



MINISTERO DELL'ECONOMIA E DELLE FINANZE

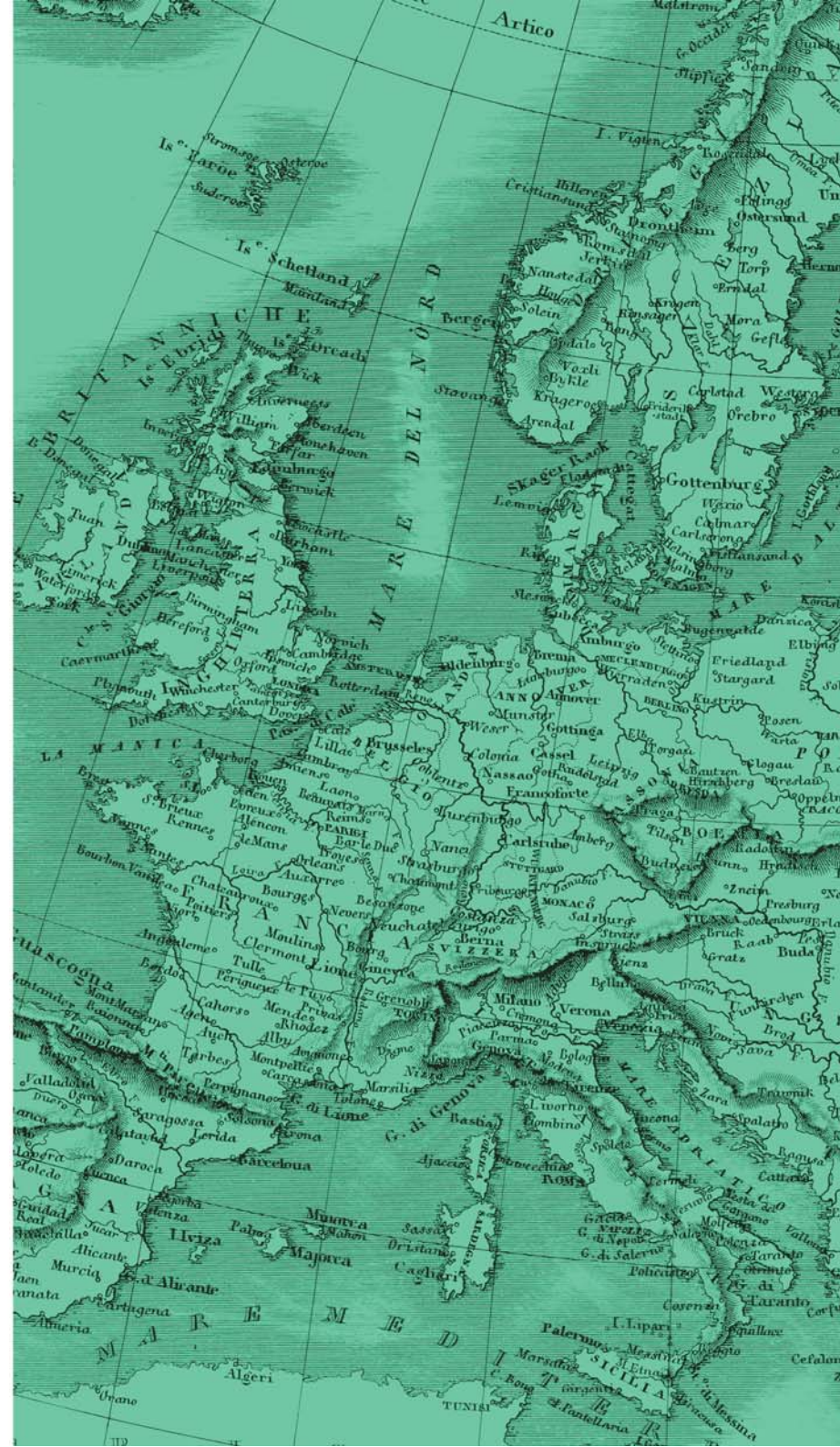
# Italy's Stability Programme

2008 Update

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ITALY'S STABILITY PROGRAMME

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Ministero dell'Economia e delle Finanze

# Italy's Stability Programme

*2008 Update  
Presented on February 2009*





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## I. INTRODUCTION

The global economic outlook has changed significantly in recent months, especially since September when the financial crisis grew markedly worse. The substantial deterioration of economic conditions has necessitated a review of macroeconomic forecasts vis-à-vis the estimates prepared in September in the *Forecasting and Planning Report*.

The economic-financial downturn has impacted the world, Europe and Italy. The Italian Government has promptly responded, by undertaking three different types of policy actions consisting of: first, a three-year consolidation plan anticipating the 2009 Budget Law; followed by urgent measures to safeguard savings and therefore guarantee the stability of the credit system; and finally, the recovery plan implemented in November in order to alleviate the unfavourable impact on the economy and the public at large.

The adjustment in the public accounts has been spelled out in a decree-law that was presented with the Economic and Financial Planning Document (DPEF) and approved prior to the end of the summer. The 2009 Budget Law, presented at the end of September, and now approved, includes only several technical adjustments so as to facilitate the implementation of the three-year budget.

Both the decree-law and the 2009 Budget Law have provided a stable framework, which has allowed for the quick adoption of measures fending off the impact of the intense financial and real crisis without significantly jeopardizing budget balances.

The *European Economic Recovery Plan* presented on 26 November by the European Commission also recognized the necessity of tackling the financial crisis and the economic recession, granting the Member States greater manoeuvring room in terms of budget policy, consistent with the regulations contained in the new Stability and Growth Pact. The European Council approved this approach on 11-12 December 2008.

The Stability and Growth Pact contains a mechanism which takes into account the effect of the business cycle on public finances so that Member States can allow automatic stabilizers to work. In this type of crisis situation, the working of this mechanism, yielding its effects especially in economic downturns, has allowed the Italian Government to continue the budget consolidation process, consistent with the Stability and Growth Pact.

Despite the worsening of the economic crisis and the resulting deterioration of public-finance conditions, the nominal deficit, without any business-cycle correction remained below 3.0 percent of GDP in 2008, and is expected to be above this threshold in 2009 (close to 3.7 percent of GDP, though it should resume a downward trend during the 2010-2011 two-year period).



The commitment to achieve the close-to-balance objective (MTO) is reaffirmed, albeit with a delayed timetable because of to the exceptional crisis that Italy has faced since the initial commitment was undertaken in 2007.

Despite the difficult economic situation, the Government is going to provide the needed support to the economy while limiting the negative impact on public accounts, thereby maintaining financial stability.

This Update of the Stability Programme<sup>1</sup> reflects the revised macroeconomic forecasts, taking into account the Government's conviction that the global economy is entering "uncharted territory", and illustrates their repercussions on public-finance balances and on the budget strategy for the achievement of financial objectives, taking into account the effects of the additional measures adopted to address the impact of the financial crisis on the economy<sup>2</sup>.

The document presents the projections of public debt relative to GDP for the next few years, extending the forecast time horizon to 2060 for the purposes of the analysis of long-term sustainability. The demographic assumptions refer to EUROSTAT's new baseline forecast (base year of 2007), whereas the macroeconomic outlook for the medium/long term incorporates the assumptions developed by the *EPC-Ageing Working Group* (EPC-AWG).

Finally, this document presents a chapter dedicated to the quality of public finance which includes, among other things, the Business Plan for the Public Administration, a description of the new State budget which will serve as a tool for resource planning and expenditure analysis, and the acknowledgement of the fiscal rules and institutions that govern the administration of budget policies. This chapter also contains a special section addressing the budget implications of the structural measures described in the *2008-2010 National Reform Programme (NRP)*, as required by the provisions of the Code of Conduct.

According to a provision in the law on government accounting, Parliament is to be presented with a *Disclosure Note* upon the submission of the Stability Programme

<sup>1</sup> The *Update of the Stability Programme* is prepared pursuant to the Council of the European Union Regulation n. 1466/97, taking into account the changes introduced by Regulation n. 1055/2005 of 27 June 2005 and the guidelines for the application of the new Stability and Growth Pact.

<sup>2</sup> More specifically, this Update is largely based on (i) the *Disclosure Note* for the 2009-2011 period presented to Parliament on 6 February 2009, (ii) Law n. 133/2008 converting Decree-Law n. 112/2008, presented in June along with the DPEF, (iii) the 2009 Budget Law presented in September, (iv) Law n. 2/2009 converting Decree-Law no.185/2008 presented in November, and (v) Decree-Law n. 207/2008 presented in December. The document takes into account the measures contained in the proposed legislation backing the budget: (i) two legislative bills covering the regulations necessary for the completion of the initiatives that contribute to the planning and achievement of the objectives by the end of 2011; and (ii) three proposed laws covering the implementation of fiscal federalism, the measures to increase the productivity of the public-sector work force, and regulatory changes relating to strenuous jobs, public-sector employment and labour disputes.





whenever the economic forecasts and public-finance balances differ from those contained in the previously approved Economic and Financial Planning Document (DPEF)<sup>3</sup>.

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<sup>3</sup> And subsequently revised with the Update to the DPEF (Law n. 468/78, Article 3, Paragraph 4bis).



## II. MACROECONOMIC SCENARIO

### II.1 THE INTERNATIONAL SCENARIO

According to the forecast provided in this document, the global economy should grow by 3.0 per cent in 2008 and remain flat this year. World trade is expected to increase by 4.1 per cent in 2008 and to contract by 2.8 per cent in 2009.

Last year the global economy entered into a recession as a result of the worsening of the financial crisis that began to take shape in 2007 and became even more severe as of September. The crisis originally involved the most industrialised countries, but it has more recently affected emerging economies as well.

Since the beginning of last year, the labour market has deteriorated in the major industrialised nations, giving rise to an increase in the unemployment rate. The most recent indicators point to a reduction in business and consumer confidence, thereby suggesting economic weakness in the quarters ahead. Against this backdrop, commodity prices have fallen significantly, resulting in a reduction of inflation from the peak levels reached at the end of the summer. Crude oil prices fell below \$45/barrel in January, with a decrease of almost 70 per cent versus the historic high registered in early July. The prices of food products and metals have also fallen substantially.

In response to the crisis, the governments and central banks of the largest countries have strengthened international coordination. The governments have approved extraordinary measures to recapitalise banks and to extend deposit guarantees. Some countries have announced plans to develop public works or to provide incentives to sectors, such as renewable energy sources, which are expected to generate positive externalities. A common framework for intervention has also been defined at the European level.

The monetary authorities have repeatedly reduced interest rates. On 28 January, the U.S. Federal Reserve left the Fed Funds rate unchanged at its historic low, with a target range of 0.00-0.25 per cent set at the previous meeting in December. The Federal Reserve has also made it clear that it will use nonconventional tools in order to support the economy and the functioning of the financial markets. In January, the Bank of Japan left rates unchanged following its previous decision which reduced the reference rate to 0.1 per cent. Starting in October, the European Central Bank also moved to cut the policy rate through four separate reductions for a total of 225 basis points, lowering it to 2.0 per cent at the 15 January meeting and left rates unchanged at this level at the most recent meeting of 5 February.

Leading international institutions have also revised downwards their projections for economic growth as the crisis has become more widespread.



## II.2 PROSPECTS FOR THE ITALIAN ECONOMY

The global financial crisis has gradually spilled over to the real economy. In order to address the unfavourable economic conditions, the European Commission presented a common plan (*European Economic Recovery Plan*) to provide guidance to the Member States in their adoption of national measures. In addition, the Commission requested updated macroeconomic forecasts which take into account the development of the crisis and the repercussions thereof on the national economies<sup>1</sup>. The European Commission released its forecast (*Interim Forecast*) on 19 January.

The Italian economy has thus far been relatively less exposed than other European countries to the specific risks of the crisis. The correction in the real estate sector seems less pronounced relative to other industrialised countries and the Italian banking system appears comparatively less exposed to the financial crisis<sup>2</sup>. Furthermore, compared with other industrialised countries, Italian households have less debt. In 2007, the ratio of financial liabilities of Italian households to GDP stood at 48 per cent versus ratios of around 64 per cent for France and Germany, 105 per cent in Ireland and roughly 110 per cent for the UK<sup>3</sup>.

In compliance with the Code of Conduct, the macroeconomic framework presented here is based on and consistent with the Commission's external assumptions contained in the Interim Forecast released on 19 January. In particular, the European Commission's assumptions have been used for oil prices, the USD/EUR exchange rate, and the European Union's and Euro Area's GDP growth rates.

At the same time, however, the Italian economy was already showing signs of weakness as early as the end of 2007, due to structural problems and other factors such as the increase in crude oil prices and the sharp appreciation of the euro against the dollar. During the third quarter of 2008, the financial crisis exerted its effects on the real economy through a decrease in foreign demand that, in turn, led to a drop in exports and investment. The labour market witnessed a decrease in employment according to national accounts data (full-time equivalents).

GDP decreased by 0.5 per cent in the third quarter over the previous quarter (after having already contracted by 0.4 per cent in the second quarter). Investment in equipment and transport in the third quarter were down sharply (-3.5 per cent and -2.2 per cent,

<sup>1</sup> ECFIN.F.4 (2008) REP 56281, 3 December 2008.

<sup>2</sup> The Government ratified two decrees (Decree-Law n. 155/2008 and Decree-Law n. 157/2008) that were incorporated into Law n. 190 of 4/12/2008 (see Box: Measures for the stability of the credit system and continuity in the disbursement of credit).

<sup>3</sup> The data refer to households and NPISH (Non-Profit Institutions Serving Households) and are not consolidated (source: Eurostat).



respectively). Investment in construction contracted for the second consecutive quarter. Household consumption showed modest growth (0.1 per cent) sustained by the increase in spending on semi-durable goods and services. Consumer spending on durable goods was down (-1.2 per cent), whereas consumption of non-durable goods remained flat. The slide in foreign demand was reflected in exports that fell by 1.6 per cent.

Export prices rose further compared with the previous quarter. At the same time, external inflationary pressures that were still present in the third quarter had the effect of pushing up import prices (3.3 per cent compared with the preceding quarter). As a result, the increase in the consumption deflator continued to be robust (1.1 per cent compared with the preceding quarter).

The crisis has produced its effects on the labour market: employment as measured in full-time equivalents was down by 0.7 per cent compared with the preceding quarter. The sector that was most affected was private services. The labour force survey is slightly less negative: during the third quarter, labour supply remained flat compared with the preceding quarter, while employment experienced a marginal increase (0.1 per cent). This outcome was supported by the employment of part-time employees, women and immigrants. The seasonally adjusted unemployment rate was slightly lower.

The latest available indicators show a further, significant contraction of GDP in the fourth quarter. In November, industrial production fell by 2.3 per cent compared with October.

In January, business confidence indicators for manufacturing firms were at historical lows. On the other hand, the level of consumer confidence has shown a modest increase, although remaining at historically low levels.

GDP is expected to contract by 0.6 per cent in 2008. Already weak in the first half, consumer spending will likely log a reduction for the full year (-0.5 per cent). Given the decrease in confidence and the weakening of the economic cycle, investment in machinery is forecast to fall by 2.5 per cent.

The crisis will have some repercussions on the real estate sector in Italy, which thus far has been less impacted than have the property markets in other European countries. Investment in construction is projected to fall by 1.1 per cent. On the supply side, the sector's production for the third quarter reflects a second consecutive quarterly reduction (-1.6 per cent compared with the preceding period). Consumer demand for mortgages continued to contract in November compared with the same month of the previous year.

Italian exports are likely to continue to be penalised by the slowdown in world trade.



Taking into account the reduction in employment expected in the fourth quarter, the employment should increase 0.5 per cent on average for the year, a deceleration of the growth rate relative to 2007. After declining for the past ten years, the unemployment rate is poised to grow to around 6.9 per cent.

In terms of consumer prices, the inflation rate averaged 3.5 per cent, reflecting the price increases seen in the first part of the year.

According to many analysts, the effects of the crisis should continue to be felt for most of 2009, with a modest recovery not expected until near year's end. GDP should contract by another 2.0 per cent in 2009. The components of aggregate demand likely to be impacted most by the crisis are investment (and, in particular, investment in machinery) and exports (due to the recession in the world's most developed countries). Household consumption is forecast to contract again on average for the year.

Consumer inflation should be around 1.2 per cent, thanks to the decrease in commodity prices in the second half of 2008.

Employment is projected to fall in 2009 by 1.0 per cent. The unemployment rate should increase for the second consecutive year, reaching 8.2 per cent. Labour costs are expected to decelerate significantly compared to 2008, due to the effect of wage moderation.

For the 2010-2011 period, growth should average just over 0.7 per cent per year. Private consumption is forecast to grow by an average of around 0.9 per cent per year, thanks to the recovery of real disposable income. Boosted by an improvement in global demand, investment in machinery and equipment should increase by an annual average of roughly 1.4 per cent. Investment in construction is projected to grow moderately as a result of the adjustment in the housing sector. Exports will be driven by the recovery in world trade and the renewed momentum in investment. Exporters will likely recover price competitiveness on a gradual basis, with the export price deflator showing a fairly weak upward trend (2.1 per cent at the end of the period). Imports are poised to recover, driven by firmer domestic demand.

Employment is forecast to grow by an average of 0.4 per cent per year for the 2010-2011 period. The unemployment rate would reach 8.2 per cent in 2011. A moderate increase in nominal wages and a modest recovery of productivity are expected to limit the growth of both unit labour costs and domestic inflation. Consistent with the moderation of external inflationary pressures, inflation, as measured by the private consumption deflator, should average just under 2.0 per cent per year.

**TABLE 1: BASIC ASSUMPTIONS (% change, unless specified otherwise)**

	2007	2008	2009	2010	2011
Short-term interest rate (1)	4.0	3.5	1.9	3.2	4.1
Long-term interest rate	4.4	4.8	4.8	5.2	5.6
USD/EUR exchange rate	1.37	1.47	1.38	1.38	1.38
Change in nominal effective exchange rate	3.9	4.6	0.3	0.0	0.0
GDP growth, world excluding EU	5.4	3.7	0.6	3.2	4.4
EU GDP growth	2.9	1.0	-1.8	0.5	2.5
Growth in Italy's foreign markets	4.6	2.7	0.6	3.3	5.4
World import volumes, excluding EU	8.2	5.1	-1.8	4.2	6.3
Oil price (Brent, USD/barrel)	72.5	98.5	52.1	61.7	61.7

1) Interest rate on three-month Italian government securities, weighted according to the planned quantities of issues. Long-term interest rates refer to ten-year Italian government securities. Interest-rate data are annual averages.

**TABLE 2a: MACROECONOMIC PROSPECTS**

	2007 level (1)	2007	2008	2009 % change	2010	2011
Real GDP	1,284,868	1.5	-0.6	-2.0	0.3	1.0
Nominal GDP	1,535,541	3.8	2.4	-0.6	2.1	2.9
COMPONENTS OF REAL GDP						
Private consumption	753,824	1.4	-0.5	-0.5	0.6	1.2
Public consumption (2)	258,539	1.3	1.1	0.3	0.0	0.0
Gross fixed investment	272,005	1.2	-1.8	-6.8	0.3	1.4
Exports of goods and services	372,081	5.0	-1.4	-5.0	1.3	3.5
Imports of goods and services	378,003	4.4	-2.9	-4.3	1.6	3.4
CONTRIBUTION TO REAL GDP GROWTH (3)						
Net exports		0.1	0.4	-0.2	-0.1	0.0
Change in inventories		0.0	-0.5	-0.1	0.0	0.0
Domestic demand		1.4	-0.6	-1.7	0.4	1.0

1) € Ml.

2) General government and NPISHs.

3) Possible imprecisions are due to rounding.

**TABLE 2b: PRICE DEVELOPMENTS**

	2007 level	2007	2008	2009 % change	2010	2011
GDP deflator	119.5	2.3	3.0	1.4	1.7	1.9
Private consumption deflator	119.4	2.2	3.6	1.2	1.8	1.9
HICP	104.3	2.0	3.5	1.2	1.7	2.0
Public consumption deflator	119.9	0.4	4.2	0.9	1.0	0.9
Investment deflator	118.9	2.6	2.7	0.3	1.6	1.9
Export deflator (goods and services)	120.5	3.6	4.8	1.4	2.0	2.1
Import deflator (goods and services)	119.8	2.3	6.1	-0.4	1.5	1.7


**TABLE 2c: LABOUR MARKET DEVELOPMENTS**

	2007 level (1)	2007	2008	2009	2010	2011
		% change				
Employment, persons (national account data)	25,165	1.1	0.5	-1.0	0.2	0.5
Employment, hours worked	45,892,027	1.7	1.0	-0.7	0.1	0.0
Unemployment rate		6.1	6.9	8.2	8.4	8.2
Labour productivity, persons	51,058	0.3	-1.0	-1.1	0.2	0.5
Labour productivity, hours worked	28	-0.2	-1.5	-1.3	0.3	1.0
Compensation of employees	630,440	3.5	5.6	1.2	2.1	2.6
Compensation per employee	35,131	1.9	4.3	1.5	1.9	2.0

1) Units of measurement: in thousands for employment (persons) and hours worked; in real € for labour productivity; in millions of current € for compensation of employees; in current € for compensation per employee.

**TABLE 2d: SECTORAL BALANCES**

	2007	2008	2009	2010	2011
	in % of GDP				
Net lending/borrowing vis-a-vis the rest of the world	-1.6	-1.6	-1.3	-1.1	-0.9
Balance of goods and services	-0.3	-0.2	0.1	0.1	0.3
Balance of primary income and transfers	-1.4	-1.5	-1.5	-1.4	-1.3
Capital account	0.2	0.2	0.1	0.1	0.1
Net lending/borrowing of the private sector	0.0	1.0	2.4	2.1	2.0
Net lending/borrowing of general government <sup>1</sup>	-1.5	-2.6	-3.7	-3.3	-2.9
Net lending/borrowing of general government	-1.6	-2.6	-3.7	-3.3	-2.9
Statistical discrepancies					

1) In 2007 the net lending of general government B.9 was introduced because ESA95 uses this balance to calculate the balance versus the rest of the world. The EDP B.9 is stated thereafter.



### III. NET BORROWING AND PUBLIC DEBT

#### III.1 THE NET BORROWING OF THE GENERAL GOVERNMENT

The forecasts of budget balances presented in the *2007 Update of the Stability Programme* have been revised several times during 2008 as the prospects for economic growth have deteriorated<sup>1</sup>.

As the international crisis started to worsen in September, the macroeconomic outlook also began to deteriorate. Acting on the request of the European Commission to promote concerted action on the part of the Member States in response to the economic crisis, the Government ratified an urgent decree in November which contained a package of measures to support families and businesses<sup>2</sup>. The measures approved for combating the crisis entailed some adjustments in the public accounts, though without changes to the overall balances. In the *Disclosure Note* published in February, net borrowing was estimated to increase from 2.5 to 2.6 per cent of GDP<sup>3</sup>, due to a contraction of tax revenues resulting from the worsening of the economic crisis.

The difference between the estimates of net borrowing for 2008 presented herein and those indicated in the last Update is equal to 0.4 percentage points (Table 3). The higher deficit can mainly be attributed to the higher percentage of expenditures relative to a lower level of GDP compared with the previous forecast (0.5 percentage points of GDP), only partly offset by the higher ratio of revenues (0.1 percentage points of GDP). Within current expenditure, the growing weight of social transfers other than in kind (0.4 percentage points) has been only marginally offset by the reduction in employee compensation (-0.1 percentage points). The percentage of gross fixed capital formation is down by 0.2 percentage points. In terms of current revenues, the growth of direct taxes (0.4 percentage points) and social security contributions (0.2 percentage points) has fully offset the reduced percentage of indirect taxes (-0.6 percentage points). The forecast for GDP growth has been revised down by 2.1 percentage points versus the forecasts in the last Update (-0.6 per cent compared to 1.5 per cent)

Compared with the results achieved in 2007, the 2008 nominal net borrowing (not cyclically-adjusted) increases by 1.0 percentage points of GDP, going from 1.6 to 2.6 per

<sup>1</sup> With an initial revision in April (in the 2008 Combined Report on the Economy and Public Finance (RUEF)), net borrowing for 2008 had been estimated to rise from 2.2 to 2.4 per cent of GDP. Later, in June (with the 2009-2013 Economic and Financial Planning Document (DPEF)), that estimate was revised once more and set at 2.5 per cent of GDP, and was then confirmed in September (with the Forecast and Planning Report (RPP) and the Update of the DPEF), when some changes were made in the mix of the accounts, though the same did not affect the overall balances.

<sup>2</sup> Decree-Law n. 185/2008 converted into Law n.2/2009.

<sup>3</sup> The estimate is based on the Decree-Law n.185/2008 (converted into Law n.2/2009) as amended by the Decree-Law n. 207/2008 with regard to the postponement of a share of the IRES and IRAP deposit.





cent<sup>4</sup>. The result for 2007 benefited from the deferral to 2008 of several programmes that had been planned and budgeted for an amount equivalent to around 0.2 points of GDP. A comparison of the balances after adjustments to include the deferred amounts and to exclude the beneficial impact of one-off measures (0.1 and 0.2 points of GDP in 2007 and 2008, respectively) shows the deficit increased by 0.7 points of GDP between 2007 and 2008.

**TABLE 3: DIFFERENCES FROM PREVIOUS UPDATE**

	2007	2008	2009	2010	2011
<b>GDP GROWTH RATE</b>					
2007 Stability Programme	1.9	1.5	1.6	1.7	1.8
2008 Stability Programme	1.5	-0.6	-2.0	0.3	1.0
Difference	-0.4	-2.1	-3.6	-1.4	-0.8
<b>NET BORROWING (% of GDP)</b>					
2007 Stability Programme	-2.4	-2.2	-1.5	-0.7	0.0
2008 Stability Programme	-1.6	-2.6	-3.7	-3.3	-2.9
Difference	0.8	-0.4	-2.2	-2.6	-2.9
<b>PUBLIC DEBT<sup>1</sup> (% of GDP)</b>					
2007 Stability Programme	105.0	103.5	101.5	98.5	95.1
2008 Stability Programme	104.1	105.9	110.5	112.0	111.6
Difference	-0.9	2.4	9.0	13.3	16.5

1) The 2009 estimate does not take into account possible public debt issue to support banks. Equally, the estimate does not include possible income that could be derived from such support inasmuch as it is currently not quantifiable.

More specifically, total revenues in relation to GDP are expected to fall by 0.2 percentage points compared with 2007, particularly as a result of lower tax revenues (-0.7 percentage points) that is only partially offset by the growth of social security contributions (0.4 percentage points). The decrease in tax revenues is due mainly to the reduction of indirect taxes (-0.9 percentage points) that is only marginally offset by higher direct taxes (0.2 percentage points).

In comparison with 2007, total expenditures should increase by an amount equivalent to around 0.8 per cent of GDP as a result of the increase in the main current expenditure components, namely, social transfers in cash (0.5 percentage points) and employee compensation (0.3 percentage points). Primary expenditure is 0.7 percentage points higher due to the simultaneous increase (0.1 percentage points) in the interest burden (which goes from 5.0 to 5.1 per cent of GDP).

<sup>4</sup> The 2007 result was revised to 1.6 per cent of GDP, following Eurostat's recent decision relative to the classification of Equitalia S.p.A. (holding company and subsidiaries) as a general government entity. As a result of this reclassification, the abolition of the tax collection agents' obligation to make advance payments of taxes due (as ordered with Decree-Law n. 248/2007 at the end of 2007) was accounted for in a different manner. The transaction with Equitalia, which was initially booked among the capital account transfers to businesses, is consolidated within the general government, thus improving the balance.

TABLE 4: GENERAL GOVERNMENT BUDGETARY PROSPECTS<sup>1</sup>

	2007		2008	2009	2010	2011
	level (2)	% of GDP				
Net borrowing by sub-sector						
1. General government	-24,094	-1.6	-2.6	-3.7	-3.3	-2.9
2. Central government	-37,656	-2.5	-2.3	-3.3	-3.1	-2.8
3. State	-36,646	-2.4	-2.3	-3.2	-3.1	-2.7
4. Local government	3,585	0.2	-0.8	-0.8	-0.6	-0.5
5. Social security entities	9,977	0.6	0.5	0.4	0.5	0.4
General government						
6. Total revenues	716,234	46.6	46.4	46.8	46.8	46.6
7. Total expenditures <sup>3</sup>	740,328	48.2	49.0	50.5	50.0	49.5
8. Net borrowing	-24,094	-1.6	-2.6	-3.7	-3.3	-2.9
9. Expenditure for interest <sup>3</sup>	76,580	5.0	5.1	5.0	5.2	5.4
10. Primary surplus <sup>3</sup>	52,486	3.4	2.5	1.3	1.9	2.6
11. One-off measures <sup>4</sup>	1,879	0.1	0.2	0.1	0.1	0.1
Selected revenue components						
12. Total tax revenues	459,888	29.9	29.2	29.2	29.2	29.1
12a. Indirect taxes	225,928	14.7	13.8	13.7	13.7	13.5
12b. Direct taxes	233,660	15.2	15.4	15.5	15.4	15.5
12c. Capital account taxes	300	0.0	0.0	0.0	0.0	0.0
13. Social security contributions	204,772	13.3	13.8	14.2	14.1	14.1
14. Property income	9,321	0.6	0.6	0.6	0.6	0.6
15. Other revenues	42,253	2.8	2.8	2.9	2.8	2.8
16. Total revenues	716,234	46.6	46.4	46.8	46.8	46.6
<i>p.m. Tax burden</i>		<i>43.3</i>	<i>43.0</i>	<i>43.3</i>	<i>43.3</i>	<i>43.2</i>
Selected expenditure components						
17. Employee compensation + intermediate consumption	244,383	15.9	16.4	16.6	16.4	16.0
17a. Employee compensation	164,645	10.7	11.0	11.3	11.2	11.0
17b. Intermediate consumption	79,738	5.2	5.4	5.3	5.2	5.0
18. Social payments	307,006	20.0	20.5	21.5	21.5	21.6
18a. Transfers in kind	41,722	2.7	2.8	2.9	2.9	2.9
18b. Social services other than in kind	265,284	17.3	17.7	18.6	18.6	18.7
19. Interest expenditure	76,580	5.0	5.1	5.0	5.2	5.4
20. Production subsidies	14,198	0.9	0.8	0.9	0.9	0.8
21. Gross fixed investments <sup>5</sup>	36,134	2.4	2.3	2.4	2.2	2.1
22. Other expenditures	62,027	4.0	3.9	4.1	3.9	3.5
23. Total expenditures	740,328	48.2	49.0	50.5	50.0	49.5
<i>p.m. Public consumption</i>	<i>303,950</i>	<i>19.8</i>	<i>20.4</i>	<i>20.8</i>	<i>20.5</i>	<i>20.1</i>

1) Because the figures are rounded to the first decimal point, there may be differences between the sum of the various expenditure accounts and total expenditures and the sum of the revenue accounts and total revenues.

2) Amounts in millions.

3) Net of swap flows, which caused expenditure for interest and thus, the debt, to be EUR 450 million higher in 2007.

4) The plus sign indicates one-off measures to reduce the debt.

5) The 2009 figure reflects the revision of the strategy on real estate investments adopted as a result of the international economic crisis and considers the unfavourable conditions of the property market for dismissals in the short term. The new formulation leads to an increase in gross fixed investments equal to 1.9 billion.

For 2009, the nominal net borrowing of the general government is forecast to total 3.7 per cent of GDP, an increase of 2.2 percentage points compared with the figure indicated in the previous Update. This estimate reflects the substantial downward revision of the growth rate expected for 2009 (-3.6 percentage points) which has a significant impact on the forecast trend of revenues.



The budget estimates for the 2010-2011 period incorporate the effects of the economic cycle. At the end of that period, the net borrowing should amount to around 2.9 per cent of GDP, while the primary surplus is projected to rise from 1.9 per cent in 2010 to 2.6 per cent in 2011, despite the growth of the ratio of interest expenditure to GDP (from 5.2 to 5.4 per cent).

### THE ANTI-CRISIS DECREE

*The anti-crisis decree adopted on 29 November 2008, immediately after the European Economic Recovery Plan, catalyzes a substantial €40 billion of resources to fight the crisis: €6 billion to support households and businesses, €16 billion to finance infrastructure, including through project financing, €8 billion (estimated) for safety nets, and €10 billion (estimated) to finance enterprise through the issue of bank bonds against the risk of a credit crunch. A part of these resources was already envisaged by the Budget Law, but the change is that the funds have been redeployed with the aim of addressing the crisis. The decree has substantially channelled the resources in two main directions by creating two budget funds:*

- a) An infrastructure fund to finance both large infrastructure projects, implemented via a much shorter administrative procedure, and small infrastructure projects, providing a direct boost to the economy.*
- b) A social fund aimed at quantitatively integrating and qualitatively modifying the safety-net mechanism, by concentrating national, regional and additional EU funds for this purpose.*

### III.2 THE CYCLICALLY ADJUSTED BUDGET BALANCE

The cyclically adjusted budget balance net of one-off measures, i.e. the structural deficit, represents the summary indicator of reference following the reform of the Stability and Growth Pact. This indicator identifies the structural condition of the public budget, i.e. net of the effects of the cyclical trend of the economy and of the impact of measures with temporary effects.

In particular, the cyclical component of the public budget, obtained by multiplying the output gap by the elasticity of the budget balance to economic growth<sup>5</sup>, measures the change in tax revenues and spending on social safety nets due to short-term economic fluctuations. Output gap developments and changes in potential GDP have been calculated by applying the methodology agreed by the ECOFIN Council.

Table 5 shows the following variables for the 2007-2011 period: GDP at constant prices, potential GDP and the cyclically adjusted public finance variables net of one-off

<sup>5</sup> This is calculated at the European level; the figure for Italy is 0.5.



measures. The growth rate of real GDP in 2008 is expected to be negative (-0.6 per cent) due to the effects of unfavourable trends in the international economy; this rate will thus reflect a contraction of almost 2 percentage points relative to 2007 (1.5 per cent). The real effects of the crisis are likely to have a negative impact on economic growth for all of 2009 (-2.0 per cent), while a gradual recovery should begin in 2010.

GDP remains below its potential in 2009, with an output gap<sup>6</sup> that reaches -2.7 per cent in 2010 and then decreases (in absolute value) to -2.4 per cent in 2011. This trend is reflected in the cyclical component of the budget balance. The Government confirms its intention to make use of one-off measures on a limited basis for the remainder of the legislature.

**TABLE 5: CYCLICAL DEVELOPMENTS<sup>1</sup> (percentage of GDP)**

	2007	2008	2009	2010	2011
GDP growth rate at constant prices	1.5	-0.6	-2.0	0.3	1.0
Net borrowing	-1.6	-2.6	-3.7	-3.3	-2.9
Interest payments	5.0	5.1	5.0	5.2	5.4
Potential GDP growth rate	1.1	0.8	0.6	0.7	0.7
Contribution of productive factors to potential growth:					
<i>Labour</i>	<i>0.9</i>	<i>0.6</i>	<i>0.5</i>	<i>0.5</i>	<i>0.3</i>
<i>Capital</i>	<i>0.6</i>	<i>0.5</i>	<i>0.3</i>	<i>0.3</i>	<i>0.3</i>
<i>Total factor productivity</i>	<i>-0.3</i>	<i>-0.3</i>	<i>-0.2</i>	<i>-0.1</i>	<i>0.0</i>
Output gap	1.6	0.3	-2.3	-2.7	-2.4
Cyclical budgetary component	0.8	0.1	-1.2	-1.3	-1.2
Cyclically adjusted budget balance	-2.4	-2.7	-2.5	-1.9	-1.7
Cyclically adjusted primary surplus	2.6	2.4	2.4	3.2	3.7
One-off measures	0.1	0.2	0.1	0.1	0.1
Budget balance, net of one-off measures	-1.7	-2.8	-3.8	-3.3	-2.9
Cyclically adjusted budget balance, net of one-off measures	-2.5	-2.9	-2.6	-2.0	-1.7
Cyclically adjusted primary surplus, net of one-off measures	2.5	2.2	2.3	3.2	3.7
Change in budget balance, net of one-off measures	-1.3	1.1	1.0	-0.5	-0.4
Change in cyclically adjusted budget balance, net of one-off measures	-1.1	0.4	-0.3	-0.6	-0.3

1) The working-age population for 2011 was calculated on the basis of the European Commission data for 2010 and by applying for the following year the growth rate calculated on the basis of ISTAT's demographic projections (2007-2051). The budget figures for 2007 take into account the reclassification of Equitalia. The rounding to the first decimal point may cause inconsistencies between the figures presented in the table.

The cyclically adjusted budget balance (net borrowing) net of the one-off measures is equal to 2.9 per cent of GDP in 2008 and is slightly lower in 2009. For 2010, the structural adjustment exceeds 0.5 per cent of GDP, and is thus consistent with the framework agreed by the ECOFIN Council.

The worsening of the economic crisis in 2008-2009 and the resulting deterioration of public-finance conditions will delay achievement of the medium-term objective; the

<sup>6</sup> It is noted that the output gap measures the difference in levels of actual GDP and potential GDP in relation to potential GDP.



commitment to achieve a balanced budget is nevertheless confirmed. The *European Economy Recovery Plan* presented on 26 November 2008 by the European Commission acknowledges the necessity of tackling the financial crisis and the economic recession, granting the Member States greater manoeuvring room in terms of budget policy, consistent with the regulations contained in the new Stability and Growth Pact. The meeting of the ECOFIN Council on 2 December 2008 and the European Council on 11-12 December 2008 confirmed this approach.

### III.3 THE PUBLIC DEBT

In 2007, the debt-to-GDP ratio decreased by 2.8 percentage points compared with 2006, going from 106.9 to 104.1 per cent. This decrease was more than one percentage point of GDP higher than that reported in the 2007 Update to the Stability Programme, which had predicted a descent from 106.8 to 105.0 per cent. A part of the difference is to be attributed to reclassifications made by ISTAT in 2008.

More specifically, on 1 October 2008, ISTAT announced various revisions in the accounting of public-finance aggregates with reference to the years of 2005, 2006 and 2007 which impacted the balances of net borrowing, the borrowing requirement and debt of the general government. ISTAT announced that general government's debt had been revised upward by amounts equivalent to 0.1, 0.4 and 0.1 percentage points of GDP, respectively, for the years 2005, 2006 and 2007. Such revisions (which are in addition to ordinary periodic reclassifications) are based in part on Eurostat's decision on 28 March 2008 to reclassify Equitalia S.p.A. as part of the public sector, and the ratification of Eurostat's opinion about the accounting treatment of certain financial transactions. With reference to Equitalia S.p.A., Eurostat's decision entailed the inclusion of debt previously contracted by the company as part of general government's liabilities, and accordingly, the debt balance was revised upward by €5,275 million in 2006 and €1,191 million in 2007. With reference to the accounting of the financial effects of the financial transaction cited above<sup>7</sup>, the reclassification regarded the lump sums collected upon the execution of interest-rate swap contracts, which, under Eurostat guidelines, are considered as loans disbursed by the counterparty to the contracting administration.

These revisions of nominal debt were nonetheless offset in the year of 2006 by the upward revision of the GDP series, with a debt-to-GDP ratio of 106.9 per cent, and thus only slightly higher than the 106.8 per cent contained in the 2007 Update.

In the case of 2007, the significant reduction seen between the ratio reported in the 2007 Update and the final result (105.0 versus 104.1 per cent of GDP) is due to a significant decrease in nominal debt, which more than offset a final GDP for 2007 that

<sup>7</sup> See *Eurostat Guidance on accounting rules for EDP*, dated 13 March 2008.



was below the level forecast in the last Update. Thus, even though nominal GDP was below the forecasts by around 0.5 per cent, general government's nominal debt stood at a level that was about 1.4 percentage points of GDP below the forecasts, even after including the aforementioned upward revisions made by ISTAT.

**TABLE 6: DEBT-TO-GDP RATIO<sup>1</sup>**

	2006	2007	2008	2009	2010	2011
Public debt						
Level	106.9	104.1	105.9	110.5	112.0	111.6
Percentage change in debt	1.0	-2.8	1.8	4.6	1.5	-0.4
Contributions to change in Government debt (as % of GDP)						
Primary balance (accrual basis)	-1.3	-3.4	-2.5	-1.3	-1.9	-2.6
Snow-ball effect	0.9	1.1	2.7	5.6	2.9	2.3
of which: Interest expenditure (accrual basis)	4.6	5.0	5.1	5.0	5.2	5.4
Stock-flow adjustment	1.4	-0.5	1.7	0.3	0.5	-0.1
of which: Difference between cash and accrual basis	-0.2	0.0	0.1	-0.5		
Net accumulation of financial assets (2)	0.6	0.4	0.6	0.4		
of which: Privatisation proceeds						
Evaluation effects of Government debt	0.2	0.3	0.2	0.2		
Other (3)	0.8	-1.2	0.7	0.2		
Memo item: Implicit interest rate on debt	4.5	4.8	5.0	4.7	4.8	5.0

- 1) The rounding to the first decimal point may cause inconsistencies between the figures presented in the table.  
 2) The estimate for 2009 doesn't take into account possible public debt issue to support the banking system, as provided by Law n. 190/2008 and Decree-Law n. 185/2008 confirmed into Law n. 2/2009.  
 3) The account (the residual balance vis-à-vis the previous accounts) includes: i) changes in the Ministry of the Economy and Finance's deposits with the Bank of Italy; ii) the effect of the revisions of the general government borrowing and the level of the public debt indicated in the Disclosure Note published in October 2008; iii) statistical discrepancies; and iv) the change in the balance of the Government Securities Amortisation Fund.

Three factors contributed for the most part to slowing the debt's momentum in 2007: a greater-than-anticipated use of the Treasury's liquidity on account with the Bank of Italy (equivalent to roughly 1.0 per cent of GDP)<sup>8</sup>, use of the Government Securities Amortisation Fund (0.3 per cent); and an improvement of the Public Sector's borrowing requirement vis-à-vis the forecasts (equivalent to roughly 0.1 per cent of GDP).

The debt-to-GDP ratio for 2008 is forecast to stand at 105.9 per cent. The increase is due to numerous factors: first of all, expected GDP growth is well below (by about 1.6 percentage points) last year's estimates; the most recent estimates of the borrowing requirement for 2008 are higher (by about 0.9 per cent of GDP) than the estimates in the 2007 Update; and finally, the valuation of the debt has been increased (mostly for securities indexed to inflation) in order to take into account the actual higher rate of inflation seen during 2008 and the higher public debt issues aimed at guaranteeing an appropriate balance of liquidity in the Treasury's account with the Bank of Italy.

<sup>8</sup> See 2008 Combined Report on the Economy and Public Finance (page 89).



For the subsequent years, the new estimates of nominal GDP growth have been significantly revised downward, and are accompanied by an increase in the debt series, as a consequence of revisions in the estimates of public-finance aggregates. The revised figures produce increases in the debt-to-GDP ratio through 2010, which are at odds with the forecast set out in the latest Update. The ratio is expected to have a more significant increase in 2009, mainly as a result of expected negative economic growth. Starting in 2011 the ratio begins a downward trend to 111.6 per cent. The combined effect of a distinctly weaker macroeconomic outlook and a less favourable trend of public finance aggregates is therefore a debt-to-GDP ratio whose profile is at a higher level overall, though a turnaround occurs in the last year.

#### MEASURES FOR THE STABILITY OF THE CREDIT SYSTEM AND CONTINUITY IN THE DISBURSEMENT OF CREDIT

*During the month of October, the Government ratified two decree-laws (155 and 157) containing urgent measures for guaranteeing savings and, therefore, the stability of the credit system and, moreover, continuity in the disbursement of credit to businesses and consumers. The decrees were later incorporated into Law 190 passed on 4 December 2008.*

*Law 190 provides for: 1) the possible recapitalisation of Italian banks, if necessary; 2) support to transactions aimed at dealing with the serious liquidity crisis; and 3) the State's deposit guarantees. The Ministry of Economy and Finance is authorised to underwrite or to guarantee capital increases approved by Italian banks which the Bank of Italy considers to be undercapitalised. In order to safeguard the interests of the taxpayers, any bank involved is required to adopt a stabilisation and reinforcement plan and a dividend policy that must be evaluated by the Bank of Italy. The shares underwritten by the Ministry will enjoy privileges in the distribution of earnings. In order to facilitate initiatives to sustain liquidity, Law 190 simplifies the formalities in relation to the guarantees provided for the Bank of Italy's disbursement of financing. In the event of severe liquidity crises, the Ministry of the Economy is also authorised to provide the State's guarantee to loans made by the Bank of Italy to Italian banks and branches of foreign banks. With reference to deposits, the Ministry of the Economy is authorised to provide the State's guarantee as a supplement to the interbank deposit insurance system, which already provides a level of cover (€103,191.38) that is well above the minimum contemplated by EU regulations (recently increased to €50,000).*

*In addition, Law 190 authorises the Ministry of the Economy through 31 December 2009 to: i) provide the State's guarantee of new liabilities of Italian banks with a maturity of up to five years; ii) carry out temporary swap transactions involving government securities and assets in the portfolios of the bank or liabilities of Italian bank counterparties; and iii) provide the State's guarantee of contracts between Italian counterparties and Italian banks that are aimed at temporarily making available to the banks securities eligible for refinancing transactions through the Eurosystem.*



Finally, with Decree 185 of 29 November 2008 (confirmed into Law n. 2 signed on 28 January 2009) containing measures for the economy, the Government introduced another tool for favouring an appropriate level of capitalisation of the banking system and an adequate flow of financing to the economy. With this decree, the Ministry of the Economy has authorisation through 31 December 2009 to underwrite, upon the request of the banks involved, financial instruments other than shares and without voting rights that are counted in the computation of regulatory capital. Such financial instruments may be converted into ordinary shares, or may be reimbursed or redeemed upon the request of the issuer, on the condition that the Bank of Italy certifies that the transaction does not compromise the issuer's financial position. The underwriting is permitted on the condition that: 1) the transaction is cost-effective overall for the Ministry; 2) the banks undertake definite commitments through a special protocol of intent with the Ministry of the Economy in relation to the level and the conditions for credit to be provided to small- and medium-sized enterprises and to consumers; and 3) the banks adopt an ethics code, including with regard to policies for executive compensation.

As for the impact of the measures on public accounts, any recapitalisation of banks or temporary swaps of securities would not change net borrowing, since such transactions are financial transactions. Instead, gross debt and the borrowing requirement would increase in an amount equal to the amount of resources tapped on the financial markets. Such increase would be re-absorbed at the time of the sale of the assets acquired or at the time of the expiration of the securities swap transactions. The extension of the guarantee to deposits and other liabilities, and the guarantees on the temporary securities swap transactions between Italian banks and Italian counterparties would have an impact on the public accounts only if the guarantees were to be enforced. In particular, with reference to the guarantees of liabilities and securities eligible for refinancing with the Eurosystem, the impact on net borrowing would be the difference between the amount of the guarantee called and the fees collected. The nominal value of the public securities issued in order to cover any guarantee called would instead directly affect debt levels. As to the underwriting of financial instruments other than shares (as provided by Decree 185), the effect on the net borrowing would be equal to the difference between the interest received by the State and the interest paid on the public securities issued to finance the purchase. The gross debt of the State would increase by the amount of the securities issued in order to tap the resources.<sup>9</sup>

<sup>9</sup> The 2009 estimate does not take into account possible public debt issue to support banks. Moreover, the estimate does not include possible income that could be derived from such support inasmuch as it is currently not quantifiable.





## IV. SENSITIVITY ANALYSIS

### IV.1 SENSITIVITY TO ECONOMIC GROWTH

The sensitivity of Italy's public finances to economic growth is analysed by simulating the trend of net borrowing and public debt under alternative macroeconomic scenarios. Consistent with the projections of selected international economic variables over the 2008-2011 period, two alternative scenarios are presented where, starting in 2009, GDP growth in one scenario is 0.5 percentage points above baseline growth and in the other is 0.5 percent below baseline growth.

**TABLE 7: SENSITIVITY TO GDP GROWTH<sup>1</sup>**

		2008	2009	2010	2011
Nominal GDP growth rate	<i>High-growth scenario</i>	2.4	0.0	2.5	3.4
	<i>Baseline scenario</i>	2.4	-0.6	2.1	2.9
	<i>Low-growth scenario</i>	2.4	-1.2	1.4	2.2
Real GDP growth rate	<i>High-growth scenario</i>	-0.6	-1.5	0.8	1.5
	<i>Baseline scenario</i>	-0.6	-2.0	0.3	1.0
	<i>Low-growth scenario</i>	-0.6	-2.5	-0.2	0.5
Potential output growth rate	<i>High-growth scenario</i>	0.9	0.8	0.9	0.9
	<i>Baseline scenario</i>	0.8	0.6	0.7	0.7
	<i>Low-growth scenario</i>	0.7	0.4	0.5	0.4
<i>Output gap</i>	<i>High-growth scenario</i>	-0.2	-2.4	-2.6	-2.1
	<i>Baseline scenario</i>	0.3	-2.3	-2.7	-2.4
	<i>Low-growth scenario</i>	0.8	-2.1	-2.8	-2.7
Net borrowing	<i>High-growth scenario</i>	-2.6	-3.5	-2.8	-2.2
	<i>Baseline scenario</i>	-2.6	-3.7	-3.3	-2.9
	<i>Low-growth scenario</i>	-2.6	-4.1	-4.0	-4.0
Cyclically adjusted budget balance	<i>High-growth scenario</i>	-2.5	-2.2	-1.5	-1.2
	<i>Baseline scenario</i>	-2.7	-2.5	-1.9	-1.7
	<i>Low-growth scenario</i>	-3.0	-3.1	-2.6	-2.6
Primary balance	<i>High-growth scenario</i>	2.5	1.5	2.3	3.1
	<i>Baseline scenario</i>	2.5	1.3	1.9	2.6
	<i>Low-growth scenario</i>	2.5	0.9	1.2	1.6
Cyclically adjusted primary balance	<i>High-growth scenario</i>	2.7	2.7	3.6	4.1
	<i>Baseline scenario</i>	2.4	2.4	3.2	3.7
	<i>Low-growth scenario</i>	2.1	1.9	2.6	3.0
Public debt	<i>High-growth scenario</i>	105.9	109.5	110.1	108.6
	<i>Baseline scenario</i>	105.9	110.5	112.0	111.6
	<i>Low-growth scenario</i>	105.9	111.5	114.4	115.8

1) The rounding to the first decimal point may cause inconsistencies between the variables.

Note: The structural balances for the alternative scenarios were calculated by using the elasticities of the revenues (equal to 1.2) and expenditures (equal to -0.04) with respect to economic growth and not the sensitivity of the public finances to the same (equal to 0.5).

The different GDP growth paths influence the primary surplus, impacting both its structural and cyclical components. The structural component is defined as the difference between structural revenues and expenditures, which are estimated by applying the EU

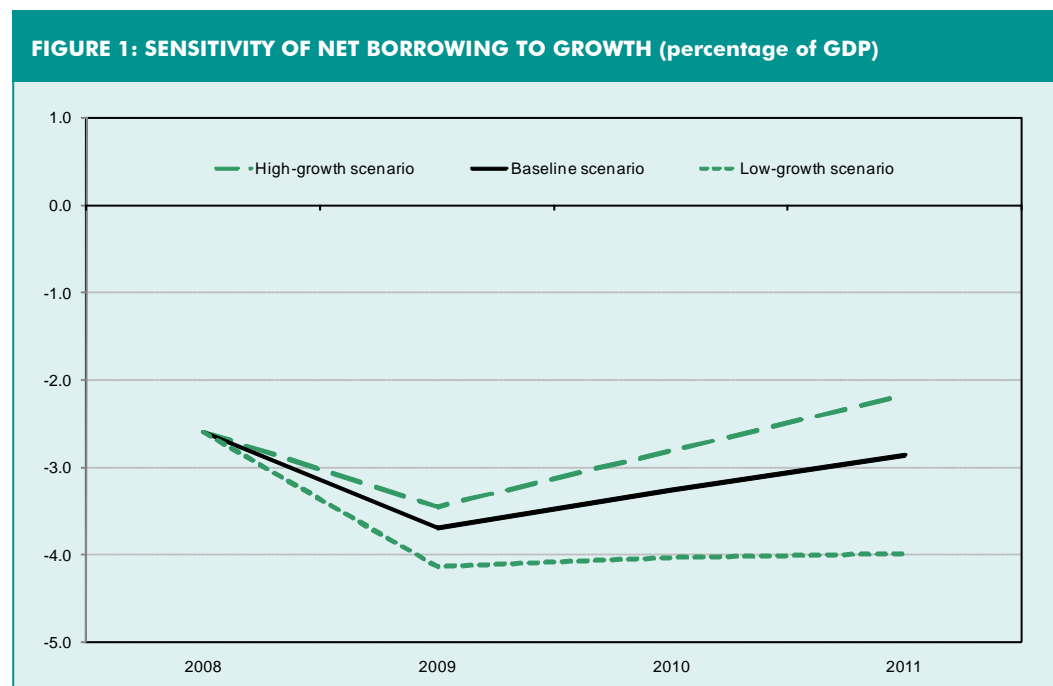


methodology. The cyclical component is calculated by multiplying the output gap by the elasticity of the primary balance to GDP<sup>1</sup>. The primary surplus' profile changes the path of debt and thus, interest expenditure.

For the purpose of estimating public debt, it is assumed that the stock-flow adjustment and the implicit interest rate for both alternative scenarios remain unchanged vis-à-vis the baseline scenario (Chapter 3, Table 6).

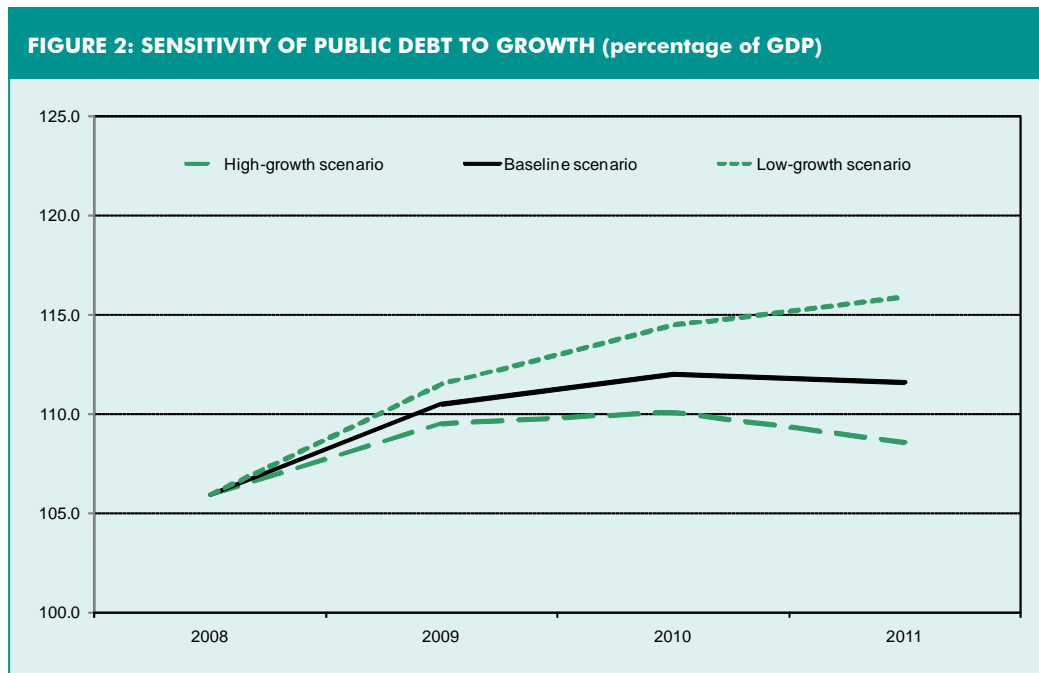
As shown by Table 7, under the low-growth scenario, net borrowing rises to 4.1 per cent of GDP in 2009 and falls to 4.0 per cent in the two years thereafter.

In the high-growth scenario, the 2009 net borrowing reaches 3.5 per cent of GDP; the aggregate then falls below the 3 per cent threshold as of 2010.



In the high-growth scenario, the debt-to-GDP ratio would go from 105.9 per cent in 2008 to 109.5 per cent in 2009, and then fall to 108.6 per cent in 2011. By contrast, in the low-growth scenario, the ratio grows over the entire forecast period, rising to 115.8 per cent in 2011, which is roughly 4 percentage points above the figure for the baseline scenario.

<sup>1</sup> According to the EU methodology, such elasticity is equal to 0.5.



#### IV.2 SENSITIVITY TO INTEREST RATES

This section considers the effects of a 100-basis-point increase in the market yield curve on the interest paid on government securities.

A description of the current and future composition of debt as represented by negotiable government securities serves as the point of departure for the analysis. As of 31 December 2008, the stock of negotiable government securities had risen by 5.26 percent compared with the stock on 31 December 2007. The negotiable government securities outstanding at the end of 2008 consisted of domestic securities, i.e. those issued on the domestic market (94.79 per cent of the total), and securities issued on foreign markets, whether denominated in euros or foreign currency (5.21 per cent).

As occurred in 2007, the percentage of the foreign component fell again in 2008 (from 6.17 to 5.21 per cent), with part of the decrease explained by costs that continue to be relatively higher than those for domestic issues.

The summary data on the structure of the debt show that the exposure to refinancing risk and interest-rate risk has remained virtually unchanged. Overall, the average life of the stock of government securities at 31 December 2008 was 6.82 years, essentially in line with the figure at 31 December 2007 (6.85 years). The financial duration as of 31 December 2008 is instead equal to 4.51 years, increasing above the same figure



for the corresponding month of 2007 (4.45 years), with the change mainly due to the effect of the marginal increase in the stock of long-term, fixed-rate securities outstanding. Consequently, the figures for 2008 can be considered as a consolidation of the trend taking shape since 2006.

In comparison with 31 December 2007, the fixed-rate component of the euro-denominated government securities issued on the domestic market was, slightly higher as of 31 December 2008, going from 67.09 per cent to 67.71 per cent. Over the same period, the component indexed to European inflation went from 6.54 per cent to 6.59 per cent, partly due to the higher rate of inflation and the resulting revaluation of this component; the short-term or variable-rate component decreased slightly, going from 26.37 per cent to 25.71 per cent.

The year of 2008 was marked by a sharp increase in volatility, a drastic reduction of liquidity on the secondary market for government securities, and an increase in risk aversion which caused a flight-to-quality (i.e. the purchase of the highest grade issues in terms of creditworthiness). More specifically, in the final four months of the year, such phenomena prompted a sharp increase in the volatility of the differentials between the yields on Italian government securities and yields on German government securities having the same maturity and differentials in money market rates. Similar to what occurred in most countries in the Euro Area, these differentials were higher relative to the start of the year, thus demonstrating the broad-based repricing of risk by the market.

Against this backdrop, the Treasury's issuing policy in 2008 was aimed at guaranteeing the achievement of the same objectives of past years, namely, minimising the cost of debt and controlling refinancing and interest-rate risk. The policy has been pursued in part by using instruments that make the supply of securities more adaptable to market movements.

The fixed-rate component of the debt represented by government securities has increased, and now accounts for almost two-thirds of the total. Consistent with past efforts and despite adverse market conditions, the issuing policy for fixed-rate securities has continued to emphasise long-term instruments: for example, a new 15-year BTP was introduced in April 2008, with various re-openings thereafter in order to guarantee the security's liquidity on the secondary market.

Inflation-indexed issues have continued to account for a greater portion of overall debt represented by government securities: although the first security of this type (BTP€i) issued in 2003 came due in September 2008, other issues have been floated to ensure continuity (including a new 10-year BTP€i in May), resulting in a quantity at the end of 2008 which is higher than at the end of 2007.

As in past years, the percentage of short-term or variable-rate securities continues to be well under 30 per cent: the slight decrease seen with respect to the end of December 2007 can be explained by a reduction in the issuance of CCTs, which more than offset the increase in the Treasury's issuance of short- or very short-term



instruments intended to meet the growing demand for BOTs on the part of retail investors resident in Italy and growing demand resulting from the higher volatility of intra-monthly cash flows.

The estimates in relation to interest expenditure were made on the basis of the rates implicit in the yield curve for Italian government securities at the end of January 2009.

Considering the current composition of public debt, as well as the change in total financial duration of the debt and the structure of coupon payments and reimbursements (which is mainly in line with that of the previous year), it is possible to confirm that the State budget had limited exposure to rate fluctuations in 2008. Indeed, even assuming an instantaneous and permanent 100-basis-point increase in the yield curves used for the estimates of interest expenditure for the 2009-2011 period, the impact of the increase (as a percentage of GDP) would be equal to 0.17 per cent in the first year, 0.37 per cent in the second year, and 0.48 per cent in the third, while the increase in rates would transfer entirely onto the cost of the debt after roughly 5.63 years (at December 2007, the comparable figure was 5.66 years).

Compared with the 2007 Update, the sensitivity to rates is thus slightly higher for the first year of estimation (around 0.01 percentage points), while in the years thereafter, such an increase, though modest, rises to 0.13 percentage points in the fourth year. There are two main factors explaining these changes: the significant downward revision of economic growth forecasts and the growth contemplated for the debt stock (which obviously tends to amplify the impact on expenditures by putting upward pressure on interest rates). In addition to these two factors, estimates of future interest expenditure are based on an issuance forecast which incorporates the plan to adjust the mix of issues to market conditions.

In order to test the soundness of the analysis, the exercise was repeated by considering yield curves with different slopes. The results in terms of sensitivity remained essentially in line with those obtained with the rate scenario illustrated above.



## V. QUALITY OF PUBLIC FINANCES

Budget policy for the 2009-2011 three-year period incorporates innovative elements that contribute to improving both the quality of fiscal governance and the credibility of the budget process.

With the adoption of a three-year financial planning framework, for the first time, the budget will allow for the complete convergence between the measures planned and the measures implemented (based on unchanged legislation), in line with the budget standards of other European countries.

The adjustment of the public accounts has been spelled out in a decree-law that was presented with the Economic and Financial Planning Document (DPEF) and approved prior to the end of the summer<sup>1</sup>. The 2009 Budget Law, presented at the end of September and now approved, includes only some technical changes so as to facilitate the implementation of the three-year budget<sup>2</sup>.

Both the decree-law and the 2009 Budget Law have provided a more stable framework than in the past, facilitating the quick adoption of measures to address the intense financial and real crisis without significantly jeopardizing budget balances. Consistent with previous legislation, the financial rescue package for 2009-2011 presented at the end of November<sup>3</sup> was designed to promote structural reform and support growth, while restoring fiscal policy's important role in stabilizing the economy.

### V.1 BUDGET POLICY FOR 2009-2011

By moving forward the typical effects of the budget law, the fiscal package approved before the summer calls for an adjustment of the primary balance which increases in magnitude over the 2009-2011 three-year period, with the net impact reaching € 30.9 billion at the end of the period. The accumulated net adjustment of the

<sup>1</sup> Law n. 133/2008 converting Decree-Law n. 112/2008.

<sup>2</sup> The only significant provisions of the Budget Law refer to the resources to be set aside for tax relief, the renewal of public-sector contracts, and the reorganisation of certain pension (INPS) accounts; they have no adverse effects on the public finances. There are other legislative measures related to the budget: (i) two legislative bills covering the regulations necessary for the completion of the initiatives that contribute to the planning and achievement of the objectives by the end of 2011; and (ii) three proposed enabling acts respectively covering the implementation of fiscal federalism, higher productivity of the public sector work force, and regulatory changes with respect to strenuous jobs, public sector employment and labour disputes. Such regulations do not entail any additional financial effects.

<sup>3</sup> Decree-Law n. 185/2008 converted in Law n.2/2009.



primary balance is equal to around 0.6 per cent of GDP in 2009, increases to just over 1.0 per cent in 2010 and finally reaches approximately 1.9 per cent in 2011 (Table 8).

The increased resources resulting from the fiscal package (via revenue increases and spending cuts) of €36.7 billion over the three-year period<sup>4</sup> mostly come from measures aimed at streamlining primary expenditure.

Significant savings come from the application of a ceiling on the growth of current and capital public expenditure, and greater flexibility in the implementation of the new budget which is based on missions and programmes. Additional measures with regard to current expenditure include the containment of public-sector labour costs, decentralised public finance, and healthcare and pensions.

With regard to public-sector employment, the spending cuts refer to the reorganisation of the hiring system, with the introduction of a stricter limit on hiring new personnel, and the implementation of a process to make better use of the personnel in the public school system<sup>5</sup>.

The measures regarding decentralised public finance result in savings from the re-negotiation of the Internal Stability Pact for the 2009-2011 three-year period, with the strengthening of sanction mechanisms, the introduction of bonuses (see Section V.3) and prohibitions against the use of financial transaction until special regulations therefor go into effect.

The savings in the healthcare sector are to be achieved within the framework of the State-Regions Accord. Should the objectives not be met, the rates for special regional taxes will be automatically increased.

With regard to pensions, the measures entail a reduction of expenditure for disabled civilians through the implementation of a new plan to strengthen the process of verifying eligibility.

Additional resources of around €6 billion (gross amount) come from revenue measures which increase taxes for firms operating in particular sectors (including banking, insurance and energy). Other measures are aimed at harmonising the tax treatment of cooperatives, eliminating tax relief for bonus compensation (stock options), and intensifying the fight against tax evasion and the underground economy (including through the preparation of a special audit programme that calls for greater involvement of municipalities).

<sup>4</sup> The resources tapped are expressed in gross terms, and therefore, include the amount of funds needed to finance the increase in spending and decrease in revenues that are occurring simultaneously.

<sup>5</sup> The measures contemplate: i) a gradual increase of one percentage point in the student/teacher ratio during the 2009-2011 three-year period; ii) a total reduction of 17 per cent of the work force made up of administrative, technical and support personnel during the 2009-2011 three-year period when compared with the work force during the 2007/2008 academic year; and iii) the use of 30 per cent of the resulting economies (in terms of expenditure) for financing initiatives aimed at the value enhancement and professional career development of the school system personnel (starting in 2010).



Additional budgetary resources of roughly €5.8 billion in gross terms over the three-year period, are mainly used to fund incremental expenditures (around €5.2 billion).

**TABLE 8: THE 2009 BUDGET<sup>1</sup>**

	2008	2009	2010	2011	2008	2009	2010	2011
	€ million				% of GDP			
<b>SOURCE OF FUNDS</b>	2,577	17,097	22,962	36,727	0.2	1.1	1.4	2.2
Incremental revenues	2,248	5,765	5,516	6,103	0.1	0.4	0.3	0.4
<i>Energy sector</i>		2,395	1,323	1,331		0.2	0.1	0.1
<i>Banking and insurance sectors</i>	2,134	2,522	3,099	2,494	0.1	0.2	0.2	0.1
<i>Tax collection and fight against tax evasion</i>	50	513	793	1,953	0.0	0.0	0.0	0.1
<i>Other</i>	64	335	301	325	0.0	0.0	0.0	0.0
Lower expenditure	329	11,332	17,446	30,624	0.0	0.7	1.1	1.8
Lower current expenditure	222	8,923	13,776	22,050	0.0	0.6	0.9	1.3
<i>Public-sector employment (net of revenue-driven effects)</i>	20	829	1,336	1,874	0.0	0.1	0.1	0.1
<i>Decentralised finance (Internal Stability Pact and other streamlining of expenditures)</i>		3,430	5,480	9,480		0.2	0.3	0.6
<i>Healthcare expenditure</i>		357	2,351	3,344		0.0	0.1	0.2
<i>Pension measures</i>		247	267	295		0.0	0.0	0.0
<i>Missions' spending reduction</i>		3,049	3,532	6,328		0.2	0.2	0.4
<i>Other</i>	202	1,011	811	729	0.0	0.1	0.1	0.0
Lower capital expenditure	107	2,409	3,670	8,574	0.0	0.2	0.2	0.5
<i>Missions' spending reduction</i>		2,280	3,616	8,574		0.1	0.2	0.5
<i>Other</i>	107	129	54		0.0	0.0	0.0	
<b>USE OF FUNDS</b>	2,239	7,204	5,825	5,802	0.1	0.5	0.4	0.3
Lower revenues	337	1,103	555	580	0.0	0.1	0.0	0.0
<i>Fund for extension of Tax Relief</i>		900	500	500		0.1	0.0	0.0
<i>VAT deductibility on hotel services</i>	168	147	-80	-17	0.0	0.0	0.0	0.0
<i>Other</i>	169	56	135	97	0.0	0.0	0.0	0.0
Incremental expenditure	1,902	6,101	5,270	5,222	0.1	0.4	0.3	0.3
Incremental current expenditure	1,789	5,182	5,003	4,978	0.1	0.3	0.3	0.3
<i>Public-sector employment (net of revenue-driven effects)</i>		1,984	1,984	1,984		0.1	0.1	0.1
<i>Healthcare expenditure</i>		834	834	834		0.1	0.1	0.1
<i>Pension measures</i>		410	415	420		0.0	0.0	0.0
<i>Measures in favour of public entities and companies</i>	613	453	453	450	0.0	0.0	0.0	0.0
<i>Social measures</i>	170	300			0.0	0.0		
<i>Security and Supplemental Contracting Fund</i>		260	100	100		0.0	0.0	0.0
<i>Economic Policy Structural Measures Fund</i>	669	599	615	603	0.0	0.0	0.0	0.0
<i>Other</i>	338	342	602	587	0.0	0.0	0.0	0.0
Incremental capital expenditure	113	919	267	244	0.0	0.1	0.0	0.0
<i>Fund for Employment</i>		700				0.0		
<i>Local Public Transport</i>	80	100	110	120	0.0	0.0	0.0	0.0
<i>Other</i>	33	119	157	124	0.0	0.0	0.0	0.0
<b>NET IMPACT ON PRIMARY BALANCE</b>	338	9,893	17,138	30,925	0.0	0.6	1.1	1.9

1) The table shows the measures included in the final draft of Law n. 133/2008 converting Decree-Law n. 112/2008.





The increases in current expenditure are related to initiatives regarding: public-sector employment; the healthcare system (the extension over the 2009-2011 three-year period of a provision which exempts the public from paying for specialised assistance services); and pensions (measures to eliminate the prohibition against simultaneously receiving a pension and earning income from employment, whether on a free-lance or full-time basis). The incremental capital expenditures refer to the increase in 2009 in funding for the Employment Fund and the Fund for the Promotion and Support of Local Public Transport.

Acting on the European Commission's request to promote concerted action by the Member States in addressing the economic crisis, the Government ratified an urgent decree in November which provided for an additional package of measures<sup>6</sup>.

Consistent with the framework of the *European Economy Recovery Plan* (which makes budget policy responsible for stabilising and sustaining demand), the measures are aimed at supporting the economy and reformulating certain economic-policy choices at a national level.

More specifically, the decree calls for the use of around €6 billion in 2009, with the amount coming from higher revenues and lower expenditures linked to the decree itself, without entailing any additional burden on public finances (Table 9a).

The increase in tax revenues comes from the realignment of carrying values of certain corporate assets (goodwill, trademarks and intangible financial assets) to valuations for tax purposes; discrepancies in valuations were caused when international accounting principles (IAS) were applied in computing valuations for tax purposes<sup>7</sup>. Additional revenues are expected from procedural modifications made to the rules for tax collection and tax assessments.

The lower expenditures are mainly the result of the re-programming (both within and across programmes) of financial resources.

The use of the resources occurs through a number of measures that are implemented over a 1-to-3-year time period.

<sup>6</sup> Decree-Law n. 185/2008 converted into Law n.2/2009.

<sup>7</sup> In addition, in exceptional situations of market turbulence when market values are not reliable, businesses are allowed to value securities held as current assets at the values reported in the most recent financial statements, an exception to the valuation criteria for short-term investments in securities such as stocks and bonds. However, the exception does not apply when the financial loss is assumed to be of a permanent nature.

TABLE 9a: EFFECTS OF DECREE-LAW no. 185/2008 <sup>1</sup>

	2009	2010	2011	2009	2010	2011
	€ million			% of GDP		
<b>SOURCE OF FUNDS</b>	6,385	4,098	4,945	0.41	0.26	0.30
Incremental revenues	5,163	2,482	2,485	0.33	0.16	0.15
<i>Realignment between fiscal and carrying values (substitute tax)</i>	2,761	124	81	0.18	0.01	0.00
<i>Measures regarding tax assessments</i>	1,992	1,947	1,993	0.13	0.12	0.12
<i>Measures to improve tax collection</i>	300	300	300	0.02	0.02	0.02
<i>Other</i>	110	112	112	0.01	0.01	0.01
Lower expenditure	1,222	1,616	2,460	0.08	0.10	0.15
Lower current expenditure	107	144	146	0.01	0.01	0.01
<i>Excise tax fund</i>	49	88	88	0.00	0.01	0.01
<i>Economies on budget appropriations</i>	54	54	54	0.00	0.00	0.00
<i>Other</i>	4	2	5	0.00	0.00	0.00
Lower capital expenditures	1,114	1,471	2,313	0.07	0.09	0.14
<i>Resources under Law n. 244/2007, art. 2, par. 554</i>	150	150	100	0.01	0.01	0.01
<i>Fund for professional training and job rotation</i>	100	150	150	0.01	0.01	0.01
<i>Fund for offsetting multi-year subsidies</i>			350			0.02
<i>FAS (Local development fund)</i>	604	941	1,493	0.04	0.06	0.09
<i>Other</i>	260	230	220	0.02	0.01	0.01
<b>USE OF RESOURCES</b>	6,353	3,906	4,760	0.41	0.24	0.29
Lower revenues	2,175	1,598	2,078	0.14	0.10	0.13
<i>Suspension of highway toll increases</i>	87			0.01		
<i>Extension of tax relief for productivity performance-related pay</i>	460	128		0.03	0.01	
<i>Deductibility of IRAP from IRES and IRE</i>	1,090	657	642	0.07	0.04	0.04
<i>Deferral of collection of VAT</i>	188	31	31	0.01	0.00	0.00
<i>Realignment between fiscal and carrying values (IRES effects)</i>	0	463	1,012	0.00	0.03	0.06
<i>Tax relief cheques</i>	286	263	342	0.02	0.02	0.02
<i>Other</i>	64	56	51	0.00	0.00	0.00
Incremental expenditure	4,178	2,307	2,682	0.27	0.14	0.16
Incremental current expenditure	3,676	1,213	1,058	0.24	0.08	0.06
<i>One-off family benefits</i>	2,400			0.15		
<i>Variable-rate residential mortgages</i>	350			0.02		
<i>Freeze on automatic increases of rates</i>	49	88	88	0.00	0.01	0.01
<i>Trenitalia S.p.A. service contracts</i>	480	480	480	0.03	0.03	0.03
<i>Fund for reimbursement of IRAP disputes</i>	100	500	400	0.01	0.03	0.02
<i>Continuation of socially useful workers in schools</i>	110			0.01		
<i>Other</i>	187	145	90	0.01	0.01	0.01
Incremental capital expenditure	502	1,094	1,624	0.03	0.07	0.10
<i>Financing of Guarantee Fund</i>	150	150	100	0.01	0.01	0.01
<i>Financing of Employment Fund</i>	254	304	304	0.02	0.02	0.02
<i>Financing of Framework Law</i>	60	400	500	0.00	0.03	0.03
<i>Establishment of FF.SS S.p.A. Group Investment Fund</i>	0	240	720	0.00	0.02	0.04
<i>Other</i>	38			0.00		
<b>NET IMPACT ON PRIMARY BALANCE</b>	32	192	185	0.00	0.01	0.01

1) The table shows the effects of the Decree-Law as converted by Law no.2/2009.



A first set of measures aims to reinstate consumer confidence and to relaunch consumer spending, via support to low-income households. The specific measures provide for the payment of a one-off family benefit for 2009 to wage earners, pensioners and persons who require assistance; the benefit is computed on the basis of family size and income<sup>8</sup>. Other measures regard the introduction of an interest subsidy for individuals paying off variable-rate mortgages on their primary residence. In 2009, the State will cover any portion of the interest over the corresponding payment calculated using a threshold rate of 4 per cent net of spreads and charges. Moreover, the European Central Bank's discount rate is expected to be used as the reference rate for new mortgages. Additional measures are planned to boost consumption, including the lowering of fees charged for several public services.<sup>9</sup> A moratorium on highway tolls has also been put into place for the first few months of 2009, with a view toward developing a pricing structure consistent with investment costs.

**TABLE 9b: SHORT-TERM MEASURES WITH DIRECT IMPACT ON GENERAL GOVERNMENT ACCOUNTS**

MEASURES	DATE OF ADOPTION, INITIAL AND FINAL FOR TEMPORARY MEASURES	DESCRIPTION OF THE MEASURES	2008	2009	2010	2011
One-off family benefits	From January 2009 to December 2009	Extraordinary bonus to families paid by the withholding agent in the month of February.	0.00	0.15	0.00	0.00
Variable-rate residential mortgages	From January 2009 to December 2009	State's contribution to interest expense for excess, if any, over interest computed at benchmark rate of 4% for variable-rate mortgages.	0.00	0.02	0.00	0.00
Suspension of highway toll increases	From 1 January to 30 April 2009	The collecting of higher highway tolls that was to begin on 1 January 2009 has been deferred to 30 April 2009.	0.00	0.01	0.00	0.00
Extension of tax relief for performance-related pay	From January 2009 to December 2009	Extension of tax-exempt status of productivity bonuses (experimental measure for increasing labour productivity in the private sector).	0.00	0.03	0.01	0.00
Continuation of socially useful workers in schools	From January 2009 to December 2009	Extension of the activities of socially useful workers employed in the school system.	0.00	0.01	0.00	0.00
Deferral of IRES and IRAP prepayments (1)	From 2008 to 2009	Deferral of 3 per cent of prepayments from 2008 to 2009.	0.11	-0.11	0.00	0.00
<b>TOTAL</b>			<b>0.11</b>	<b>0.11</b>	<b>0.01</b>	<b>0.00</b>

1) D.L. n. 207/2008.

<sup>8</sup> The bonus can be combined with the purchases card introduced with Law no. 133/2008 (conversion of Decree-Law n.112/2008).

<sup>9</sup> The rate freeze established by the crisis-prevention decree does not apply to toll highways, electricity and gas, where the decision-making powers of the respective regulatory authorities has been confirmed.



A second set of measures is aimed at providing support to businesses, and includes tax relief as well as tools to facilitate access to financing.

The specific measures provide for the extension through 2009 of tax relief for performance-related pay for individuals earning up to €35,000 per year, with a maximum limit of €6,000. The tax benefits are also extended to law enforcement personnel.

For the tax year ending 31 December 2008, businesses will have the option of deducting from their corporate income tax (IRES) an amount equal to 10 per cent of the regional tax (IRAP) paid on labour cost and interest payments, and to reduce the prepayments of IRES and IRAP by three percentage points.

The date of payment of VAT will be changed from the date of issuance of the invoice to the date of receipt of payment. A revision of sector studies to take into account the economic crisis and market performance is also planned, particularly with regard to specific sectors and specific regions of the country. In order to accelerate the economic recovery, arrangements have been made to speed up payment of VAT refund claims that have been outstanding for 10 years or more, and to step up the payments by the public administration to suppliers of goods and services, thanks also to guarantees from insurance companies and from the export credit guarantee entity (SACE) aimed at facilitating the collection of receivables.

Programmes have also been put in place to provide incentives for Italian researchers abroad to return to Italy, with tax credits also extended to research activity carried out in Italy that is commissioned by foreign counterparties.

As part of an effort to facilitate the flow of credit to businesses, the State is authorised until the end of 2009 to underwrite bonds issued by publicly traded banks to bolster their regulatory capital, subject to bank commitments documented in a special protocol of intent and their adoption of an ethics code. The Government will set up an entity in each of the prefectures in order to monitor the actual allocation of liquidity.

At the same time, government guarantees have also been broadened in order to alleviate the risk of a credit crunch for small- and medium-sized businesses.



**TABLE 9c: MEDIUM-TERM MEASURES IMPROVING THE QUALITY AND LONG-TERM SUSTAINABILITY OF PUBLIC FINANCE**

MEASURES	DATE OF ADOPTION, INITIAL AND FINAL FOR TEMPORARY MEASURES	DESCRIPTION OF THE MEASURES
Reimbursement of tax refund claims which are ten years old or older and acceleration of payments of the public administration	From 2009	Acceleration of both the payment to taxpayers of tax refund claims that are ten years or older, and the payment of trade debt incurred by the ministries.
Incentives to Italian scientific researchers and professors abroad to return to Italy	From 2008 to 2013	Flat income tax rate (10%) to income earned by researchers from full-time employment or self-employment and exclusion of income from IRAP. The incentive is applied during the tax period in which the researcher becomes a tax resident of Italy and in the two tax periods thereafter.
Incentives for research	From 2009	Extension of tax credit to research carried out in Italy, including when commissioned by a foreign counterparty.
Improvements to tax assessment procedures	From 2009	Streamlining and acceleration of procedures contained in tax assessment rules, with an increase in the related percentage collected.
Improvements to receivables collection procedures	From 2009	Plan for rules that will allow the public administrations to collect on sureties and to enforce guarantees on demand when such instruments have been procured to guarantee the public administrations' receivables exceeding EUR 250 million.
Improvements to controls over private clubs and adjustment of VAT on television broadcasting services	From 2009	Stepped-up tax audits of private clubs and an increase in the VAT rate (to 20%) for television and radio broadcasting.
Improvements to tax collection procedures	From 2009	Changes to the procedures covering tax collection via the tax rolls with reference to persons participating in the tax amnesty programmes introduced by Law n. 289 of 2002.
Recovery of illegal aid	From 2009	Provisions to recover aid declared illegal following the European Commission's decision, i.e. amounts paid in favour of joint-stock companies which are majority owned by the state.

A third series of measures is aimed at reshaping political strategies at a national A level with regard to infrastructure, and social policies from the perspective of tackling the economic crisis over a longer time horizon based on more effective use of national and European funds.

The Government aims to mobilise resources of roughly €80 billion, through the resumption of a series of investment projects and active use of the *Cassa Depositi e Prestiti*, consistent with its view that, in the short run, fiscal stimulus is needed to support demand and growth.



TABLE 9d: STRUCTURAL MEASURES TO SUSTAIN DEMAND AND PROMOTE RESILIENCE

MEASURES	DATE OF ADOPTION, INITIAL AND FINAL FOR TEMPORARY MEASURES	DESCRIPTION OF THE MEASURES
Subsidised rates for gas	From 1 January 2009	Application of subsidised rates for low-income households as identified through the ISEE indicator.
Tax relief for micro projects for urban facelifts or micro projects of local interest	From 29 January 2009 (60 <sup>th</sup> day from the date on which the Decree-Law went into effect)	Projects of local interest proposed to local entities by groups of citizens will be exempt from taxes and administrative charges (except for VAT).
Deductibility of IRAP from IRES and IRE	Starting from tax period ending 31 December 2008	Deductibility of 10 per cent of IRAP from direct income taxes (IRES and IRE).
Deferral of collection of VAT	From 2009	Deferral of VAT payment from the date of issuance of the invoice to the date of receipt of payment.
Financing of Guarantee Fund	From 2009 to 2012	New financing of the fund, partly to back the issuance of guarantees to banks in order to facilitate the access to credit by small-/medium-sized businesses. Part of the resources will be for the Fund's issue of counter-guarantees in favour of Confidi, consortiums providing collective guarantees of credit facilities.
Financing of Employment Fund	From 2009	Financing of social safety nets: i) ordinary unemployment compensation, ii) family allowances, iii) notional contribution in the event of job loss, and iv) allowance to protect the income of non-company employees working with a company on a coordinated and continuous basis, paid in a single lump sum on an experimental basis over the 2009-2011 period and equal to 10 per cent of income earned for the previous year.
Financing of Framework Law	From 2009-2010 to 2024-2025	Allocation of resources for planning and completing strategic works of pre-eminent national interest.
Establishment of <i>FF.SS S.p.A</i> Group Investment Fund	From 2010	Allocation of resources for setting up a fund to finance railway investments.
Public sector's underwriting of special bank bonds	From 29 November 2008	The Ministry of the Economy and Finance is authorised until 31 December 2009 to underwrite, upon the specific request of the banks involved, financial instruments (special bank bonds) designed to favour an adequate flow of investments to the economy.
Equity investment in the banking industry	From 2009	Implementation of the provisions of Directive EU 2007/44 on equity investment in the banking industry with elimination of the 15 per cent ceiling for businesses' investment in banks.
Reduction of administrative costs for businesses	From 2009	Elimination of certain obligations for tax reporting to authorities.
Re-assignment of resources for training and employment and infrastructure projects	From 2009	Replanning of FAS (Local development fund) resources for training and re-training and for infrastructure projects.
Acceleration of executive procedures for projects that are part of the National Strategic Framework	From 2009	Revision of procedures for planning and completing investments through the institution of extraordinary commissions especially appointed therefor.

In particular, the decree orders the re-assignment of resources for training and employment as well as for infrastructure projects, with the priorities placed on the security of schools, the building of schools and prisons, environmental recovery and clean-up, museum and archaeological infrastructure, and technological innovation.

Two 15-year subsidies, starting in 2009 and 2010 respectively, have been authorised for the continuation of planning and completion of strategic, high-priority projects.



A special fund has been set up for the planning and execution of investments by the *Ferrovie dello Stato* S.p.A. Group; the fund's resources will be allocated and disbursed in accordance with the terms and conditions to be defined in future legislation. New resources have been allocated for each year of the 2009-2011 three-year period in order to ensure the necessary public-transport service by rail, with the disbursement of the resources being governed by conditions in new service contracts that have a greater focus on efficiency and rationalisation. The investments are expected to be implemented in both the northern regions of the country (15 per cent) and the southern regions (85 per cent).

Special measures have been defined for speeding up administrative procedures for projects that are part of the National Strategic Framework. The projects are considered a priority for national economic development, as well as for their employment implications and related social repercussions, in conformity with international commitments. Special commissions are expected to be instituted in order to guarantee compliance with the implementation timetables.

Turning to social safety nets, the measures provided by the Budget Law have been supplemented by more robust instruments to protect the income of workers who have lost their jobs either temporarily or permanently. The subsidies have also been extended on an experimental basis for the 2009-2011 period to non-employee associates who work on a coordinated and continuous basis with companies.

## **V.2 BUDGET IMPLICATIONS OF THE STRUCTURAL MEASURES CONTAINED IN THE 2008-2010 NATIONAL REFORM PLAN**

In the three years since the presentation of the first *National Reform Programme (NRP)* in 2005, the policies contained therein have been implemented and have had positive repercussions; this was documented by the European Commission's and European Council's assessments and recommendations, which acknowledged that Italy has made "good progress" in the implementation of the strategy.

However, time is needed in order for the structural reforms to produce significant effects. Italy is still contending with its fundamental economic problem of low productivity growth, which is amplified by sharp regional disparity. In this context, the Government remains committed to its stated national priorities, as supplemented after the first assessment of the NRP: i) stability of public finances; ii) expansion of the area of free choice for citizens and companies; iii) incentives for scientific research and technological innovation; iv) adjustment of tangible and intangible infrastructure; v) environmental protection; vi) strengthening education and training of human capital; and vii) labour policies (consistent with common flexicurity principles).



The planning and execution of the reforms outlined in the NRP requires a financial investment (in terms of appropriations for the next three years) of €17,561 million of national resources, and another €26,393 million of resources for implementation of policies at the regional level.

Consistent with the priority of 'financial stability', the three-year stabilisation plan approved prior to the summer of 2008, significantly improves the quality of fiscal governance and promotes development and economic growth (see Section V.1).

**TABLE 10: PRINCIPAL NATIONAL APPROPRIATIONS FOR LISBON STRATEGY THROUGH 2011 SUBDIVIDED BY PRIORITIES OUTLINED IN THE NRP**

National priorities (2008)	Number of measures	Appropriations to 2011 (€ million)
Expansion of the area of free choice for citizens and companies	19	1,453
Incentives for research and innovation	10	3,959
Strengthening of education and training of human capital	6	246
Adjustment of tangible and intangible infrastructure	9	9,838
Environmental protection	5	942
Policies for employment and social inclusion	7	1,123
Total		17,561
Improvement of long-term sustainability of public finances	6	30,925
Total <sup>1</sup>	62	

1) The total number of measures is 60, if corrected to reflect the fact that certain measures refer to two or more national priorities.  
Source: 'Lisbon Strategy for growth and employment - 2008-2010 National Reform Programme', 6 November 2008.

The priority of expanding the area of free choice for citizens and companies has been addressed through the creation of a special-purpose ministry, and the 2007 ratification of an Action Plan for Simplification (PAS)<sup>10</sup>, the implementation of which is being monitored on a semi-annual basis. The budget for the 2009-2011 three-year period has also introduced two specific measures, the first of which aims to streamline the legal framework in Italy<sup>11</sup> (which entails the abolition of more than 3,000 obsolete laws) and the second of which is aimed at cutting bureaucratic costs<sup>12</sup>. It is estimated that the efforts already undertaken will lead to savings of more than €4,000 million, or 59 per cent with respect to costs under the previous framework.

<sup>10</sup> The plan was set up to define strategic objectives and planned efforts with regard to the following: simplification of regulations and reduction of the number of laws, measurement and reduction of bureaucratic costs, analysis of the impact of regulation, indicators of the quality of regulation, monitoring and reduction of time required for administrative proceedings, consultation with the unions and relationships with the regions and autonomous provinces.

<sup>11</sup> Law n. 133/2008, Article 24.

<sup>12</sup> Law n. 133/2008, Article 25.





As a tool to modernise public administration, the Business Plan for the Public Administration is aimed at improving the quality of collective bargaining, introducing a merit-based system through more transparent rules for staff performance evaluation, and redefining responsibilities, rights and obligations (see box).

Efforts to promote deregulation will focus on three main sectors: private services, energy, and local public services.

In the private services sector, legislation has covered two initiatives: i) the gratis conversion of variable-rate mortgages into fixed-rate obligations for first-home buyers if contracted on or before 28<sup>th</sup> of May 2008; and ii) the streamlining of the framework governing professions<sup>13</sup> by creating associations based on voluntary participation rather than professional organisations, to administer the system .

In the energy sector, the measures have been aimed at the full opening up of markets and the development of true competition on the demand and supply side of the electricity and gas sectors, while providing adequate protection of consumers in the deregulated market.

With regard to local public services, the new regulations establish that the award of service contracts on an ordinary basis must be done through publicly documented competitive procedures<sup>14</sup>. Contracts may be awarded with exceptional means only if there are unusual circumstances which warrant the different approach. Such contracts are subject to adequate public disclosure and an explanation of the decision must be provided to the sector regulatory authority, if existing, and to the antitrust authority.

**TABLE 11: ADDITIONAL RESOURCES FOR REGIONAL POLICY: ESTIMATE OF 2008-2010 EXPENDITURE EARMARKED FOR NRP PRIORITIES<sup>1</sup>**

Priorities	Forecasts of expenditure	
	€ million	% of total
Expansion of the area of free choice for citizens and companies	845	3.2
Incentives for research and innovation	2,928	11.1
Strengthening education and training of human capital	3,002	11.4
Adjustment of tangible and intangible infrastructures	8,555	32.4
Environmental protection	6,117	23.2
Policies for employment and social inclusion	4,946	18.7
<b>Total Lisbon priorities</b>	<b>26,393</b>	<b>100.0</b>

Source: 'Lisbon Strategy for growth and employment - 2008-2010 National Reform Programme', 6 November 2008.

1) The forecasts of the additional resources for regional policy for the 2008-2010 period also include disbursements made during the closing phase of the 2000-2006 structural fund programmes.

<sup>13</sup> Minister of Justice's Decree of 28<sup>th</sup> of April 2008, as part of the implementation of Decree-Law n. 206/2007, which ratified the EU Directive 2005/36/CE.

<sup>14</sup> Law n. 133/2008, Article 23-bis converting Decree-Law n. 112/2008.



In the field of research and development, the tenders finalised thus far as part of the Industrial Innovation Projects (IIP) have regarded three projects for a total value of €570 million. The tax relief for research provided by the 2007 and 2008 Budget Laws will entail lower tax revenues of €1,359 million in 2008, €864 million in 2009 and €143 million in 2010.

With the aim of developing infrastructure, the National Operating Programme (NOP) for Networks and Mobility covers investments of €2,750 million.

In accordance with the common flexicurity principles approved by the Council of Labour and Social Affairs Ministers of the European Union, Italy has embarked on a six-month trial of reducing the tax burden on bonuses and overtime; these measures are in addition to the tax relief already provided for variable components of compensation<sup>15</sup>.

While a reduction of the Italian economy's emission intensity has been pursued, a scenario based on policies implemented through May 2007 shows a shortfall of 93 metric tons of CO<sub>2</sub> per year relative to meeting the Kyoto target for 2010. For this reason, the budget package ratified in 2008 approved other measures aimed at intensifying the efforts to reach the Kyoto target, with particular reference to the renewable energy sector and energy efficiency.

In education, Italy is aiming to achieve new territorial governance of schooling/training, with the full involvement of the regions and autonomous provinces. The initiatives for training the work force are part of the life-long learning strategy, with the priority going to the categories of workers who have the greatest risk of exiting the labour market and to workers encountering the greatest difficulty in gaining access to refresher, training and retraining courses.

Regional policy has also provided a significant contribution to the achievement of the Lisbon objectives, particularly through the Structural Funds and the Fund for Underutilised Areas.

## BUSINESS PLAN FOR THE PUBLIC ADMINISTRATION

*The Business Plan of the Minister of the Public Administration and Innovation presented in 2008 is part of the overall reform of the general government initiated in the nineties. Several of the plan's measures have already gone into effect<sup>16</sup>, while others are contained in pending legislation<sup>17</sup> currently being debated in Parliament.*

<sup>15</sup> The measure was introduced by Law n. 244/2007 (2008 Budget Law).

<sup>16</sup> Law n. 133/2008 converting Decree-Law n. 112/2008, setting out urgent provisions for economic development, simplification, competitiveness, the stabilisation of public finance and tax equalisation.

<sup>17</sup> Legislative bill related to the budget package for 2009-2013 (House Act n. 1441-*quater*) and the Government's enabling act centred on increasing the productivity of the public-sector work force (Senate Act n. 847).



*The project to modernise the running of the general government outlined in the Business Plan is designed to improve the effectiveness, efficiency and cost consciousness of the operations so as to hold down current public expenditure while also emphasising meritocracy, innovation and transparency as elements needed for sustaining the growth of the nation's productive system.*

*The Plan calls for efforts on two fronts: first, legislation reforming public-sector employment with a view toward increasing labour productivity; and second, action, mostly of an administrative nature, aimed at streamlining the organisation of the public administrations and accelerating technological innovation.*

*Significant changes to the rules governing public-sector employment include a greater emphasis on the recognition and reward of individual merit and the reform of performance-based compensation mechanisms<sup>18</sup> (which will be linked to the quality, productivity, and innovative capacity of job performance). Increases in compensation will be achieved exclusively through selective testing, while career advancement will occur only through open competition. The public administration will be required to prepare and publish annually indicators of productivity and quality rendered by the staff so as to facilitate peer comparison, and to ensure the supply of services in accordance with international quality standards. Other measures regard the reform of top management and of national collective bargaining for public-sector workers. As a result of the former, top managers will be given greater autonomy<sup>19</sup> and responsibility. Managerial performance will be evaluated partly in relation to the resources assigned, and any compensation over and above the base salary will be strictly linked to the results achieved. More specifically, the public administrations will not be able to pay any performance-based compensation unless they have adopted performance-evaluation systems.*

*With the reform of collective bargaining, the governance of public employment will be restructured between contracting and the law, with the law to govern matters regarding: the organisation of departments, definition of general criteria, methods and procedures for performance evaluation, identification of the tools to provide incentives and bonuses for productivity and quality of output, the system of accountability<sup>20</sup> and general criteria on the subject of professional advancement of a competitive nature. Other measures regard aligning the public contracting system to the private system<sup>21</sup> and the reform of the ARAN<sup>22</sup> which needs to be made more independent, including through new rules governing conflicts of interest for members of the administrative body.*

<sup>18</sup> Reference is made to the draft of the enabling act.

<sup>19</sup> The regulations contemplate access to first-level general management positions through competition and no longer by means of political appointment.

<sup>20</sup> Including the principles on the subject of the types of violations, related sanctions and disciplinary proceedings.

<sup>21</sup> The term of the contracts is expected to be changed to be consistent with that in the private sector so as to reduce the time and the delays in relation to the renewals, and to have the period applicable for legal terms and conditions coincide with the period for the economic terms and conditions.

<sup>22</sup> The Public Administrations' Contracting Representation Agency (ARAN) is a public-law technical organisation with organisational, operational and accounting autonomy; it carries out a range of activities related to the negotiation and definition of collective contracts for the personnel of various parts of the public-sector work force.



*The efforts to reform public-sector employment are accompanied by other measures aimed at streamlining the organisation of public administration, containing current expenditure and reducing waste. The budget package<sup>23</sup> has strengthened the controls over spending, with the public administrations now required to document any expenditure for supplemental contracting and to send a report to the State Audit Court. In addition to the measures already approved, Parliament is now examining other initiatives<sup>24</sup> to reduce the charges to the State budget, including regulations on job mobility, regulations on the mobility of administrative personnel and programmes to use public buildings for non-institutional purposes.*

### V.3 FISCAL RULES

The budget policy for 2009-2011 focuses on improving fiscal governance at both a central level -via the achievement of greater efficiency in managing the State budget (see box)-, and a local level (through increasing the accountability of various levels of government and strengthening the instruments for the enforcement of the Internal Stability Pact).

Specific fiscal rules have been inserted into the framework of general regulation of the budget process to make budget constraints more robust, particularly at a local level<sup>25</sup>. Several rules were outlined in the previous Update; other rules govern healthcare expenditure and the growth of expenditure on pharmaceuticals.

The Internal Stability Pact<sup>26</sup> is flanked by a more general principle of a permanent nature (which is conceptually close to a 'golden rule') referenced in Article 119 of the Constitution, which allows local administrations to incur debt exclusively for financing investments<sup>27</sup>.

The Pact's annual revision approved with the 2009-2011 budget package<sup>28</sup> has confirmed the fundamental principles established in last year's Budget Law, which define

<sup>23</sup> Reference is made to Law n. 133/2008 converting Decree-Law n. 112/2008.

<sup>24</sup> Legislative bill, House Act n. 1441-*quater*.

<sup>25</sup> In accordance with the definition assigned at the EU level, national fiscal rules are permanent rules expressed through summary indicators of fiscal performance, defined in terms of budget balances, public expenditure and revenues, or the larger components thereof.

<sup>26</sup> Introduced by legislation related to the 1999 Budget Law, the Pact determines the means through which the territorial entities pursue the achievement of public-finance objectives, defining specific constraints that the entities must respect, reporting obligations and certification with respect to the Ministry of the Economy and Finance, and sanctions in the event of non-compliance.

<sup>27</sup> This principle has been incorporated into the Constitution with the reform of Title V of the Constitution in 2001.

<sup>28</sup> Law n. 133/2008, Articles 77, 77-bis and 77ter, converting Decree-Law n. 112/2008.



the budget balance for the local entities (municipalities and provinces) and total expenditure for the regions as the parameters of reference<sup>29</sup>.

The methods for calculating the target for the local entities have nonetheless been changed. The targets for the 2009-2011 three-year period are calculated by applying the percentages of reduction or increase to the budget balance recorded in 2007, determined by compliance or non-compliance with the Internal Stability Pact for 2007. Under past regulations, the adjustment would have been commensurate with the average budget balance recorded over a three-year period (for example, the 2003-2005 period used in 2006).

The new provisions introduce a mechanism for rewarding local entities that achieve the programme target contained in the Internal Stability Pact for the 2008-2011 period. The entities which have achieved the target may exclude from the computation of the budget balance target for the following year an amount computed on the basis of two indicators relating to the degree of the structural rigidity of the budget and the degree of the financial autonomy of the entity.

Finally, there are provisions to strengthen the enforcement instruments: should local entities or regions not comply with the Pact, they may not commit current expenditures for amounts in excess of the minimum made in the most recent three-year period nor may they incur any debt for investments. In addition, the ordinary subsidies for local entities due from the Ministry of the Interior will be cut by 5 per cent.

The budget package also provides for the introduction of a limitation on the growth of the debt of municipalities and provinces, which, as of 2010, may not increase the amount of their borrowings by more than a given percentage (as defined annually for the three-year period thereafter).

Another rule applying to the regions is defined by the Healthcare Pact and is aimed at the achievement of proper planning of public healthcare expenditure (an expenditure not governed by the Internal Stability Pact). In line with the federalist reform of public healthcare (progressively implemented through State-Region accords and agreements signed since 2000), the Healthcare Pact confirms the changeover to a model of 'shared governance' of the healthcare system, in which the State's role of coordination is accompanied by the Regions' operational autonomy.

In its current form, the Healthcare Pact<sup>30</sup> subordinates the access to financing of the healthcare system (to which the State contributes) for the 2007-2009 three-year period

<sup>29</sup> In particular, the objective for the municipalities and provinces with 5,000 or more inhabitants continues to be the budget balance, calculated using a mixed cash/accrual criterion, whereas for the regions, it is the final total expenditure, calculated using a mixed cash/accrual criterion and net of healthcare expenditure and expenditure for granting credit. The changeover to the budget balance as an objective for the regions is still being tested, in the presence of specific equilibrium limitations in the healthcare sector.

<sup>30</sup> The State and Regions signed an agreement on the Healthcare Pact on 28 September 2006, the contents of which were included in the Budget Law for the year of 2007.



to the Regions' achievement of specific goals: i) respect of profit-and-loss equilibrium within the annual budget; ii) containment of the part of spending on pharmaceuticals which is under the Regions' control; and iii) adoption of measures to streamline the supply of hospitals. For 2010 and 2011, the level of financing has been recalculated as part of the preparation of the 2009-2011 budget package and access has been conditioned on the execution of a new agreement which amends and supplements the previous agreement aimed at increasing the efficiency of the system and containing costs.

The Pact also calls for the creation of a special fund to support the regions that have incurred high structural deficits. The use of the fund is subordinated to the execution of a deficit-reduction plan containing the measures needed to restore profit-and-loss equilibrium, consistent with defined quality standards (*Livelli essenziali di assistenza*).

Regarding spending on pharmaceuticals, the prevailing regulations set specific limits vis-à-vis total healthcare expenditure: the limit is 14 per cent for spending on pharmaceuticals covered by the National Healthcare reimbursement scheme (inclusive of tickets, a percentage to be paid by the patients), at a regional and national level, and 2.4 per cent for spending on pharmaceuticals administered in hospitals at the regional level<sup>31</sup>.

## THE STATE BUDGET: PLANNING OF RESOURCES AND ANALYSIS OF EXPENDITURE

*The reclassification of the budget into missions and programmes<sup>32</sup> that was effected in 2007 has not only made it possible to simplify significantly the accounting structure (by reducing the number of units subject to Parliamentary approval<sup>33</sup>), but it has also made it possible to provide more immediate documentation of the objectives pursued by the State and of the resources dedicated to those objectives.*

*With reference to the preparation of the budget, and in particular, the means with which the resources are allocated, the assignment of resources for each administration has been defined on the basis of an overall ceiling provided for each ministry. In formulating its own proposed budget, each administration allocates the resources available for its missions to spending programmes, based on objectives and thus, on strategic and institutional aims, rather than on a specified increase over the historical level of spending.*

<sup>31</sup> Law n. 222/2007, Article 5, converting Decree-Law n. 159/2007. The limitations on the spending on pharmaceuticals were introduced with Law n. 405/2001 converting Decree-Law n. 347/2001, which set the State-Regions agreement of 2001.

<sup>32</sup> The reform of the State budget centred on identification of missions and programmes was introduced with the 2007 Budget Law and went into effect in the 2008 budget session. The missions represent the main functions and the strategic objectives funded by the expenditure, the programmes represent the standard aggregates of activities carried out within each individual Ministry, in order to pursue well-defined objectives, given the institutional purposes assigned to the administration.

<sup>33</sup> Following the reclassification, the number of units to be voted on went from 1,671 in 2006 to 669 in 2008, while the number of budget chapters went from 7,903 to 6,501.



### Trend of accounting units over the 2006-2008 three-year period

	Units subject to vote		Chapters	
	Revenues	Expenditure	Revenues	Expenditure
2006	169	1,502	740	7,163
2007	169	1,502	766	4,265
2008	60	634	781	5,720

NB: Only active chapters were considered in the count.  
The final definitive figure was considered for the years of 2006 and 2007.  
The most recent figure available from the system was used for 2008.

*In addition, the programme period was extended to the entire three-year period for the budget, and is no longer only the first financial year. The current approach provides, on the one hand, greater certainty to the planning of resources and to the planning of the activities of each ministry (by giving a timely picture of resource availability for each programme of activity); on the other hand, it results in a planning effort by administrations that up to now had not been requested of them.*

*In order to achieve increased efficiency of resource management, more intelligent spending, and a results-oriented approach to budget management, the expenditure reductions for the ministries have been flanked by more flexible budget mechanisms both for 2008<sup>34</sup> and, on an experimental basis for 2009<sup>35</sup>. The administrations can thus restructure the financial resources for their programmes within the framework of each mission, with the exclusion of so-called 'non-deferrable' charges<sup>36</sup>, consistent with the requirement of not making changes in the budget balances.*

*The action on the planning front is accompanied by efforts to strengthen the control and evaluation of the results achieved. Circular 21/2008 highlights the critical role of the system of performance indicators defined within the framework of the preliminary notes that accompany the budget; these indicators make it possible to measure results<sup>37</sup> in relation to the objectives pursued. The new approach to budgeting also calls for each minister to submit to the House each year by 15 June<sup>38</sup> a Report on the status of the expenditure, the effectiveness of the allocation of resources in the administrations under the minister's responsibility, and the degree of efficiency of the administrative action carried out, with reference to the missions and programmes outlined in the State budget<sup>39</sup>.*

*Finally, a permanent programme for analysing and evaluating expenditure has been launched with the objective of improving the level of efficiency and effectiveness of public expenditure. The analyses will cover the processes, the organisational structure of the individual productive units, as well as individual regulatory provisions, which need to be consistent with the priorities defined by administrative action and the strategic objectives set by each administration.*

<sup>34</sup> Law n. 126/2008, Article 5, Paragraph 3, converting Decree-Law n. 93/2008.

<sup>35</sup> Law n. 133/2008, Article 60, converting Decree-Law n. 112/2008.

<sup>36</sup> Law n. 133/2008, Article 60, Paragraph 2 converting Decree-Law n. 112/2008.

<sup>37</sup> Circular 21/2007, Ministry of the Economy and Finance.

<sup>38</sup> For 2008, the deadline was extended to 30 September with Article 60 of Decree-Law n. 112/2008.

<sup>39</sup> Law n. 244/2007 (2008 Budget Law) Article 3, Paragraph 68.



## VI. SUSTAINABILITY OF PUBLIC FINANCES

All of the latest demographic projections tend to come to the same conclusion, namely that factors such as lower birth rates and extended life expectancy will significantly alter the demographic structure of the population in Europe in coming decades, with non-negligible consequences on both public finance and the socio-economic framework. Against this backdrop, Italy is the country with the most rapidly ageing population and is among the group of countries reporting an increase of more than 30 percentage points in the old-age dependency ratio over the 2005-2060 period<sup>1</sup>. Despite these dynamics, the expected trend of age-related expenditures appears to be rather encouraging due to the reforms implemented in the last 10-15 years.

Table 12 reports the projections of public expenditure for pensions, healthcare, assistance to the elderly, education and unemployment compensation in relation to GDP, for the 2005-2060 period, as well as details about key demographic and macroeconomic assumptions underlying the analysis<sup>2</sup>. The new scenario and the new projections extend the time horizon from 2050 to 2060. The demographic assumptions refer to EUROSTAT's baseline scenario with 2007 as the base year, whereas the medium-/long-term macroeconomic framework is consistent with the assumptions agreed by the members of the *EPC-Ageing Working Group* (EPC-AWG).

Compared with the demographic assumptions underlying the 2007 Update of the Stability Programme, the new scenario assumes an upward revision in all demographic parameters. In particular, the net flow of immigrants is higher by 70,000-80,000 on average per year; the life expectancy as of 2050 was raised by more than 1.5 years for men and by more than 2.0 years for women; the birth rate went from 1.41 to 1.52 over the same period.

With reference to the macroeconomic assumptions, the annual rate of real GDP growth for the 2009-2060 period is around 0.2 percentage points higher than the forecast contained in the 2007 Update of the Stability Programme. This difference is attributable to higher growth of employment resulting from the greater immigrant flows projected,

<sup>1</sup> Referring to the forecasts contained in the baseline scenario prepared by Eurostat in 2007, the old-age dependency ratio was 31.7 per cent in 2005 and will grow to 64.5 per cent in 2060.

<sup>2</sup> The projections were formulated using medium-/long-term forecast models of the State's General Accounting Office. The projections fully incorporate the demographic and macroeconomic assumptions underlying the baseline scenario defined and agreed as part of the EPC-AWG for the purpose of preparing the third year of projections of age-related expenditure components, with the exception of the updating of several initial figures related to 2008-2009 (including growth rates of GDP lower than those reported in the RPP 2009, as a consequence of the economic turmoil) and several adjustments needed to make these last figures consistent with the data for subsequent years included in the baseline scenario agreed at the EU level.





whose positive effects on growth are only partially offset by a less pronounced upward trend in the growth of productivity and the employment rate.

Projections of the expenditure components have been brought up to date with the regulatory framework in existence as of December 2008. The projections incorporate (i) the effects of the implementation of the Welfare Protocol of 23 July 2007<sup>3</sup> and already considered in the forecasts contained in the 2007 Update, and (ii) the effects of the measures contained in the Decree-Law n. 112/2008 (converted with Law n. 133/2008) and the Decree-Law n.185/2008.

**TABLE 12: PUBLIC EXPENDITURES ON PENSIONS, HEALTHCARE, LONG-TERM CARE, EDUCATION AND UNEMPLOYMENT BENEFITS (2005-2060)<sup>1</sup>**

	2005	2010	2015	2020	2025	2030	2035	2040	2045	2050	2055	2060
	% of GDP											
Total expenditure	48.2	50.0	49.0	49.2	49.5	50.1	50.8	51.5	51.7	51.4	51.1	50.6
of which: age-related expenditure	26.1	27.1	26.6	26.8	27.1	27.7	28.4	29.1	29.3	29.0	28.7	28.2
Pension expenditure	14.0	14.7	14.3	14.3	14.5	14.9	15.3	15.6	15.4	14.7	14.2	13.6
of which: seniority and old-age pensions	13.4	14.2	13.8	13.8	14.0	14.5	14.9	15.3	15.1	14.4	13.9	13.3
of which: other pensions (disability and survivors)	0.6	0.5	0.5	0.5	0.5	0.4	0.4	0.3	0.3	0.3	0.3	0.3
Healthcare expenditure (2)	6.7	7.1	7.2	7.4	7.6	7.8	8.0	8.3	8.5	8.6	8.7	8.7
Long-term care expenditure	0.8	0.9	0.9	1.0	1.0	1.1	1.1	1.2	1.3	1.5	1.6	1.6
Education expenditure (3)	4.2	4.0	3.8	3.7	3.6	3.5	3.5	3.6	3.7	3.8	3.8	3.8
Unemployment benefits	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Interest expenditure	4.5	5.2	5.0	4.3	3.6	3.1	2.8	2.6	2.5	2.4	2.2	1.9
Total revenues (4)	43.8	46.8	46.3	46.2	46.2	46.2	46.2	46.2	46.2	46.1	46.1	46.1
of which: property income	0.6	0.6	0.6	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.4	0.4
	ASSUMPTIONS											
	% change											
Labour productivity growth rate	0.4	0.6	1.5	1.6	1.7	1.7	1.7	1.7	1.7	1.7	1.7	1.7
Real GDP growth rate	0.6	1.5	2.5	1.9	1.7	1.3	1.0	1.0	1.2	1.3	1.3	1.4
Male participation rate (20-64)	79.2	80.4	81.7	82.0	82.8	83.1	83.2	83.4	83.7	83.7	83.5	83.5
Female participation rate (20-64)	53.6	55.8	58.7	59.9	60.5	60.8	60.8	60.8	61.1	61.1	61.0	61.0
Total participation rate (20-64)	66.4	68.1	70.2	71.0	71.7	72.1	72.1	72.3	72.6	72.7	72.5	72.5
Unemployment rate	7.7	7.8	5.7	5.7	5.6	5.6	5.6	5.6	5.6	5.6	5.6	5.6
Population aged 65 and over / total population (5)	19.5	20.3	21.7	22.7	24.0	26.2	28.6	30.8	32.2	32.6	32.7	32.7
Old-age dependency ratio (65 years and older / [20-64]) (5)	31.7	33.5	36.2	38.3	41.1	45.9	52.1	58.4	62.6	64.2	64.5	64.5

1) Given rounding to the first decimal point, the individual figures added together may not equal the totals shown.

2) Includes public healthcare spending for assistance to the elderly.

3) Does not include public spending for adult education (continuous training) and pre-primary school.

4) Inclusive of property income.

5) Source: Eurostat, baseline scenario, base year = 2007.

<sup>3</sup> Decree-Law n. 81/2007, converted with amendments by Law n. 127/2007, and Law n. 247/2007.



The sustainability of public finances is analysed both by projecting the debt-to-GDP ratio over the 2012-2060 period and by calculating summary sustainability indicators, and in particular the two sustainability gaps (S1 and S2) and the required primary balance (RPB)<sup>4</sup>. According to the sustainability indicators, the fiscal consolidation up to 2011 projected in this Update is sufficient to ensure the long-term sustainability of public finances.

**TABLE 13: LONG-TERM SUSTAINABILITY INDICATORS**

	S <sub>1</sub>	S <sub>2</sub>	RPB
Value	-0.3	-0.8	3.1
of which:			
Initial budgetary position	-2.0	-1.9	-
Debt requirement in 2060	0.7	-	-
Long-term changes in the primary balance	1.0	1.1	-

<sup>4</sup> These are well known indicators agreed at the EU level and reported in prior Updates of the Stability Programme. In this Update, however, they are calculated with reference to a time horizon that is ten years longer.