boeri and Del Boca (2007), concerns the introduction of a tax credit for couples with dependants, conditional upon both spouses working and requiring proof of payment of the sustained care costs. Clearly, this proposal would pose fewer implementation problems, but would come at the cost of complicating further the tax code.

Finally, as regards financial disincentives to increase work effort by people who are already in work (i.e. the low-wage trap), they do not seem to be a particular issue in Italy, also due to the absence of in-work benefits. The government has recently approved some fiscal measures aimed at enhancing labour productivity that may increase incentives to increase hours worked. The Protocol agreement signed by the social partners and the government in July 2007 intended to promote decentralised bargaining by making wage increases stemming from the second tier of collective bargaining accountable for accruing pension rights, while at the same time reducing social contributions on these wage increases to be paid by both employers and employees. The protocol also scrapped the social contribution supplement on overtime work, which was established in 1997 with the purpose of discouraging the use of overtime work. The introduction, on 1 July 2008, of the 10% flat rate withholding tax on overtime and performance-related pay is a further step. This measure was adopted on an experimental basis for the second half of 2008. It was later confirmed with the recovery package adopted on 28 November, for performance-related pay only, for the entire 2009. Overall, this measure has the effect of lowering further the low-wage trap. The provisions aimed at promoting decentralised bargaining have the potential to create a more favourable framework for the competitiveness of the Italian economy, by encouraging productivity growth and allowing a better alignment of wage and productivity developments.

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[20] Alesina, A., Ichino, A. and L. Karabarbounis (2007), Gender Based Taxation and the Division of Family Chores, Discussion Paper No. 6591, Centre for Economic Policy Research, London.

[21] For a critique of the proposal in Alesina *et al* (2007), see Gilles Saint-Paul (2007), Against 'Gender-based Taxation', CEPR Discussion Paper No. 6582, December, London.

6. CONCLUSIONS

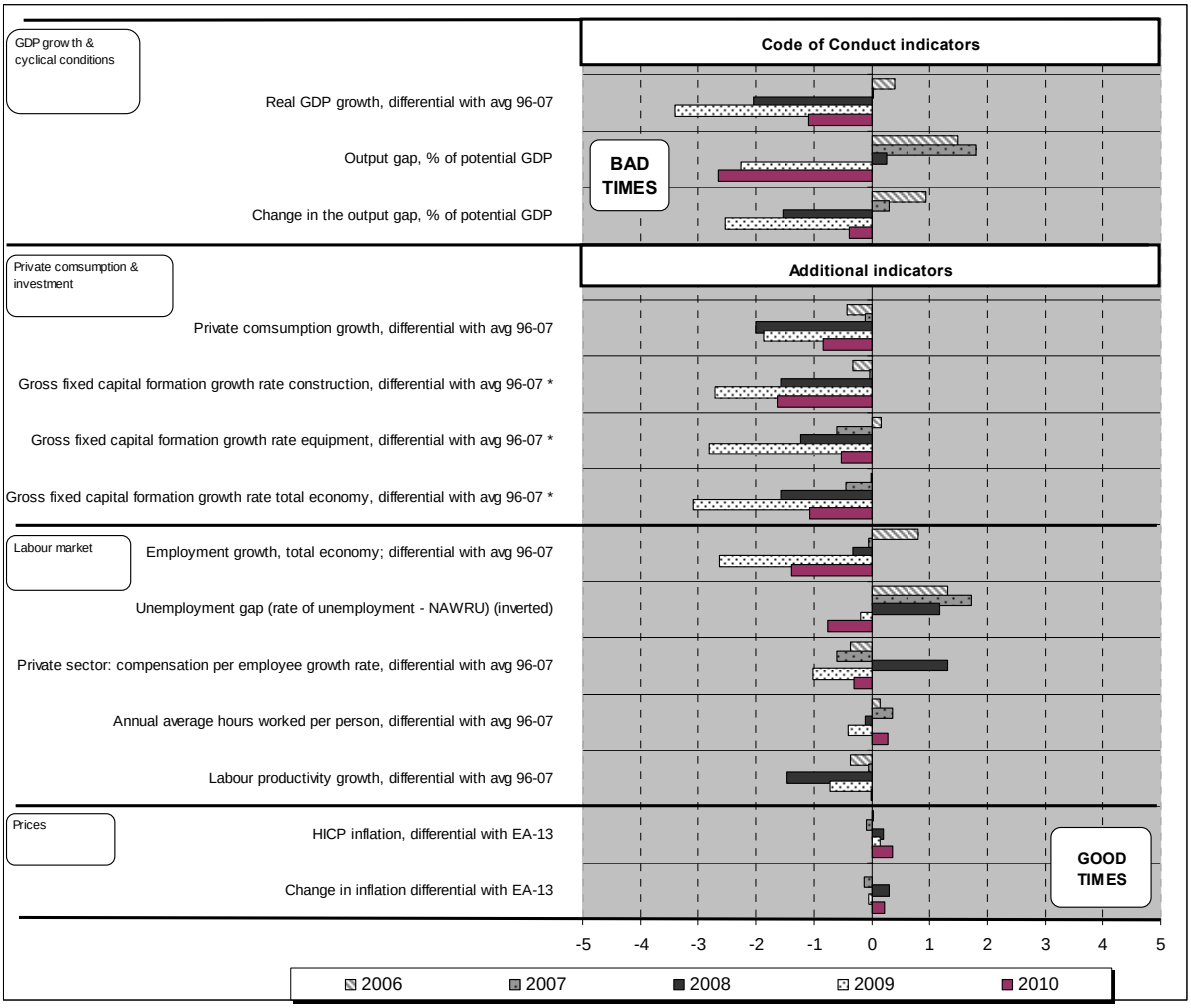
Italy's relatively high taxation of labour has certainly contributed to its overall unsatisfactory employment and labour market participation performance. Given the need to reduce the high government debt ratio, a reduction in the overall tax burden is not possible in the short to medium term. Still, there may be scope for a revenue-neutral and efficiency-enhancing tax reform. Research has shown that shifting the tax burden from labour to consumption and/or immovable property can allow governments to achieve a long-term improvement of the structural conditions for increasing employment and growth. Looking at the structure and operation of the Italian taxation system, there appears to be some scope for such reforms. In particular, the low implicit taxation rate on consumption in Italy suggests that part of the tax burden could be shifted onto this economic function. Priority should be given to increasing the efficiency of VAT collection by further fighting tax evasion / avoidance on this specific levy, which would help achieve this goal without increasing tax rates. More in general, effective action to fight tax evasion/avoidance would allow reducing the tax burden at the level of individuals. Progress achieved so far in this area, in parallel with action to fight undeclared work, should be pursued. As for taxation of immovable property, the recent complete abolition of the residential property tax on primary dwellings goes against the above-mentioned efficiency principles and makes urgent a comprehensive review of property taxation, in particular in the context of the forthcoming fiscal federalism.

As raising employment rates should be a policy priority in Italy, it is also important to look at the role of taxation in encouraging labour supply. Although Italy is free from many of the welfare benefit traps besetting other European countries, as the unemployed and working age people with low earnings potential are entitled to a relatively narrow social safety net, the analysis in this Annex provides an explanation of why the combination of tax and benefit policies may be important in this respect also in Italy. First, in a possible move towards restructuring the unemployment benefit system, more in line with the flexicurity approach, attention will need to be paid to the design of the new benefits so as to avoid creating unemployment traps. Second, tax deductions for dependent spouses create inactivity traps at low incomes that discourage participation of women, in particular of low-skilled ones. This may have reinforced or at least supported the tradition of women staying at home to care for children and ageing parents, which in turn has certainly had a role in the underdevelopment of affordable and quality care facilities. A policy challenge in this area is therefore to “make work pay”, particularly among the low skilled and women in couples where a principal earner is already in the labour market.

Finally, to address the strong regional disparities in the labour market, improving the conditions for labour cost adjustment could help. Reducing further the tax wedge for low-skilled labour, in particular social contributions, could have some positive effects on labour demand. In addition, enhancing wage adjustment at the firm level would allow a better alignment of wage and productivity developments.

ANNEX 2. ADDITIONAL TABLES AND FIGURES

Figure 1: Good and bad economic times



* These variables have been divided by their standard deviation over the period 2003-2010, with a view to reducing their variability relative to other variables in the graph.

Source: Commission services' January 2009 interim forecast

Table 1: Budgetary implementation in 2008

	2007		2008	
	Planned SP Nov 2007	**Outcome COM**	**Planned SP Nov 2007**	**Outcome COM**
Government balance (% of GDP)	-2.4	-1.6	-2.2	-2.8
Difference compared to target	**0.8**		**-0.6**	
Of which : due to a different starting position end 2007			0.8	
due to different revenue / expenditure growth in 2008			-1.3	
p.m. Denominator effect and residual [2,3]			-0.1	
p.m. Nominal GDP growth (planned and outcome)			4.0	2.4
Revenue (% of GDP)	46.2	46.6	46.3	46.4
Revenue surprise compared to target [1]	**0.4**		**0.1**	
Of which : due to a different starting position end 2007			0.4	
due to different revenue growth in 2008			-1.0	
p.m. Denominator effect [2]			0.7	
p.m. Residual [3]			0.0	
p.m. Revenue growth rate (planned and outcome)			4.0	1.8
Expenditure (% of GDP)	48.6	48.2	48.5	49.2
Expenditure surprise compared to target [1]	**0.4**		**-0.7**	
Of which : due to different starting position end 2007			0.4	
due to different expenditure growth rate in 2008			-0.33	
p.m. Denominator effect [2]			-0.7	
p.m. Residual [3]			0.0	
p.m. Expenditure growth rate (planned and outcome)			3.7	4.4

Notes:

[1] A positive number implies that the outcome was better (in terms of government balance) than planned.

[2] The denominator effect captures the mechanical effect that, if GDP turns out higher than planned, the ratio of revenue or expenditure to GDP will fall because of a higher denominator. Although the denominator effect can be very significant for revenue and expenditure separately, on the balance they usually largely cancel against each other.

[3] The decomposition leaves a small residual that cannot be assigned to the previous components. The residual is generally small, except in some cases where planned and actual growth rates of revenue, expenditure and GDP differ significantly.

Source : Commission services

Table 2: Evolution of budgetary targets in successive programmes

		2007	2008	2009	2010	2011
General government balance (% of GDP)	**SP Feb 2009**	**-1.6**	**-2.6**	**-3.7**	**-3.3**	**-2.9**
	SP Nov 2007	*-2.4*	*-2.2*	*-1.5*	*-0.7*	*0.0*
	COM Jan 2009	-1.6	-2.8	-3.8	-3.7	n.a.
General government expenditure (% of GDP)	**SP Feb 2009**	**48.2**	**49.0**	**50.5**	**50.0**	**49.5**
	SP Nov 2007	*48.6*	*48.5*	*47.9*	*47.3*	*47.0*
	COM Jan 2009	48.2	49.2	50.3	50.2	n.a.
General government revenue (% of GDP)	**SP Feb 2009**	**46.6**	**46.4**	**46.8**	**46.8**	**46.6**
	SP Nov 2007	*46.2*	*46.3*	*45.9*	*45.8*	*45.7*
	COM Jan 2009	46.6	46.4	46.5	46.5	n.a.
Structural balance[1] (% of GDP)	**SP Feb 2009**	**-2.5**	**-2.9**	**-2.7**	**-2.0**	**-1.7**
	SP Nov 2007	*-2.2*	*-2.0*	*-1.3*	*-0.5*	*0.2*
	COM Jan 2009	-2.6	-3.1	-2.8	-2.5	n.a.
Real GDP (% change)	**SP Feb 2009**	**1.5**	**-0.6**	**-2.0**	**0.3**	**1.0**
	SP Nov 2007	*1.9*	*1.5*	*1.6*	*1.7*	*1.8*
	COM Jan 2009	1.5	-0.6	-2.0	0.3	n.a.

Note:

[1]Cyclically-adjusted balance excluding one-off and other temporary measures. Cyclically-adjusted balances according to the programmes as recalculated by the Commission services on the basis of the information in the programmes. One-off and other temporary measures are 0.1% of GDP in 2007, 0.2% in 2008 and 0.1% 2009-2011; all deficit-reducing according to the most recent programme and in the Commission services' January interim forecast.

Source :
Stability programmes (SP); Commission services' January 2009 interim forecasts (COM)

Table 3: Assessment of tax projections

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

Notes:

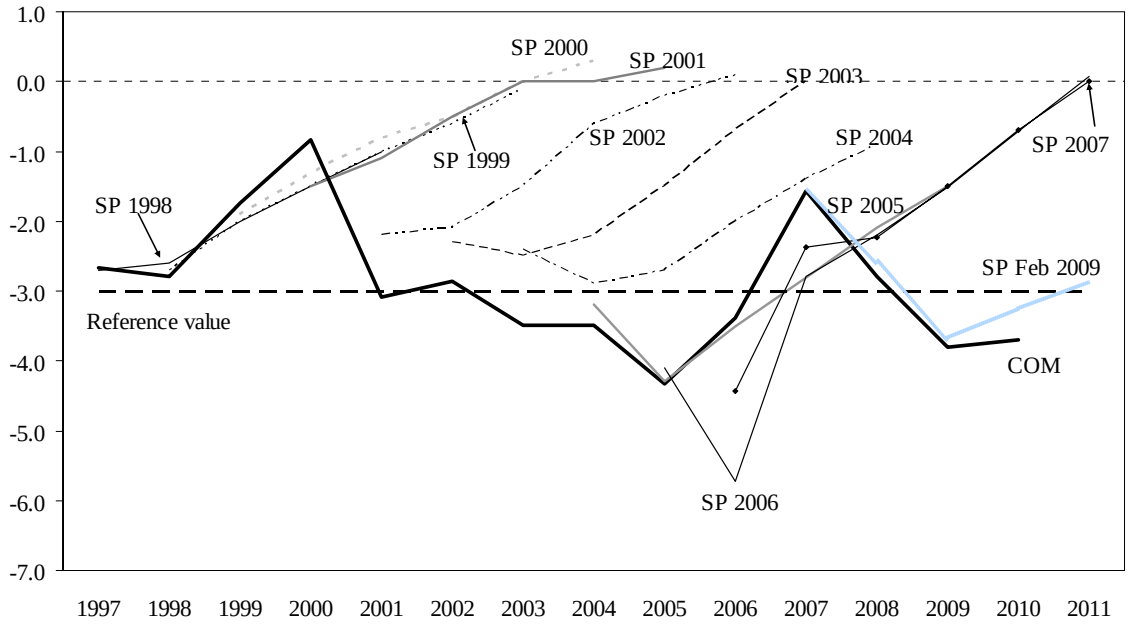
[1]On a no-policy change basis.

[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.

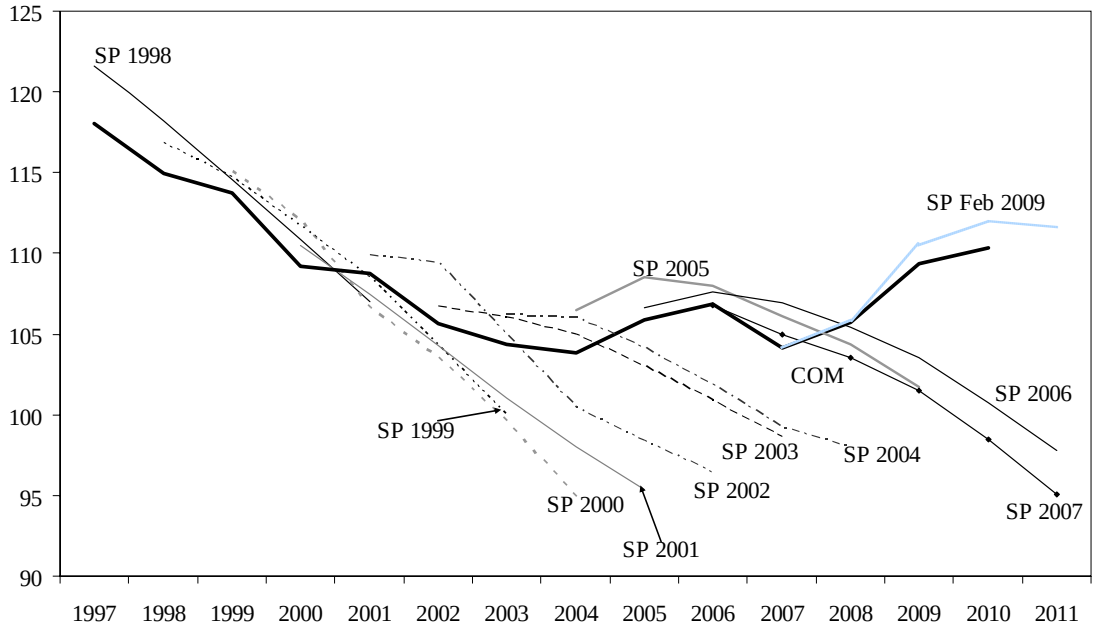
Source:
Commission services' January 2009 interim forecasts (COM); Stability programme (SP); Commission services' calculations; OECD (N. Girouard and C. André (2005), "Measuring Cyclically-Adjusted Budget Balances for the OECD Countries", OECD Working Paper No. 434).

Figure 2: Government balance projections in successive programmes (% of GDP)



Source: Commission services' January 2009 interim forecast (COM) and successive stability programmes

Figure 3: Debt projections in successive programmes (% of GDP)



Source: Commission services' January 2009 interim forecast (COM) and successive stability programmes

Table 4: Long-term age-related expenditure: main projections

(% of GDP)	2004	2010	2020	2030	2040	2050	Change 2010- 50
Total age-related spending	**26.2**	**25.7**	**25.9**	**27.3**	**28.7**	**28.0**	**2.3**
- Pensions	14.2	14.0	14.0	15.0	15.9	14.7	0.7
- Healthcare	5.8	6.0	6.3	6.7	7.0	7.1	1.1
- 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	-0.2
- 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**

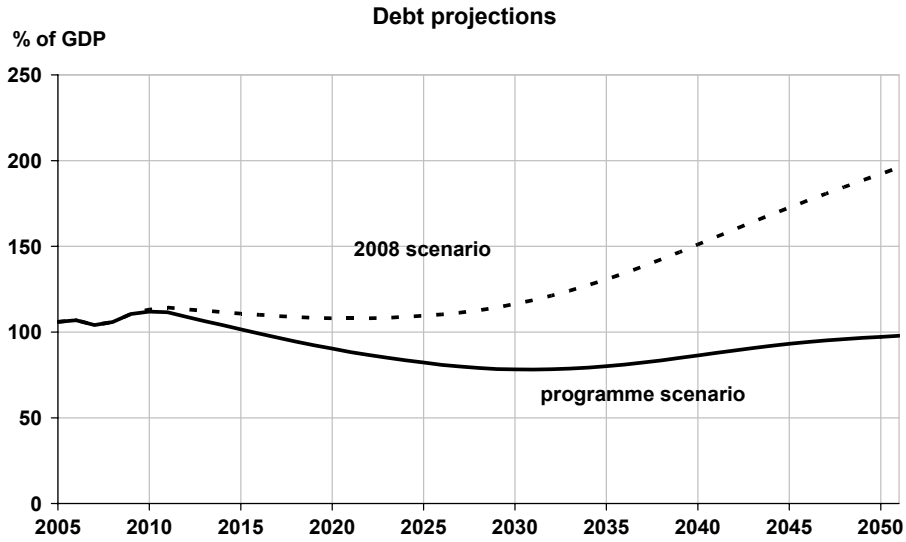
Source: Economic Policy Committee and Commission services.

Table 5: Sustainability indicators and the required primary balance

	2008 scenario			Programme scenario		
	S1	**S2**	**RPB**	**S1**	**S2**	**RPB**
Value	2.3	1.9	4.0	0.6	0.3	4.0
of which:						
Initial budgetary position (IBP)	-0.1	-0.1	-	-1.7	-1.7	-
Debt requirement in 2050 (DR)	0.9	-	-	0.9	-	-
Long-term change in the primary balance (LTC)	1.5	2.0	-	1.5	2.0	-

Source: Commission services.

Figure 4: Long-term projections for the government debt ratio



Note: 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.
Source: Commission services.

Table 6: Additional factors

	Impact on risk
Debt and pension assets	-
Decline in structural balance until 2010 in COM January 2009 interim forecast	+
Significant revenues from pension taxation	na
Alternative projection of cost of ageing	na
Strong decline in benefit ratio	na
High tax burden	na
Non-age related budgetary measures with intertemporal effect	na

Note: '-': factor tends to increase the risk to sustainability, '+': factor tends to decrease the risk to sustainability.
'na': not applicable.
Alternative projections are often presented in the programmes, whose assumptions often diverge from the common method. Projections currently discussed in the Economic Policy Committee but not yet published, are for the time being also considered "unofficial".
An explanation on these factors can be found in chapter IV of: European Commission (2006), The long-term sustainability of public finances in the European Union, European Economy No. 4/2006.
Source: Commission services.

ANNEX 3. COMPLIANCE WITH THE CODE OF CONDUCT AND TABLES FROM THE PROGRAMME

The tables in this Annex show the data presented in the February 2009 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.

The programme provides all compulsory data and most of the optional data.

Table 1a. Macroeconomic prospects

	ESA Code	2007	2007	2008	2009	2010	2011
		Level	rate of change	rate of change	rate of change	rate of change	rate of change
1. Real GDP	B1*g	*1284868*	1.5	-0.6	-2.0	0.3	1.0
2. Nominal GDP	B1*g	*1535540.99*	3.8	2.4	-0.6	2.1	2.9
Components of real GDP							
3. Private consumption expenditure	P.3	*753824*	1.4	-0.5	-0.5	0.6	1.2
4. Government consumption expenditure	P.3	*258539*	1.3	1.1	0.3	0.0	0.0
5. Gross fixed capital formation	P.51	*272005*	1.2	-1.8	-6.8	0.3	1.4
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.
7. Exports of goods and services	P.6	*372081*	5.0	-1.4	-5.0	1.3	3.5
8. Imports of goods and services	P.7	*378003*	4.4	-2.9	-4.3	1.6	3.4
Contributions to real GDP growth							
9. Final domestic demand		-	1.4	-0.6	-1.7	0.4	1.0
10. Changes in inventories and net acquisition of valuables	P.52 + P.53	-	0.0	-0.5	-0.1	0.0	0.0
11. External balance of goods and services	B.11	-	0.1	0.4	-0.2	-0.1	0.0

Table 1b. Price developments

	ESA Code	2007	2007	2008	2009	2010	2011
		Level	rate of change	rate of change	rate of change	rate of change	rate of change
1. GDP deflator		*119.5*	2.3	3.0	1.4	1.7	1.9
2. Private consumption deflator		*119.4*	2.2	3.6	1.2	1.8	1.9
3. HICP[1]		*104.3*	2.0	3.5	1.2	1.7	2.0
4. Public consumption deflator		*119.9*	0.4	4.2	0.9	1.0	0.9
5. Investment deflator		*118.9*	2.6	2.7	0.3	1.6	1.9
6. Export price deflator (goods and services)		*120.5*	3.6	4.8	1.4	2.0	2.1
7. Import price deflator (goods and services)		*119.8*	2.3	6.1	-0.4	1.5	1.7

[1] Optional for stability programmes.

Table 1c. Labour market developments

	ESA Code	2007	2007	2008	2009	2010	2011
		Level	rate of change	rate of change	rate of change	rate of change	rate of change
1. Employment, persons[1]		*25165*	1.1	0.5	-1.0	0.2	0.5
2. Employment, hours worked[2]		*45892027*	1.7	1.0	-0.7	0.1	0.0
3. Unemployment rate (%)[3]		-	6.1	6.9	8.2	8.4	8.2
4. Labour productivity, persons[4]		*51058*	0.3	-1.0	-1.1	0.2	0.5
5. Labour productivity, hours worked[5]		*28*	-0.2	-1.5	-1.3	0.3	1.0
6. Compensation of employees	D.1	*630440*	3.5	5.6	1.2	2.1	2.6
7. Compensation per employee		*35131*	1.9	4.3	1.5	1.9	2.0

[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	2007	2008	2009	2010	2011
1. Net lending/borrowing vis-à-vis the rest of the world	B.9	-1.6	-1.6	-1.3	-1.1	-0.9
of which :						
- Balance on goods and services		-0.3	-0.2	0.1	0.1	0.3
- Balance of primary incomes and transfers		-1.4	-1.5	-1.5	-1.4	-1.3
- Capital account		0.2	0.2	0.1	0.1	0.1
2. Net lending/borrowing of the private sector	B.9	0.0	1.0	2.4	2.1	2.0
3. Net lending/borrowing of general government	EDP B.9	-1.5	-2.6	-3.7	-3.3	-2.9
4. Statistical discrepancy		-	optional	optional	optional	optional

Table 2. General government budgetary prospects

	ESA Code	2007	2007	2008	2009	2010	2011
		Level	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP
Net lending (EDP B.9) by sub-sector							
1. General government	S.13	*-24094*	-1.6	-2.6	-3.7	-3.3	-2.9
2. Central government	S.1311	*-37656*	-2.5	-2.3	-3.3	-3.1	-2.8
3. State government	S.1312	*-36646*	-2.4	-2.3	-3.2	-3.1	-2.7
4. Local government	S.1313	*3585*	0.2	-0.8	-0.8	-0.6	-0.5
5. Social security funds	S.1314	*9977*	0.6	0.5	0.4	0.5	0.4
General government (S13)							
6. Total revenue	TR	*716234*	46.6	46.4	46.8	46.8	46.6
7. Total expenditure	TE[1]	*740328*	48.2	49.0	50.5	50.0	49.5
8. Net lending/borrowing	EDP B.9	*-24094*	-1.6	-2.6	-3.7	-3.3	-2.9
9. Interest expenditure	EDP D.41	*76580*	5.0	5.1	5.0	5.2	5.4
10. Primary balance[2]		*52486*	3.4	2.5	1.3	1.9	2.6
11. One-off and other temporary measures[3]		*1879*	0.1	0.2	0.1	0.1	0.1
Selected components of revenue							
12. Total taxes (12=12a+12b+12c)		*459888*	29.9	29.2	29.2	29.2	29.1
12a. Taxes on production and imports	D.2	*225928*	14.7	13.8	13.7	13.7	13.5
12b. Current taxes on income, wealth, etc	D.5	*233660*	15.2	15.4	15.5	15.4	15.5
12c. Capital taxes	D.91	*300*	0.0	0.0	0.0	0.0	0.0
13. Social contributions	D.61	*204772*	13.3	13.8	14.2	14.1	14.1
14. Property income	D.4	*9321*	0.6	0.6	0.6	0.6	0.6
15. Other [4]		*42253*	2.8	2.8	2.9	2.8	2.8
16=6. Total revenue	TR	*716234*	46.6	46.4	46.8	46.8	46.6
p.m.: Tax burden (D.2+D.5+D.61+D.91-D.995)[5]			43.3	43.0	43.3	43.3	43.2
Selected components of expenditure							
17. Compensation of employees + intermediate consumption	D.1+P.2	*244383*	15.9	16.4	16.6	16.4	16.0
17a. Compensation of employees	D.1	*164645*	10.7	11.0	11.3	11.2	11.0
17b. Intermediate consumption	P.2	*79738*	5.2	5.4	5.3	5.2	5.0
18. Social payments (18=18a+18b)		*307006*	20.0	20.5	21.5	21.5	21.6
18a. Social transfers in kind supplied via market producers	D.6311, D.63121, D.63131	*41722*	2.7	2.8	2.9	2.9	2.9
18b. Social transfers other than in kind	D.62	*265284*	17.3	17.7	18.6	18.6	18.7
19=9. Interest expenditure	EDP D.41	*76580*	5.0	5.1	5.0	5.2	5.4
20. Subsidies	D.3	*14198*	0.9	0.8	0.9	0.9	0.8
21. Gross fixed capital formation	P.51	*36134*	2.4	2.3	2.4	2.2	2.1
22. Other[6]		*62027*	4.0	3.9	4.1	3.9	3.5
23=7. Total expenditure	TE[1]	*740328*	48.2	49.0	50.5	50.0	49.5
p.m.: Government consumption (nominal)	P.3	*303950*	19.8	20.4	20.8	20.5	20.1

[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.

Table 3. General government expenditure by function

% of GDP	COFOG Code	2006	2011
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	2007	2008	2009	2010	2011
1. Gross debt[1]		104.1	105.9	110.5	112.0	111.6
2. Change in gross debt ratio		-2.8	1.8	4.6	1.5	-0.4
Contributions to changes in gross debt						
3. Primary balance[2]		-3.4	-2.5	-1.3	-1.9	-2.6
4. Interest expenditure[3]	EDP D.41	5.0	5.1	5.0	5.2	5.4
5. Stock-flow adjustment		-0.5	1.7	0.3	0.5	-0.1
of which:						
- Differences between cash and accruals[4]		0.0	0.1	-0.5	n.a.	n.a.
- Net accumulation of financial assets[5]		0.4	0.6	0.4	n.a.	n.a.
of which:						
- privatisation proceeds		-	-	-	-	-
- Valuation effects and other[6]		-0.9	0.9	0.4	n.a.	n.a.
p.m.: Implicit interest rate on debt[7]		4.8	5.0	4.7	4.8	5.0
Other relevant variables						
6. Liquid financial assets[8]		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.

[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	2007	2008	2009	2010	2011
1. Real GDP growth (%)		1.5	-0.6	-2.0	0.3	1.0
2. Net lending of general government	EDP B.9	-1.6	-2.6	-3.7	-3.3	-2.9
3. Interest expenditure	EDP D.41	5.0	5.1	5.0	5.2	5.4
4. One-off and other temporary measures[1]		0.1	0.2	0.1	0.1	0.1
5. Potential GDP growth (%)		1.1	0.8	0.6	0.7	0.7
contributions:						
- labour		0.9	0.6	0.5	0.5	0.3
- capital		0.6	0.5	0.3	0.3	0.3
- total factor productivity		-0.3	-0.3	-0.2	-0.1	0.0
6. Output gap		1.6	0.3	-2.3	-2.7	-2.4
7. Cyclical budgetary component		0.8	0.1	-1.2	-1.3	-1.2
8. Cyclically-adjusted balance (2 - 7)		-2.4	-2.7	-2.5	-1.9	-1.7
9. Cyclically-adjusted primary balance (8 + 3)		2.6	2.4	2.4	3.2	3.7
10. Structural balance (8 - 4)		-2.5	-2.9	-2.6	-2.0	-1.7

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

Table 6. Divergence from previous update

	ESA Code	2007	2008	2009	2010	2011
Real GDP growth (%)						
Previous update		1.9	1.5	1.6	1.7	1.8
Current update		1.5	-0.6	-2.0	0.3	1.0
Difference		-0.4	-2.1	-3.6	-1.4	-0.8
General government net lending (% of GDP)	EDP B.9					
Previous update		-2.4	-2.2	-1.5	-0.7	0.0
Current update		-1.6	-2.6	-3.7	-3.3	-2.9
Difference		0.8	-0.4	-2.2	-2.6	-2.9
General government gross debt (% of GDP)						
Previous update		105.0	103.5	101.5	98.5	95.1
Current update		104.1	105.9	110.5	112.0	111.6
Difference		-0.9	2.4	9.0	13.5	16.5

Table 7. Long-term sustainability of public finances[1]

% of GDP	2005	2010	2020	2030	2040	2050	2060
Total expenditure	48.2	50.0	47.9	47.6	48.5	48.2	46.9
Of which: age-related expenditures	26.1	27.1	26.8	27.7	29.1	29.0	28.2
Pension expenditure	14.0	14.7	14.3	14.9	15.6	14.7	13.6
Social security pension	-	-	-	-	-	-	
Old-age and early pensions	13.4	14.2	13.8	14.5	15.3	14.4	13.3
Other pensions (disability, survivors)	0.6	0.5	0.5	0.4	0.3	0.3	0.3
Occupational pensions (if in general government)	-	-	-	-	-	-	
Health care	6.7	7.1	7.4	7.8	8.3	8.6	8.7
Long-term care *(this was earlier included in the health care)*	0.8	0.9	1.0	1.1	1.2	1.5	1.6
Education expenditure	4.2	4.0	3.7	3.5	3.6	3.8	3.8
Other age-related expenditures (Unemployment benefits)	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Interest expenditure	4.5	5.2	4.3	3.1	2.6	2.4	1.9
Total revenue	43.8	46.8	46.2	46.2	46.2	46.1	46.1
Of which: property income	0.6	0.6	0.5	0.5	0.5	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.	n.a.
Pension reserve fund assets	n.a.	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.	n.a.
Assumptions							
Labour productivity growth	0.4	0.6	1.6	1.7	1.7	1.7	1.7
Real GDP growth	0.6	1.5	1.9	1.3	1.0	1.3	1.4
Participation rate males (aged 20-64)	79.2	80.4	82.0	83.1	83.4	83.7	83.5
Participation rates females (aged 20-64)	53.6	55.8	59.9	60.8	60.8	61.1	61.0
Total participation rates (aged 20-64)	66.4	68.1	71.0	72.1	72.3	72.7	72.5
Unemployment rate	7.7	7.8	5.7	5.6	5.6	5.6	5.6
Population aged 65+ over total population	19.5	20.3	22.7	26.2	30.8	32.6	32.7

[1]The years presented in the programme are more than those required.

Table 8. Basic assumptions

	2007	2008	2009	2010	2011
Short-term interest rate[1] (annual average)	4.0	3.5	1.9	3.2	4.1
Long-term interest rate (annual average)	4.4	4.8	4.8	5.2	5.6
USD/€ exchange rate (annual average) (euro area and ERM II countries)	1.37	1.47	1.38	1.38	1.38
Nominal effective exchange rate	3.9	4.6	0.3	0.0	0.0
(for countries not in euro area or ERM II) exchange rate vis-à-vis the € (annual average)	-	-	-	-	-
World excluding EU, GDP growth	5.4	3.7	0.6	3.2	4.4
EU GDP growth	2.9	1.0	-1.8	0.5	2.5
Growth of relevant foreign markets	4.6	2.7	0.6	3.3	5.4
World import volumes, excluding EU	8.2	5.1	-1.8	4.2	6.3
Oil prices (Brent, USD/barrel)	72.5	98.5	52.1	61.7	61.7

[1]If necessary, purely technical assumptions.

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