EUROPEAN COMMISSION
DIRECTORATE GENERAL
ECONOMIC AND FINANCIAL AFFAIRS

Brussels, 31 March 2010
ECFIN/F1/Ares(2010)171751

ITALY: MACRO FISCAL ASSESSMENT

AN ANALYSIS OF THE JANUARY 2010 UPDATE OF THE STABILITY PROGRAMME

The Stability and Growth Pact requires each EU Member State to present an annual update of its medium-term fiscal programme, called 'stability programme' for countries that have adopted the euro as their currency and 'convergence programme' for those that have not. The most recent update of Italy's stability programme was submitted on 28 January 2010.

The attached technical analysis of the programme prepared by the staff and under the responsibility of the Directorate-General for Economic and Financial Affairs (DG ECFIN) of the European Commission was finalised on 17 March 2010. Comments should be sent to Paolo Battaglia, Marco Montanari 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' autumn 2009 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 10 November 2009) and (iii) the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances.

Based on this analysis, the European Commission adopted a recommendation for a Council opinion on the programme on 17 March 2010. The ECOFIN Council is expected to discuss the opinion on the programme on 16 April 2010.

* * *

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/sgp/index_en.htm

TABLE OF CONTENTS

1. INTRODUCTION 4
2. KEY CHALLENGES IN THE ECONOMIC DOWNTURN AND THE POLICY RESPONSE 6
3. MACROECONOMIC OUTLOOK 7
4. GENERAL GOVERNMENT BALANCE 9
   - 4.1. Budgetary implementation in 2009 9
   - 4.2. The programme's budgetary strategy for 2010 12
   - 4.3. The programme's medium-term budgetary strategy 13
   - 4.4. Risk assessment 16
5. GOVERNMENT DEBT AND LONG-TERM SUSTAINABILITY 18
   - 5.1. Recent debt developments and medium-term prospects 18
     - 5.1.1. Debt projections in the programme 18
     - 5.1.2. Assessment 20
   - 5.2. Long-term debt projections and the sustainability of public finances 21
     - 5.2.1. Sustainability indicators and long-term debt projections 21
     - 5.2.2. Additional factors 23
     - 5.2.3. Assessment 24
6. FISCAL FRAMEWORK AND QUALITY OF PUBLIC FINANCES 24
   - 6.1. Fiscal framework 24
   - 6.2. Quality of public finances 26
7. OVERALL ASSESSMENT 27

ANNEX. COMPLIANCE WITH THE FORMAT AND CONTENT REQUIREMENTS FOR STABILITY AND CONVERGENCE PROGRAMMES 29

1. INTRODUCTION

This document assesses the January 2010 update of Italy's stability programme, which was submitted in the original language on 28 January 2010[1] and covers the period 2009-2012. The programme is published under the responsibility of the Ministry of Economy and Finance and is presented to Parliament for information only. On 28 January 2010 the government submitted an information note to Parliament highlighting the macroeconomic projections and fiscal targets in the programme. The programme takes into account the measures included in the 2010 budget law adopted by the government in September 2009 and subsequently approved by Parliament in December 2009.

This assessment is structured as follows. Section 2 discusses the key challenges for public finances in Italy. Section 3 assesses the plausibility of the macroeconomic scenario underpinning the public finance projections of the stability programme against the background of the Commission services' economic forecasts[2]. Section 4 analyses budgetary implementation in the year 2009, the budgetary plans for 2010 and the medium-term budgetary strategy. It also assesses risks attached to the budgetary targets. Section 5 reviews recent debt developments and medium-term prospects, as well as the long-term sustainability of public finances. Section 6 discusses institutional features of public finances. Finally, section 7 concludes with an overall assessment of the programme. The annex provides a detailed assessment of compliance with the code of conduct, including an overview of the summary tables from the programme.

[1] The English translation was submitted on 17 February 2010.

[2] This assessment uses the Commission services' autumn 2009 forecast, published on 3 November 2009, as a benchmark. However, more recent information that has become available since then has also been taken into account to assess the risks to the programme scenario.

Table 1. Comparison of key macroeconomic and budgetary projections

		2008	2009	2010	2011	2012
Real GDP (% change)	**SP Jan 2010**	**-1.0**	**-4.8**	**1.1**	**2.0**	**2.0**
	COM Nov 2009	-1.0	-4.7	0.7	1.4	n.a.
	SP Feb 2009	*-0.6*	*-2.0*	*0.3*	*1.0*	*n.a.*
HICP inflation (%)	**SP Jan 2010**	**3.5**	**0.8**	**1.5**	**2.0**	**2.0**
	COM Nov 2009	3.5	0.8	1.8	2.0	n.a.
	SP Feb 2009	*3.5*	*1.2*	*1.7*	*2.0*	*n.a.*
Output gap[1] (% of potential GDP)	**SP Jan 2010**	**1.1**	**-4.0**	**-3.5**	**-2.5**	**-1.6**
	COM Nov 2009[2]	1.3	-3.6	-3.2	-2.5	n.a.
	SP Feb 2009	*0.3*	*-2.3*	*-2.7*	*-2.5*	*n.a.*
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	**SP Jan 2010**	**-2.9**	**-1.8**	**-1.6**	**-1.3**	**-1.3**
	COM Nov 2009	-2.9	-2.3	-2.3	-2.3	n.a.
	SP Feb 2009	*-1.6*	*-1.3*	*-1.1*	*-0.9*	*n.a.*
General government revenue[3] (% of GDP)	**SP Jan 2010**	**46.0**	**46.4**	**45.9**	**45.5**	**45.6**
	COM Nov 2009	46.0	46.3	45.5	45.4	n.a.
	SP Feb 2009	*46.4*	*46.8*	*46.8*	*46.4*	*n.a.*
General government expenditure[3] (% of GDP)	**SP Jan 2010**	**48.8**	**51.7**	**50.9**	**49.9**	**49.5**
	COM Nov 2009	48.8	51.6	50.8	50.5	n.a.
	SP Feb 2009	*49.0*	*50.5*	*50.0*	*49.5*	*n.a.*
General government balance (% of GDP)	**SP Jan 2010**	**-2.7**	**-5.3**	**-5.0**	**-3.9**	**-2.7**
	COM Nov 2009	-2.7	-5.3	-5.3	-5.1	n.a.
	SP Feb 2009	*-2.6*	*-3.7*	*-3.3*	*-2.9*	*n.a.*
Primary balance (% of GDP)	**SP Jan 2010**	**2.4**	**-0.5**	**-0.1**	**1.3**	**2.7**
	COM Nov 2009	2.4	-0.5	-0.6	0.1	n.a.
	SP Feb 2009	*2.5*	*1.3*	*1.9*	*2.6*	*n.a.*
Cyclically-adjusted balance[1] (% of GDP)	**SP Jan 2010**	**-3.3**	**-3.2**	**-3.2**	**-2.7**	**-1.9**
	COM Nov 2009	-3.4	-3.5	-3.7	-3.8	n.a.
	SP Feb 2009	*-2.7*	*-2.6*	*-1.9*	*-1.6*	*n.a.*
Structural balance[4] (% of GDP)	**SP Jan 2010**	**-3.5**	**-3.8**	**-3.3**	**-2.7**	**-1.9**
	COM Nov 2009	-3.6	-3.7	-3.7	-3.7	n.a.
	SP Feb 2009	*-2.9*	*-2.7*	*-2.0*	*-1.7*	*n.a.*
Government gross debt (% of GDP)	**SP Jan 2010**	**105.8**	**115.1**	**116.9**	**116.5**	**114.6**
	COM Nov 2009	105.8	114.6	116.7	117.8	n.a.
	SP Feb 2009	*105.9*	*110.5*	*112.0*	*111.6*	*n.a.*

Notes:

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

[2] Based on estimated potential growth of 0.4%, 0.2%, 0.3% and 0.7% respectively in the period 2008-2011.

[3] Budgetary data provided in the programme are trends based on unchanged legislation. In order to achieve the targeted general government balances, additional measures with a cumulative positive impact of 0.4% of GDP in 2011 and 1.2% in 2012 are envisaged.

[4] Cyclically-adjusted balance excluding one-off and other temporary measures. One-off and other temporary measures are 0.2% of GDP in 2008, 0.6% in 2009 and 0.1% 2010; all deficit-reducing according to the most recent programme. In the Commission services' autumn 2009 forecast one-off and other temporary measures are 0.2% of GDP in both 2008 and 2009 deficit-reducing; 0 in 2010, and 0.1% of GDP in 2011, deficit-increasing.

Source :
Stability programme (SP); Commission services' November 2009 forecasts (COM); Commission services' calculations

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

This section describes recent economic and budgetary developments for Italy, which form the background against which the current programme assessment should be viewed, and outlines the key challenges to be addressed by future economic policies.

While the low indebtedness of the household sector and a relatively solid financial sector have provided some shelter from the global financial crisis, deep-seated structural weaknesses giving rise to unsatisfactory productivity growth had weakened the Italian economy long before the global downturn. A marked slowdown of economic activity was already underway before the deepening of the financial crisis. In the second quarter of 2008, real GDP started declining at an increasing pace, initially driven by the impact of surging commodity prices. Subsequently, the collapse in global demand was reflected in a large decline in export volumes and triggered a sharp fall in investment. Manufacturing value-added shrank by around one-fifth between the beginning of 2008 and mid-2009. After having contracted for five quarters, GDP rebounded in the third quarter of 2009, but declined again slightly in the fourth quarter. The recession has taken its toll on the labour market with a lag. In spite of declining economic activity, employment still rose in the first three quarters of 2008, particularly in the services sector. Subsequently, the impact of the economic downturn has materialised more in terms of hours worked than of headcount employment. Many workers, in particular in the hardest hit manufacturing sector, have accessed the wage supplementation fund (*Cassa Integrazione Guadagni* – CIG) to complement their salary for the fewer hours worked.

The government's policy response to the crisis was constrained by Italy's fragile public finances, in particular its very high government debt, in a context of increased risk aversion. The latter caused a considerable widening of the spread between Italian and German 10-year sovereign securities in the last months of 2008 and the first months of 2009, which was only partly reversed in the following months. Since the last quarter of 2008, the government approved several measures to shore up the stability of the financial sector and support the economy, focused on restoring confidence and offering relief to distressed firms and households. In October 2008 the government issued guarantees to protect savers and set up schemes to allow banks to maintain adequate levels of capitalisation and liquidity. Overall, the Italian banking sector made a limited use of the direct capital injection facilities available (only 0.3% of GDP). The November 2008 economic recovery package provided for cash transfers to low-income households and, to a lesser extent, relief for firms, while trying to accelerate investment in infrastructure and public works. To counter the impact of the crisis on the labour market, the government temporarily extended the coverage of unemployment benefits and the wage supplementation scheme. In February 2009 it introduced incentives for the purchase of energy-efficient durable goods, above all motor vehicles, which expired in December 2009. A third recovery package, approved in July 2009, included a 12-month tax break on investment in machinery and further allocations to workers who lose their job.

According to the government's estimates, the recovery and stimulus measures were fully financed by redeploying existing funds and by increasing revenues, with no effect on the deficit. Notwithstanding the government's prudent fiscal stance, the impact of the economic downturn on the Italian public finances has been significant. The government deficit ratio doubled between 2008 and 2009, to 5.3% of GDP. This, in conjunction with the very high debt ratio, triggered the opening of the excessive deficit procedure (EDP) on 2 December 2009 (see Box 1 for details on the EDP for Italy). Besides fiscal consolidation, which is a condition to keep public finances on a sustainable path, the key challenge for Italy's economic policy in the coming years will be to ensure a swift and durable recovery in productivity growth so as to restore competitiveness and raise the

country's low potential GDP growth. Far-reaching structural reforms are key to addressing the productivity challenge. These include initiatives to strengthen competition in product and services markets, simplify legislation, reduce the administrative burden at all levels of government and, within a "flexicurity" approach and with a view to reducing regional disparities, improve the functioning of the labour market and the efficiency, outcomes and standards of the education system. In addition, restoring competitiveness in the short term also requires ensuring that wage developments are aligned with productivity developments.

3. MACROECONOMIC OUTLOOK

Against the background of the current macroeconomic situation and the main policy challenges set out in the previous section, this section makes an assessment of the plausibility of the macroeconomic scenario underpinning the public finance projections of the programme.

The programme projects real GDP to have contracted by 4.8%[3] in 2009. Economic activity was dragged down by plummeting exports and a sharp decline in investment, especially in the first half of the year, while private consumption fell more moderately. In 2010, the recovery in global demand is assumed to spur investment and exports and, according to the programme, Italy will record real GDP growth of 1.1%[4]. In 2011 and 2012, private consumption is projected to regain momentum and real GDP growth is expected to reach 2% in both years. The programme highlights that a larger-than-anticipated lagged impact of the crisis on the labour market could negatively affect private consumption. As regards cyclical conditions, the output gap, as recalculated by Commission services based on the information in the programme following the commonly agreed methodology, is estimated to have turned sharply negative in 2009 and is expected to narrow as from 2010, remaining nonetheless negative throughout the period covered by the programme.

[3] According to the latest data released by ISTAT on 1 March 2010, real GDP fell by 5% in 2009, after -1.3% in 2008.

[4] The programme's macroeconomic scenario uses the main external assumptions on extra-EU variables included in the Commission services' autumn 2009 forecast.

Table 2: Comparison of macroeconomic developments and forecasts

	2009		2010		2011		2012
	COM	SP	COM	SP	COM	SP	SP
Real GDP (% change)	-4.7	-4.8	0.7	1.1	1.4	2.0	2.0
Private consumption (% change)	-1.5	-1.7	0.8	0.8	1.3	1.9	1.9
Gross fixed capital formation (% change)	-12.2	-12.7	0.1	1.4	2.4	2.7	2.7
Exports of goods and services (% change)	-20.2	-18.8	1.6	2.3	3.7	4.0	4.3
Imports of goods and services (% change)	-15.7	-15.0	2.0	1.8	3.9	3.0	4.0
Contributions to real GDP growth:							
- Final domestic demand	-3.2	-3.5	0.6	0.8	1.3	1.7	1.9
- Change in inventories	-0.2	-0.2	0.2	0.1	0.1	0.0	0.0
- Net exports	-1.2	-1.0	-0.1	0.1	-0.1	0.2	0.0
Output gap[1]	-3.6	-4.0	-3.2	-3.5	-2.5	-2.5	-1.6
Employment (% change)	-1.1	-1.2	-0.8	-0.5	0.3	0.9	1.1
Unemployment rate (%)	7.8	7.7	8.7	8.4	8.7	8.3	8.0
Labour productivity (% change)	-2.1	-3.7	1.1	1.6	1.0	1.0	0.9
HICP inflation (%)	0.8	0.8	1.8	1.5	2.0	2.0	2.0
GDP deflator (% change)	2.3	2.5	1.8	1.5	1.8	1.8	1.9
Comp. of employees (per head, % change)	1.7	1.7	1.6	1.8	1.9	1.8	2.1
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	-2.3	-1.8	-2.3	-1.6	-2.3	-1.3	-1.3

Note:

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

Source :

Commission services' November 2009 forecasts (COM); Stability programme (SP).

Due to assumed larger contributions from net exports and investment, the projection of economic growth for 2010 is higher in the programme than in the Commission services' autumn 2009 forecast, as confirmed in the February 2010 interim forecast. The programme's scenario for real GDP growth in 2011 is also more favourable than that of the Commission services' forecast, notably with regard to the performance of private consumption and net exports. Finally, the further 2% GDP growth assumed in the programme for 2012 does not appear to be a cautious base for the programme's budgetary plans considering the average growth recorded over 1999-2008 (1.2%).

As regards labour market developments for 2010 and 2011, the projections for employment growth and the unemployment rate in the programme are more favourable than in the Commission services' autumn 2009 forecast, consistent with the former's higher real GDP growth projections. Confirming the lagged effect of the crisis on the labour market, recent estimates by ISTAT show that the unemployment rate rose more markedly in the last months of 2009, reaching 8.4% in December. From an estimated average of 7.8% in 2009, both scenarios project the unemployment rate to increase by around ¾ pp. in 2010 and remain above 8% in 2011. The programme's path for the unemployment rate appears consistent with the moderate improvement in cyclical conditions over the programme horizon, as measured by the recalculated output gap.

According to both scenarios, labour productivity (measured on headcount employment) declined significantly in 2009 and is expected to recover in 2010, but in the programme these developments appear more accentuated. By contrast, the expected rebound in inflation in 2010 is somewhat more moderate in the programme than in the autumn forecast. The outlook for both labour productivity and inflation in 2011 is the same in the two scenarios, and the projected growth in compensation of employees in 2010 and 2011 is similar. Over the programme horizon, the latter is expected to be higher than productivity growth, implying a modest rise in unit labour costs, after sharp increases in 2008 and 2009.

Overall, assessed against currently available information, the programme's macroeconomic assumptions appear favourable. As a consequence, the revenue projections put forward in the programme may be overestimated. The programme's projections for inflation are broadly plausible.

4. GENERAL GOVERNMENT BALANCE

This section consists of four parts. The first three parts discuss the budgetary implementation in the year 2009, the budgetary plans for 2010 and the medium-term budgetary strategy in the programme. The final part analyses the risks attached to the budgetary targets.

4.1. Budgetary implementation in 2009

The 2009 general government deficit is estimated at 5.3% of GDP in the programme, up from 2.7% recorded in 2008. This estimate is in line with the Commission services' autumn 2009 forecast and was confirmed by data released by ISTAT on 1 March 2010. For the first time since 1991, the primary balance turned out negative (-0.6% of GDP from +2.5% in 2008), while interest expenditure fell significantly (4.7% of GDP from 5.2% in 2008), thanks to historically low short-term interest rates.

Table 3 compares the projected outcome for the general government balance, revenue and expenditure (as a percentage of GDP) in 2009 as presented in the new update of the stability programme with the targets from the previous update. Differences between outcomes and targets (excluding the impact of unanticipated GDP developments which may have affected the ratio, referred to as the 'denominator effect') are decomposed in the impact of a different starting position (i.e. the outcome of 2008 may also have been different from what was anticipated in the previous programme update) and the impact of differences in the revenue / expenditure growth rate from the planned growth rates[5].

[5] Mathematically, the difference in the revenue ratio in Table 3 can be expressed as:

$$\rho^o - \rho^p = \underbrace{\frac{1+r^p}{1+g^p}\Delta\rho_{-1}}_{\text{Base effect}} + \underbrace{\frac{\rho^o_{-1}}{(1+g^o)(1+g^p)}\Delta r}_{\text{Revenue growth effect}} - \underbrace{\frac{\rho^o_{-1}}{(1+g^o)(1+g^p)}\Delta g}_{\text{Denominator effect}} + \underbrace{\frac{\rho^o_{-1}(r^o g^p - r^p g^o)}{(1+g^o)(1+g^p)}}_{\text{Residual}}$$

where r is the growth rate of revenue and g is the growth rate of GDP. The subscript -1 refers to the previous year's value. Superscripts o and p refer to the outcome and the planned value respectively. Similarly for the expenditure ratio.

Table 3: Budgetary implementation in 2009

	2008		2009	
	Planned SP Feb 2009	**Outcome SP Jan 2010**	**Planned SP Feb 2009**	**Outcome SP Jan 2010**
Government balance (% of GDP)	-2.6	-2.7	-3.7	-5.3
Difference compared to target [1]	-0.1		-1.6	
Difference excluding denominator effect [1,2]			**-1.5**	
Of which : due to a different starting position end 2008			-0.1	
due to different revenue / expenditure growth in 2009			-1.4	
p.m. Residual [3]			0.0	
p.m. Nominal GDP growth (planned and outcome)			*-0.6*	*-2.5*
Revenue (% of GDP)	46.4	46.0	46.8	46.4
Revenue surprise compared to target [1]	-0.4		-0.4	
Revenue surprise excluding denominator effect [1,2]			**-1.3**	
Of which : due to a different starting position end 2008			-0.4	
due to different revenue growth in 2009			-0.9	
p.m. Residual [3]			0.0	
p.m. Revenue growth rate (planned and outcome)			*0.3*	*-1.6*
Expenditure (% of GDP)	49.0	48.8	50.5	51.7
Expenditure surprise compared to target [1]	0.2		-1.2	
Expenditure surprise excluding denominator effect [1,2]			**-0.2**	
Of which : due to different starting position end 2008			0.2	
due to different expenditure growth rate in 2009			-0.5	
p.m. Residual [3]			0.0	
p.m. Expenditure growth rate (planned and outcome)			2.5	3.4

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

The 2009 deficit target in the previous update of the programme was set at 3.7% of GDP. The starting position from the 2008 deficit outcome was only 0.1% of GDP worse than anticipated in the previous programme, as both revenues and expenditure turned out lower than assumed. The worse outcome in 2009 is thus explained by very different revenue and expenditure dynamics from those foreseen in the previous update, especially driven by the much deeper economic contraction than expected: the 1% and 4.8% real GDP contractions in 2008 and 2009 respectively reported in the new programme compare with reductions by 0.6% and 2% projected in the previous programme for the same years. Several recovery packages were adopted in line with the European Economic Recovery Plan (EERP), together amounting to around 0.7% of GDP and, according to the authorities, fully financed by redeploying existing funds and additional revenues.

In the new programme, the revenue-to-GDP ratio is projected to have increased by 0.4 pp. in 2009, as planned in the previous programme. This was achieved also thanks to sizeable one-off revenues from (*i*) the withholding tax on the revaluation of company assets (yielding 0.4% of GDP vs. 0.2% targeted in the previous programme); and (*ii*) an extraordinary tax on illegally expatriated assets – *scudo fiscale* – (yielding 0.35% of GDP, not foreseen and thus unbudgeted in the previous programme). These revenues more than compensated the postponement from December 2009 to June 2010 of part of the payment of the self-assessed personal income tax due by small firms and self-employed people (estimated by the government at 0.25% of GDP, again not foreseen in

the previous programme), decided in the budget for 2010 (see next section). The proceeds of this postponement cannot be considered as one-off, as they are related to taxes of a permanent nature. By contrast, some permanent tax revenues turned out significantly lower than projected, reflecting the more negative evolution of nominal GDP and thus of the related tax bases. Within direct taxation, the corporate income tax (IRES) fell sharply relative to 2008 (-23.1%), mainly due to plummeting profits. A similar development was recorded in the self-assessed personal income tax, beyond the impact of the above-mentioned partial postponement into 2010. On the other hand, the bulk of personal income tax revenue remained broadly stable, thanks to resilient dependent employment, increasing wages and the indexation of pensions to the relatively high 2008 inflation rate. Indirect tax revenue also fell more than expected. Besides shrinking nominal consumption the large annual contraction in VAT (-6.7%) can in part be explained by a different composition of private consumption (away from relatively tax-rich durable goods) and declining housing investment. Finally, the regional tax on economic activities (IRAP) recorded a larger-than-anticipated fall following the contraction in private sector value added. As a result of the developments described above, the programme indicates an overall revenue reduction by 1.6% in 2009 relative to 2008. This compares with the marginal increase projected in the previous programme.

The expenditure-to-GDP ratio is set to have increased by nearly 3 pps. in 2009, compared with 1.5 pps. projected in the previous programme. About 1 pp. of the difference can be explained by the denominator effect (lower nominal GDP than anticipated driving up the expenditure ratio). The remainder is due to higher expenditure growth than planned. Given that interest expenditure fell more than projected in the previous programme, it is primary expenditure which recorded a significantly higher annual increase than budgeted, of close to 5% vs. the planned 3.1%. Part of this increase is related to the additional recovery measures adopted since the previous programme was submitted (adopted in February and July 2009 - see section 2), including measures aimed at bringing forward some investment plans. Other factors are the emergency spending for the Abruzzi earthquake adopted in April 2009 and some expenditure overruns especially in intermediate consumption, which increased substantially despite the budgetary measures adopted to contain it.

One-off measures improved the budgetary outturn in 2009 by 0.6% of GDP as against 0.1% planned in the previous programme. More specifically, one-off revenues were 0.8% of GDP compared with 0.2% planned in the previous programme. The difference is explained by the higher-than-budgeted outturn of the withholding tax on the revaluation of company assets and by the unbudgeted *scudo fiscale*. One-off measures increased 2009 expenditure by 0.2% of GDP vs. 0.1% planned in the previous programme. The difference is due to the repurchase of some previously securitised real estate.

Box 1: The excessive deficit procedure (EDP) for Italy

On 2 December the Council adopted a decision stating that Italy had an excessive deficit in accordance with Article 126(6) of the Treaty on the Functioning of the European Union (TFEU). At the same time, the Council addressed a recommendation under 126(7) TFEU specifying that the excessive deficit had to be corrected by 2012. In particular, Italy was recommended to bring the general government deficit below 3 % of GDP in a credible and sustainable manner by taking action in a medium-term framework. Specifically, to this end, the Italian authorities should implement the budgetary measures in 2010 as planned in the three-year fiscal package for 2009-2011 approved in summer 2008 and confirmed in the Economic and Financial Planning Document for 2010-2013 updated in September 2009. They should also ensure an average annual fiscal effort of at least 0.5 percentage point of GDP over the period 2010-2012. This should also contribute to bringing the government gross debt ratio back on a declining path that approaches the 60% of GDP reference value at a satisfactory pace by restoring an adequate level of the primary surplus. Furthermore, the Italian authorities should specify the measures that are

necessary to achieve the correction of the excessive deficit by 2012, cyclical conditions permitting, and accelerate the reduction of the deficit if economic or budgetary conditions turn out better than currently expected. In addition, the Italian authorities should seize any opportunities beyond the fiscal effort, including from better economic conditions, to accelerate the reduction of the gross debt ratio towards the 60% of GDP reference value. The Council established the deadline of 2 June 2010 for the Italian government to take effective action to implement the fiscal measures in 2010 as planned and to outline in some detail the consolidation strategy that will be necessary to progress towards the correction of the excessive deficit. The assessment of effective action will take into account economic developments compared to the economic outlook in the Commission services' autumn 2009 forecast.

The Italian authorities should report on progress made in the implementation of these recommendations in a separate chapter in the updates of the stability programmes which will be prepared between 2010 and 2012.

4.2. The programme's budgetary strategy for 2010

For 2010, the programme plans a 0.3 pp. of GDP reduction in the general government deficit, to 5.0% of GDP. The revenue-to-GDP ratio is set to fall by 0.5 pp. of GDP, also because of the expiry of the one-off revenue-increasing measures impacting on 2009. In particular, capital taxes are projected to fall by 0.3 pp. because of the positive impact of the *scudo fiscale* in 2009. The expenditure-to-GDP ratio is planned to fall more significantly, by 0.8 pp. of GDP, mainly through enhanced efficiency of the public sector and the rationalisation of the public administration expected from the expenditure restraint that was adopted with the fiscal package for 2009-2011 approved in summer 2008[6]. This is visible in the slowing of primary expenditure growth, which is set to increase by just 0.6% in 2010 (compared to close to 5% in 2009). Table 5 shows that virtually all primary expenditure components would record slight falls as a percent of GDP, with the exception of a more marked fall in the public investment ratio after the acceleration that occurred in 2009. The debt service cost is projected to increase by 0.1 pp. of GDP. The primary balance is thus planned to improve by 0.4 pp of GDP.

Like the successive recovery packages adopted since November 2008, the 2010 budgetary package has, according to the authorities, a neutral impact on the budgetary position. The government thus continues to pursue a cautious fiscal policy, mindful of the negative effects that a large deficit would have on economic agents' confidence given the very high debt ratio.

The final 2010 budget approved by Parliament on 22 December contains some additional expansionary measures compared to the draft presented by the government in September, which did not envisage any additional budgetary measures beyond those planned in the fiscal package for 2009-2011 approved in summer 2008. These measures, amounting to around 0.4% of GDP, are directed at supporting low-income workers and ensuring the funding of additional health and social expenditure, as well as of military missions abroad. The main item of financing is represented by the above-mentioned one-off revenues from the *scudo fiscale* recorded in 2009 (0.35% of GDP) as its positive outturn gave rise to the decision, made in the budget for 2010, to postpone from 2009 to 2010 the collection of some income taxes estimated at 0.25% of GDP (see section 4.1). As mentioned above, the proceeds of this postponement cannot be considered as one-off, as they are related to taxes of a permanent nature. Yet, their positive budgetary impact will be limited to 2010. On 17 December, the government adopted a decree law that postpones the time limit to pay the *scudo fiscale* from 15 December 2009 to 30 April

[6] See also Box 2 in the Macro Fiscal Assessment of the previous programme at http://ec.europa.eu/economy_finance/sgp/pdf/20_scps/2008-09/02_technical_assessment/it_2009-03-11_ta_en.pdf

2010, but with higher tax rates. For the time being, the government estimated no additional revenue in 2010 from this extension.

After worsening by ¼ pp. of GDP in 2009, the structural balance, as recalculated by Commission services based on the information in the programme following the commonly agreed methodology, is set to improve by ½ pp. of GDP in 2010 mainly thanks to the expenditure restraint.

Taken at face value, the strategy for 2010 laid down in the programme – 2010 planned deficit reduction based on expenditure restraint decided already in summer 2008; structural improvement by ½ pp. of GDP – is broadly in line with the EDP recommendations under Article 126(7) adopted by the Council on 2 December 2009 (see Box 1). However, the final budget for 2010 contains additional expansionary measures beyond those planned in the three-year fiscal package for 2009-2011 approved in summer 2008, implying some deviation from the recommendations for 2010. At the same time, it has to be recognised that these are of a small amount and, according to the authorities' estimate, fully financed thanks to the above-mentioned carry-forward of the one-off proceeds of the *scudo fiscale*.

Table 4. Main budgetary measures for 2010

Revenue measures[1]	Expenditure measures[2]
• Postponement from 2009 to 2010 of 20% of personal income taxes due by small firms and self-employed people (+0.25% of GDP) • Other (+0.05% of GDP) • Extension of tax break on productivity bonus and other tax breaks (-0.08 % of GDP)	• Health-related expenditure and social transfers (0.07% of GDP) • Defence and security (missions abroad, emergency personnel recruitment) (0.05% of GDP) • Other (net +0.1% of GDP) • Enhanced efficiency of the public sector and rationalisation in the management of resources by general government (-0.5% of GDP)[3]

Notes:

[1] Estimated impact on general government revenue.
[2] Estimated impact on general government expenditure.
[3] Measures adopted in the fiscal package for 2009-2011 approved in summer 2008.

Source: Commission services and Ministry of the Economy and Finance

4.3. The programme's medium-term budgetary strategy

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

The programme confirms the medium-term budgetary strategy laid out in the Economic and Financial Planning Document updated in September 2009. Its main aim is to reduce the deficit below the 3% of GDP deficit reference value by 2012, the deadline for the correction of the excessive deficit set by the Council (see Box 1). Deficit targets are set at

3.9% of GDP for 2011 and 2.7% of GDP in 2012. Starting from "trend" deficit projections of 4.3% of GDP in 2011 and 3.9% in 2012 presented in the programme, which are based on unchanged legislation[7] and incorporate the above-mentioned fiscal package for 2009-2011 adopted in summer 2008, reaching these targets will require an additional consolidation effort amounting to 0.4 pp. of GDP in 2011 and a further 0.8 pp. in 2012. Factoring in these additional consolidation efforts, the primary balance is planned to be back in surplus, at 1.3% of GDP in 2011 and 2.7% in 2012. In structural terms, the deficit targets in the programme correspond to a structural effort, as recalculated by Commission services, of ½ pp. of GDP in 2011 and ¾ pp. in 2012 (the primary structural balance is projected to improve even more, by 1 pp. per year). Looking at the period 2010-2012 as a whole, the budgetary adjustment thus appears to be somewhat back-loaded.

Taken at face value, the strategy in the programme (nominal deficit targets and structural efforts) seems to be broadly in line with the Council's EDP recommendations. However, no information is provided on the broad measures behind the additional consolidation efforts required in 2011 and 2012. The programme does not even indicate to what extent they will impact on the expenditure or the revenue side. Great emphasis is given to the spending efficiency gains that could be brought about by the ongoing reform of the public administration. The recently adopted reform of the budgetary framework and the forthcoming implementation of fiscal federalism are also assumed to generate savings by improving fiscal governance, increasing the accountability of local administrations in managing resources and fostering further spending efficiency.

The expenditure-based consolidation strategy for 2011 laid out in the summer 2008 fiscal package for 2009-2011 is confirmed. The main elements are:

- A partial freeze of the employee turnover in the State and other central administrations (ceilings to recruitment were set at 20% of employees retiring in 2011, and at 50% in 2012), and a reallocation of personnel in the education sector, with a view to increasing efficiency.

- Lower spending for intermediate consumption and other current expenditure, including a curbing of spending on publicly-supplied and reimbursed pharmaceutical products.

- Lower capital spending.

The programme reports revenue and expenditure projections for 2011 and 2012 under an unchanged legislation scenario only, corresponding to the trend deficit projections mentioned above (see Table 5). In this scenario, total revenue growth is projected to accelerate from 1.4% in 2010 to 2.9% in 2011 and 4% in 2012, largely reflecting nominal GDP (and thus tax base) developments.

For 2011, the programme projections of revenues as a share of GDP are similar to those in the Commission services' autumn 2009 forecast. In the programme, the projected decline in direct taxes as a share of GDP in 2011 relative to 2010 is explained by the temporary positive effect of the postponement of some personal income taxes from 2009 to 2010 (see sections 4.1 and 4.2). This effect was not incorporated in the autumn forecast as the measure was adopted after the cut-off date.

[7] Projections based on unchanged legislation tend to underestimate expenditure trends compared to the projections derived on the basis of a no-policy change criterion (as e.g. in the Commission services' forecasts). To bridge the difference between the no-policy change scenario and the unchanged legislation scenario, the latter should be increased by the amount of: (*i*) "commitments" not yet financed by legislation that will probably be included in future budgets, for instance new public investment projects; and (*ii*) "customary obligations", including the renewal of public employment contracts.

In 2012, indirect tax revenues are projected to expand by just 2.6%, noticeably less than nominal private consumption (3.8%); conversely, direct taxes are assumed to increase by 5.8%, probably reflecting positive assumptions on corporate profits. Finally, the programme expects social contributions to grow in line with the wage bill (3.4% vs. 3.3%). Overall, the revenue-to-GDP ratio is set to increase marginally relative to 2011.

Table 5: Composition of the budgetary adjustment

(% of GDP)	2008	2009		2010		2011		2012	Change: 2009-2012
	COM	COM	SP	COM	SP	COM[1]	SP	SP	SP
Revenue[2]	**46.0**	**46.3**	**46.4**	**45.5**	**45.9**	**45.4**	**45.5**	**45.6**	**-0.8**
of which:									
- Taxes on production and imports	13.7	13.4	13.4	13.3	13.4	13.3	13.2	13.0	-0.4
- Current taxes on income, wealth, etc.	15.4	15.0	15.3	14.9	15.3	15.1	15.1	15.4	0.1
- Social contributions	13.7	13.8	13.9	13.7	13.8	13.6	13.8	13.7	-0.2
- Other (residual)	3.3	4.0	3.9	3.6	3.5	3.5	3.4	3.4	-0.4
Expenditure[2]	**48.8**	**51.6**	**51.7**	**50.8**	**50.9**	**50.5**	**49.9**	**49.5**	**-2.2**
of which:									
- Primary expenditure	43.6	46.8	46.9	46.1	46.0	45.4	44.6	44.1	-2.9
of which:									
Compensation of employees	10.9	11.4	11.4	11.3	11.2	11.1	10.9	10.6	-0.8
Intermediate consumption	5.4	5.9	5.7	5.8	5.6	5.6	5.4	5.3	-0.5
Social payments	20.4	21.9	21.9	21.8	21.8	21.6	21.6	21.5	-0.4
Subsidies	0.9	0.9	0.9	0.9	0.9	0.9	0.9	0.8	-0.1
Gross fixed capital formation	2.2	2.5	2.7	2.2	2.2	2.1	2.0	2.1	-0.5
Other (residual)	3.7	4.2	4.3	4.1	4.2	4.1	3.9	3.7	-0.5
- Interest expenditure	5.1	4.7	4.8	4.7	4.9	5.1	5.2	5.5	0.7
General government balance (GGB)	**-2.7**	**-5.3**	**-5.3**	**-5.3**	**-5.0**	**-5.1**	**-3.9**	**-2.7**	**2.5**
Primary balance	**2.4**	**-0.5**	**-0.5**	**-0.6**	**-0.1**	**0.1**	**1.3**	**2.7**	**3.2**
One-off and other temporary measures	0.2	0.2	0.6	0.0	0.1	-0.1	0.0	0.0	-0.6
GGB excl. one-offs	**-2.9**	**-5.5**	**-5.9**	**-5.4**	**-5.1**	**-5.0**	**-3.9**	**-2.7**	**3.1**
Output gap[3]	1.3	-3.6	-4.0	-3.2	-3.5	-2.5	-2.5	-1.6	2.4
Cyclically-adjusted balance[3]	-3.4	-3.5	-3.2	-3.7	-3.2	-3.8	-2.7	-1.9	1.3
Structural balance[4]	**-3.6**	**-3.7**	**-3.8**	**-3.7**	**-3.3**	**-3.7**	**-2.7**	**-1.9**	**1.9**
Change in structural balance		*-0.1*	*-0.2*	*0.0*	*0.5*	*0.0*	*0.6*	*0.8*	
Structural primary balance[4]	1.5	1.0	0.9	1.0	1.5	1.4	2.5	3.6	2.6
Change in structural primary balance		*-0.5*	*-0.6*	*-0.1*	*0.6*	*0.4*	*1.0*	*1.1*	

Notes:

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

[2]Budgetary data provided in the programme are trends based on unchanged legislation. In order to achieve the targeted general government balances, additional measures with a cumulative positive impact of 0.4% of GDP in 2011 and 1.2% in 2012 are envisaged.

[3]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.

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

Source :

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

In the programme's trend scenario, primary expenditure is set to increase moderately in nominal terms in 2011 (0.7%). The faster growth anticipated for nominal GDP implies a further substantial reduction in primary expenditure as a share of GDP, which is broad-based (see Table 5).

This relative restraint in primary expenditure in 2011 derives from a combination of moderately growing current primary spending (+1.4%) and further shrinking capital spending (-7.2%). The Commission services' autumn forecast, under a no-policy change scenario, expected current primary expenditure to rise more (2%) and capital expenditure to fall less markedly (-2.5%). This, combined with the lower nominal GDP growth,

implies a significantly higher primary expenditure ratio than in the programme's trend scenario. On the other hand, interest expenditure is slightly higher in the programme.

In 2012, which is not covered by the summer 2008 package, the programme trend scenario shows much more dynamic current primary expenditure (+2.2% relative to 2011). In addition, capital expenditure is set to pick up (+5.3%), driven by soaring gross fixed capital formation (+11.5%). As a result the level of capital expenditure is projected to go back to just below the 2010 level. The overall increase in primary expenditure projected for 2012 is 2.5%, implying a further reduction as a share of GDP thanks to the favourable growth assumptions. Interest expenditure is set to continue increasing, which is consistent with the programme's assumptions on interest rates.

The programme confirms the commitment to the medium-term objective (MTO) of a balanced budgetary position in structural terms (see Box 2), without specifying a date for its achievement.

Box 2: The medium-term objective (MTO) for Italy

As noted in the Code of Conduct[8], the MTO aims to (a) provide a safety margin with respect to the 3% of GDP deficit limit; (b) ensure rapid progress towards fiscal sustainability; and (c) allow room for budgetary manoeuvre, in particular taking into account the needs for public investment. The MTO is defined in cyclically-adjusted terms, net of one-off and other temporary measures. On 7 July 2009, the ECOFIN Council took note of a new methodology for setting MTOs, ensuring that implicit liabilities (costs related to ageing populations, in particular projected healthcare and pension expenditure) are also accounted for.

Specifically, the country-specific MTOs should take into account three components: (i) the debt-stabilising balance for a debt ratio equal to the (60% of GDP) reference value (dependent on long-term potential growth), implying room for budgetary manoeuvre for Member States with relatively low debt; (ii) a supplementary debt-reduction effort for Member States with a debt ratio in excess of the (60% of GDP) reference value, implying rapid progress towards it; and (iii) a fraction of the adjustment needed to cover the present value of the future increase in age-related government expenditure. This implies a partial frontloading of the budgetary cost of ageing irrespective of the current level of debt. In addition to these criteria, MTOs should provide a safety margin with respect to the 3% of GDP deficit reference value and, for euro area and ERM II Member States, in any case not exceed a deficit of 1% of GDP.

As communicated by the authorities, the MTO of Italy is a balanced balance in structural terms. In view of the new methodology and given the most recent projections and debt level, the MTO adequately reflects the objectives of the Pact.

4.4. Risk assessment

This section discusses the plausibility of the programme's budgetary projections by analysing various risk factors. For the period until 2011, Table 5 compares the detailed revenue and expenditure projections in the Commission services' autumn 2009 forecast, which are derived under a no-policy change scenario, with those in the updated programme based on unchanged legislation. However, although the assessment uses the autumn forecast as a benchmark, it also takes explicitly into account all available information about more recent developments.

[8] "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 on 10 November 2009, available at: http://ec.europa.eu/economy_finance/sgp/legal_texts/index_en.htm

First, as real GDP growth could be lower than assumed in the programme for the whole period 2010-2012 (see section 3), there are risks to the programme's budgetary targets for all three years. In particular, the revenue growth projections put forward in the programme may be overestimated as they rely on favourable tax bases developments. In this context, the sensitivity analysis carried out in the programme indicates that a 0.5% lower annual GDP growth over the programme horizon would imply a 0.7 pp. of GDP higher headline deficit by 2012 (3.4% of GDP vs. the 2.7% target) and, due to the implications for potential growth, a ½ pp. smaller overall structural adjustment over the period 2010-2012.

Another very specific revenue-related risk to the 2010 target is the above-mentioned tax postponement from 2009 to 2010, which may yield less than the budgeted 0.25% of GDP. The measure was in fact adopted just before the tax payment deadline, implying that several taxpayers might have already paid the due amount.

Third, the budgetary targets for 2011 and 2012 rely on the specification and implementation of further consolidation efforts (0.4 pp. of GDP and further 0.8 pp. respectively). Yet, the programme does not spell out the broad measures behind this planned additional adjustment relative to the trend scenario based on unchanged legislation. The latter, moreover, tend to understate actual expenditure trends[9] and thus the size of the consolidation measures needed to achieve the budgetary targets.

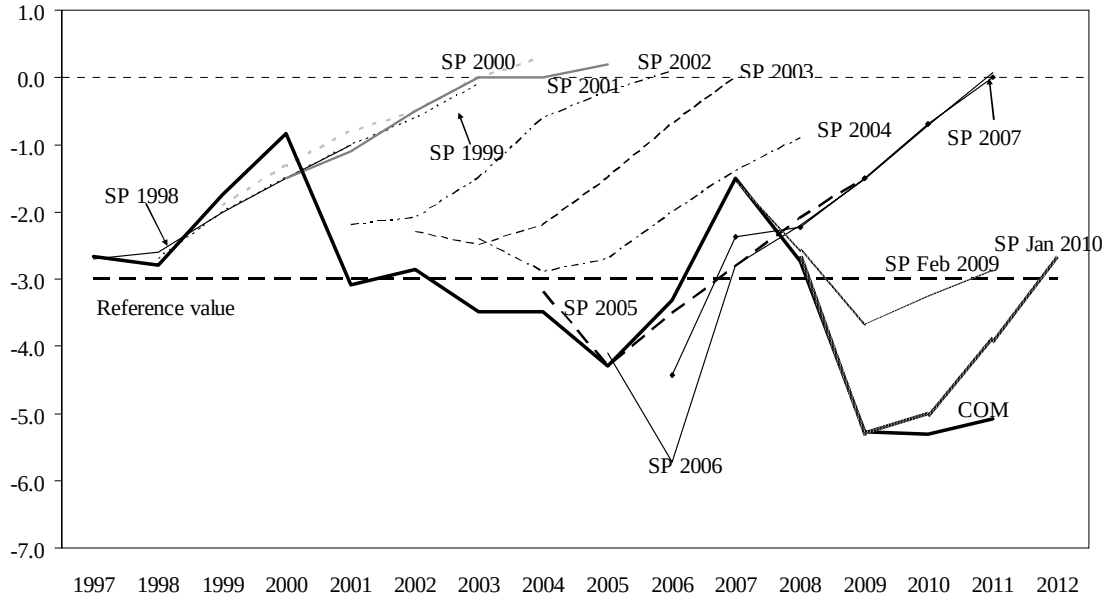
Fourth, even before considering the required additional consolidation efforts, achieving the trend projections, which incorporate the summer 2008 fiscal package for the period 2009-2011, will be challenging because they already envisage a very significant degree of expenditure restraint. In this context, the track record indicates that expenditure overruns at the central and local administration level cannot be ruled out, particularly in current primary expenditure, which increased by around 4.5% on average over the last decade. Respecting the tight expenditure targets will require an intensification of efforts to cut spending, increase efficiency and improve service quality.

As already mentioned above, the programme expects much from the recent changes to the legal budgetary framework (public accounting and budgeting, see section 6), which should ensure long-lasting improvements in budgetary accountability, execution, and adherence to policy priorities, and from the ongoing introduction of fiscal federalism, which should help keep sub-national governments' spending in check. However, both the reform of the budgetary framework and fiscal federalism are long-run processes which have barely begun. It remains to be seen whether their practical implementation will deliver the expected results.

Overall, the budgetary outcomes could be worse than targeted in the programme. This possibility increases in the outer years of the programme period. By 2011, for instance, the gap between the no-policy-change deficit in the Commission services' autumn 2009 forecast and the target set in the programme is more than 1 pp. of GDP.

[9] See footnote 7.

Figure 1: Government balance projections in successive programmes (% of GDP)



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

5. GOVERNMENT DEBT AND LONG-TERM SUSTAINABILITY

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

5.1. Recent debt developments and medium-term prospects

5.1.1. Debt projections in the programme

In the programme, the general government gross debt-to-GDP ratio is estimated to have increased by 9.3 pps. to 115.1% of GDP in 2009. This follows the 2.2 pps. of GDP rise already recorded in 2008. Consistently with the revised GDP estimates, on 1 March 2010 ISTAT reported the debt ratio at 106.1 in 2008 (+2.6 pps. of GDP from 2007) and at 115.8 in 2009 (+9.7 pps.).

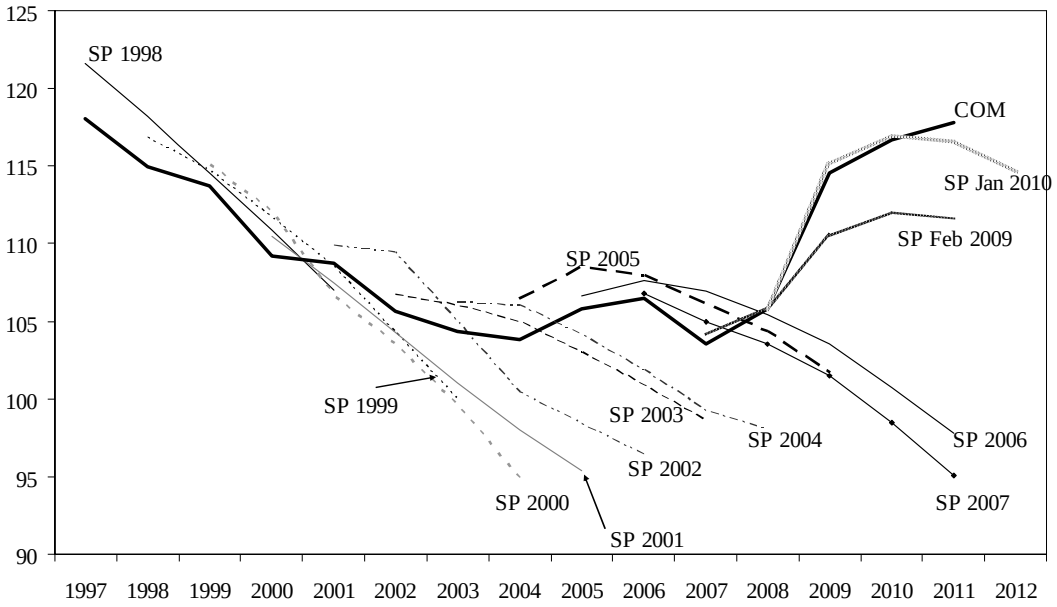
The so-called "snow-ball" effect explains the bulk of the increase in the debt ratio in 2009. More specifically, although falling thanks to historically low short-term interest rates, interest expenditure remained close to 5% of GDP. In addition, the sharp contraction in real GDP implied a further increase of the debt ratio, only partially offset by a still sizeable GDP deflator effect. As already noted (section 4.1), the primary balance turned out negative in 2009, so for the first time since 1991 it increased the debt. Regarding the "stock-flow" adjustment in 2009, its debt-increasing contribution is to a large extent explained by the further precautionary accumulation of liquid assets held by the Treasury with the Bank of Italy at the end of the year (+0.7% of GDP). The proposed recapitalisation of the banking sector on a voluntary basis entailed a further accumulation of financial assets, although the amount requested was limited (less than 0.3% of GDP).

For 2010 the programme projects an additional 1.8 pps. rise in the debt-to-GDP ratio. The debt-increasing impact of the interest burden is projected to be only partly offset by the assumed positive growth of real GDP and the GDP deflator. The planned primary

balance, still slightly negative, provides no support to debt reduction, while the "stock-flow" adjustment is set to turn slightly negative (i.e. debt-reducing).

In 2011 and 2012 the programme projects the debt ratio to resume a declining path. This is achieved mainly thanks to the planned positive and growing primary balances and the assumed acceleration in real GDP growth. Finally, the "stock-flow" adjustment is projected to remain slightly negative.

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



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

Table 6: Debt dynamics

(% of GDP)	average 2003-07	2008	2009		2010		2011		2012
			COM	SP	COM	SP	COM	SP	SP
Gross debt ratio[1]	**104.8**	**105.8**	**114.6**	**115.1**	**116.7**	**116.9**	**117.8**	**116.5**	**114.6**
Change in the ratio	-0.4	2.2	8.8	9.3	2.1	1.8	1.1	-0.4	-1.9
Contributions[2]:									
1. Primary balance	**-1.6**	**-2.4**	**0.5**	**0.5**	**0.6**	**0.1**	**-0.1**	**-1.3**	**-2.7**
2. "Snow-ball" effect	**1.2**	**3.3**	**7.3**	**7.4**	**1.9**	**2.0**	**1.5**	**1.0**	**1.2**
Of which :									
Interest expenditure	4.8	5.1	4.7	4.8	4.7	4.9	5.1	5.2	5.4
Growth effect	-1.2	1.1	5.1	5.3	-0.8	-1.2	-1.5	-2.2	-2.2
Inflation effect	-2.4	-2.9	-2.5	-2.7	-2.1	-1.7	-2.1	-2.0	-2.1
3. Stock-flow adjustment	**0.0**	**1.3**	**0.9**	**1.3**	**-0.4**	**-0.3**	**-0.3**	**-0.1**	**-0.3**
Of which :									
Cash/accruals diff.	0.2	0.4	0.1	0.0	-0.4	-0.6	-0.3	-0.5	-0.6
Acc. financial assets	-0.1	0.9	0.8	0.5	0.0	0.2	0.0	0.2	0.2
Privatisation	-0.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Val. effect & residual	-0.1	0.0	0.0	0.8	0.0	0.0	0.0	0.2	0.1

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' autumn 2009 forecasts (COM); Commission services' calculations

5.1.2. Assessment

The programme's projections for the debt ratio in 2009 and 2010 are similar to those put forward in the Commission services' autumn 2009 forecast. In the latter, a lower increase is expected in 2009 due to a smaller "stock-flow" adjustment. On the other hand, in 2010 the larger negative primary balance expected in the autumn forecast entails a faster increase in debt ratio.

For 2011, the autumn forecast points to a further increase in the debt ratio, under a no-policy change scenario. This contrasts with the programme's projected reduction, which depends on: (*i*) the planned primary balance, significantly higher than in the autumn forecast, also because of the additional consolidation effort still to be specified (see section 4.3); and (*ii*) the smaller "snow-ball" effect due to the assumed favourable real GDP outlook (see section 3).

The risks already highlighted for the budgetary targets (see section 4.4) also apply to the debt path presented in the programme. Concerning the growth outlook, the sensitivity analysis carried out in the programme indicates that a 0.5% lower GDP growth per year over the programme's horizon would imply a debt ratio at 117.3% of GDP at the end of 2012, i.e. nearly 3 pps. of GDP higher than planned. On the positive side, at the end of 2009 the average life and financial duration of government securities both increased compared to a year before (to 7.07 and to 4.81 years respectively from 6.82 and 4.51 at end-2008). This is mainly due to the larger share of fixed-rate securities (70.5% as compared to 67.7% at the end of 2008). Taking account of these characteristics, the sensitivity analysis performed in the programme indicates that a permanent hike in the yield curve by 100 basis points would imply a relatively moderate increase in interest expenditure compared with the planned scenario. The debt service cost would be around 0.2%, 0.4% and 0.5% of GDP higher in 2010, 2011 and 2012 respectively.

Overall, the risk that the debt outcomes will be worse than targeted in the programme increases in the outer years of the programme period. The same risks identified for budgetary consolidation also apply to the programme's debt projections (see section 4.4). In addition, a less favourable real GDP growth than assumed in the programme would further affect the debt ratio. In this context, the 2011 no-policy-change debt ratio in the autumn forecast is around 1¼ pps. higher than planned in the programme.

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

5.2.1. Sustainability indicators and long-term debt projections

This section presents sustainability indicators based on the long-term age-related government spending as projected by the Member States and the EPC in 2009 according to an agreed methodology.[10]

Table 7: Long-term age-related expenditure: main projections

(% of GDP)	**2007**	**2010**	**2020**	**2030**	**2040**	**2060**	**Change 2010-2060**
Total age-related spending	**26.0**	**26.0**	**26.3**	**27.3**	**28.7**	**27.6**	**1.6**
- Pensions	14.0	14.0	14.1	14.8	15.6	13.6	-0.4
- Healthcare	5.9	5.9	6.2	6.5	6.9	6.9	1.0
- Long-term care	1.7	1.7	1.8	2.0	2.3	3.0	1.2
- Education and unemployment benefits	4.5	4.3	4.1	3.9	4.0	4.2	-0.2
Property income received	0.6	0.6	0.5	0.5	0.5	0.4	-0.2

Source: Economic Policy Committee and Commission services.

Table 7 shows that age-related spending is projected to rise by 1.6 percentage points of GDP between 2010 and 2060, clearly below the EU average (4.6 pps.). Sustainability indicators for two scenarios are presented in Table 8. The "2009 scenario" is based on a no-policy-change assumption and takes the 2009 structural primary balance as a starting point, while the "programme scenario" takes into account the consolidation planned in the programme up to 2012 and is based on the projected 2012 structural primary balance as a starting position. Including the increase of age-related expenditure and assuming that the structural primary balance remained at its 2009 level, the sustainability gap (S2)[11] would amount to 2.6% of GDP, about ¾ of a percentage point higher than in last year's assessment. This is due to a deterioration in the estimated structural primary balance in the starting year. The starting budgetary position is not sufficient to stabilise the debt ratio over the long-term and entails a risk of unsustainable public finances even before considering the long-term budgetary impact of ageing.

While the "2009 scenario" reflects the weakening of the budgetary position in response to the current economic crisis, according to the "programme scenario" the gap would be

[10] Economic Policy Committee and the European Commission (2009), '2009 Ageing Report: Economic and budgetary projections for the EU-27 Member States (2008-60)', *European Economy* No. 2/2009. European Commission (2009), 'Sustainability Report 2009, European Economy No. 9/2009. European Commission (2008), 'Public finances in EMU – 2008', *European Economy* No. 4/2008.

[11] 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.

significantly reduced. Achieving the budgetary consolidation planned in the programme would mitigate the risks to long-term sustainability of public finances.

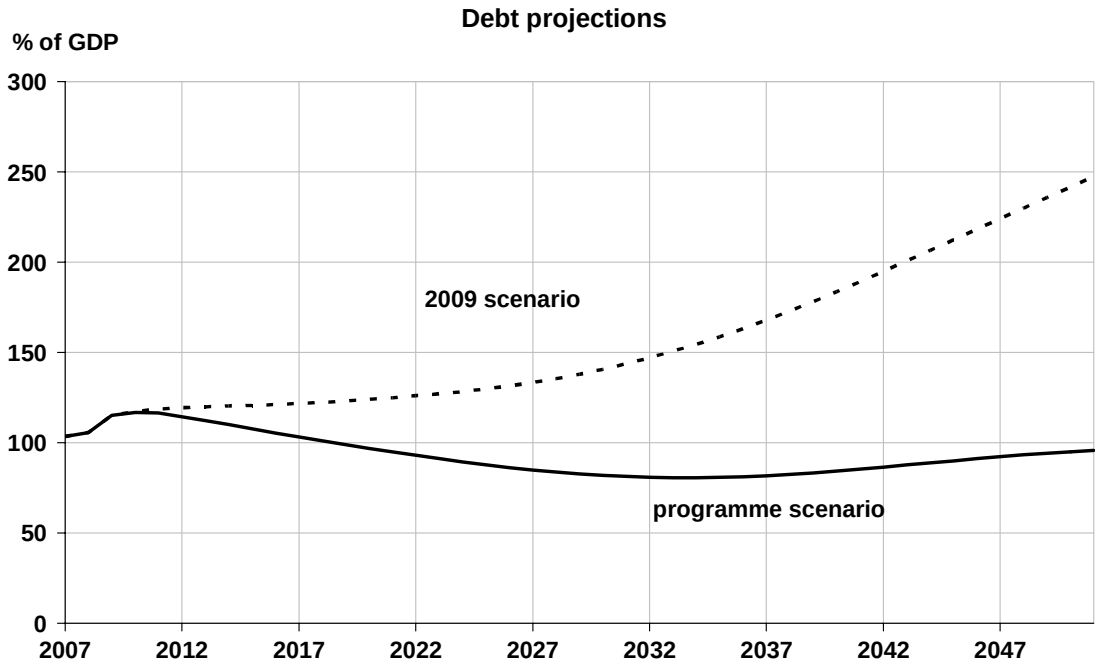
Table 8: Sustainability indicators and the required primary balance

	2009 scenario			Programme scenario		
	S1	**S2**	**RPB**	**S1**	**S2**	**RPB**
Value	3.3	2.6	3.4	0.5	-0.1	3.4
of which:						
Initial budgetary position (IBP)	1.0	1.1	-	-1.7	-1.6	-
Debt requirement in 2060 (DR)	0.8	-	-	0.8	-	-
Long-term change in the primary balance (LTC)	1.5	1.6	-	1.5	1.6	-

Source: Commission services.

Based on the assumptions used in the projection of the age-related expenditure and the calculation of the sustainability indicators, Figure 3 displays the long-term projection for the debt-to-GDP ratio.

Figure 3: Long-term projections for the government debt ratio

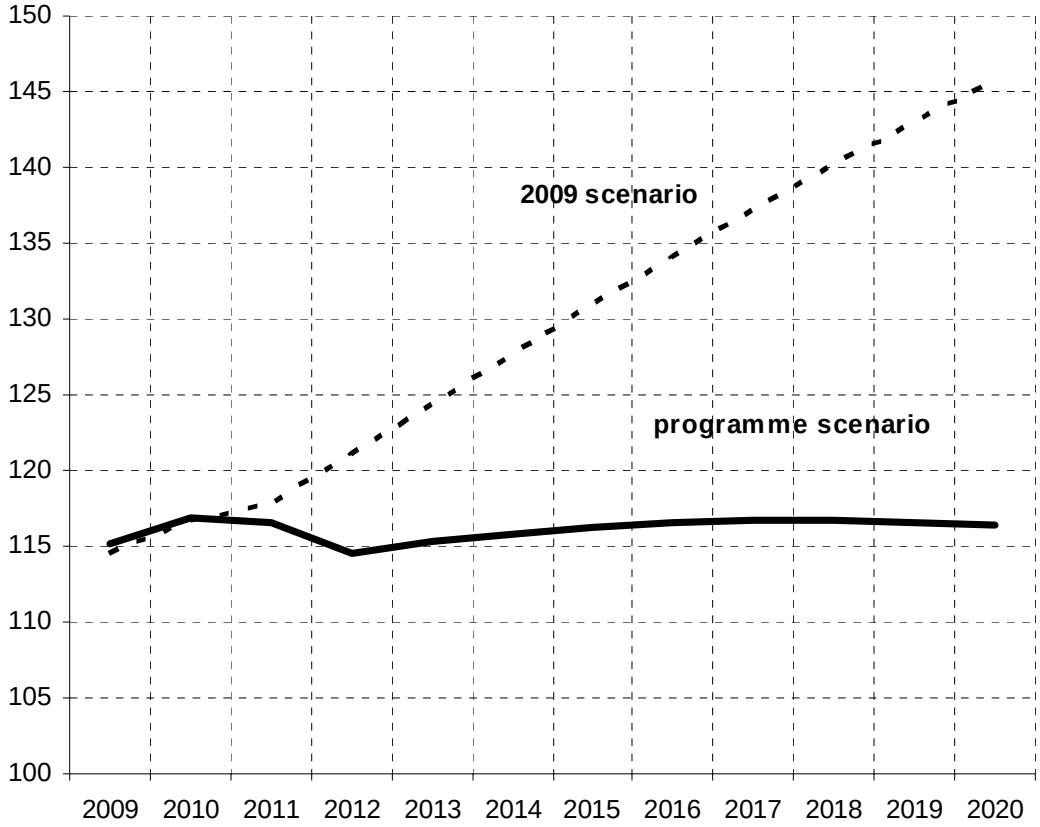


Note: Being a mechanical, partial-equilibrium analysis, the long-term debt projections are bound to show highly accentuated profiles. As a consequence, the projected evolution of debt levels should not be seen as a forecast similar to the Commission services' short-term forecasts, but as an indication of the risks faced by Member States.
Source: Commission services' calculations

By contrast, Figure 4 shows the projections for the debt-to-GDP in the medium term, based on the alternative assumptions of economic developments presented in the

Commission services' autumn 2009 forecast[12]. The projected debt trajectories show relatively similar paths under both sets of assumptions. However, when account is taken on most recent economic developments under the alternative assumptions, the gap between the programme and the 2009 scenarios is wider and the debt level would only be stabilised but not reduced under the programme scenario by 2020.

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



Source: Commission services' calculations

5.2.2. Additional factors

For an overall assessment of the sustainability of public finances, other relevant factors are taken into account, as shown in Table 9. These would not change the overall assessment of the risk to the sustainability of public finances.

[12] Section 3.5 in European Commission (2009), 'European Economic Forecast – autumn 2009', European Economy No. 10/2009. This economic scenario assumes that the output gap caused by the crisis will be closed by 2017.

Table 9: Additional factors for the assessment of long-term sustainability risks

	Impact on risk
Debt and pension assets	na
Decline in structural balance until 2011 in COM Autumn 2009 forecast	na
Alternative projection of cost of ageing	na
Strong decline in benefit ratio	na
High tax burden	na
Difference between S1 and S2	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 V of: European Commission (2009), Sustainability Report 2009, European Economy No. 9/2009.

Source: Commission services.

5.2.3. Assessment

The long-term budgetary impact of ageing is lower than the EU average, with pension expenditure showing a more limited increase than on average in the EU, through the full implementation of the adopted reforms. Yet, pension expenditure as a share of GDP remains among the highest in the EU. The budgetary position in 2009 as estimated in the programme would not be sufficient to stabilise the current debt ratio. Moreover, the current level of gross debt is well above the Treaty reference value. Achieving high primary surpluses would therefore contribute to limiting the medium risk to the long-term sustainability of public finances.

Medium-term debt projections that assume GDP growth rates to only gradually recover to the values projected before the crisis and tax ratios to return to pre-crisis levels show that the budgetary strategy envisaged in the programme for the period until 2012, taken at face value, would be enough to stabilise the debt-to-GDP ratio by 2020.

6. FISCAL FRAMEWORK AND QUALITY OF PUBLIC FINANCES

This section is subdivided into two elements: the fiscal framework and the quality of public finances in a broader sense.

6.1. Fiscal framework

Italy's fiscal framework improved considerably since joining the euro area, prompted by the budgetary constraints imposed by the Stability and Growth Pact. However, there remains scope for improvement in several dimensions of its fiscal framework. In particular, Italy ranks below average in the Commission services' ranking of the 27 EU countries according to numeric fiscal rules[13]. The three main existing rules – the domestic stability pact for local entities, the health pact between central and regional

[13] See DG Ecfin database on fiscal governance at: http://ec.europa.eu/economy_finance/db_indicators/fiscal_governance/index_en.htm

governments and the expenditure ceiling for pharmaceuticals – cover less than half of total public finances. Gaps in monitoring and enforcement, despite the formal sanctions foreseen for non-compliant administrations, and lack of stability due to frequent changes in rules and definitions of key variables are other weaknesses. For example, the domestic stability pact was repeatedly revised by successive budget laws, and the revisions were far from minor – they involved piecemeal changes in its objectives, ranging from ad-hoc deficit targets to a variety of expenditure caps. The programme update reports on some further minor changes that have been introduced to the Pact as temporary derogations for 2009 and 2010 to allow for additional capital expenditure in response to the crisis, while tighter controls on local administrations' debt enter into force as from 2010.

A number of initiatives have been taken recently to improve fiscal governance in Italy, at first without modifying the legal setting. Namely, to address the traditional short-term orientation of the budgetary plans, in summer 2008 the government adopted a three-year package spelling out not only yearly targets for single expenditure and revenue items, but also the broad measures needed to achieve them; regrettably, however, this experience was not repeated with the budget for 2010. Second, the structure of the State budget has been streamlined, allowing for a simpler and policy-oriented allocation of resources and for more flexibility in the budgetary execution. Third, some steps have been taken to improve the monitoring of expenditure and its feedback into the budgetary process, through detailed spending reviews at the level of ministries.

A framework law reforming public accounting and the budgetary process, which was adopted in December 2009, has enshrined these progresses in legislation and has brought further modifications to the budgetary framework (see Box 3). The programme highlights that the reform will allow improving expenditure control and enhancing fiscal governance in support of the planned budgetary consolidation.

The medium-term budgetary consolidation strategy in the programme also relies on the expected benefits in terms of enhanced fiscal discipline at all levels of government from the forthcoming fiscal federalism. The framework law on fiscal federalism, approved in May 2009, lays down the path for the gradual devolution of tax-raising powers from the central to the sub-national governments, after responsibility for spending in a number of policy areas was delegated to the latter with a constitutional reform in 2001. The law outlines a system of revenue equalisation to compensate the poorer regions for their lower tax revenue-raising potential and stipulates that centrally-defined "essential levels" of services (including in the key areas of health, education and social assistance) will be funded with central revenues on a standard cost basis. While based on sound principles, the framework law still requires the central government to adopt, in agreement with the sub-national governments, enacting decrees by mid-2011 in order to specify the rules governing fiscal federalism. In particular, the details of the revenue sharing mechanism and of how the essential levels of services and their standard costs must be defined are still to be determined.

Box 3: The reform of the budgetary process and public accounting

A comprehensive reform of public accounting and the budgetary process was approved by the Italian Parliament in December 2009 and entered into force on 1 January 2010. In view of the new institutional set-up between central government and the sub-national entities that will be created with the forthcoming fiscal federalism, the reform lays down the principles for establishing a single and consistent framework applying to all entities falling within the definition of general government. The reform is also intended to strengthen the medium-term budgetary framework, also by reinforcing budgetary monitoring through better data collection tools and procedures, and make the State budget simpler and more adherent to policy.

An important novelty introduced by the reform is that budgetary planning will take a medium-term horizon, with a three-year planning period for policies, objectives and resources, along the lines of the three-year package that was adopted in the summer 2008. The various stages and documents of the economic and budgetary cycle have been redesigned, also with a view to allowing greater involvement of all government levels in setting targets and the relevant responsibilities. To improve expenditure planning, the reform foresees regular spending reviews and the introduction of three-year ceilings for some expenditure items (which however only cover a limited share of total government spending).

The reform is also intended to enhance the transparency and clarity of public finances by better linking the planning and reporting phases of the budgetary process, improving the information content requirements of the various public finance documents and reinforcing the relevant monitoring tools for the whole of the general government sector, starting from the setting up of integrated databases and the harmonisation of accounting systems across all levels of government. Accounting will be in cash terms only, after gradually abandoning the customary "legal accrual" system of recording tax assessments and spending commitments when the legal obligation arises. This practice will improve the central government's ability to control cash flows and reduce margins of uncertainty over the annual budget balances in cash terms, without hampering the availability of ESA95 figures.

With regard to the structure of the State budget, the reform institutionalises the functional classification of expenditure into missions and programmes, already introduced as of 2008 without a legal basis. This new streamlined structure of the State budget will support a more flexible and transparent allocation of resources to the set objectives according to policy priorities.

Overall, the reform is an important step for the modernisation of the institutional framework governing Italy's public finances and is set to improve the credibility of the medium-term budgetary framework as, contrary to for instance the most recent update of the stability programme, it will be underpinned by consolidation measures. However, the law is an enabling law that requires the adoption of subsidiary legislation for the specification of the details of many of its provisions. In particular, while the overhaul of the budgetary cycle has already entered into force and will start being implemented as from the planning for 2011-2013, crucial aspects like the harmonisation of the accounting system and the definition of expenditure ceilings still need to be specified through appropriate enacting decrees within the next two years. In addition, in the context of the forthcoming introduction of fiscal federalism, important aspects of the reform related to the coordination between the different levels of government may raise conflicts over the attribution of specific responsibilities, which will have to be solved. Thus, the reform's success in terms of enhanced expenditure control, monitoring and assessment of the results of government activity will depend on the appropriate specification and consistent implementation of all its elements.

6.2. Quality of public finances

The composition and quality of public finances in Italy do not seem to support the priority of enhancing the growth potential. Although the implementation of pension reforms and the gradual increase of the retirement age for female civil servants introduced in 2009 are positive developments, the composition of expenditure remains

biased towards high pension spending. This takes the toll on other social spending and more productive expenditure aimed at supporting research and innovation. In addition, given that the consolidation strategy over the programme period relies on an expenditure-based adjustment, significant efficiency gains are needed to avoid compromising the level and quality of services provided. There is also evidence of scope for improvement in the quality of public services in Italy, with in particular different degrees of efficiency in running public services across regional and local authorities. The definition and use of standard costs to finance output targets, as foreseen in the framework law on fiscal federalism, could help foster spending efficiency by the sub-national governments and lead to long-lasting improvements in their ability to control expenditure. At the national level, recent efforts to improve the efficiency and cost-effectiveness of the public administration and to reform the organisation of upper-secondary school curricula could potentially deliver positive budgetary outcomes in the medium to long run, but it is too early to assess their effectiveness as many challenges lie in their implementation.

7. OVERALL ASSESSMENT

Taking into account risks attached to the budgetary targets discussed above, this section assesses the appropriateness of the fiscal strategy in relation to the Council Recommendations under Article 126(7) of 2 December 2009 with a view to correcting the excessive deficit and the budgetary objectives of the Stability and Growth Pact, against the background of the current economic situation, the debt and long-term sustainability position of the country, and the institutional features of its public finances.

As mentioned in Sections 4.2 and 4.3 above, the strategy laid down in the programme for 2010-2012 (deficit targets and structural efforts), taken at face value, is broadly in line with the Council recommendations under Article 126(7), which require the excessive deficit to be corrected by 2012. While the final budget for 2010 contains additional expansionary measures beyond those planned in the three-year fiscal package for 2009-2011 approved in summer 2008, implying some deviation from the recommendations for 2010, it has to be recognised that these are of a small amount and, according to the authorities' estimate, fully financed thanks to the carry-forward of the one-off proceeds of the *scudo fiscale* that were collected in 2009. For 2011 and 2012, the budgetary targets rely on the specification and implementation of additional consolidation efforts (0.4 pp. of GDP and further 0.8 pp. respectively) but the programme provides no information on the broad measures to achieve this and does not even indicate to what extent they will impact on the expenditure or the revenue side.

In addition to the lack of information on the additional consolidation measures required for the outer years, the deficit outcomes could be higher than targeted due to the following factors. First, real GDP growth assumptions appear favourable throughout the programme period, implying favourable growth projections for revenues. Second, even before considering the required additional consolidation efforts, achieving the trend deficit projections under unchanged legislation will be challenging because they envisage a very significant degree of expenditure restraint, while the track record indicates that expenditure overruns at the central and local administration level cannot be ruled out, particularly in current primary expenditure, which increased by around 4.5% per year on average over the last decade. While the programme expects the reform of the budgetary framework and introduction of fiscal federalism to play a crucial role in improving expenditure control and fostering spending efficiency, it remains to be seen whether the practical implementation of these reforms, which will take several years, will gradually deliver the expected results. Finally, it should be noted that the trend scenario based on unchanged legislation tends to understate actual expenditure trends and thus the size of

the additional consolidation measures needed to achieve the budgetary targets for 2011-2012.

Overall, taking into account risks to the deficit targets, the budgetary strategy set out in the programme for 2010 is broadly consistent with the Council recommendations under Article 126(7). However, from 2011 on the budgetary strategy may not be consistent with the Council recommendations. In particular, the budgetary targets for 2011-2012 should be backed up by concrete measures and the plans for the entire period sufficiently strengthened to address the risks from possibly less favourable GDP growth and possible slippages on the expenditure side. The same conclusion holds for the structural effort planned in the programme, which may fall short of what was recommended by the Council.

The programme projects the government debt ratio to continue increasing in 2010, but to be back on a downward path as from 2011, mainly thanks to the planned return to primary surpluses. The same risks identified for budgetary consolidation also apply to the programme's debt projections. Unless these risks are adequately addressed, and the consolidation plans fully implemented, the budgetary strategy may not to be sufficient to bring the very high government debt ratio back on a declining path in 2011-2012.

* * *

ANNEX. COMPLIANCE WITH THE FORMAT AND CONTENT REQUIREMENTS FOR STABILITY AND CONVERGENCE PROGRAMMES

This annex provides an assessment of whether the programme respects the requirements of Section II of the code of conduct (guidelines on the format and content), notably as far as (i) the model structure (Annex 1 of the code of conduct); (ii) the formal data provisions (Annex 2 of the code of conduct); (iii) a separate chapter on progress made in the correction of the excessive deficit; and (iv) other information requirements are concerned.

(i) Model structure

The programme does not fully adhere to the code of conduct. In particular, the programme does not provide clear indications about the budgetary strategy and the related broad measures needed to achieve the budgetary objectives in the medium term (see section 4.3). Accordingly, the expenditure and revenue ratios presented in the programme for 2011 and 2012 are not consistent with the budgetary targets put forward in the programme.

(ii) Data requirements

The standard tables in the programme contain all the compulsory data required in the code of conduct. Regarding optional data, general government expenditure by function is missing (Table 3 in Annex 2 of the code of conduct). In addition, optional data on liquid financial asset and net financial debt are not presented (Table 3 in Annex 2 of the code of conduct).

The tables on the following pages show the data presented in the January 2010 update of stability programme, following the structure of the tables in Annex 2 of the code of conduct. Compulsory data are in bold, missing data are indicated with grey-shading.

(iii) Separate chapter on progress made in the correction of the excessive deficit

In its recommendations under Article 126(7) of 2 December 2009 with a view to bring the excessive deficit situation to an end, the Council also invited Italy to report on progress made in the implementation of the Council's recommendations in a separate chapter in the updates of the stability programmes. Italy partly complied with this recommendation.

(iv) Other information requirements

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

* * *

The SCP…	Yes	No	Comments
a. Involvement of parliament			
… mentions status vis-à-vis national parliament.	X		
… indicates whether Council opinion on previous programme has been presented to national parliament.		X	
b. Economic outlook			
… (for euro area and ERM II Member States) uses "common external assumptions" on main extra-EU variables.	X		
… explains significant divergences with Commission services' forecasts[1].	X		
… bears out possible upside/downside risks to economic outlook.	X		
… analyses outlook for sectoral balances and, especially for countries with high external deficit, external balance.		X	
c. Monetary/exchange rate policy			
… (CP only) presents medium-term monetary policy objectives and their relationship to price and exchange rate stability.			Not applicable
d. Budgetary strategy			
… presents budgetary targets for general government balance in	X		

The SCP…	Yes	No	Comments
relation to MTO and projected path for debt ratio.			
… (in case new government has taken office) shows continuity with respect to budgetary targets endorsed by Council.			Not applicable
… (when applicable) explains reasons for deviations from previous targets and, in case of substantial deviations, whether measures are taken to rectify situation (+ provides information on them).	X		
… backs budgetary targets by indication of broad measures necessary to achieve them and analyses their quantitative effects on balance.		X	From 2011
… specifies state of implementation of measures.	X		
e. "Major structural reforms"			
… (if MTO not yet reached or temporary deviation is planned from MTO) includes comprehensive information on economic and budgetary effects of possible 'major structural reforms' over time.			Not applicable
… includes quantitative cost-benefit analysis of short-term costs and long-term benefits of reforms.			Not applicable
f. Sensitivity analysis			
… includes comprehensive sensitivity analyses and/or develops alternative scenarios showing impact on balance and debt of: a) changes in main economic assumptions b) different interest rate assumptions c) (for CP only) different exchange rate assumptions d) if common external assumptions are not used, changes in assumptions for main extra-EU variables.	X		
… (in case of "major structural reforms") analyses how changes in assumptions would affect budget and potential growth.			Not applicable
g. Broad economic policy guidelines			
… provides information on consistency with broad economic policy guidelines of budgetary objectives and measures to achieve them.	X		
h. Quality of public finances			
… describes measures to improve quality of public finances, both revenue and expenditure sides.	X		
i. Long-term sustainability			
… outlines strategies to ensure sustainability.	X		
… includes common budgetary projections by the AWG and all necessary additional information (esp. new relevant information).	X		
j. Other information (optional)			
… includes information on implementation of existing national budgetary rules and on other institutional features of public finances.	X		

Notes: SCP = stability/convergence programme; CP = convergence programme

[1]To the extent possible, bearing in mind the typically short time period between the publication of the Commission services' autumn forecast and the submission of the programme.

Source:
Commission services

Tables from Annex 2 of the code of conduct

Table 1a. Macroeconomic prospects

	ESA Code	2008	2008	2009	2010	2011	2012
		Level	rate of change	rate of change	rate of change	rate of change	rate of change
1. Real GDP	B1*g	*1276578.2*	-1.0	-4.8	1.1	2.0	2.0
2. Nominal GDP	B1*g	*1572243.4*	1.8	-2.5	2.6	3.8	3.9
Components of real GDP							
3. Private consumption expenditure	P.3	*747955.2*	-0.9	-1.7	0.8	1.9	1.9
4. Government consumption expenditure	P.3	*258586.6*	0.6	0.5	0.2	0.0	0.8
5. Gross fixed capital formation	P.51	*267571.5*	-3.0	-12.7	1.4	2.7	2.7
6. Changes in inventories and net acquisition of valuables (% of GDP)	P.52 + P.53	-	-	-	-	-	-
7. Exports of goods and services	P.6	*357172.7*	-3.7	-18.8	2.3	4.0	4.3
8. Imports of goods and services	P.7	*358481.1*	-4.5	-15.0	1.8	3.0	4.0
Contributions to real GDP growth							
9. Final domestic demand		-	-1.0	-3.5	0.8	1.7	1.9
10. Changes in inventories and net acquisition of valuables	P.52 + P.53	-	-0.3	-0.2	0.1	0.0	0.0
11. External balance of goods and services	B.11	-	0.3	-1.0	0.1	0.2	0.0

Table 1b. Price developments

	ESA Code	2008	2008	2009	2010	2011	2012
		Level	rate of change	rate of change	rate of change	rate of change	rate of change
1. GDP deflator		*123.2*	2.8	2.5	1.5	1.8	1.9
2. Private consumption deflator		*123.4*	3.2	0.1	1.5	1.8	1.9
3. HICP[1]		*108.0*	3.5	0.8	1.5	2.0	2.0
4. Public consumption deflator		*125.4*	3.8	2.4	0.6	0.8	0.9
5. Investment deflator		*122.7*	3.2	1.2	1.7	2.3	2.2
6. Export price deflator (goods and services)		*126.9*	5.0	0.0	1.3	1.8	2.0
7. Import price deflator (goods and services)		*128.6*	6.9	-5.8	0.7	1.5	1.6

Table 1c. Labour market developments

	ESA Code	2008	2008	2009	2010	2011	2012
		Level	rate of change	rate of change	rate of change	rate of change	rate of change
1. Employment, persons[1]		*25262.9*	0.3	-1.2	-0.5	0.9	1.1
2. Employment, hours worked[2]		*45511444.0*	-0.5	-3.1	-0.1	1.3	1.3
3. Unemployment rate (%)[3]		-	6.7	7.7	8.4	8.3	8.0
4. Labour productivity, persons[4]		*50531.7*	-1.4	-3.7	1.6	1.0	0.9
5. Labour productivity, hours worked[5]		*28.0*	-0.5	-1.8	1.1	0.6	0.6
6. Compensation of employees	D.1	*654986.2*	3.7	-0.6	2.1	3.2	3.3
7. Compensation per employee		*36426.6*	3.3	1.7	1.8	1.8	2.1

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

[2]National accounts definition.

[3]Harmonised definition, Eurostat; levels.

[4]Real GDP per person employed.

[5]Real GDP per hour worked.

Table 1d. Sectoral balances

% of GDP	ESA Code	2008	2009	2010	2011	2012
1. Net lending/borrowing vis-à-vis the rest of the world	B.9	-2.9	-1.8	-1.6	-1.3	-1.3
of which: - Balance on goods and services		-0.5	-0.1	0.2	0.5	0.7
- Balance of primary incomes and transfers		-2.5	-1.8	-1.9	-2.0	-2.1
- Capital account		0.1	0.1	0.1	0.1	0.1
2. Net lending/borrowing of the private sector	B.9	-0.2	3.4	3.4	2.6	1.4
3. Net lending/borrowing of general government	EDP B.9	-2.7	-5.3	-5.0	-3.9	-2.7
4. Statistical discrepancy		-	optional	optional	optional	optional

Table 2. General government budgetary prospects

	ESA Code	2008	2008	2009	2010	2011	2012
		Level	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP
Net lending (EDP B.9) by sub-sector							
1. General government	S.13	*-42979*	-2.7	-5.3	-5.0	-3.9	-2.7
2. Central government	S.1311	*-41848*	-2.7	-4.7	-4.7	-4.1	-3.7
3. State government	S.1312	*-42320*	-2.7	-4.8	-4.7	-4.1	-3.7
4. Local government	S.1313	*-3490*	-0.2	-0.6	-0.4	-0.4	-0.4
5. Social security funds	S.1314	*2359*	0.2	0.1	0.1	0.1	0.1
General government (S13)							
6. Total revenue	TR	*723742*	46.0	46.4	45.9	45.5	45.6
7. Total expenditure	TE[1]	*766721*	48.8	51.7	50.9	49.9	49.5
8. Net lending/borrowing	EDP B.9	*-42979*	-2.7	-5.3	-5.0	-4.3	-3.9
9. Interest expenditure	EDP D.41	*80891*	5.1	4.8	4.9	5.2	5.5
10. Primary balance[2]		*37912*	2.4	-0.5	-0.1	0.9	1.5
11. One-off and other temporary measures[3]		*3288*	0.2	0.6	0.1	0.0	0.0
Selected components of revenue							
12. Total taxes (12=12a+12b+12c)		*457424*	29.1	29.0	28.7	28.3	28.4
12a. Taxes on production and imports	D.2	*215519*	13.7	13.4	13.4	13.2	13.0
12b. Current taxes on income, wealth, etc	D.5	*241427*	15.4	15.3	15.3	15.1	15.4
12c. Capital taxes	D.91	*478*	0.0	0.3	0.0	0.0	0.0
13. Social contributions	D.61	*214718*	13.7	13.9	13.8	13.8	13.7
14. Property income	D.4	*9273*	0.6	0.6	0.6	0.6	0.6
15. Other[4]		*42327*	2.7	3.0	2.8	2.8	2.8
16=6. Total revenue	TR	*723742*	46.0	46.4	45.9	45.5	45.6
p.m.: Tax burden (D.2+D.5+D.61+D.91-D.995)[5]		-	42.8	42.9	42.5	42.1	42.1
Selected components of expenditure							
17. Compensation of employees + intermediate consumption	D.1+P.2	*256574*	16.3	17.2	16.9	16.3	15.9
17a. Compensation of employees	D.1	*171160*	10.9	11.4	11.2	10.9	10.6
17b. Intermediate consumption	P.2	*85414*	5.4	5.7	5.6	5.4	5.3
18. Social payments (18=18a+18b)		*321036*	20.4	21.9	21.8	21.6	21.5
18a. Social transfers in kind supplied via market producers	D.6311, D.63121, D.63131	*43028*	2.7	3.0	2.9	2.9	2.9
18b. Social transfers other than in kind	D.62	*278008*	17.7	19.0	18.9	18.8	18.6
19=9. Interest expenditure	EDP D.41	*80891*	5.1	4.8	4.9	5.2	5.5
20. Subsidies	D.3	*14237*	0.9	0.9	0.9	0.9	0.8
21. Gross fixed capital formation	P.51	*34973*	2.2	2.7	2.2	2.0	2.1
22. Other[6]		*59010*	3.8	4.3	4.2	3.9	3.7
23=7. Total expenditure	TE[1]	*766721*	48.8	51.7	50.9	49.9	49.5
p.m.: Government consumption (nominal)	P.3	*318112*	20.2	21.4	21.0	20.4	19.9

[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	2007	2012
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	2008	2009	2010	2011	2012
1. Gross debt[1]		105.8	115.1	116.9	116.5	114.6
2. Change in gross debt ratio		2.3	9.3	1.8	-0.4	-1.9
Contributions to changes in gross debt						
3. Primary balance[2]		-2.4	0.5	0.1	-1.3	-2.7
4. Interest expenditure[3]	EDP D.41	5.1	4.8	4.9	5.2	5.4
5. Stock-flow adjustment		1.4	1.3	-0.3	-0.1	-0.3
of which:						
- Differences between cash and accruals[4]		0.2	0.0	-0.6	-0.5	-0.6
- Net accumulation of financial assets[5]		0.3	0.5	0.2	0.2	0.2
of which:						
- privatisation proceeds		0.0	0.0	0.0	0.0	0.0
- Valuation effects and other[6]		0.9	0.8	0.0	0.2	0.1
p.m.: Implicit interest rate on debt[7]		5.1	4.4	4.3	4.6	4.8
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	2008	2009	2010	2011	2012
1. Real GDP growth (%)		-1.0	-4.8	1.1	2.0	2.0
2. Net lending of general government	EDP B.9	-2.7	-5.3	-5.0	-3.9	-2.7
3. Interest expenditure	EDP D.41	5.1	4.8	4.9	5.2	5.4
4. One-off and other temporary measures[1]		0.2	0.6	0.1	0.0	0.0
5. Potential GDP growth (%)		0.7	0.4	0.5	0.6	0.7
contributions:						
- labour		0.4	0.4	0.3	0.3	0.1
- capital		0.5	0.2	0.2	0.3	0.3
- total factor productivity		-0.2	-0.2	0.0	0.1	0.3
6. Output gap		0.8	-4.5	-4.0	-2.7	-1.5
7. Cyclical budgetary component		0.4	-2.3	-2.0	-1.4	-0.7
8. Cyclically-adjusted balance (2 - 7)		-3.1	-3.0	-3.0	-2.6	-2.0
9. Cyclically-adjusted primary balance (8 + 3)		2.0	1.8	1.9	2.6	3.5
10. Structural balance (8 - 4)		-3.3	-3.6	-3.1	-2.5	-2.0

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

Table 6. Divergence from previous update

	ESA Code	2008	2009	2010	2011	2012
Real GDP growth (%)						
Previous update		-0.6	-2.0	0.3	1.0	n.a.
Current update		-1.0	-4.8	1.1	2.0	n.a.
Difference		-0.4	-2.8	0.8	1.0	n.a.
General government net lending (% of GDP)	EDP B.9					
Previous update		-2.6	-3.7	-3.3	-2.9	n.a.
Current update		-2.7	-5.3	-5.0	-3.9	n.a.
Difference		-0.1	-1.6	-1.7	-1.0	n.a.
General government gross debt (% of GDP)						
Previous update		105.9	110.5	112.0	111.6	n.a.
Current update		105.8	115.1	116.9	116.5	n.a.
Difference		-0.1	4.6	4.9	4.9	n.a.

Table 7. Long-term sustainability of public finances

% of GDP	2000	2005	2010	2020	2030	2050
Total expenditure	n.a.	48.2	51.4	47.5	47.2	47.4
Of which: age-related expenditures	n.a.	26.1	28.3	27.5	28.4	29.4
Pension expenditure	n.a.	14.0	15.2	14.7	15.3	14.9
Social security pension	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Old-age and early pensions	n.a.	13.4	14.7	14.2	14.9	14.6
Other pensions (disability, survivors)	n.a.	0.6	0.5	0.5	0.4	0.3
Occupational pensions (if in general government)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Health care	n.a.	6.7	7.4	7.6	8.0	8.9
Long-term care *(this was earlier included in the health care)*	n.a.	0.8	1.0	1.0	1.1	1.5
Education expenditure	n.a.	4.2	4.2	3.7	3.5	3.7
Other age-related expenditures	n.a.	0.4	0.6	0.4	0.4	0.4
Interest expenditure	n.a.	4.5	4.9	4.5	3.3	2.5
Total revenue	n.a.	43.8	46.5	46.8	46.7	46.7
Of which: property income	n.a.	0.6	0.6	0.5	0.5	0.5
Of which : from pensions contributions (or social contributions if appropriate)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Pension reserve fund assets	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Of which : consolidated public pension fund assets (assets other than government liabilities)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Assumptions						
Labour productivity growth	n.a.	0.5	1.1	1.6	1.7	1.7
Real GDP growth	n.a.	0.7	1.1	2.0	1.3	1.4
Participation rate males (aged 20-64)	n.a.	79.2	78.6	81.8	82.5	84.0
Participation rates females (aged 20-64)	n.a.	53.6	55.3	60.2	61.2	62.0
Total participation rates (aged 20-64)	n.a.	66.4	66.9	71.0	71.9	73.3
Unemployment rate	n.a.	7.7	8.4	5.9	5.6	5.6
Population aged 65+ over total population	n.a.	19.5	20.3	22.7	26.2	32.6

Table 8. Basic assumptions

	2008	2009	2010	2011	2012
Short-term interest rate[1] (annual average)	3.5	1.0	1.8	2.9	3.7
Long-term interest rate (annual average)	4.8	4.3	4.8	5.1	5.4
USD/€ exchange rate (annual average) (euro area and ERM II countries)	1.47	1.40	1.50	1.50	1.50
Nominal effective exchange rate	4.9	0.8	2.4	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	3.6	-0.3	3.8	4.1	4.6
EU GDP growth	0.8	-4.1	0.9	1.6	2.4
Growth of relevant foreign markets	1.2	-12.3	2.0	4.1	4.2
World import volumes, excluding EU	4,6	-12,6	4,6	5,0	7.0
Oil prices (Brent, USD/barrel)	96.9	61.9	76.8	76.8	76.8

[1]If necessary, purely technical assumptions.