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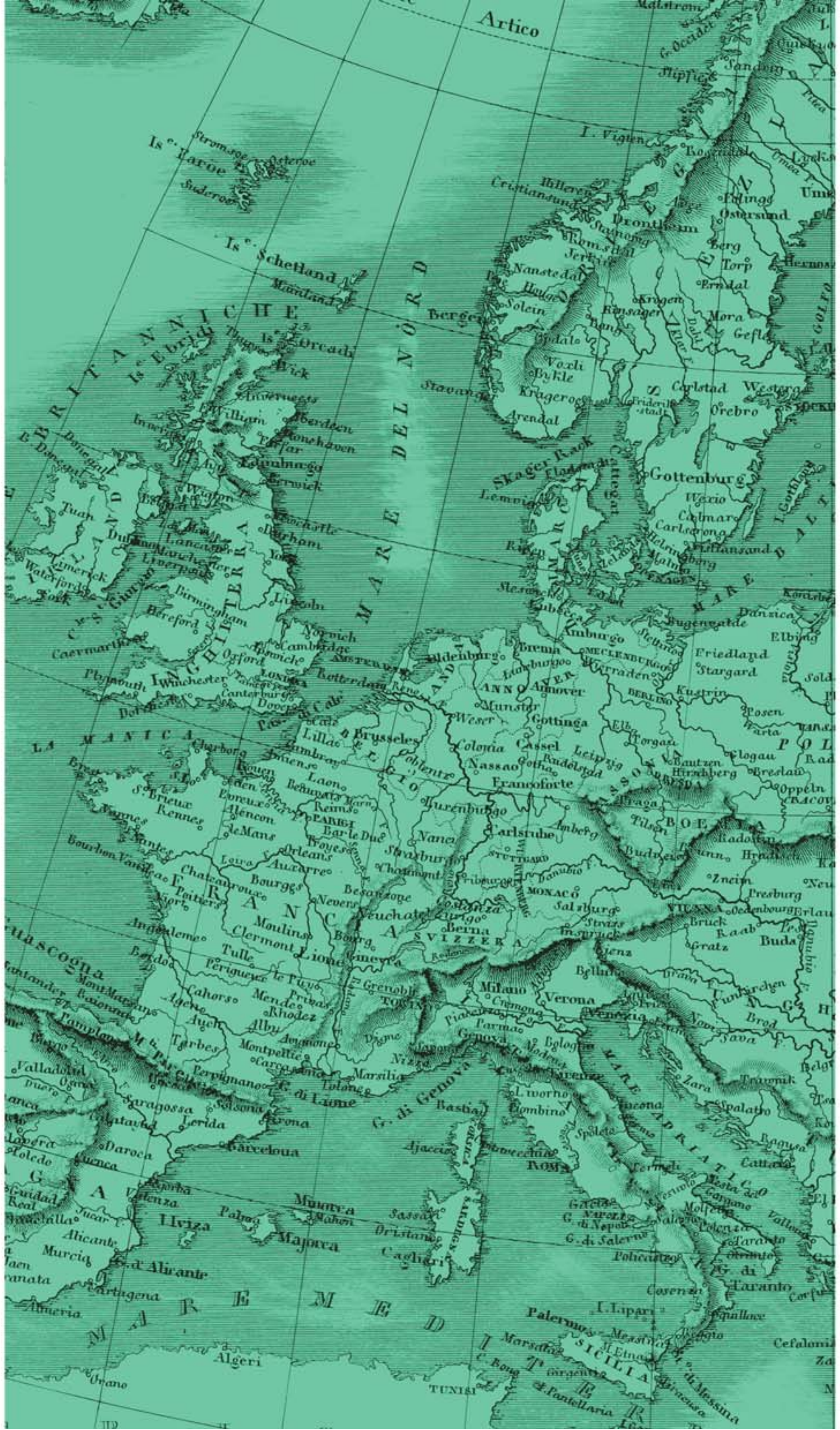

Ministero dell'Economia e delle Finanze

Italy's Stability Programme

2009 Update

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2009 Update
Presented on January 2010

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I. INTRODUCTION

Signs of a global economic recovery emerged in 2009, with the rebound of activity first seen in Asia's emerging economies, and then extending to the more industrialised countries.

As a result of the improvement of economic conditions, the estimates for Italy's macroeconomic framework have been revised relative to those presented in the Forecast and Planning Report (RPP) published in September.

Though maintaining a prudent fiscal posture, the Italian Government took prompt action both during the acute phase of the crisis, as well as at the first signs of stabilisation and indications of an actual recovery.

The high degree of uncertainty about economic and financial prospects has justified caution in budget planning; measures which have an excessive impact on public finance trends over the next three years and beyond have been avoided inasmuch as they might hamper the impulses to growth via a negative reaction of financial markets or economic agents.

The budget strategy has therefore focused on reallocating resources to measures having the highest possible positive impact on the economy in the short term so as to counter the socioeconomic effects of the crisis, in advance of the more pronounced consolidation of the economic recovery. Consistent with what occurred last year, the budgeting for the 2010-2012 three-year period was put into effect, starting with a decree-law that was presented with the Economic and Financial Planning Document (DPEF) and approved before the start of summer. The 2010 Budget Law, presented at the end of September and now approved, is the final piece of legislation of the public finance budget process. Incorporating initiatives designed to have as neutral a fiscal impact as possible, the Decree Law and the Budget Law are both aimed at limiting any deterioration of the deficit-to-GDP and debt-to-GDP ratios, and of financial sustainability in general.

The opening of the excessive deficit procedure (EDP) with respect to most EU Member States has made it necessary a coordinated approach in developing strategies for exiting from the excessive deficit situation; this approach also aims at reinstating stability in the financial sector, ensuring long-term sustainability of public finances, and enhancing potential GDP. The exit strategies will need to be calibrated on the basis of the specific situation of each Member State, in accordance with the rules of the Stability and Growth Pact and the recommendations of the EDP. In December, the ECOFIN Council called on Italy to bring the nation's deficit to a level below the threshold of 3.0 per cent of GDP by 2012, to implement the fiscal consolidation programme inaugurated with the 2009-2011 budget package and confirmed by the 2010-2013 DPEF, and to guarantee average

annual deficit reduction equal to at least 0.5 percentage points of GDP for the 2010-2012 period.

In response to these recommendations, the Italian Government has confirmed its consolidation objectives: the net borrowing, in terms of the nominal balance, is to move back below the threshold of reference within the time horizon considered by the Stability Programme.

The commitment to achieve a balanced budget, net of cyclical conditions and one-off measures, has also been confirmed as a medium-term objective (MTO). In structural terms, the fiscal consolidation will get back on track in 2010. The cyclically adjusted budget balance, net of one-off measures, is to fall by 0.5 percentage points in 2010, while the adjustment will amount to approximately 0.6 percentage points per year for 2011 and 2012, in line with the agreements made at the EU level.

This Update of the Stability Programme[1] reflects new macroeconomic forecasts, and illustrates the effects thereof on public finance balances and on budget strategy for the achievement of public finance objectives[2].

As requested at EU level, this Update contains a specific chapter that deals with (i) the measures already initiated with the 2009 Budget Law, the mechanism that introduced a solid three-year plan to reduce the deficit through expenditure measures, and (ii) the other initiatives adopted with the 2010 Budget Law, which guarantee the continuation of the fiscal consolidation effort. The chapter outlines the fundamental orientation of additional measures that the Government is planning to undertake when cyclical conditions permit, in line with the ECOFIN recommendations.

A decisive element in fiscal consolidation is represented by the reform of the law regarding public finance and government accounting approved by Parliament in December 2009. The reform will further strengthen the consolidated governance of public finance, thereby facilitating better monitoring of public accounts. The legislation also enhances control over public spending.

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[1] The Update of the Stability Programme is prepared in accordance with European Council Regulation No. 1466/97, taking into account the changes introduced by Regulation No. 1055/2005 of 27 June 2005, and the guidelines for the application of the new Stability and Growth Pact.

[2] More specifically, this update is largely based on the Update Note for 2010-2012 presented to Parliament on 28 January 2010, Law No.102/2009 (conversion of Decree-Law. No.78/2009 presented in June 2009), and the 2010 Budget Law presented in September 2009 and now approved (Law No.191/2009). The document takes into account the measures of draft legislation backing the Budget Law, namely: (i) a legislative bill aimed at (a) optimising the productivity of the public-sector labour force and (b) reorganising regulations applicable to strenuous work, as indicated last year and not yet definitively approved; and (ii) two proposed laws containing provisions about the governing bodies and functions of local entities and the simplification of relations between government and citizens and businesses, both of which were examined and approved by the Cabinet in November 2009.

The biggest improvements are expected to come from the implementation of fiscal federalism for which the Government has already received approval. In this regard, positive effects are expected on both the expenditure side (application of standard costs) and the revenue side (the fight against tax evasion through participation/involvement of local governments).

This document presents the projections of the public debt-to-GDP ratio for the coming years. The forecast time horizon for analysing long-term sustainability has been extended to 2060, in line with the 2008 Update. The demographic assumptions refer to EUROSTAT's new central forecast (base year of 2007), whereas the macroeconomic framework incorporates the effects of the crisis (lost-decade scenario) converging toward the assumptions agreed at the EPC-Ageing Working Group (EPC-AWG) for the medium term only. The chapter analysing sustainability contains a series of simulations that are broader ranging than in the past so as to evaluate the effects of alternative macroeconomic and public finance assumptions on the long-term trend of public debt. The results show that Italy's public debt remains largely sustainable over the long term in the scenarios analysed, on the basis of the public finance objectives contained in this Update and even accounting for the effects of the crisis.

Finally, the Update contains a chapter dedicated to the quality of public finances which outlines various factors, including (i) the regulatory framework outlined by the law reforming public finance and government accounting, (ii) a description of the regular analysis and evaluation of central government expenditures, and (iii) a review of the fiscal rules and the institutions governing budget policy. This chapter also contains a section covering the structural measures described in the 2009-2011 National Reform Programme (PNR), in line with the provisions of the Code of Conduct.

As occurred for the first time last year, the Update of the Stability Programme is preceded by the presentation to Parliament of an appropriate Update Note in consideration of the changes in the macroeconomic framework that affect Italy's public finances, although the effects of such changes are limited and mostly refer to changes in the mix of individual budget components.

II. MACROECONOMIC SCENARIO

II.1 THE INTERNATIONAL SCENARIO

Significantly weakened by the effects of the financial crisis starting in 2007, the global economy was showing signs of a recovery in 2009. The recovery in economic activity was first seen in the Asian emerging economies and then extended to the industrialised countries.

The forecast for 2010 suggests the global economy will grow by 3.1 per cent, after contracting by an estimated 1.3 per cent in 2009. World trade is also expected to rebound in 2010, expanding by 3.5 per cent, following the substantial 12.5 per cent reduction estimated last year.

The latest indicators point to general improvement in confidence, with positive prospects for the next six months. Even so, factors capable of undermining the recovery still remain.

The turnaround in commodity prices relative to the peaks of mid-2008 has sharply reduced inflationary pressure at an international level; in various industrialised countries, growth in the consumer price index was actually in negative territory during the summer of 2009. As signs of economic recovery emerged, crude oil prices (Brent) started to climb once again, rising to around $75/barrel during the month of December; still, prices are currently at less than one-half of their peak reported in July 2008. Overall, the prices for metals and food products have shown a rising trend since the start of 2009, though they have continued to stay well below the highs posted in 2008.

In responding to the crisis, the governments and central banks of the largest countries strengthened international coordination. In Europe, a common framework for intervention was defined together with support initiatives at a national level. Economic policy makers approved important fiscal measures and extraordinary provisions for recapitalising banks, extending deposit guarantees, and favouring normalisation of financial markets. Some countries also approved public works programmes.

Despite increasingly convincing signs of an end to the crisis, the strength of the economic recovery is still uncertain, primarily because it has mostly been driven by the rebuilding of inventories and by monetary and fiscal stimulus measures, factors which have only a temporary impact.

A significant rebound was seen in international stock markets in 2009; volatility decreased substantially in comparison with the highs in the second half of 2008. The monetary authorities in the United States, Japan and the Euro Area adopted very expansionary policies in 2009. Aside from leaving the Fed Funds rate at a historical low, with the interval of reference at 0.00-0.25 per cent, the Federal Reserve made extensive use of non-conventional instruments to support the economy and the functioning of

financial markets. The Bank of Japan kept the policy rate at 0.1 per cent and implemented temporary measures for combating the continuation of a deflationary process and the instability of the foreign-exchange markets, a source of concern for domestic firms. The European Central Bank reduced the policy rate to 1.0 per cent and, like the other major central banks, adopted extraordinary measures in order to guarantee liquidity to the banking system, and to ensure the flow of credit to firms and consumers.

In recent months, leading international organisations have revised upwards the estimates for global economic growth.

II.2 PROSPECTS FOR THE ITALIAN ECONOMY

The recovery spread to the world's main industrial countries during the summer months, with the Italian economy also logging a significant rebound in production.

Italy's GDP began expanding again in the third quarter (0.6 per cent quarter on quarter) after five consecutive quarters of contraction. Italy produced one of the best results in the Euro Area, whose GDP rose by 0.4 per cent quarter on quarter. Germany's growth rate of 0.7 per cent was more pronounced, whereas France posted an increase of 0.3 per cent.

Investment regained momentum in Italy (0.3 per quarter on quarter), especially for the effect of capital accumulation in the equipment sector. Favourable indications also came from exports. After slightly rebounding in the second quarter, consumption accelerated in response to higher spending on durable and semi-durable goods. Finally, inventories provided a positive contribution to growth of 0.1 percentage points.

As shown by the latest indicators, firms are benefiting from the recovery of global demand and international trade. Capacity utilisation began to move up again in the third quarter; industrial production recovered by 4.4 per cent with respect to the preceding quarter, and was followed by a slight month-on-month increase in both October and November (0.7 per cent and 0.2 per cent, respectively). Consistent with trends during the recession, the recovery has been most pronounced for consumer durables, as well as capital goods and intermediate goods, which lead the cycle. Additional potential for another increase in industrial production is currently discernible, given the lower-than-normal level of inventories and the continuous improvement in expected orders as shown by confidence surveys[1].

Taking into account third-quarter results and the expectations of slight moderation in the fourth quarter, it is estimated that GDP contracted by 4.8 per cent in 2009. In 2010, the Italian economy is poised to grow by 1.1 per cent, 0.4 percentage points above the level indicated in the Forecast and Planning Report (RPP) published in September,

[1] Source: ISAE.

thanks to the positive effects of the carry-over and to expectations of a more robust recovery in world trade. For the 2011-2012 two-year period, annual growth of GDP should remain at around 2.0 per cent.

Private consumption is estimated to have remained weak in 2009, especially in view of the contraction recorded in the first quarter and the negative impact of the carry-over from 2008. According to estimates prepared by the Bank of Italy[2], the net wealth of households decreased by 1.9 per cent in nominal terms (5 per cent in real terms) in 2008, while remaining virtually unchanged in the first half of 2009, in both nominal and real terms. Despite the reduction in labour compensation, household consumption is likely to have been supported as of the second quarter by a rebound in confidence, the easing of uncertainty and the impact of the fiscal measures aimed at stimulating demand for durable goods. In the third quarter of 2009, household debt remained stable with respect to the prior quarter at 58 per cent of disposable income[3]. Consumer confidence[4] in December moved up to the pre-crisis high (first quarter of 2007) thanks to favourable conditions for purchasing durable goods and increasing savings. Household consumption is forecast to rise by 0.8 per cent in 2010, benefiting from the expected increase in real disposable income. An average increase of private consumption of roughly 1.9 per cent is projected for the years thereafter. The delay with which the effects of the recession have shown up in the labour market could have a larger-than-expected impact on the evolution of private consumption, representing perhaps the biggest risk factor in relation to the forecasts.

Investment in machinery and equipment is estimated to have contracted by 17.8 per cent in 2009, for the effect of the drop in the first half of the year. The recovery of global demand and the fiscal incentives introduced by the Government[5] started to produce positive effects in the third quarter, which could well continue to be seen in the quarters thereafter. Critical factors become evident in the granting of credit to firms which, with the usual delay seen vis à vis key macroeconomic variables, started to decrease in October and November 2009 compared with the same months of 2008[6]. In an overall framework marked by scarcity of working capital, payment delays and deteriorating profit margins[7], small- and medium-sized enterprises (SMEs) are the most

[2] 'The wealth of Italian households', Bank of Italy, December 2009.
http://www.bancaditalia.it/statistiche/stat_mon_cred_fin/banc_fin/ricfamit/2009/suppl_67_09.pdf

[3] In the second quarter of 2009, the ratio for the Euro Area was 94 per cent (see Economic Bulletin No. 59, 15 January 2010, Bank of Italy).

[4] Source: ISAE.

[5] Law No. 102/2009.

[6] According to the Bank of Italy, the credit granted to non-financial firms in November 2009 was down by 0.5 per cent compared with the same month of the preceding year (following a contraction of 1.6 per cent posted in October compared with the same month of the preceding year), especially as a result of the reduction in the medium-term segment (1-5 years).

[7] On the basis of ISTAT data, in the third quarter of 2009, non-financial firms were reporting a 49.9 per cent ratio of gross operating surplus to gross added value (at basic prices), with a reduction of 0.3 percentage

affected given that they have fewer sources of financing as an alternative to bank credit. The structure of Italian industry, which is mainly made up of SMEs[8], looks vulnerable from this perspective. Positive effects are expected not only from the moratorium on principal repayment on bank loans to firms approved in 2009, but also from Government's recent decision to promote the creation of a private equity investment fund for firms (including SMEs) for firm restructuring to raise competitiveness. The *Cassa Depositi e Prestiti* and the banking system both contribute to the initiative. Taking into account the revival of both exports and international trade, investment in machinery for the 2010-2012 three-year period is forecast to rise by an average of 2.7 per cent per year.

Investment in construction in 2009 is estimated to have contracted to a lesser extent than investment in machinery. The correction is expected to have been slightly above the level assumed in the RPP[9]. Real estate sale transactions decreased significantly in 2008, although the indications available for 2009 suggest that the decline has subsided[10]. According to the Bank of Italy[11], there was continuing disparity between demand- and supply-side prices in the third quarter of 2009: in the fourth quarter, it is expected that prices fell again, albeit in moderation with respect to the preceding quarters. The confidence climate for construction firms has remained volatile; in November, the confidence index fell to levels seen at the end of 2008, mainly due to scarcity of demand and bad weather.

Investment in construction is projected to grow by 0.5 per cent per year in 2010, including as a result of the positive effect of the 'Housing Plan' expected to be finalised after the regional elections[12]. For the two years thereafter, investment in construction is slated to grow by an average of 2.7 per cent per year.

points compared with the preceding quarter. Compared with the third quarter of the preceding year, the ratio for such companies fell by 2 percentage points. See: http://www.istat.it/salastampa/comunicati/in_calendario/redrisp/20100111_00/testointegrale20100111.pdf

[8] On the basis of ISTAT's most recent survey about business structure (with reference to 2007), firms with less than 20 employees account for 92.7 per cent of industry, excluding construction. Exporting manufacturing firms have an average number of employees that is significantly higher than those who do not export (29.9 versus 4.7 respectively). See ISTAT, 'Structure and competitiveness of the system of industrial and services firms, year 2007'.

[9] In the third quarter, production and investment in the construction sector fell by 13.6 per cent and 9.1 per cent, respectively, compared with the same period of the prior year.

[10] In 2008, the sale-purchase transactions in the real estate sector decreased by 13.4 per cent compared with 2007 (ISTAT data). According to the *Agenzia del Territorio*, the year-on-year decrease in sale-purchase transactions contracted in the first three quarters of 2009, standing at 11.3 per cent in the third quarter.

[11] Bank of Italy, Sample survey on the housing market in Italy, November 2009. http://www.bancaditalia.it/statistiche/indcamp/sondaggio_market_abitazioni/2009/12_09/suppl_63_09.pdf

[12] Article 11 of Decree-Law No. 112 of 25 June 2008, converted into Law No. 133 as of 6 August 2008.

Exports in 2009 felt the effects of the fall in world trade, recording a decline of 18.8 per cent. The decrease in domestic demand likely affected imports too (-15.0 per cent). The growth of exports looks poised to accelerate as of 2010, in line with the recovery of world trade. The contribution of net exports to growth is expected to be positive for the 2010-2011 two-year period. The current account deficit of the balance of payments is projected at around 2.7 per cent of GDP in 2009, an improvement over 2008. The goods balance is estimated to have returned to positive territory (0.2 per cent of GDP), following the zero balance reported for 2008.

According to the labour force survey for the third quarter, the number of employed fell by 2.2 per cent with respect to the same quarter of 2008 (equal to a decrease of around 500,000 people). The number of employed enrolled in the wage supplementation scheme programme (*Cassa Integrazione Guadagni* (*CIG*)) was around 280,000. In the same quarter, according to national accounts data, the number of employed had dropped by 1.5 per cent compared with the same period of 2008; in terms of full-time equivalent, namely the total full-time equivalent employees net of workers enrolled in the wage supplementation scheme, the number of employed fell by 2.9 per cent. The trend is particularly evident in industry, excluding construction.

Although the use of CIG was strong in 2009, some improvement was seen in recent months with respect to ordinary CIG. The total hours authorised by the Social Security Administration (INPS) came to roughly 918 million. From January to November 2009, around 64 per cent of the hours authorised had been used.

The labour market is expected to regain momentum starting in 2011. The unemployment rate for 2009 is estimated at 7.7 per cent, one percentage point above the rate posted for 2008; the unemployment rate is projected to rise to 8.4 per cent in 2010, and then to decline to 8.0 per cent by 2012.

As of November, renewed labour contracts amounted to 87 per cent of the total. Compensation per employee is estimated to have grown by 1.7 per cent in 2009, and is projected to remain contained over the 2010-2012 three-year period growing by an average of 1.9 per cent per year. Given the effect of the contraction of productivity, the unit labour costs (measured against value added) are estimated to have risen moderately between 2008 and 2009; unit labour costs are expected to decelerate significantly in 2010, particularly in industry, excluding construction, which is more exposed to international competition; for the years thereafter, growth of unit labour costs is projected to remain contained.

Inflation in Italy as measured by the harmonised index of consumer prices fell to 0.8 per cent in 2009, reflecting the reduction in commodity prices starting in the second half of 2008 and the decrease in demand. Consumer inflation is projected to be in the range of 1.5 per cent in 2010, and 2.0 per cent for the years thereafter.

The structure of Italy's economy appears to have changed towards the end of the recession. The drop in production was pronounced[13] and differentiated across sectors, having the greatest impact on industry, excluding construction. The food and pharmaceutical industries proved to be relatively unaffected by the crisis, partly due to their anti-cyclical nature; on the other hand, sectors specialised in investment goods, consumer durables and intermediate goods used in initial processing phases were all adversely impacted. This situation is symptomatic not only of the heterogeneity in the cyclical nature of sectors, but also of the differences in the exposure to international trade.

The scenario described above incorporates the European Commission's assumptions about external variables which were contained in the Autumn Forecast of 3 November 2009, in line with the requirements of the Code of Conduct. Since then, the economic trends have suggested further improvement in growth forecasts.

TABLE 1: BASE ASSUMPTIONS

	2008	2009	2010	2011	2012
Short-term interest rate (1)	3.5	1.0	1.8	2.9	3.7
Long-term interest rate	4.8	4.3	4.8	5.1	5.4
USD/EUR exchange rate	1.47	1.40	1.50	1.50	1.50
Change in nominal effective exchange rate	4.9	0.8	2.4	0.0	0.0
GDP growth, world excluding EU	3.6	-0.3	3.8	4.1	4.6
EU GDP growth	0.8	-4.1	0.9	1.6	2.4
Growth in Italy's foreign markets	1.2	-12.3	2.0	4.1	4.2
World import volumes, excluding EU	4.6	-12.6	4.6	5.0	7.0
Oil price (Brent, USD/barrel)	96.9	61.9	76.8	76.8	76.8

1) Interest rate on three-month Italian government securities, weighted according to the planned quantities of issues. Long-term interest rate refers to 10-year Italian government securities. Interest-rate data are annual averages.

[13] The decrease experienced by industry excluding construction during the most recent crisis is more rapid and greater in terms of magnitude than in past crises. At its low in March 2009, the industrial production index had come down by 25.3 per cent from April 2008 (peak). During the 1992-94 recession, industrial production hit a low in October 1993 that was 4.9 per cent under the peak of April 1992. See also Antonio Bassanetti, Martina Cecioni, Andrea Nobili, Giordano Zevi, 'The main recessions in Italy: a retrospective comparison', Bank of Italy, Occasional Papers (Economic and Finance Questions), No. 46 July 2009.

TABLE 2a: MACROECONOMIC PROSPECTS

	2008 level (1)	2008	2009	2010	2011	2012
				% change		
Real GDP	1,276,578	-1.0	-4.8	1.1	2.0	2.0
Nominal GDP	1,572,243	1.8	-2.5	2.6	3.8	3.9
COMPONENTS OF REAL GDP						
Private consumption	747,955	-0.9	-1.7	0.8	1.9	1.9
Public consumption (2)	258,587	0.6	0.5	0.2	0.0	0.8
Gross fixed investment	267,571	-3.0	-12.7	1.4	2.7	2.7
Exports of goods and services	357,173	-3.7	-18.8	2.3	4.0	4.3
Imports of goods and services	358,481	-4.5	-15.0	1.8	3.0	4.0
CONTRIBUTION TO REAL GDP GROWTH (3)						
Domestic demand		-1.0	-3.5	0.8	1.7	1.9
Change in inventories		-0.3	-0.2	0.1	0.0	0.0
Net exports		0.3	-1.0	0.1	0.2	0.0

1) € Mln.
2) General government and NPISHs.
3) Possible discrepancies are due to rounding.

TABLE 2b: PRICES

	2008 level	2008	2009	2010	2011	2012
					% change	
GDP deflator	123.2	2.8	2.5	1.5	1.8	1.9
Private consumption deflator	123.4	3.2	0.1	1.5	1.8	1.9
HICP	108.0	3.5	0.8	1.5	2.0	2.0
Public consumption deflator	125.4	3.8	2.4	0.6	0.8	0.9
Investment deflator	122.7	3.2	1.2	1.7	2.3	2.2
Export deflator (goods and services)	126.9	5.0	0.0	1.3	1.8	2.0
Import deflator (goods and services)	128.6	6.9	-5.8	0.7	1.5	1.6

TABLE 2c: LABOUR MARKET DEVELOPMENTS

	2008 level (1)	2008	2009	2010	2011	2012
				% change		
Employment, persons (national account data)	25,263	0.3	-1.2	-0.5	0.9	1.1
Employment, hours worked	45,511,444	-0.5	-3.1	-0.1	1.3	1.3
Unemployment rate		6.7	7.7	8.4	8.3	8.0
Labour productivity, persons	50,532	-1.4	-3.7	1.6	1.0	0.9
Labour productivity, hours worked	28,0	-0.5	-1.8	1.1	0.6	0.6
Compensation of employees	654,986	3.7	-0.6	2.1	3.2	3.3
Compensation per employee	36,427	3.3	1.7	1.8	1.8	2.1

1) Units of measurement: in thousand 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

	2008	2009	2010	2011	2012
			as % of GDP		
Net lending/borrowing vis à vis the rest of the world	-2.9	-1.8	-1.6	-1.3	-1.3
Balance of goods and services	-0.5	-0.1	0.2	0.5	0.7
Balance of primary income and transfers	-2.5	-1.8	-1.9	-2.0	-2.1
Capital account	0.1	0.1	0.1	0.1	0.1
Net lending/borrowing of the private sector	-0.2	3.4	3.4	2.6	1.4
Net lending/borrowing of general government B.9 (1)	-2.7	-5.3	-5.0	-3.9	-2.7
Net lending/borrowing of general government EDP B.9	-2.7	-5.3	-5.0	-3.9	-2.7
Statistical discrepancies					

1) In 2008 the level of net lending of general government EDP B.9 was slightly different from the one used for ESA95 to calculate the balance versus the rest of the world. The difference does not affect the GDP-ratio. For data on Italy please refer to the ISTAT web site: http://www.istat.it/salastampa/comunicati/non_calendario/20090714_00/

III. NET BORROWING AND PUBLIC DEBT

III.1 GENERAL GOVERNMENT NET BORROWING

The public finance forecasts presented in the 2008 Update of the Stability Programme were revised in 2009 in line with the changes in growth prospects for the Italian economy, against the backdrop of an international cycle that showed initial signs of recovery during the second half of the year.

The forecasting of the public-finance balances incorporates more uncertainty than in the past due to the effects of the unfavourable macroeconomic scenario. Within the framework of the common European initiative (European Economic Recovery Plan) for favouring a more rapid end of the economic recession, the crisis-deterrence measures adopted by Italy's Government[1] have been drafted in a manner compatible with the nation's commitment to maintaining fiscal stability, thereby limiting the negative impact of the measures on the public accounts.

In the 2009 Combined Report on the Economy and Public Finance issued in April, the 2009 net borrowing estimate was revised upward from 3.7 to 4.6 per cent of GDP due to (i) another downward revision to the GDP forecast of 2.2 percentage points (from -2.0 to -4.2 per cent) and (ii) new economic support measures targeted to specific sectors and to stimulating consumption.

In June, with the publication of the 2010-2013 Economic and Financial Planning Document (DPEF), the estimate of net borrowing was revised further upward to 5.3 per cent of GDP. The revision was made following the update of the year-on-year trends of public-finance aggregates, with part of the change due to the 2009 budget balancing. The revised estimate incorporated the effects of both the crisis-deterrence measures approved during the year and the urgent actions taken in the areas hit by earthquake[2].

The estimate was confirmed in September with the Forecast and Planning Report (RPP) and the Update to the 2010-2013 DPEF, albeit with a change in the individual components (though this did not have any impact on the balances overall).

Thereafter, the updating of the public accounts at the end of 2009 led to the revision of several revenue and current expenditure items, without impacting the value of net borrowing to GDP ratio[3].

[1] Decree Law No. 185/2008 converted into Law No. 2/2009; Decree Law No. 5/2009 converted into Law No. 33/2009; Decree Law No. 78/2009 converted into Law No. 102/2009; State-Regions Accord signed on 13 February 2009.

[2] Decree Law No. 39/2009 converted into Law No. 77/2009.

[3] More specifically, the revision of expenditures included a 0.1 per cent reduction of interest expenditure versus the September estimate; the revision of revenues includes lower revenues from direct taxes

Considered altogether, the difference between the 2009 net borrowing estimate presented in this report and that indicated in the 2008 Update of the Stability Programme is equal to 1.6 percentage points (Table 3). Given the decrease in GDP, the higher deficit can mainly be attributed to the resulting higher percentage of total expenditure to GDP (an increase of 1.2 percentage points compared with the previous forecast), combined with a lower percentage of total revenues (-0.4 percentage points). Within current expenditure, the increased percentage of both social transfers in cash (+0.4 percentage points) and employee compensation (+0.1 percentage points) is offset by lower interest expenditure (-0.2 percentage points). The percentage of gross fixed investment increased by 0.3 percentage points. Within current revenues, the higher weight of other current revenues (+0.1 percentage points) offsets only a small part of the reduction in indirect taxes (-0.3 percentage points), direct taxes (-0.2 percentage points), and social-welfare contributions (-0.3 percentage points). The projection of GDP growth for 2009 is therefore 2.8 percentage points below that projected in the 2008 Update (-4.8 per cent versus -2.0 per cent).

In comparison with the results achieved in 2008, the nominal net borrowing for 2009 rises by 2.6 percentage points of GDP, going from 2.7 per cent to 5.3 per cent[4].

TABLE 3: DIFFERENCES FROM PREVIOUS UPDATE

	2008	2009	2010	2011
GDP growth rate				
2008 Stability Programme	-0.6	-2.0	0.3	1.0
2009 Stability Programme	-1.0	-4.8	1.1	2.0
Difference	-0.4	-2.8	0.8	1.0
Net borrowing (% of GDP)				
2008 Stability Programme	-2.6	-3.7	-3.3	-2.9
2009 Stability Programme	-2.7	-5.3	-5.0	-3.9
Difference	-0.1	-1.6	-1.7	-1.0
Public debt (% of GDP)				
2008 Stability Programme	105.9	110.5	112.0	111.6
2009 Stability Programme	105.8	115.1	116.9	116.5
Difference	-0.1	4.6	4.9	4.9

essentially offset by higher capital account revenues derived from payments received through the repatriation/regularisation of capital held abroad (the so-called 'tax shield' programme).

[4] The 2008 result has been revised marginally, from 2.6 per cent of GDP (indicated in the 2008 Update) to 2.7 per cent of GDP, following the forecast of a decline in GDP that is greater than the previously forecast decline (from -0.6 to -1.0 per cent). The result was also impacted by measures to support the real economy (e.g. the reduction of the percentages of the prepayments of corporate income taxes and regional taxes on productivity activity, and other measures to support low-income brackets).

More specifically, total revenues to GDP is estimated to increase by 0.4 percentage points compared with 2008, particularly for the effect of higher revenue derived from social-welfare contributions and other current revenues (+0.2 and +0.1 percentage points, respectively) which was accompanied, as a result of the crisis, by a reduction in tax revenue, most of which due to fall in indirect taxes (-0.3 percentage points).

The ratio of total expenditure to GDP rose by 2.9 percentage points compared with 2008; the change stems from increases in the main expenditure items as a percentage of GDP, namely, social transfers in cash (+1.3 percentage points)[5], employee compensation (+0.5 percentage points), and expenditure on gross fixed investment (+0.4 percentage points). The ratio of primary expenditure to GDP rose by 3.3 percentage points, while the ratio of interest expenditure to GDP went from 5.1 to 4.8 per cent. The primary balance fell by 2.9 percentage points (from 2.4 per cent to -0.5 per cent).

For 2010, the nominal net borrowing of the general government is estimated at 5.0 per cent of GDP, an increase of 1.7 percentage points compared with the figure presented in the 2008 Update, whereas the primary balance is projected to be near zero (-0.1 per cent). The forecast takes into account the revision of growth prospects for the 2009-2010 two-year period, and is in line with the strategy agreed at an EU level calling for a gradual approach to deficit reduction.

For the two-year period thereafter, 2011-2012, the public-finance estimates reflect the projected trends for the economic cycle and the fiscal consolidation measures that the Government has agreed to adopt. At the end of the period, the net borrowing is expected to be equal to approximately 2.7 per cent of GDP for the effect of an additional correction to the primary balance estimated to equal about 0.4 percentage points in 2011 and 0.8 percentage points in 2012. Consistent with the targets, the current primary surplus is projected to increase from 1.3 per cent in 2011 to 2.7 per cent in 2012.

As indicated in the introduction to this report, the biggest improvements on both the revenue side (reduction in tax evasion) and the expenditure side (standard costs) are expected to come from the implementation of fiscal federalism.

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[5] The expenditure for social services in cash is expected to grow by 4.8 per cent in comparison with 2008 for the effect of the increase in pension expenditure (+4.2 per cent) and the increase in expenditure for other social welfare benefits in cash (+7.2 per cent), which takes into account the refinancing of exceptional social safety net programmes that have been extended.

TABLE 4: GENERAL GOVERNMENT BUDGETARY PROSPECTS[1]

	2008		2009	2010	2011	2012
	level (2)	% of GDP	% of GDP			
			Net borrowing by sub-sector			
1. General Government	-42,979	-2.7	-5.3	-5.0	-3.9	-2.7
annual correction (3)				0.0	0.4	0.8
2. Central Government	-41,848	-2.7	-4.7	-4.7	-4.1	-3.7
3. State Government	-42,320	-2.7	-4.8	-4.7	-4.1	-3.7
4. Local Government	-3,490	-0.2	-0.6	-0.4	-0.4	-0.4
5. Social security entities	2,359	0.2	0.1	0.1	0.1	0.1
			General government			
6. Total revenues	723,742	46.0	46.4	45.9	45.5	45.6
7. Total expenditures	766,721	48.8	51.7	50.9	49.9	49.5
8. Net borrowing	-42,979	-2.7	-5.3	-5.0	-4.3	-3.9
9. Interest expenditure	80,891	5.1	4.8	4.9	5.2	5.5
10. Primary balance	37,912	2.4	-0.5	-0.1	0.9	1.5
11. One-off measures (4)	3,288	0.2	0.6	0.1	0.0	0.0
			Selected revenue components			
12. Total tax revenues	457,424	29.1	29.0	28.7	28.3	28.4
12a. Indirect taxes	215,519	13.7	13.4	13.4	13.2	13.0
12b. Direct taxes	241,427	15.4	15.3	15.3	15.1	15.4
12c. Capital taxes	478	0.0	0.3	0.0	0.0	0.0
13. Social contributions	214,718	13.7	13.9	13.8	13.8	13.7
14. Property income	9,273	0.6	0.6	0.6	0.6	0.6
15. Other revenues	42,327	2.7	3.0	2.8	2.8	2.8
16. Total revenues	723,742	46.0	46.4	45.9	45.5	45.6
p.m. Tax burden		*42.8*	*42.9*	*42.5*	*42.1*	*42.1*
			Selected expenditure components			
17. Employee compensation + intermediate consumption	256,574	16.3	17.2	16.9	16.3	15.9
17a. Employee compensation	171,160	10.9	11.4	11.2	10.9	10.6
17b. Intermediate consumption	85,414	5.4	5.7	5.6	5.4	5.3
18. Social payments	321,036	20.4	21.9	21.8	21.6	21.5
18a.Social transfers in kind	43,028	2.7	3.0	2.9	2.9	2.9
18b.Social transfers other than in kind	278,008	17.7	19.0	18.9	18.8	18.6
19. Interest expenditure	80,891	5.1	4.8	4.9	5.2	5.5
20. Subsidies	14,237	0.9	0.9	0.9	0.9	0.8
21. Gross fixed investment	34,973	2.2	2.7	2.2	2.0	2.1
22. Other expenditures	59,010	3.8	4.3	4.2	3.9	3.7
23. Total expenditures	766,721	48.8	51.7	50.9	49.9	49.5
p.m. Public consumption	*318,112*	*20.2*	*21.4*	*21.0*	*20.4*	*19.9*

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) Amount in €millions.
3) The annual correction is calculated on the primary balance. The cumulated correction amounts to about 1.2 per cent of GDP in 2012.
4) The plus sign indicates one-off measures to reduce debt.
Note: The first row of the table shows the target values, while the remaining values show trends under unchanged legislation.

III.2 CYCLICALLY-ADJUSTED BUDGET BALANCE

The effects of the economic cycle must be taken into consideration in order to evaluate appropriately the public-finance results and targets outlined in this Stability Programme Update. For the period 2008-2012, the paths of both the GDP growth rate at constant prices and the key public-finance variables are compared with the dynamic of potential GDP growth and cyclically-adjusted budget balances, net of one-off measures. The cyclical adjustment of the budget indicators was calculated by applying the methodology for computing potential GDP and the output gap[6] approved by the ECOFIN Council. Though the methodology has been widely tested and agreed at an EU level, it is important to note that the current cyclical phase makes the estimates of potential GDP growth particularly uncertain. Thus, even the cyclically-adjusted public finance aggregates need to be interpreted cautiously.

The data reported in Table 5 show the serious repercussions of the financial crisis on Italy's economy. In 2009, GDP experienced a substantial contraction (-4.8 per cent) which was added to that already seen in 2008 (-1.0 per cent). The decrease in the GDP growth rate is reflected in the potential growth rate, which was effectively halved between 2008 and 2009, falling by 0.3 percentage points. As a result the output gap, which measures the shift of the level of actual GDP vis à vis potential GDP (in relation to the latter), decreased markedly, going from approximately 0.8 per cent in 2008 to -4.5 per cent in 2009. The 2009 estimate is larger in absolute terms than the value of the representative output gap estimated by the European Commission as part of the process for the computation of minimum benchmarks[7].

The marked deterioration of cyclical conditions took its toll on the pattern of the general government budget balance. In 2009, Italy's net borrowing dynamic was much more favourable than that in other European countries, yet, the ratio of net borrowing to GDP still almost doubled with respect to 2008, reaching the level of 5.3 per cent of GDP. However, the deterioration of public finances is mainly the result of automatic stabilisers which dampened the effects of the economic cycle. Indeed, during the past two years, the cyclical component of the public budget, which approximates the automatic change in tax

[6] In terms of methodology, potential GDP and the output gap are derived from the estimation of a production function. For additional information, see: Denis, C., Grenouilleau, D., Mc Morrow, K., and W. Röger (2006); 'Calculating potential growth rates and output gaps – A revised production function approach'; European Economy, European Commission, Directorate-General for Economic and Financial Affairs; Economic Paper No. 247.

[7] The representative output gap (ROG) is that which would result at 95 per cent probability, in the presence of 'normal' cyclical conditions. For Italy, the ROG estimated by the European Commission is -3.1 per cent. For additional details, see: European Commission 2007, Public Finance in EMU 2007, European Economy, No. 3.

revenues and spending on social safety nets due to cyclical fluctuations of the economy[8], went from 0.4 per cent for 2008 to -2.3 per cent of GDP for 2009.

By contrast, the cyclically-adjusted budget balance, net of one-off measures (i.e. the structural deficit), an aggregate that reflects the public finances net of temporary cyclical effects[9], was broadly stable between 2008 and 2009, experiencing a negative change of only 0.2 percentage points.

The gradual recovery of economy activity expected in 2010 should place GDP growth on a positive track (1.1 per cent) and favour a slight rebound of potential GDP growth compared with the value for 2009. The output gap is likely to remain in negative territory (-4.0 per cent), though some improvement should be seen with respect to the previous year. Given the effect of more robust GDP growth and the deficit-reduction measures adopted by the Government, net borrowing should fall by 0.3 percentage points, ending up at 5.0 per cent of GDP. Accordingly, in 2010, in line with the ECOFIN Council's recommendations for the excessive deficit procedure addressed to Italy, the cyclically-adjusted budget balance net of one-off measures would fall by 0.5 percentage points.

Though projected to grow at an annual rate of 2.0 per cent in 2011 and 2012, Italy's GDP is expected to remain below its potential level, and the output gap is thus expected to stay in negative territory through the end of the forecast period (-1.5 per cent in 2012) thereby indicating an excess of unused productive capacity. This pattern will also be reflected in the cyclical component of the budget balance which is projected to be around -0.7 per cent of GDP in 2012. However, during the period 2011-2012, the cyclically-adjusted budget balance (net borrowing) net of one-off measures should continue to decline by more than one percentage point compared with the 2010 figure, thereby reaching -2.0 per cent of GDP in 2012. In both 2011 and 2012, the structural adjustment is estimated to equal 0.6 per cent of GDP, in line with the ECOFIN Council recommendations.

Against this backdrop, Italy maintains its commitment to achieving the medium-term objective (MTO) of balancing the budget in structural terms[10].

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[8] The cyclical component of the public budget is obtained by multiplying the output gap by the elasticity of the budget balance to economic growth. Such value is then determined at a European level, and is equal to 0.5 for Italy.

[9] The structural budget balance is a summary indicator of reference for the Stability and Growth Pact for the purpose of evaluating the public budget conditions, net of both the effects of the economic cycle and the impact of temporary fiscal measures (one-offs).

[10] With reference to the new methodology for calculating Medium Term Objectives (MTO) including implicit liabilities as agreed at an EU level, Italy has opted for the partial front-loading of the cost of ageing in the amount of 33 per cent.

TABLE 5: CYCLICAL DEVELOPMENTS (percentage of GDP)

	2008	2009	2010	2011	2012
GDP growth rate at constant prices	-1.0	-4.8	1.1	2.0	2.0
Net borrowing	-2.7	-5.3	-5.0	-3.9	-2.7
Interest payments	5.1	4.8	4.9	5.2	5.4
Potential GDP growth rate	0.7	0.4	0.5	0.6	0.7
Contribution of productive factors to potential growth					
Labour	*0.4*	*0.4*	*0.3*	*0.3*	*0.1*
Capital	*0.5*	*0.2*	*0.2*	*0.3*	*0.3*
Total factor productivity	*-0.2*	*-0.2*	*0.0*	*0.1*	*0.3*
Output gap	0.8	-4.5	-4.0	-2.7	-1.5
Cyclical budgetary component	0.4	-2.3	-2.0	-1.4	-0.7
Cyclically-adjusted budget balance	-3.1	-3.0	-3.0	-2.6	-2.0
Cyclically-adjusted primary surplus	2.0	1.8	1.9	2.6	3.5
One-off measures	0.2	0.6	0.1	0.0	0.0
Budget balance, net of one-off measures	-2.9	-5.8	-5.1	-3.9	-2.7
Cyclically-adjusted budget balance, net of one-off measures	-3.3	-3.6	-3.1	-2.5	-2.0
Cyclically-adjusted primary surplus, net of one-off measures	1.8	1.2	1.8	2.7	3.5
Change in budget balance, net of one-off measures	1.3	2.9	-0.8	-1.2	-1.2
Change in cyclically-adjusted budget balance, net of one-off measures	0.4	0.2	-0.5	-0.6	-0.6

1) The rounding to the first decimal point may cause inconsistencies between the figures presented in the table.
Note: the discrepancies in the potential GDP growth rate, in the output gaps and in the cyclically-adjusted indicators with respect to the figures presented by the European Commission in the 2009 Autumn forecasts are mainly due to a different projection period and to different underlying macroeconomic assumptions.

III.3 PUBLIC DEBT

In 2008, the debt-to-GDP ratio rose by 2.3 percentage points compared with 2007, going from 103.5 to 105.8 per cent, whereas the forecasts in the 2008 Update of the Stability Programme called for an increase of 1.8 percentage points, with the ratio going from 104.1 to 105.9 per cent. The difference of 0.5 percentage points can be primarily attributed to an upward revision of the value of GDP for 2007[11] of approximately 0.6 percentage points compared with the forecast contained in the 2008 Update, and a slight decrease of the debt for 2008[12], equal to approximately 0.1 percentage points, compared with the estimate produced last year.

For 2009, the debt-to-GDP ratio is estimated to come to 115.1 per cent, thereby exceeding the previous forecast by approximately 4.6 percentage points. The difference can be ascribed to a number of factors: first of all, an expected decrease in nominal GDP (which accounts for approximately 2.2 percentage points of the change in the ratio); in addition, the most recent figures for the borrowing requirement for 2009 are well above those contained in the 2008 Update of the Stability Programme, impacting the level of the debt by approximately 2.1 percentage points. Finally, the residual difference, equal to

[11] ISTAT, ESA95 National Accounts Data, 2 March 2009.
[12] Bank of Italy, Public Finance - Statistical Bulletin - January 2010.

approximately 0.3 percentage points of GDP, is mainly due to the positive change in the liquidity account (equivalent to 0.7 percentage points). This increase was partially offset by a reduction of other components such as the uplift of securities indexed to inflation and issuing discounts (causing a fall in the ratio of approximately 0.2 percentage points), and a decrease by roughly 0.2 per cent due to the lower level of debt at the end of 2007.

For the subsequent years, compared with the 2008 Update of the Stability Programme, nominal GDP estimates contained in this report reflect downward revisions for 2010 and 2011, while there are virtually no changes for 2012; at the same time, the estimates of the public sector borrowing requirement have been revised upward for 2010 and 2011, and downward with respect to the previous forecast for 2012. Such elements explain the higher forecast of the debt-to-GDP ratio for the entire period compared with the 2008 Update. The new forecast of the debt-to-GDP ratio reflects a further increase in 2010, followed by a decline whose momentum accelerates in 2012. The debt-to-GDP ratio is therefore estimated to stand at 116.5 per cent by the end of 2011 and 114.6 per cent by the end of 2012. The trend described is the result of the economic growth estimated for 2010 and 2011 and the forecast trend of the public-finance balances.

TABLE 6: DEBT-TO-GDP RATIO[1]

			2008	2009	2010	2011	2012
Government debt							
Level			105.8	115.1	116.9	116.5	114.6
% change in debt			2.3	9.3	1.8	-0.4	-1.9
Contribution to change in Government debt (as % of GDP)							
Primary balance (accrual basis)			-2.4	0.5	0.1	-1.3	-2.7
Snow-ball effect			3.3	7.5	2.0	1.0	1.1
of which:	*Interest expenditure (accrual basis)*		*5.1*	*4.8*	*4.9*	*5.2*	*5.4*
Stock - flow adjustment			1.4	1.3	-0.3	-0.1	-0.3
of which:	*Difference between cash and accrual basis*		*0.2*	*0.0*	*-0.6*	*-0.5*	*-0.6*
	Net accumulation of financial assets		*0.3*	*0.5*	*0.2*	*0.2*	*0.2*
	of which:	*Privatisation proceeds*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*
	Evaluation effects of Government debt		*0.3*	*0.0*	*0.2*	*0.2*	*0.2*
	Other (2)		*0.6*	*0.8*	*-0.2*	*0.0*	*-0.1*
memo: debt implicit interest rate			5.1	4.4	4.3	4.6	4.8

1) Rounding to the first decimal point may cause inconsistencies between the figures presented in the table.
2) 'Other' includes: changes in cash holdings on the Treasury deposit account held at Bank of Italy and statistical discrepancies.

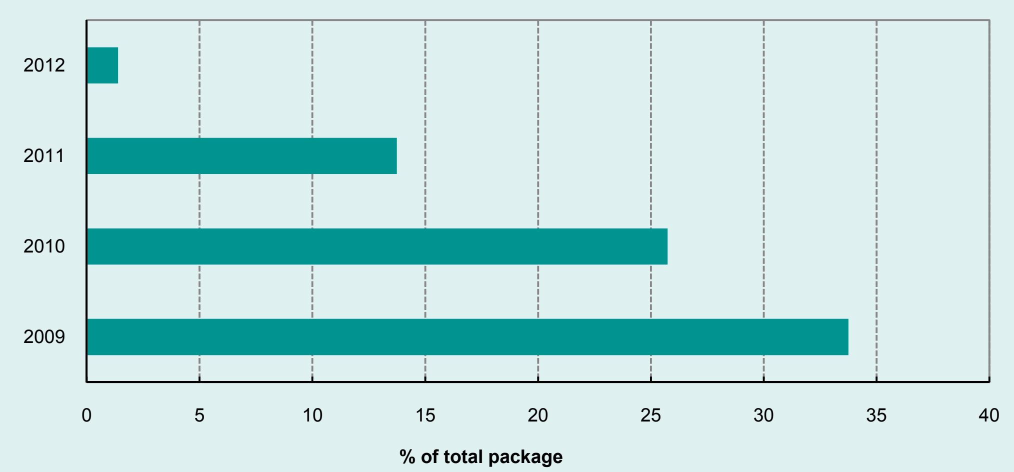
IV. EXCESSIVE DEFICIT PROCEDURE

IV.1 THE STRATEGY TO OVERCOME THE CRISIS

The start of the excessive deficit procedure (EDP) for most Member States calls for a coordinated approach in designing strategies to overcome excessive deficits, restore stability to the financial sector, ensure the sustainability of public finances and increase potential output. The ECOFIN Council of October, 1-2 2009 confirmed this policy. The exit strategies will have to be weighed carefully against the specific situation of each Member State within the framework of the rules of the Stability and Growth Pact and according to the recommendations of the EDP procedure.

During the economic and financial crisis, the Italian Government took action immediately, albeit with fiscal prudence, both in the acute phase and subsequently as the first signs of stabilisation emerged and the economy began recovering. The budget strategy adopted by the Government focused on fiscal rigour, limiting discretional action to a minimum and allotting a significant share of public resources to automatic stabilizers. In line with this policy, during the 2008-2009 period the Government adopted temporary budget–neutral measures designed to have an impact on the real economy.

FIGURE 1: THE ANTI-CRISIS PACKAGE'S STRUCTURE BASED ON THE EXPIRATION DATE OF MEASURES



Over the next three years, the extraordinary measures to support income and employment will be phased out.

A survey of the fiscal stimulus package, based on the deadline envisaged for the individual measures, shows that the financial impact of approximately 60 per cent of gross resources committed to overcome the crisis will expire by 2010. The stimulus package timeline is relatively short: 75 per cent of the measures will expire by 2012 (Figure 1), while the remaining ones (amounting to 25 per cent of the total) are structural measures and include those resulting from the 2008 PNR (National Reform Programme), tax breaks for companies and researchers and some multi-year expenditure programmes.

While maintaining the prudent approach followed thus far, the Italian Government will soon refinance some stimulus measures, especially incentives for the purchase of low emission vehicles, even though they will be smaller than those provided last year as there are signs indicating that the economy is picking up again. Moreover, the 2010 Budget envisages further resources to finance additional income support measures (*ammortizzatori in deroga*) for workers who are not protected by standard safety nets, as well as new employment support measures for the 2010-2011 period.

IV.2 CONSOLIDATING PUBLIC FINANCES

With the start of the excessive deficit procedure in December the ECOFIN Council requested that Italy bring its deficit back below the 3 per cent of GDP threshold by 2012, implement the fiscal consolidation programme launched in the 2009-2011 budget package and confirmed in the 2010-2013 Economic and Financial Planning Document, and ensure an average consolidation of at least 0.5 per cent of GDP in the 2010-2012 period.

In its reaction to the Council recommendations, the Government confirmed its intention to pursue the consolidation goals: net borrowing, in terms of nominal balance, shall go back to below the 3 per cent threshold within the Programme timeline.

The Government also confirmed its intention to balance the budget in the medium term (MTO) objective. In structural terms, Italy will be back on its consolidation track as of 2010: in the current year the budget balance, adjusted for the cycle and net of one-off measures, will decrease by 0.5 percentage points a year, while for the 2011-2012 period the structural adjustment is about 0.6 per cent per year, in line with the Council recommendations.

However, the fragility of the recovery and the remaining uncertainty over economic prospects call for caution when designing measures to correct public finances. In the coming months, the Italian Government will adopt appropriate measures that will be weighed carefully against the changing macroeconomic environment. The Government shares the concerns expressed by the major international financial

institutions, including the International Monetary Fund, and wants to avoid the risk of stifling the ongoing economic recovery.

However, the Government is fully committed to pursuing the fiscal consolidation effort started with the 2009 budget package, which introduced a sound three-year plan to cut the deficit, focused on the expenditure side. Measures to cut public spending mainly concerned civil servants and expenditure on intermediate consumption, with effects not just in 2009, but also in 2010 and in the following two-year period.

More specifically, Decree Law No. 112 of 2008[1], which for the first time brought forward to the summer of 2008 the budget package for the following three-year period, put a cap on staff turnover in 2009, setting it at 10 per cent of employee terminations in 2008. For the 2010-2011 period, the above Decree Law sets a cap on staff turnover at 20 per cent of the previous year's terminations. Finally, a further limit has been envisaged for 2012, when turnover reduction has been set at 50 per cent of the previous year's terminations. Moreover, in order to ensure that spending cuts are structural, the Decree laid down that as of 2013 general government entities may start employing new staff in numbers equal to the previous year's terminations. In addition to introducing a stricter limit to the hiring of new employees, the amnesty provided for in previous Budgets, whereby temporary workers in the public sector were offered permanent employment, was scrapped and also State schools were downsized. The entire set of measures, as shown by the General Government Account at unchanged legislation, will have a stronger impact as of 2010, when a cut in expenditure for salaries in the public sector of approximately 0.2 per cent of GDP compared to 2009 is expected. This expenditure is expected to decline further by approximately 0.3 percent of GDP in the 2011-2012 period to then reach 10.6 per cent of GDP.

The above-mentioned Decree Law No. 112 of 2008 envisaged an adjustment of mission appropriations for each Ministry, except for mandatory expenditure and mandatory burdens, which will translate into significant savings. This adjustment leads to spending reductions that cut across a number of expenditure items according to a linear percentage of approximately 21.9 per cent in 2009, 22.9 per cent in 2010 and 40.5 per cent in 2011. In the 2009-2011 three-year period, savings on current expenditure are expected to total €13 billion, €3 billion of which in 2009. This saving accounts for 0.2 per cent of GDP in both 2009 and 2010, and approximately 0.4 per cent of GDP in 2011. In line with these forecasts, the General Government Account shows the largest cut in 2011 in the Intermediate Consumption and Other Expenditure items; the latter includes current account and capital account transfers to local government entities. The cut in capital account expenditure will result in similarly significant savings, i.e. approximately €14 billion over the three-year period. Similarly to what has been estimated for current

[1] Decree Law No. 112/2008, converted into Law No. 133/2008.

expenditure, the strongest impact is expected in the 2010-2011 period with a capital account spending cut of approximately 0.2 and 0.5 per cent of GDP, respectively, over the two years. Broadly speaking, the adjustment of financial endowments will entail a cut in general government final expenditure of 0.4 and 0.9 per cent of GDP in the next two years.

The budget package for 2010, which was also brought forward to the summer through the approval of Decree Law No. 78 of 2009[2] and completed through the Budget submitted in September which has now been adopted[3], was centered upon rigour and a strong focus on abiding by the budget constraints; it sets the stage for the implementation of more comprehensive structural reforms.

The package, which includes a series of measures, builds on the effort to cut and rationalize spending (see section VI.1).

More specifically, efforts to rationalise spending on intermediate consumption continue taking a long-term perspective, especially with regard to spending on pharmaceuticals. According to the provisions of Decree Law No. 78 of 2009, the spending ceiling on pharmaceutical care at a national and regional level[4] was brought down from 14.0 to 13.3 per cent, thanks to the action implemented by AIFA (*Agenzia italiana del farmaco* – Italy's pharmaceuticals agency). The ceiling on hospital pharmaceutical spending has remained unchanged at 2.4 per cent in every region (see section VI.3). To further ensure that the saving goals are met, the decree has established a mechanism whereby, should the regional pharmaceutical spending ceiling be breeched, any amount above the ceiling will be charged to pharmaceutical companies, wholesalers and pharmacists.

In addition, the 2010 Budget identifies fiscal federalism as a further driver of expenditure rationalisation, as it envisages the launch of an effort to streamline local bureaucracy[5] and the implementation of decentralised functions in certain regions and autonomous provinces. Current expenditure savings expected over the 2010-2012 period amount to approximately €1.9 billion.

Moreover, the Budget provides for a stronger role of the State Property Agency (*Agenzia del Demanio*) in the three-year planning and the monitoring of premises to be used as offices by general government entities, and in ensuring that the requirements of general government entities are in line with public spending-cut targets (see section VI.1). More

[2] Converted into Law No. 102/2009.
[3] Law No. 191/2009.
[4] The expenditure includes the share charged to recipients (co-payment).
[5] The entry into force of the provision, envisaged by the 2010 Budget, has been postponed to 2011 through the Decree Law '*Interventi urgenti concernenti Enti locali e Regioni*' (Urgent measures concerning local and regional authorities) adopted by the Cabinet on January 13, to be published shortly. The Decree is budget neutral.

specifically, the Agency will check if any State-owned property is available for use, and, where necessary, it will check that the rent for property belonging to third parties is adequate, monitoring the signing and renewing of lease contracts. Concentrating these tasks in a single agency, while at the same time improving the management of the assets owned by State agencies, also through the sale of State property, will ensure a more rational use of public spaces, better conditions on rent contracts, and spending cuts of €700 million over the 2010-2010 three-year period. Approximately €250 million of these savings are expected in 2010, about €400 million in 2011, and the rest in 2012.

Recent changes to pension rules, with the gradual increase in the retirement age for female civil servants[6] complete the framework of the structural fiscal-policy measures outlined above and make a significant contribution to the sustainability of public finances (see section VI.1 and chapter VII).

Further measures to control spending are linked to the implementation of the *Piano Industriale per la Pubblica Amministrazione* (Public Administration Business Plan). This Plan envisages two kinds of action: legislative action to optimise labour productivity through a reform of civil service; and mainly administrative action to rationalise the organisation of general government and to speed up technological innovation[7]. In October 2009, Legislative Decree No. 150 implemented the reform of civil service[8], whose aim was to modernise general government, increasing the efficiency and the productivity of the public sector, thus contributing to revitalising economic growth. Preliminary estimates about the impact of the *Piano Industriale* as a whole, based on the assumption of an increase in total factor productivity in the public sector ranging between 10 and 20 per cent in the 2010-2014 five-year period, have shown that the country's potential growth would increase on average by 0.5 to 1.0 per cent a year[9].

In addition to taking action on the expenditure side, the Government also implemented measures on the revenues side, focusing its action on the fight against tax evasion, also with the aim to achieve a fairer tax burden-sharing.

With Decree Law No. 185 of 2008[10], a stricter system of tax collection and inspection procedures by the tax authorities were introduced. Subsequently, with Decree Law No. 78 of 2009 in the 2010 budget package, measures were introduced against the so-called 'tax-havens' and the international tax arbitrations through *Controlled Foreign Companies* (CFC). The new provisions implement the agreements reached by the OECD

[6] Decree Law No. 78/2009, converted into Law No. 102/2009.
[7] See the box on this issue in section V.3 of the Update of the 2008 Stability Programme.
[8] Legislative Decree No. 150/2009, implementing Law No. 15/2009, concerning the optimization of labour productivity in the civil service and efficiency and transparency of general government, came into force on November 15, 2009.
[9] See the 2010-2013 Economic and Financial Planning Document, section IV.I
[10] Converted into Law No. 2/2009.

Member States concerning economic and financial activities in countries with preferential tax regimes, with the primary objective of improving the current level of tax transparency and information exchange, by increasing administrative cooperation among countries.

The fight against tax evasion already proved successful in 2009. Emphasis is placed on effective collection resulting from tax verification and inspections which continue to sustain tax revenues; in the period from January to October 2009, revenue raised from tax rolls increased by 19.6 per cent over the same period in 2008.

In addition to the new extremely strict regulations for combating international tax evasion and tax havens, in order to increase the transparency of the relationship between the tax authorities and tax payers, when Decree Law No. 78 was confirmed into law, the so-called 'tax shield' was introduced to turn illegal offshore assets into legal ones, through the payment of an extraordinary duty of 5 per cent of the assumed returns, calculated on the basis of a 2 per cent yearly rate for the five years before 2009[11].

A key element in the consolidation of public finances is the reform of the *Legge di contabilità e finanza pubblica* (Public Finance and Accounting Law), passed by Parliament in December 2009[12]. The reform entails a change in the budget cycle and in planning tools, which increases the involvement of regional and local authorities in setting budget targets and their relevant responsibilities. These improvements in budget governance will contribute to strengthen the achievement of medium-term public-finance goals, also thanks to increased control over spending.

The main elements of the reform include: the harmonisation of general government budget systems and procedures, in line with both the schemes adopted at European level for EDP purposes and the COFOG classification; the establishment of a single database on budget and management information of all general government entities; the improvement of the information contained in the State budget, which, inter alia, now permanently includes the classification based on missions and programmes[13]; and the institutionalisation of the analysis and assessment process of the Central Administrations of the State with a view to increasing control over spending, while at the same time improving its quality (for a more thorough analysis of the reform, see subsection VI.4).

[11] The duration of the so called 'tax shield' was set from September 15 to December 15, 2009 with Law No. 141/2009, then Decree Law No. 194/2009 which extended it and envisaged two deadlines with two different tax rates: i) 6 per cent for repatriation or "legalisation" transactions completed by February 28 2010; ii) 7 per cent for repatriation or 'legalisation' transactions completed between March 1, 2010 to April 30, 2010.

[12] Law No. 196/2009.

[13] Before the reform, the classification based on missions and programmes in the State budget was only experimental. It should be noted that, by virtue of the Accounting Law, a programme may now either be adopted or rejected only in its entirety with a parliamentary vote, therefore Parliament's power to determine how public funds are used has been strengthened.

V. SENSITIVITY ANALYSIS

V.1 SENSITIVITY TO ECONOMIC GROWTH

Over the 2009-2012 period, the sensitivity of Italy's public finance to economic growth is assessed through a simulation of the pattern of net borrowing and public debt vis-à-vis two alternative macroeconomic scenarios, in which, in line with the evolution of some international economic variables, real annual GDP growth starting from 2010 is assumed to be 0.5 percentage points higher or lower in each year relative to the baseline scenario[1].

The different GDP growth dynamics assumed in the alternative scenarios modify the evolution of potential output and therefore the output gap. Therefore, both the structural and cyclical components of the primary surplus adjust. The structural component is the difference between structural revenues and structural expenditure resulting in the individual simulated scenarios[2]. The cyclical component is calculated by multiplying the output gap of the alternative scenarios by the elasticity of the budget balance to economic growth[3]. The new profile of the primary surplus changes the evolution of public debt and therefore interest expenditures. In order to estimate public debt in the alternative scenarios, the stock-flow adjustment and the implicit interest rate are assumed to remain unchanged relative to the baseline scenario (see chapter III, table 6).

In 2010, the ratio of net borrowing to GDP in the pessimistic scenario should not change significantly compared to the baseline (-5.0 per cent of GDP). In the following years, net borrowing is expected to continue to decline, albeit at a slower pace, hovering around -3.4 per cent of GDP in 2012 as against -2.7 per cent projected by the Government. In the higher growth scenario, net borrowing is expected to hover at -4.4 per cent of GDP in 2010 and to converge to -1.8 per cent in 2012.

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[1] The optimistic (pessimistic) scenario assumes a more (less) favourable international outlook compared to the baseline scenario and, among other things, it assumes a more (less) rapid recovery in the U.S. and the euro area. Its impact on the Italian economy translates into a more (less) favourable export performance with spill-over effects on productive investment and the labour market.

[2] Structural revenues and expenditure in alternative scenarios are calculated by applying a correction parameter to the corresponding variable of the baseline scenario. Hence, in order to calculate the structural revenues of the higher-growth scenario, the structural revenues (as a percentage of GDP) of the baseline scenario are multiplied by an index expressing the ratio of nominal baseline GDP to that of the alternative scenario. Subsequently, the resulting figure is multiplied by the product of the semi-elasticity of revenues and the relative discrepancy between potential GDP in the alternative scenario and that in the baseline scenario.

[3] According to a methodology agreed on at European level this elasticity is 0.5.

TABLE 7: SENSITIVITY TO GDP GROWTH [1]

		2009	2010	2011	2012
Nominal GDP growth rate	High-growth scenario	-2.5	3.1	4.5	4.5
	Baseline scenario	-2.5	2.6	3.8	3.9
	Low-growth scenario	-2.5	2.1	3.2	3.4
Real GDP growth rate	High-growth scenario	-4.8	1.6	2.5	2.5
	Baseline scenario	-4.8	1.1	2.0	2.0
	Low-growth scenario	-4.8	0.6	1.5	1.5
Potential output growth rate	High-growth scenario	0.5	0.6	0.8	0.9
	Baseline scenario	0.4	0.5	0.6	0.7
	Low-growth scenario	0.3	0.3	0.5	0.5
Output gap	High-growth scenario	-4.9	-4.1	-2.5	-1.0
	Baseline scenario	-4.5	-4.0	-2.7	-1.5
	Low-growth scenario	-4.1	-3.8	-2.9	-1.9
Net borrowing	High-growth scenario	-5.3	-4.4	-3.2	-1.8
	Baseline scenario	-5.3	-5.0	-3.9	-2.7
	Low-growth scenario	-5.3	-5.0	-4.3	-3.4
Cyclically-adjusted budget balance	High-growth scenario	-3.0	-2.3	-1.9	-1.3
	Baseline scenario	-3.0	-3.0	-2.6	-2.0
	Low-growth scenario	-3.0	-3.0	-2.9	-2.5
Primary balance	High-growth scenario	-0.5	0.5	1.9	3.5
	Baseline scenario	-0.5	-0.1	1.3	2.7
	Low-growth scenario	-0.5	-0.1	0.9	2.1
Cyclically-adjusted primary balance	High-growth scenario	2.4	2.5	3.2	4.0
	Baseline scenario	1.8	1.9	2.6	3.5
	Low-growth scenario	1.9	1.8	2.4	3.1
Public debt	High-growth scenario	115.1	115.7	113.9	110.5
	Baseline scenario	115.1	116.9	116.5	114.6
	Low-growth scenario	115.1	117.4	118.0	117.3

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 the expenditures (equal to -0.04) with respect to economic growth and not the parameter that expresses the sensitivity of net borrowing to growth (equal to 0.5). Moreover, for technical reasons, it has been assumed that the amount of the programmed additional budgetary interventions, equal to 0.4 per cent of GDP in 2011 and 1.2 per cent of GDP in 2012, will be entirely implemented through expenditures cuts.

In the higher-growth scenario, the debt-to-GDP ratio is expected to go from 115.1 in 2009 to 115.7 in 2010, then to decrease more rapidly compared to the pattern of the baseline scenario and reach 110.5 in 2012. Conversely, in the lower-growth scenario, the debt-to-GDP ratio is expected to increase in both 2010 and 2011 and then decline slightly in 2012 reaching 117.3. At the end of the projection period, public debt is expected to be less than 3 percentage points above the corresponding figure of the baseline scenario.

FIGURE 2: SENSITIVITY OF NET BORROWING TO GROWTH (percentage of GDP)

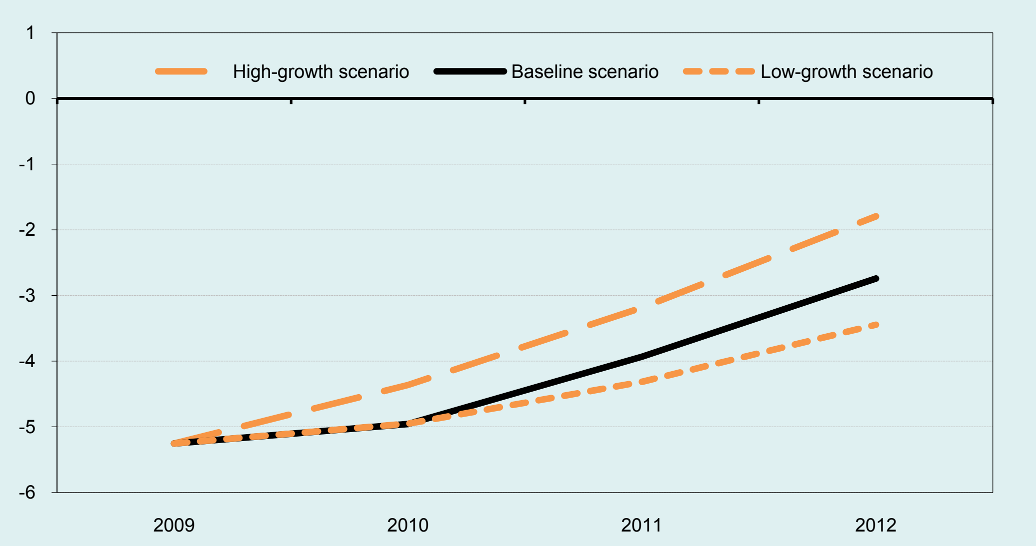
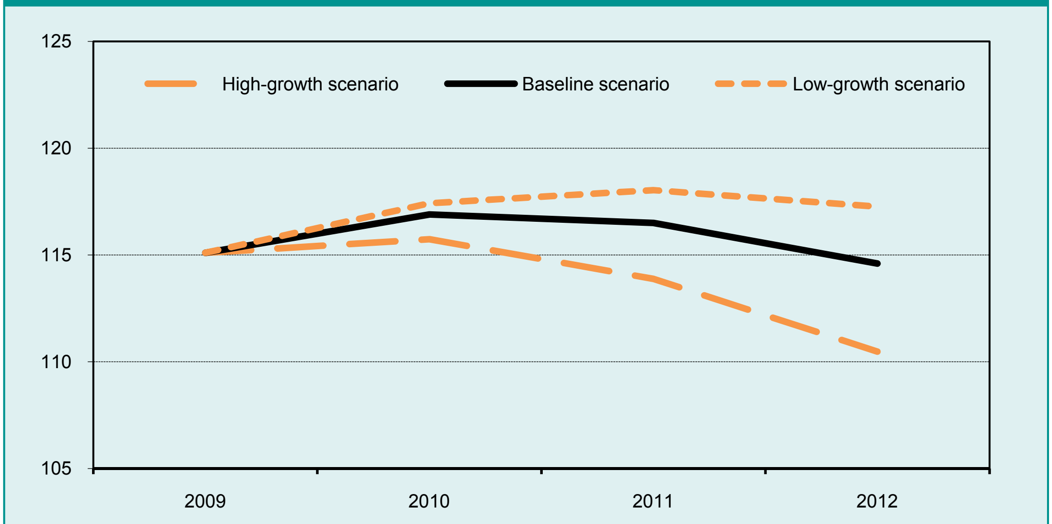


FIGURE 3: SENSITIVITY OF PUBLIC DEBT TO GROWTH (percentage of GDP)



V.2 SENSITIVITY TO INTEREST RATES

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

First, the analysis considers current and future debt composed of negotiable government securities, which at December 31, 2009 had risen by 6.63 per cent compared to December 31, 2008. At the end of December 2009, 95.19 per cent of the aggregate of negotiable government securities was composed of domestic securities (i.e. issued on the domestic market), while 4.81 per cent consisted of foreign securities (i.e. issued on foreign markets both in euros and foreign currencies).

In 2009, consistent with the tendency in the last few years, the share of foreign securities was again reduced (down from 5.21 per cent in 2008 to 4.81 per cent in 2009), as a result of costs, which only for brief periods in 2009 seemed to be more favourable for international market issuances than domestic market ones.

The summary data on the debt structure show how the exposure to refinancing risk and interest rate risk has improved and has now become consolidated. The average overall life of all government securities at December 31, 2009 was 7.07 years which is a significant increase over the December 31, 2008 figure (6.82 years). The financial duration at December 31, 2009 is 4.81 years and is increasing relative to the figure of the same date in 2008 (4.51 years), due to the increase in long-term fixed-rate securities.

Compared to December 31, 2008, the structure of tradable public debt in terms of euro-denominated domestic market government securities at December 31, 2009 shows that the share of fixed-rate securities has increased substantially from 67.71 per cent to 70.54 per cent, while short-term or variable-rate securities have gone down from 25.71 per cent to 22.06 per cent of the total; in addition, the securities linked to European inflation have edged up from 6.59 per cent to 7.40 per cent.

2009 was a year marked by the impact of the international financial crisis. The market for government securities in the euro area was strongly influenced by the so-called flight to quality*,* i.e. the preference for the purchase of government securities with the highest rating. The high issuance of government bonds, as a result of increased public sector borrowing requirements to sustain the economy, has generated greater risk aversion to the detriment of government securities of the so-called peripheral countries. However, this phenomenon has affected Italy only marginally; indeed, in 2009 Italy, compared to other peripheral countries (Greece, Portugal, Ireland and Spain) succeeded in keeping both a stable rating and outlook from Moody's, Standard & Poor's and Fitch. This is also confirmed by the reduction in the spread between BTP (Italy's long-term government securities) and the Bund at the end of last year, also thanks to the lower volatility of spreads of Italy's government securities on the secondary market.

Against this backdrop of imbalances and significant instability on financial markets, the Treasury ensured the funding of the Public Sector Borrowing Requirements. Under these market conditions, the targets set were the same as in previous years in terms of minimising the cost of borrowing and controlling the refinancing risk and interest-rate risk, while at the same time adjusting the elements of flexibility in supply introduced at the end of 2008.

Regarding the composition of debt which is made up of government securities, the proportion of fixed-rate securities has increased further and now accounts for over two thirds of the debt. As in the past, the issuance policy for fixed-rate securities continued to focus also on long-term instruments. During the course of the year, tensions on the market have decreased, the conditions of the interbank market have improved and liquidity on the secondary market has moderately increased: so, two new fixed-rate nominal instruments were issued with 15 and 30 year maturities in July and September 2009 respectively, and a new bond linked to European inflation was launched in the 30-year segment in October. With regard to government securities, the issuance of the 30-year BTP€i has consolidated the presence of inflation-linked securities; moreover, thanks to regular issuances, the BTP€i portion at the end of 2009 was higher than in the two previous years.

Once again, the 2009 trend shows that the portion of short-term or variable-rate securities is decreasing and currently accounts for less than 25 per cent. This decline may be accounted for by the reduction in net issuances of both CCT and BOT, even though the gross issuance of BOT is stable compared to 2008, due to the need to meet strong demand in 2009 and to avoid the problem of volatile intra-monthly cash-flows. As to CCT, issuances were significantly fewer than the securities reaching maturity (almost 45 billion), but in absolute terms they were higher than in 2008, also thanks to investors showing renewed interest in this instrument.

Estimates of interest expenditure have been made on the basis of rates implicit in the yield curve of Italy's government securities from early January 2010.

The composition of Italy's debt, as well as the evolution of the total financial duration of debt and the structure of payments for coupons and repayments, has strengthened performance over the last few years, and is once again evidence of the limited exposure of Italy's government securities to interest-rate fluctuations. Indeed, assuming a sudden and permanent 1 per cent increase in the yield curves used to estimate interest expenditure over the 2010-2012 period, the impact on the debt burden (as a percentage of GDP) is estimated at 0.17 per cent in the first year, 0.37 per cent in the second year and 0.48 per cent in the third year, while the increase in interest rates would transfer entirely onto the cost of debt after about 5.87 years (at the end of 2008 the figure was 5.63 years).

The fact that estimates of the impact of interest rate changes on the debt burden are consistent with those contained in the 2008 Update of the Stability Programme, despite an increase both in the duration and in the Average Refixing Period, of 0.30 and 0.24 years respectively, is explained by the international crisis. In fact, the combination of a forecast of moderate economic growth with a more sustained growth of debt amplifies

the impact on expenditure of the same interest-rate shock. In addition, one should consider that issuance assumptions on the basis of estimates of future interest expenditure include the forecast adjustment of the issuance composition to market conditions.

To test the soundness of this analysis, the exercise has been repeated taking into consideration yield curves with different slopes. The sensitivity results have remained basically in line with those obtained using the interest-rate scenario described above.

VI. QUALITY OF PUBLIC FINANCES

Budget policy for the 2010-2012 period is predicated on fiscal prudence, which was followed by the Government both in the acute stage of the crisis and also when the initial signs of stabilisation and subsequent economic recovery first appeared.

The high degree of uncertainty over economic prospects called for an extremely cautious fiscal package, so as to avoid the adoption of measures that would have too strong an impact on public finance developments in the following three-year period and which might adversely affect growth in case of a negative reaction of financial markets or economic agents.

The budget strategy focused on reallocating resources to measures that would have the strongest positive impact on the economy in the short term, so as to counter the most painful social and economic consequences of the crisis, while waiting for evidence of a solid economic recovery. The consolidation will be resumed as of 2011.

As was the case last year, the budget package for the next three-year period started with a Decree Law submitted at the same time as the Economic and Financial Planning Document and passed before the summer[1]. The 2010 Budget Law submitted at the end of September, which has now been adopted, completes the implementation of the fiscal package.

Both Decree and Budget Law contain measures designed to be as budget neutral as possible, with an impact that intends to prevent a worsening of the deficit- and debt-to-GDP ratios and more generally of financial sustainability, while at the same time reducing to a minimum the negative effects on potential growth. In view of the long-term challenges ahead, the measures with an immediate impact envisaged in the packages set the stage for the implementation of far-reaching structural reforms that are needed for balanced and sustainable economic growth.

[1] Law No. 102/2009 converting Decree Law No. 78/2009.

VI.1 BUDGET POLICY FOR THE 2010-2012 PERIOD

By bringing forward the expected impact of the Budget Law, the decree that was adopted before the summer achieved the dual objectives of providing a first update of the fiscal package adopted in 2008 and encouraging an early exit from the recession.

The decree provides resources amounting to approximately €13 billion (higher revenues and lower expenditure) in the years 2010-2012 (€17 billion if one includes the effects resulting from bringing forward the package to 2009)[2].

Higher revenues mainly result from the reorganisation of the tax credit offsetting system to reduce abuses, as well as from the measures to combat tax havens and international tax arbitrations through Controlled Foreign Companies (CFC)[3]. Further measures to fight tax evasion include the regularisation - through the payment of a lump-sum contribution for each worker of €500 for tax and social-security-contribution purposes - of EU and non-EU nationals residing in Italy and working as caregivers or domestic workers.

Lower expenditure is the result of action taken in the health sector through the readjustment of the pharmaceutical expenditure ceiling (see subsection VI.3) and the measures to cap pension expenditure by raising the retirement age of female civil servants.

The freed-up resources are used to finance higher expenditure and lower revenues of approximately €7.5 and 5.5 billion respectively over the 2010-2012 period (the sums amount to 11 and 6 billion if one includes the impact of the measures for 2009).

A significant package of measures is aimed at supporting employment and revitalising business investment. The specific measures provide for greater flexibility in the use of social safety nets via the possibility of the early return of workers on wage supplementation schemes (*cassa integrazione guadagni*) for the purposes of training, with the payment of an employment bonus to companies that is equivalent to the compensation accruing to the worker (80 per cent of the wage financed by the wage supplementation scheme and 20 per cent paid by the company); the early lump-sum disbursement of a bonus also for the self-employed; and the experimental increase for 2009 and 2010 of wage supplements for solidarity contracts[4].

The decree's provisions in support of businesses include a tax exemption on business income of 50 per cent of the value of investment in equipment and machinery made between the effective date of the decree and 30 June 2010; more rapid depreciation of capital goods (as a consequence of a broader amortisation cycle for real estate) and

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[2] The resources made available are expressed as gross figures and therefore include the sum needed to finance the envisaged higher expenditure and lower revenues.

[3] The new provisions implement the agreements reached by OECD Member States in order to regularise assets illegally held abroad in tax havens; the main aim of these agreements is to improve the current level of tax transparency and information exchange, by increasing administrative cooperation among countries.

[4] The decree also envisaged refinancing the 24-month extension of the wage supplementation scheme (*cassa integrazione*) in the event of the termination of business' activity, with financial impact in 2009 only.

easier terms in the writing off of non-performing loans for tax purposes and offsets for VAT receivables; the public administration's more timely payment of amounts due to purveyors and suppliers and amounts due on contracts, in order to work off the amounts in arrears and to reduce those for the future. The new provisions to reduce energy bills, especially gas bills, are designed to sustain both households and firms. Costs are reduced through a mechanism whereby large gas producers are required to yield a share to be placed on the market on easier terms, set by the Energy Authority for the thermal year 2009-2010. Further incentives for firms are the provisions aimed at regulating flows with banks, via the containment of the commission costs and reduced transaction settlement times for bank transfers, cashier cheques and bank cheques.

Action to support families mainly concern the repayment of Alitalia bonds, whose amount increases to 70.97 per cent of the nominal value, as well as the equity securities, which may be substituted with newly issued government securities, for a counter value equal to the average price of the last trading month reduced by 50 per cent.

The additional resources freed up by the decree go into the Fund for economic-policy structural programmes with medium- to long-term objectives.[5]

In addition to these measures, the decree also envisages provisions to set up an integrated export bank system, which will make an effective contribution to revitalising the economy, albeit without an immediate financial impact. In this connection, a clear benefit will result from the benchmarking role played by *Cassa Depositi e Prestiti* in cooperation with SACE, whose aim is to lower the cost of medium-term financing for export firms on transactions guaranteed by SACE.

Moreover, some measures concerning accounting provisions in the Budget Law and of the State budget have been extended to the 2009 financial year[6] on an experimental basis. In particular, the central administrations shall be given the possibility to use some flexibility when drawing up the State budget by readjusting financial resources among the various spending programmes of each mission.

[5] Further capital account programmes, with financial impact in 2009, concern the financing of reconstruction efforts in the Abruzzo region and exceptions to the Internal Stability Pact accorded to local authorities for investment purposes.

[6] Decree Law No. 112/2008 converted into Law No. 133/2008.

TABLE 8: EFFECTS OF DECREE LAW NO. 78/2009 FOR 2009-2012

	2009	2010	2011	2012	2009	2010	2011	2012
	€ mln				% of GDP			
FREEING OF FUNDS	4,162	4,760	4,235	3,913	0.27	0.30	0.26	0.23
Incremental revenues	1,473	3,443	3,095	2,652	0.10	0.22	0.19	0.16
Increase in tax credit offsetting	*200*	*1,000*	*1,000*	*1,000*				
Tax havens and efforts to fight international tax arbitrage		*1,021*	*996*	*819*				
Obligation for withholding against sums held by third parties as security	*174*	*262*	*224*	*224*				
Recovery of taxes and welfare contributions in Abruzzo		*257*	*257*					
Concession of gaming licenses	*500*	*300*						
Effects of tax abatement on machinery investment	*160*							
Programme to provide regular work contracts for in-home caregivers	*280*	*402*	*421*	*412*				
Other	*159*	*202*	*197*	*197*				
Lower expenditure	2,690	1,317	1,141	1,261	0.18	0.08	0.07	0.07
Lower current expenditure	89	999	1,141	1,161	0.01	0.06	0.07	0.07
Reduction of regional pharmaceutical expenditure ceiling		*800*	*800*	*800*				
Redetermination of National Health Service financing	*50*	*50*	*50*	*50*				
Increase in eligible retirement age for government workers		*120*	*242*	*242*				
Other	*39*	*29*	*49*	*69*				
Lower capital expenditure	2,601	318		100				
Fund for employment and training	*85*	*230*						
Fund for offsetting financial effects	*201*	*88*		*100*				
Savings from balancing order and lapsed residual liabilities	*2,315*							
USE OF FUNDS	4,156	4,667	4,136	3,814	0.27	0.30	0.25	0.23
Lower revenues	513	2,006	2,687	495	0.03	0.13	0.17	0.03
Tax abatement on machinery investment		*1,861*	*2,406*	*240*				
Writedowns of non-performing loans		*39*	*79*	*112*				
Suspension of taxes and welfare contributions in Abruzzo	*513*							
Effects of providing regular work contracts to in-home caregivers		*106*	*202*	*143*				
Incremental expenditure	3,643	2,661	1,449	3,319	0.24	0.17	0.09	0.20
Incremental current expenditure	735	1,429	1,334	3,240	0.05	0.09	0.08	0.19
Establishment of fund for initiatives in healthcare sector		*800*	*800*	*800*				
Establishment of fund for Bambino Gesù *pediatric hospital*	*50*	*50*	*50*	*50*				
Extension of peace missions	*510*							
Supplement to Fund for structural economic-policy initiatives	*2*	*203*	*4*	*1,907*				
Incremental charges for programme to provide regular work contracts to in-home caregivers	*79*	*208*	*212*	*215*				
Strategic fund for real economy support		*120*	*242*	*242*				
Other	*93*	*47*	*26*	*26*				
Incremental capital expenditure	2,908	1,233	115	78	0.19	0.08	0.01	0.00
Flexibility in use of social safety nets	*20*	*150*						
Termination of biennial activities	*25*							
Solidarity contracts	*40*	*80*						
Fund for employment and training	*100*							
Alitalia *securities transactions*		*230*						
Participation in international banks/funds		*284*						
Fund for offsetting financial effects	*256*	*377*	*91*	*54*				
Increase in capacity to spend Funds for Underutilised Areas for initiatives in favour of Abruzzo	*201*	*88*						
Exceptions to Internal Stability Pact	*2,250*							
Other	*16*	*24*	*24*	*24*				
IMPACT ON PRIMARY BALANCE	7	92	99	99	0.00	0.01	0.01	0.01

Note: Tax-induced effects deriving from tax reduction measures are imputed as incremental revenues.

The 2010 Budget Law was adopted to complete the fiscal package adopted in the summer. Even though predicated on principles of rigour and with a strong focus on abiding by the budget constraints, this piece of legislation envisages earmarking a portion of the available resources to stimulate growth, by creating the conditions for the implementation of more comprehensive structural reforms. During its passage through Parliament additional measures were included in the draft Budget Law at the Government's initiative, because of higher revenues resulting from the 'tax shield'[7].

The 2010 Budget Law frees up resources (higher revenues and lower spending) totalling €11 billion for the 2010-2012 period, implementing programmes (higher expenditure and lower revenues) for the same amount, without undermining the public finance balance[8]. About 55 per cent of the fiscal package is concentrated in 2010.

In 2010, the bulk of the resources comes from higher revenues (about ¾ of the freed up resources) and is mainly the result of the postponement of a share of the personal income tax IRE (ex IRPEF) advance payment resulting from a 20 per cent reduction on the advance payment percentage in 2009 and the recovery of illegal State subsidies and the revaluation of income from land. In the following two-year period the financing structure changes as a result of fewer resources on the revenue side and increased savings on the current expenditure side.

Current expenditure is contained through measures concerning local government entities and is linked to the reorganisation of political and administrative bodies of local government entities[9].

Expenditure is also rationalised by the revision of the financial system in the *Trentino Alto Adige* region and in the autonomous provinces of *Trento* and *Bolzano*, which entails the cutting of central government transfers to the above provinces thanks to higher shares of tax revenues transferred to regional or provincial authorities and their assignment a function falling within the central government remit.

Further savings are expected as a result of entrusting the State Property Agency with the task of planning and monitoring the use of government property in order to rationalise expenditure due to liabilities in respect of rents. The decline in capital expenditure reflects expected proceeds from the sale of real estate over the 2010-2011 period, which will also benefit from some simplification of procedures.

In addition to the reallocation of some capital account appropriations, the freed up resources are allotted to the Fund for urgent programmes, set up within the Ministry of

[7] The measure envisages the regularisation of assets illegally detained abroad through an extraordinary 5 per cent levy on assumed returns, which are calculated on the basis of a 2 per cent annual rate for the five years before 2009.

[8] Total Freeing and Uses of funds do not include the financial impact resulting from the simultaneous recording of the financing and use of the Fund for urgent programmes, equal to 5 billion in 2010, and 1.3 and 1 billion respectively in the following years. These entries would only lead to the same gross increase both in higher and lower expenditure, with net expenditure remaining unchanged.

[9] See note 5 of subsection IV.2.

the Economy and Finance as part of the stimulus package. The aim of the Fund is to implement a wide range of programmes to reduce taxes and increase expenditure: it includes some more prominent packages of measures, such as those concerning the labour market, health care, education and business incentives.

The labour market package envisages the extension to 2010 of several income-support measures (*mobilità* and *cassa integrazione straordinaria*) as well as the scrapping of personal income tax for productivity contracts and introduces - for 2010 only - specific measures to support unemployed people in great need of assistance.

Further measures in the package envisage the extension of existing tax breaks for redundant workers entitled to *mobilità* benefits, also to those who - having paid social security contributions for at least 35 years - are entitled to the standard unemployment benefit, as well as the introduction of cash incentives to be paid to Employment Agencies for enabling disadvantaged workers with less secure employment contracts to be rehired or to find new employment. For the purposes of entitlement accrual to access the non-agricultural ordinary unemployment benefit, the periods of time spent in atypical employment (on a coordinated and continuous basis or on a temporary employment contract linked to projects) will also be taken into account on an experimental basis. Finally, the labour market package authorises the financing of special agreements with municipalities to implement active policies for providing stable employment to those who do socially useful work. All the programmes described cost approximately 1.4 billion in 2010 and 300 million in 2011.

In addition to measures supporting employment especially in the private sector, the Fund for urgent programmes is used to finance the permanent hiring of civil servants of law-enforcement agencies or the fire brigade, for which there is an exemption from the staff turnover limit included in the 2009-2011 package.

Additional resources are provided to health care to implement the agreements signed at the *Conferenza Stato-Regioni* of December 3, amounting to €1.1 billion in 2010; €400 and 300 million respectively in the two following years, in order to adjust the central government funding for the National Health Service, supplement the Fund for non-self-sufficiency and the Fund for social policies and, finally, to finance the recovery of construction investment in the health sector[10].

Resources for education have been adjusted to a total of €470 million in 2010; these include the Fund for the regular financing of Universities, as well as those to support non-State schools, and, finally, the funds necessary to ensure that school textbooks are provided partly free of charge.

[10] For further details on the use of resources allocated to this sector see subsection VI.3 on fiscal rules.

TABLE 9: EFFECTS OF LAW NO. 191/2009 (2010 BUDGET LAW)

	2010	2011	2012	2010	2011	2012
		€ mln			% of GDP	
FREEING OF FUNDS (1)	6,104	1,604	3,103	0.4	0.1	0.2
Incremental revenues	4,521	421	323	0.3	0.0	0.0
Land revaluation	*350*	*175*	*175*			
Recovery of taxes and welfare contributions in Abruzzo			*103*			
Increased IRPEF balance	*3,716*					
Recovery of illegal State subsidies	*270*					
Other	*185*	*246*	*46*			
Lower expenditure	1,583	1,184	2,780	0.1	0.1	0.2
Lower current expenditure	1,028	828	2,775	0.1	0.1	0.2
Reorganization of local bodies	*58*	*136*	*170*			
Rents containment		*65*	*65*			
Transfer of functions to the provinces of Trento and Bolzano	*500*	*500*	*500*			
Strategic fund for real economy support	*120*					
Fund for structural economic-policy initiatives	*200*		1927.9			
Other	*150*	*127*	*112*			
Lower capital expenditure	555	355	5	0.0	0.0	0.0
Divestment of State buildings	*250*	*350*				
Reduction of Fund for Underutilised Areas	*205*	*5*	*5*			
Reduction of Social fund for employment and training	*100*					
USE OF FUNDS (1)	6,055	1,556	3,041	0.4	0.1	0.2
Lower revenues	1,200	419	416	0.1	0.0	0.0
Extension of IRPEF-IVA tax allowances for building restructuring			*407*			
Social contribution allowances for aged workers	*132*					
Extension of suspension of taxes and welfare contributions in Abruzzo	*197*	*154*				
Extension of tax abatement for productivity work contracts	*800*	*256*				
Other	*71*	*10*	*9*			
Incremental expenditure	4,855	1,136	2,625	0.3	0.1	0.2
Incremental current expenditure	4,151	783	1,110.3	0.3	0.0	0.1
Increase in National Health Service financing	*584*	*419*				
Fund for Non-self-sufficiency and Fund for social policies	*550*					
Aid to agriculture sector	*130*					
Aid to auto carriers	*400*					
Social contribution allowances for hiring over-50 unemployed	*27*					
Extension of the use of 5 per 1000 (IRPEF)	*400*					
Exception to the turnover rule for the sector of police and firemen	*60*	*175*	*272*			
Security and defence sector	*52*	*52*	*52*			
Fund for the financing of new spending laws	*780*	*20*	*720*			
Active polices on labour market: stabilisation of Social Useful Workers (LSU)	*370*					
Other	*798*	*118*	*67*			
Incremental capital expenditure	705	353	1,515	0.0	0.0	0.1
Solidarity fund for agriculture	*100*	*100*	*100*			
Incentives for the hiring of disadvantaged people	*65*					
Tax credit for research investment	*200*	*200*				
Infrastructural initiatives (among which construction in the health sector)	*47*	*21*	*311*			
Provision of free course books	*103*					
Fund for the financing of new spending laws			*509*			
Other	*190*	*32*	*595*			
IMPACT ON PRIMARY BALANCE	49	49	62	0.0	0.0	0.0

1) Total resources of Freeing and Uses of funds do not include financial effects resulting from the simultaneous recording of the financing and use of the Fund for urgent initiatives (Art. 7-quinquies, c. 1 of D.L. No. 5/2009), equal to about €5 bln in 2010, and €1.3 e 1 bln respectively in the following years. These entries would lead to the same gross increase in both the Incremental expenditure and the Lower expenditure items, with net expenditure remaining unchanged.

The main programmes to support firms include increased financing of tax credit for investment in research over the 2010-2011 period, measures in favour of the agricultural sector, through refinancing of the National Solidarity Fund, as well as tax breaks for auto carriers for a total amount of approximately €1.3 million over the three year period.

In addition to these programmes, the Budget Law also includes some provisions concerning the establishment of a Committee promoting the *Banca del Mezzogiorno S.p.A.*, which, without any financial burden for the State, enables the launch of a structural effort to restore an economic balance throughout the national territory and to indirectly support private initiative, with a special focus on young and female entrepreneurs, the increase of business size and internationalisation, and the sustain of research and innovation as well as employment.

Further measures funded by the same law concern a prison construction programme aimed at building new infrastructure to meet the demand for more prison facilities and the strengthening of justice services.

Finally, tax breaks for households have also been envisaged by extending to 2012 personal income tax IRE and VAT deductions for costs incurred as a result of works to preserve buildings, as well as through the measure concerning the suspension of tax and contribution payment in areas struck by the earthquake in the Abruzzo region.

VI.2 STRUCTURAL MEASURES INCLUDED IN THE 2009-2011 NATIONAL REFORM PROGRAMME

In November 2009 Italy submitted its Progress Report on the implementation of the Lisbon Strategy against the backdrop of the economic crisis which hit Europe at the end of 2008. The European Union stepped in immediately to sustain the economy with measures concerning monetary policy and lending, as well as budget policies and measures envisaged by the Lisbon Strategy[11].

Italy's challenges and priorities can be seen, on the one hand, as a response to the current economic crisis, and, on the other, as the implementation - at a national level - of the Strategy goals reflected in the 2009 country recommendations, especially with regard to the consolidation and sustainability of public finances, the simplification of administrative procedures, market deregulation and labour market efficiency.

[11] In December 2009, the European Commission launched a public consultation on the future of the Lisbon Strategy, available at http://ec.europa.eu/eu2020. The response of the Italian Government to the consultation is available at http://www.politichecomunitarie.it.

The slowdown in the economy required action to boost demand and restore trust, given circumstances in Italy. Therefore, to respond to the crisis, medium- and long-term consolidation measures have to be coupled with short-term action to sustain small and medium-sized enterprises. Even though the Government was under tighter budget constraints relative to other countries, it took action within an initiative coordinated at EU level and in compliance with the Stability and Growth Pact. Hence, it opted for maximising the effectiveness of programmes, while ensuring the stability of public finances.

In 2009, there were 95 envisaged national programmes. The relative weight of measures in terms of the three pillars of the Lisbon Strategy (microeconomic, macroeconomic and employment) remained substantially unchanged compared to the previous year. Over half of the programmes fall within the microeconomic pillar, where the increase was highest (26 per cent). Within the 95 programmes envisaged in 2009, 80 are being implemented, 12 have been completed and 3 have not started yet. Bearing in mind the country-specific recommendations, the following list contains a summary of the main reform policies, except for public finance measures, which are discussed in greater detail in other sections of this document.

With regard to deregulation, Article 47 of Law No. 99/2009 introduced the annual market and competition law, whose aim is to remove obstacles that hinder the opening up of markets, promote the development of competition and ensure consumer protection through a closer cooperation between the Government and the Competition Authority.

The 'Services Directive' (2006/123/CE) has been transposed; it will remove obstacles to the establishment and free circulation of services in the European Union, as well as strengthening and automating the Points of Single Contact system.

Regulations in the field of local public services have undergone a further and final innovation process aimed at bringing Italy's regulations in line with those of the EU and strengthen the deregulation push within a well-defined and consistent regulatory framework, which encourages the initiative of private individuals, reduces costs for general government and ensures better quality of services for users.

TABLE 10: MEASURES ADOPTED IN RESPONSE TO COUNTRY-SPECIFIC RECOMMENDATIONS

Italy's country-specific recommendations	Number of measures	Financial resources (€ mln)
Fiscal consolidation, growth and efficiency of expenditure, fiscal federalism framework	6	-
Competition in products and services markets, legislation simplification, administrative burden	45	9,603
Employment services, LLL, comprehensive unemployment insurance system, undeclared work, education system	22	2,487
Total	73	12,090

Source: 'Lisbon Strategy for Growth and Jobs - National Reform Programme 2008-2010' Implementation report and response to the economic crisis - October 28, 2009.

With regard to the quality of regulation, the Government continued efforts to simplify its regulatory and administrative environment, perform technical and regulatory analysis and regulatory impact analysis, and introduced the review of the competitive impact of regulatory projects. So far, the so called 'law-cut' package has enabled the repeal of over 36,000 obsolete Government regulations. Once the entire effort is completed, the total number of existing pieces of legislation (before and after 1970) will number 14,000. A piece of delegated legislation and the relevant legislative decree to implement it have been adopted to carry out a comprehensive reform of regulations governing the employment contract of civil servants. The new rules – based on the principle of recognising merit – apply in collective bargaining, staff assessment, executives of public institutions and responsibility for disciplinary matters.

According to the 'points to watch' formulated by the European Commission[12], the main policy lines concerned the fields of research, infrastructure and the fight against climate change.

The 2009-2013 Research Programme is being drafted; it will provide the 'National framework' for research activities in Italy. The new Programme is quite different from past ones and takes note of the growing importance of some factors (globalization, non-linearity of the innovative process, overlap of different scientific subjects). It gives strategic value to public-private partnership for the development of products and processes needed to maintain and further develop the country's competitiveness and

[12] In a departure from past practices, the 'points to watch' for 2009 have not been formally adopted by the Council, but are simply contained in the European Commission report.

boost exports, as well as to reduce the country's economic and political dependence in sectors such as energy, health and the environment.

In addition, Italy continues to actively participate in all the European initiatives launched within the European Research Space as it firmly believes that European cooperation in research activities is essential.

Finally, the improvement of the assessment and financing of research activities has also been significant, as well the improvement of the assessment of the efficiency and effectiveness of teaching, which will be based on peer review and internationally agreed quality standards. The assessments are considered a preparatory step to the distribution of part of the Fund for the regular financing of research institutions that achieve the best results.

The new innovation policy based on industrial property rights is composed of three initiatives: the economic and financial assessment of patents, the national innovation fund, and a database on patents of Universities and State Research Centres. A feature shared by the three initiatives is the medium- to long-term impact and the involvement of major private institutions (research centres, businesses and banks).

The industrial policy programme '*Industria 2015*' continues with the adoption of Industrial Innovation Projects relating to technological areas such as energy efficiency, sustainable mobility and technology for products made in Italy, as well as with the implementation of strategic action through calls for bids with a view to granting more favourable terms for research, development and innovation programmes.

In the infrastructure sector, with the 2010-2013 Economic and Financial Planning Document, the Government adopted a package entailing investment of approximately 30 billion. The PNR envisages the start of new construction sites to build 14 billion worth of new projects, accounting for approximately 2.3 per cent of GDP.

With regard to greenhouse gas emissions, in 2008 total emissions were 4.7 per cent higher than the 1990 level (whereas the increase was 7.1 per cent in 2007 and 9.0 per cent in 2006). The drop is due, in large part, to the economic crisis. As for measures aimed at stepping up efforts to achieve the Kyoto targets, the 2009 financial package, albeit reducing appropriations, essentially confirmed the action started in the 2008 Budget. More specifically, the €60 billion appropriated to the revolving fund to finance measures to implement the Kyoto protocol have been confirmed (the so-called Kyoto Fund).

As far as energy is concerned, it is worth noting that Law No. 99/2009 came into force; it outlines the path to return to nuclear energy; additional incentives are provided for the production of wind energy, with particular reference to off-shore production, and biomass, as well as measures for energy efficiency and for simplifying the construction of energy infrastructure.

As for the labour market, employment policy focuses on two priorities: the use of integrated approaches to flexicurity, as well as the improvement and development of

skills. The goal here is to encourage and protect professional transitions not just within but also towards the labour market, while at the same time ensuring adequate safety nets and minimum income benefits and improving the efficiency of public employment services and active labour market policies.

TABLE 11: MEASURES ADOPTED IN RESPONSE TO THE POINTS TO WATCH

Points to watch	Number of measures	Financial resources (€ mln)
R&D efficiency and spending	15	4,930
Greenhouse gas emission targets	10	1,583
Quality of regulation	5	-
Effectiveness and efficiency of public administration	10	-
Infrastructure	13	9,848
Women labour market participation	2	7
Employment of older workers	1	-
Wage developments in line with productivity	2	-
Total	58	16,368

Source: 'Lisbon Strategy for Growth and Jobs - National Reform Programme 2008-2010' Implementation report and response to the economic crisis - October 28, 2009.

A major contribution to the Lisbon targets has been made by regional policy and, more specifically, by the programmes financed by the Structural Funds and the Fund for Underutilised Areas. Regional policy, whose aim is to increase infrastructure and improve the competitiveness of regions, has been readjusted to counter the cycle only at a national level to deal with the urgent economic and social problems caused by the financial crisis.

At the end of 2008, over 69 per cent of expenditure on programmes envisaged by the two Structural Fund planning cycles (2000-2006 and 2007-2013) concerned the Lisbon priorities and over half of these programmes were allocated to infrastructure and environmental protection. In the 2000-2008 period, the financial resources spent by regional policies on Lisbon priorities amounted to €40.5 billion.

The 2007-2013 National Strategic Framework included goals that are key for the quality of life and welfare of Southern Italy and are related to incentives to achieve quantifiable targets in the following four areas: waste, water, quality of education and care services for children and the elderly.

A total amount of €3 billion has been appropriated on the basis of the performance reserve mechanism for the achievement of the Service Objectives. It will be allotted to the 8 regions of Southern Italy and to the Ministry of Education, Universities and Research on the basis of the progress made in achieving the targets set in 11 indicators relating to 4 major areas. A share of the performance reserve will be allocated during a work-in-progress assessment of performance.

TABLE 12: STRUCTURAL FUNDS: PAYMENTS BY PRIORITY DURING THE 2000-2008 PERIOD

National priorities (2008-2010)	Cumulative expenditure to December 312008		Expenditure in 2008	
	€ mln	% of total	€ mln	% of total
Extending the area of free choice	1,147	2.8	147	3.2
Research and technological innovation	2,936	7.2	307	6.6
Human capital - Education and training-	5,754	14.2	770	16.7
Infrastructure	10,690	26.4	1,155	25.0
Environmental protection	12,854	31.7	1,656	35.9
Policies for employment and social inclusion	7,152	17.6	583	12.6
Total Lisbon priorities	40,533	100.0	4,618	100.0
Total 2000-2008 Structural Funds	58,371		6,688	

Source: 'Lisbon Strategy for Growth and Jobs - National Reform Programme 2008-2010' Implementation report and response to the economic crisis - October 28, 2009.

VI.3 FISCAL RULES

The Internal Stability Pact is the pillar of Italy's fiscal governance framework. In addition to the Pact, there are further fiscal rules ensuring fiscal discipline[13] aimed at promoting appropriate planning of public health expenditure and controlling the increase of pharmaceutical expenditure.

The Internal Stability Pact[14] lays down the ways in which regional and local authorities contribute to achieving public finance targets, by identifying specific constraints which the authorities have to abide by, together with information, communication and certification requirements imposed on them by the Ministry of the Economy and Finance and a system of sanctions in case of failure to comply. It is supplemented by the more general fundamental principle, which is conceptually akin to a 'golden rule', invoked in Article 119 of the Constitution, which allows local authorities to overspend and overshoot their budgets only to finance investment[15].

The Pact envisages a budget-balance rule for municipalities and provinces with over 5,000 inhabitants, and a constraint on the nominal growth of final expenditure for regions. The expenditure considered is overall expenditure, both current and capital account expenditure, excluding lending and healthcare expenditure[16]. When the Pact was

[13] In line with the definition normally used within the EU, national fiscal rules are permanent provisions expressed through synthetic indicators of fiscal performance. The rules are aimed at reaching specific targets defined in terms of budget balances (or their most important components) as well as public debt targets.

[14] The Pact was introduced by the 1999 Budget Law, Law No. 448/1998, Art. 28.

[15] The principle whereby local authorities are not to overshoot their budgets has been enshrined in the Constitution through the reform of Title V in 2001.

[16] As of 2008 the budget targets of local and regional authorities are calculated in terms of mixed accrual. According to this criterion, introduced by the 2008 Budget, the financial balance is the result of the

renegotiated through the 2009–2011 budget package[17], the suspension of local authorities' powers to raise their own taxes established an implicit rule on final expenditure also for municipalities and provinces.

After strengthening enforcement tools and introducing performance reserve mechanisms in 2008, the deepening of the economic crisis and other exceptional events necessitated the inclusion of a number of exceptions to the Pact for the current year.

In July 2009, as part of the 2010-2012 fiscal package, the Government envisaged excluding from the calculations of the budget-balance target the capital account payments made by December 31, 2009 by municipalities and provinces to boost public investment and sustain economic activity at a regional level. However, this exception applies to payments not exceeding 4 per cent of capital account expenditure arrears accounted for in the finalised 2007 balance sheet and is conditional upon compliance with the Internal Stability Pact in 2008[18].

The 2010 Budget Law[19], which completes the review undertaken with the early submittal of the package, extended to 2010 the exclusion of local authorities' expenditure on investment in the protection of security and in temporary and extraordinary social programmes (to mitigate the effects of the earthquake in the Abruzzo region) up to a maximum amount of €150 million, as already envisaged in 2009[20].

In the current year, exceptions to the enforcement of sanctions have been envisaged in case of failure to comply with the Pact, when such failure is due to capital account programmes co-financed by the European Union.

The exceptions described above, which apply for a limited period of time, do not weaken the structure of the Pact, which, on the contrary, is bound to become stronger following the entry into force as of 2010 of a new mechanism for local authorities to control the nominal growth of public debt. This is particularly important for the consolidation process and the reduction of the debt-to-GDP ratio. In line with what had already been envisaged in the 2009-2011 fiscal package[21], municipalities[22] and provinces can increase their debt to a degree that shall not exceed a given percentage, to be fixed every year on the basis of a three-year projection and calculated separately for municipalities and provinces, consistent with the policy targets set in the economic and

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algebraic sum of two quantities: the first resulting from the difference between revenues assesments and spending commitments on current accounts, and the second resulting from the difference between collections and payments on capital accounts, excluding loan-raising and reimbursement operations.

[17] Law No. 133/2008, Articles 77 bis and ter, confirming Decree Law No. 112/2008.

[18] Law No. 102/2009 converting Decree Law No. 78/2009, Art. 9 bis.

[19] Law No. 191/2009.

[20] This exception was introduced in Law No. 33/2009, Art. 7 quater, converting Decree Law No. 5/2009 on urgent measures to support industrial sectors hit by the crisis.

[21] Law No. 133/2008, Article 77-bis, paragraphs 10, 11 and 29, confirming Decree Law No.112/2008.

[22] The provisions on borrowing also apply to municipalities not envisaged in the Pact, i.e. those with fewer than 5,000 inhabitants.

financial planning documents. This percentage is referred to as the ratio between the overall amount of debt of the local authority and the total amount of its own current revenues, net of central government and regional transfers. It therefore reflects the degree of solvency of the local authority in terms of its ability to repay the whole stock of debt. In case of failure to abide by the constraints, a sanction is enforced, whereby the threshold that had been previously laid down by decree is reduced by 1.0 per cent.

In addition to the Internal Stability Pact, the rules imposed on regions include the Health Pact, aimed at achieving sound planning of public healthcare spending, which had been excluded from the regulations of the Internal Stability Pact.

The Health Pact fixes the total resources to be allotted to the National Health Service and aims at improving quality of service by ensuring equal provision of services throughout the system. In line with the federalist reform of public health care, the Pact confirmed the gradual shift towards a 'joint governance' model between central and local government authorities.

The financial resources made available through the implementation of the Pact for the 2010-2012 period[23] in the 2010 Budget Law are sufficient to ensure essential health care services, to be provided efficiently and adequately by the regions. While central government transfers covering a variety of purposes[24] will be increased, there will need to be greater responsibility by the regions, as they will have to contribute to achieving public finance targets by adopting, among other things, measures to rationalise the hospital network and to contain staff costs[25].

Any deficit registered during the annual review will not only trigger automatic mechanisms to cover it, as already envisaged in the past, such as increasing IRE and IRAP surcharges, but also an automatic freeze on staff turnover and the prohibition against any expenditure other than mandatory. The Budget Law also fixed a 5 per cent level, calculated on the overall revenues of the regional health service, as the standard size of an economic imbalance – which – if reached or exceeded – requires the regions to submit a three-year deficit-reduction plan. This requirement also applies in the case of a deficit below the 5 per cent threshold when no tax revenues or budget funds are available to cover it.

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[23] The Pact was signed at the *Conferenza Stato-Regioni* of December 3.

[24] Among these, mention should be made of: increasing the National Health Fund necessary to ensure employment contract renewals, restarting the funding of investment in construction in the health sector and technological upgrade, supplementing the Non-self-sufficiency fund and the National fund for social policies.

[25] The standard for hospital beds has been reduced from 4.5 to 4 per 1,000 inhabitants. Staff expenditure, net of contract renewals, in each of the years of the 2010-2012 period, shall not exceed the funds appropriated to staff in 2004, reduced by 1.4 per cent.

The ceilings for pharmaceutical expenditure have been fixed again bearing in mind existing regulations on public health expenditure[26]. In July 2009, with the Decree Law bringing forward the 2009-2012 fiscal package, the pharmaceutical expenditure ceiling at a national and regional level[27] was reduced from 14.0 to 13.3 per cent, thanks to the *Agenzia italiana del farmaco* (AIFA) whose task is to reduce the prices of generic drugs. The 2.4 per cent ceiling envisaged for hospital pharmaceutical expenditure remained unchanged in every region.

VI.4 REFORM OF THE PUBLIC FINANCE AND ACCOUNTING LAW

The reform of the public finance and accounting law[28], in force since 1 January 2010, was dictated by the need to adjust the rules governing public finance and the budget to the requirements arising from a changing economic system, as well as from Italy's joining the European Monetary Union and the new institutional set-up between the central government and decentralised entities.

The new law comprehensively regulates the framework of rules governing public finance and accounting and it applies to all entities that make up general government, according to national accounting standards; moreover, it is an essential prerequisite for achieving a coherent and effective governance of public finance. The area covered by the previous law, which has now been repealed[29], has been broadened and a single and consistent regulatory framework has been established for all the entities falling within the category of general government.

This has been done by harmonising accounting systems as well as the budget systems of general government - that can be linked up to those adopted at EU level for EDP purposes - and the terms for their submittal and adoption. In addition, a single database for all general government entities has been established within the Ministry of the Economy and Finance. It will collect data concerning budgets, including any changes, final balances and information relating to management transactions, so as to ensure a more effective and timely monitoring of public finance performance, implement fiscal federalism, as well as prepare the necessary information to start the analysis and assessment of spending.

The various stages and documents of the economic and financial cycle have been redesigned, with greater involvement of all government levels in setting agreed budget targets and the relevant responsibilities. In this new system, the planning cycle starts with

[26] These constraints were introduced in Law No. 405/2001 confirming Decree Law No. 347/2001, which implemented the agreement between the State and the regions in 2001.
[27] The expenditure includes the co-payment charged to health-care recipients (*ticket*).
[28] Law No. 196/2009.
[29] Law No. 468/1978.

the Public Finance Decision (which replaces the Economic and Financial Planning Document), to be submitted to Parliament by September 15. By postponing the submittal of the policy review document (from June 30 to September 15), it is now possible to draw up a more up-to-date macroeconomic and public finance scenario. In order to ensure the necessary coordination of all levels of government, the drafting of the policy review document starts on July 15 with the forwarding of the guidelines for agreeing on budget targets to the permanent Conference for the coordination of public finance and to the Chamber of Deputies and the Senate.

Planning has a medium-term horizon, with a three-year planning period for policies, objectives and resources and a greater focus on the structural figures of the budget. Finally, forecasts made at unchanged legislation are to be supplemented by an estimate of the financial requirements necessary to fund investment and economic policy, as well as the fiscal programmes, which in any case are expected to be confirmed in future years (unchanged policies).

The programmes needed to achieve the set targets in each one of the three years of the planning period are laid down in the fiscal package, which, in turn, is composed of the Stability Law, replacing the Finance Law (*Legge Finanziaria*), and the Budget Law.

This stronger planning method is also applied to the State budget. The proposals put forward by individual central administration units will have to consider the whole three-year period and not just the first financial year of the forecast period, as is the case now.

The cycle ends with a Report on the Economy and Public Finance, published in April, setting out the final balance and containing updates of economic and public-finance forecasts.

To provide better information to Parliament, the information content of public-finance documents has been improved, since the revenue and expenditure forecasts are now broken down into subsectors; in addition, explanatory notes have been added on the methods used to develop year-on-year scenarios and to monitor the effectiveness of public-finance packages.

With regard to the structure of the State budget, the reform institutionalises the functional classification of expenditure into missions and programmes, introduced as of 2008. In line with the new budget scheme and in order to establish a clearer and more transparent link between the policy-setting role of Parliament and the allocative function of the budget, a spending programme may now either be adopted or rejected in its entirety with a parliamentary vote. Entrusting each programme to one entity that will be responsible for it increases the responsibilities of administrative entities and the effectiveness of the coordination of activities aimed at implementing the programme. Greater emphasis is also laid on linking the system of missions and programmes with the COFOG classification of the functions of general government. The information content

of the budget has been enhanced through the introduction of a detailed note and an informative factsheet on the content of each programme.

The new structure of the adjustable area of the budget - relating to expenditure 'for adjusting to the financial requirements' and the 'legislative factors' - together with a parliamentary vote that may either adopt or reject a programme only in its entirety ensures a higher degree of flexibility to the budget.

The budget regulations will be completed with the implementation of two pieces of delegated legislation. The first relates to the structure of the budget and is aimed at reducing the number and structure of missions and programmes, at introducing actions such as basic budget units, as well as the presentation of profit-and-loss accounting with the financial budget for a better understanding of both. The second envisages a change from the current system of drawing up the budget on an accrual and a cash basis to a cash basis only, subject to a two-year trial period.

The reform also aims at strengthening the mechanisms and tools for keeping expenditure under control and increasing the efficiency of Government action. To increase control over public finance, the funding of all budget balances (net balances of the State budget have to be funded, as well as net requirements and net borrowing of general government) is mandated, as is the funding of any legislative measure involving new or higher expenditure, thereby ensuring that the funding requirement enshrined in the Constitution is met and is consistent with EU criteria.

Greater emphasis on measuring and assessing performance is ensured through the introduction of an expenditure analysis and assessment programme for the central administrations, to be designed in cooperation with the Ministry of the Economy and Finance through the establishment of ad hoc analysis and assessment units. These units have to review the entire set of programmes, put forward proposals for rationalising expenditure laws and for developing methodologies to quantify actual requirements and performance indicators related to budget forecasts. Finally, they will have to verify the efficacy of measures laid down in the Stability Law.

VI.5 ANALYSIS AND EVALUATION OF PUBLIC EXPENDITURE

The need to ensure the sustainability of expenditures has led to an analysis of its main features for the purpose of identifying efficient and effective plans, through a systematic analysis and assessment of central government expenditure. This has now become standard practice since 2008[30]. In contrast to controlling expenditure from a legal and accounting point of view, based on ex ante constraints on spending authorisations and ex post reviews of formal compliance with envisaged procedures, the expenditure

[30] 2007 Budget Law, Article 1, paragraphs 474-481 and 2008 Budget Law, Article 3, paragraph 67.

analysis now uses economic assessment tools of expenditure performance, examining the procedures which determine it and identifying any scope for reallocation.

In the last few years, spending-cut measures – such as investment or spending constraints or the reduction of Ministries' endowment funds, have been only partially successful.

To be effective and lasting, control of public expenditure must act on the mechanisms generating it and the processes regulating it, thereby affecting the behaviour of those involved in the management of public resources. This requires a thorough understanding of the entire spending process, of the relations between the centre and the periphery and the way in which general government as well as other entities are involved.

In this context, the 2009 work schedule focused on analysing the State budget and its spending procedures. The results were set out in the 2009 Report on the expenditure of the central administration of the State[31]. By focusing its attention on the drawing up and management of the State budget, the Report is a preliminary and preparatory step for a more comprehensive and complete assessment of Ministries' expenditure.

Through this approach it is possible to identify and define - also from a quantitative point of view - the factors that hinder optimal allocation and effective management of public resources. More specifically, a number of phenomena have been identified that are common to the various general government entities - even though each has its own characteristics linked to the activities it performs - such as: some budget information is not always fully transparent, thus making it difficult to compare how funds were actually used relative to what had been authorised in the forecast; the drawing-up and management stages of the budget show a certain degree of rigidity; some procedures are overly complex, thus increasing the time required to provide resources to general government entities, which, in turn, affects the use of such resources and further increases residual liabilities; some forms of 'decentralised expenditure', which were initially designed to ensure flexibility, now hinder the monitoring and assessment of the use of resources. Following a thorough analysis of budget classifications, missions and programmes have been fine-tuned so as to better reflect expenditure. In addition, now, the targets that have

[31] The Report and its summary are posted on the website of the Ministry of the Economy and Finance – General Accounting Office at http://www.rgs.mef.gov.it/VERSIONE-I/Servizio-s/Studi-per-1/Rapporto-s/index.asp. The main areas of analysis on which the Report focuses are: information that can be directly derived from the State budget and the degree to which it can be used for the purpose of analysing and assessing expenditure; measurements of the performance of the activity of the central administration according to the information in the 'Preliminary notes', which accompany the State budget, the resources, the expenditure goals, the organisational structure, as well as some in-depth analyses of certain types of expenditure of the central administration of the State. The Report is accompanied by a statistical appendix, reporting analytical data – in historical series from 2003 to 2009 – on the State budget, broken down by administration, mission, programme and economic category. The tables are posted on the website in a format that can be processed.

been set – rather than the entities responsible for managing expenditure – are clearly identified.

The analysis and assessment of spending identified some scope for rationalisation and improvement, which in some cases enabled a review of the use of resources already in 2009 (as was the case, for example, for the repeal of Law No. 488 of 1992 and for the use of mortgage loans that had been granted but not yet provided by the State and the *Cassa depositi e prestiti*). In addition, some recommendations made as a result of the analysis, contributed to the development of specific proposals when the public finance and accounting reform law was drafted; for example the piece of delegated legislation for the merging of reserve funds, the phasing out of special accounting procedures (except in some specific cases) and the increase in the flexibility of the budget.

The degree of rigidity of the budget, covering 93 per cent of predetermined expenditure[32], weakens its allocative function when the budget is being drawn up and its operational efficiency when it is implemented. As was highlighted in the 2009 Report on the expenditure of the central administration of the State, expenditure can be predetermined on the basis of the so called 'mandatory expenditure' identified in the State budget in List No. 1 annexed to the forecast made by the Ministry of the Economy and Finance (which can also be covered by resorting to the relevant reserve fund) and by the type of legislative constraint (mandatory burdens, legislative factors and financial requirements) imposed on each expenditure chapter by the authorisation provision[33].

When the budget is being drafted, the share of expenditure mandated by law (mandatory burdens and legislative factors - bearing in mind the mechanism of existing legislation on the basis of which a forecast is made) largely constrains the initial budget forecasts and gives general government entities little scope for reallocations. When the budget is executed, the mandatory nature of expenditure gives general government entities some scope to change endowments through internal administrative decrees or decrees to change the budget.

A subset of expenditure that was considered 'adjustable' (i.e. expenditure over which the administration can exert actual control in terms of the variables that determine it when it is drawn up, allocated and quantified[34]) was identified on an experimental basis

[32] The figure refers to the final budget expenditure and therefore does not include the costs of repaying financial liabilities, which by definition are mandatory. If these were included, the degree of budget predetermination would rise to 95 per cent.

[33] Expenditure authorization can be of three types: the 'mandatory burdens' which entail expenditure that has to be made according to special mechanisms or criteria laid down by law that regulate its development (such as subjective rights laid down by norms) or because they derive from contract requirements (such as those resulting from national employment contracts); the 'legislative factors' which are resources envisaged in the budget by virtue of a specific legislative measure that fixes their duration and amount for each financial year; and the 'financial requirements' which include all the remaining expenditure, mostly earmarked for the operational requirements of general government.

[34] This category also includes expenditure authorised by legal provisions fixing the total amount of resources, but does not identify their parameters or criteria of use (hence mainly those classified as requirements and legislative factors).

in 2009, and again in 2010, in order to increase the degree of flexibility of the budget. Within this new subset, general government entities may reallocate resources among the various programmes, provided they are reallocated within each mission in the forecast[35]. The adjustable area of the budget has been institutionalised and further extended by the reform of the public finance and accounting law, by both broadening the types of expenditure that are considered adjustable (within the 'legislative factors' aggregate, parts of which were previously excluded) and adopting or rejecting a programme only in its entirety through a parliamentary vote (thus including a much larger set of resources than was the case in previous macro-aggregates).

With regard to the analysis of expenditure of individual general government entities, the in-depth analyses performed this year specifically concerned the ways in which sector spending is managed, highlighting those linked to the presence of extensive peripheral networks of general government entities or to the fact that the latter mainly transfer resources to other entities responsible for spending or for the provision of social services (which strongly depend on the area where these services are provided) or individual services (where the portion resulting from staff costs plays a key role).

However, despite the limitations that may be due to the peculiar nature of the tasks performed by public entities, the experience so far with expenditure analysis shows that in order to truly assess the efficiency and effectiveness of individual programmes, it is essential to measure the results that are achieved against the targets set and the resources used. The identification of systems and methods to set targets and review the performance indicators related to public policy provides the instrument to evaluate performance against targets. Currently general government entities do not seem to be performance-oriented, even in the context of the tools that accompany the State budget, such as the so-called 'Preliminary notes' whose content definitely needs to be improved[36].

With the implementation of the public finance and accounting reform, expenditure analysis will certainly play a key role in the future[37].

[35] The readjustments between operational expenditure and programmes cannot exceed 10 per cent of the resources earmarked for programmes. The financial endowments of each expenditure mission can be readjusted within programmes, except in the case of mandatory expenditure, yearly expenditure and deferred payment expenditure. Capital account appropriations cannot be used to finance current expenditure.

[36] A workshop organised by the *Ragioneria Generale dello Stato* (General Accounting Department) held on 20-21 April 2009 on 'Measuring performance and quality of public expenditure', brought together representatives of general government and international experts (see http://www.rgs.mef.gov.it/VERSIONE-I/Servizio-s/Workshop-e/index.asp).

[37] Law No. 196/2009, Articles 39-41-49.

VII. SUSTAINABILITY OF PUBLIC FINANCES

Affecting not only Italy, but all the European Union Member States, the issue of the progressive ageing of the population is likely to become even more serious in the years to come. Factors such as low birth rates and longer life expectancy will radically modify the age structure of the European population in the decades ahead. Such developments will have important consequences for public finance and the socio-economic framework and include a sharp decrease in the size of the working-age population, which will only partially be offset by the projected increase in the net flow of immigrants.

Against this backdrop, Italy is among the countries with the fastest ageing population, with a projected increase in the old-age dependency ratio of more than 30 percentage points[1] over the next five decades.

Notwithstanding the acceleration of the demographic trends, which will be further affected by the non-negligible consequences of the current economic crisis on medium-term growth prospects, the impact of population ageing on some public expenditure items, directly or indirectly tied to demographic developments, remains contained in Italy. As a result of reforms implemented during the past 20 years, the trend of total age-related expenditure in Italy is today one of the most moderate among EU countries.

These results become evident when looking at both the demographic trends and the macroeconomic assumptions agreed at a European level, and the dynamic of age-related expenditures as published in the 2009 Ageing Report[2] prepared jointly by the European Commission and the Economic and Policy Committee-Ageing Working Group (EPC-AWG). In addition, according to the European Commission Sustainability Report[3] published in October 2009, the long-term trend of age-related expenditures in Italy, under the assumption of no-policy changes and taking into consideration the negative effects of the economic crisis, should not lead to an explosion of public debt during the next 50 years.

In recent years, and in particular, during the current economic crisis, the long-term sustainability of public finances has become an essential component of multilateral surveillance, and not only within the framework of the European Union Stability and Growth Pact.

[1] Based on the projections for the baseline scenario prepared by Eurostat in 2007, the old-age dependency ratio was 31.7 per cent in 2005 (among the highest levels in the EU-27) and is projected to grow to 64.5 per cent by 2060.

[2] European Commission, 2009, 2009 Ageing Report, European Economy, vol. 2.

[3] European Commission, 2009, Sustainability Report 2009, European Economy, vol. 9.

In Europe, the sustainability of public finances appears at present to be at risk in many countries as a result of the impact of the crisis and the marked increase in public debt due to the adoption in 2008 and 2009 of fiscal-stimulus packages and measures to support the financial system. Against this backdrop and in view of the adoption of credible fiscal exit strategies by Member States, demographic conditions and macroeconomic assumptions become particularly important variables in measuring the extent to which public debt can remain on, or get back to, a sustainable path over the long term. In this regard, this chapter presents a series of simulations of long-term dynamics of Italy's public debt; based on alternative assumptions about the evolution of both key macroeconomic variables and initial levels of the primary surplus relative to the values assumed in the baseline scenario.

VII.1 IMPACT OF THE AGEING OF THE POPULATION ON PUBLIC EXPENDITURES

This section reports the projections of public expenditure for pensions, healthcare, assistance to the elderly, education, and unemployment compensation in relation to GDP, as well as details of the demographic and macroeconomic assumptions for the baseline scenario (Table 13) with reference to the 2005-2060 period. The projections incorporate the demographic and macroeconomic assumptions of the baseline scenario, as agreed by the EPC-AWG, for the estimation of the components of the age-related expenditure contained in the Ageing Report, published in April 2009[4].

The demographic assumptions refer to the EUROSTAT baseline scenario with 2007 as the base year[5], whereas the medium/long-term macroeconomic outlook incorporates the base assumptions as agreed by the EPC-AWG[6] with the introduction of several important changes. In addition to the updating of the initial data for 2008 and 2009 and several adjustments applied to achieve the consistency of such data with the

[4] The projections were formulated using medium/long-term forecast models of the State's General Accounting Office (*Ragioneria Generale dello Stato,* RGS). The presentation of the age-related expenditure in the 2009 Ageing Report represents the third projection exercise undertaken by the Commission and the EPC-AWG and follows that realized in 2006.

[5] The baseline scenario approved by the representatives of the national statistics offices of each Member State and by the delegates of the EPC-AWG assumes for Italy: (i) a net annual flow of immigrants averaging 226,000 unit, with a trend which is increasing in the initial period of the projections and decreasing in the outer years; (ii) an increase in life expectancy of 6.9 years for men and 5.8 years for women between 2008 and 2060; and (iii) a total birth rate as of 2060 equal to 1.56 with an increase of 0.16 percentage points in comparison with the initial level of approximately 1.4.

[6] The baseline scenario assumes that the annual growth rate of real productivity is increasing during the first part of the projection period, converging to 1.7 per cent as of 2025. With regard to the labour market, it is projected that the employment rate for the 15-64 age bracket will grow from 58.7 per cent in 2008 to 63.9 per cent in 2060, basically as a result of the increase in the female participation rate. The resulting real GDP growth rate is equal to an average of 1.48 per cent over the 2010-2060 period.

structural variables of the baseline scenario, the macroeconomic framework also incorporates (i) the effects on the activity rates determined by the tightening of the eligibility requirements for old age pensions of women employed in the public sector[7] and (ii) the medium-term effects of the financial crisis.

As indicated by the macroeconomic scenario outlined in chapter II, GDP growth contracted by 1.0 per cent in 2008 and by 4.8 per cent in 2009. As a consequence of the crisis, the unemployment rate increased in 2008 and 2009, and is expected to reach a high of 8.4 per cent in 2010.

In addition, in order to fully take the effects of the crisis into account, the trend of labour productivity has been revised downward so as to guarantee a real GDP growth rate for the 2008-2020 period that is approximately 0.5 percentage points per year lower than the average rate assumed in the original (pre-crisis) scenario as defined by the EPC-AWG[8]. Furthermore, it is assumed that employment levels and the rates of change of labour productivity in the next 10-15 years will gradually be aligned with the rates assumed in the EPC-AWG baseline scenario. These differences with respect to the EPC-AWG baseline scenario produce, over the medium term, an economic outlook which is substantially in line with the assumptions underlying the definition of the lost-decade scenario[9].

The projections of the age-related expenditures reported in Table 13 have been updated in line with the regulatory framework in place as of December 2009. They incorporate the effects of last year's Budget Law[10], the effects of the measures contained

[7] Law No. 102/2009 (converting Decree-Law No. 78/2009 with amendments) implements the European Court of Justice's ruling on the subject. In addition, in comparison with the original EPC-AWG scenario, the projection of the activity rates has been slightly revised in order to take into account in a more precise way the effects of the tightening of the minimum requirements for early retirement pensions, foreseen at current legislation (Law No. 243/2004 and Law No. 247/2007). In the aforementioned scenario, such effects have been considered only in an 'approximate' manner from the standpoint of the temporal, the age and sex distributions (Ministry of the Economy and Finance, RGS, 'EPC-AWG pension projections –Italy's fiche 2009', Paragraph 3.4).

[8] During the 2010-2020 period, the average productivity growth rate is approximately 1.3 per cent, a figure substantially in line with the trend assumed in the original EPC-AWG scenario for the same time horizon.

[9] The process of defining the EPC-AWG baseline scenario described in the Ageing Report came to a conclusion in June-July 2008 and therefore it does not take into account the impact of the financial crisis on economic growth. The report nonetheless makes an approximate evaluation of the impact that the crisis might have on the projections of the expenditure-to-GDP ratio under the assumption of a temporary shock (lost-decade scenario), a permanent shock (permanent-shock scenario) and a recovery of employment and productivity levels, vis-à-vis the original baseline scenario as from 2021 (rebound scenario). Notwithstanding the high margins of uncertainty about the economic effects of the financial crisis, the lost-decade scenario contains a set of assumptions which guarantee the less invasive correction of the baseline scenario with respect to the structural trends agreed by EPC-AWG. In this regard, see: European Commission, 2009 Ageing Report, European Economy, Vol. 2.

[10] Decree-Law No. 112/2008, converted into Law No. 133/2008.

in the anti-crisis package[11] and, consistent with the new Healthcare Pact for 2010-2012, the effects of the Budget Law for 2010.

In particular, the projections of pension expenditure incorporates the financial effects of the gradual increase in the retirement age (to 65) for women employed in the public sector, as mandated by the ruling of the European Court of Justice[12]. The projections of healthcare expenditure, carried out on the basis of the methodology of the reference scenario, takes into consideration both the effects arising from the ageing of the population and other explicatory factors, and include also the savings foreseen by the 2008 Budget Law, which were already incorporated in the forecast produced for the Update of the Stability Programme of last year[13]. In addition, the healthcare projections include both the additional expenditures arising from extending the coverage of the National Healthcare Service to recently regularised immigrants[14] and the effects[15] of the 2010-2012 Healthcare Pact foreseen by the 2010 Budget Law. The projections of the unemployment benefits take into account the refinancing of the fund for employment[16] and the effects of the strengthening and extension of income-protection instruments in the event of separation from work or unemployment (the so-called *ammortizzatori sociali in deroga*[17]), as provided up until 2011 under current legislation. Finally, the projections for education expenditure take into account the effects of the savings stemming from the re-organisation and rationalisation of staff within the public school system which should lead to a reduction of the gap in the average of teacher/student ratio vis-à-vis other countries. Such effects were already considered in last year's Stability Programme projections[18].

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[11] Decree-Law No. 185/2008, converted into Law No. 2/2009 and Decree-Law No. 78/2009, converted with amendments into Law No. 102/2009.

[12] Measure provided by Law No. 102/2009.

[13] See Decree-Law No. 112/2008, converted into Law No. 133/2008. The savings on healthcare expenditure provided by the Decree Law amount to € 2,000 million in 2010 and € 3,000 million starting in 2011. The projections assume that these consolidation measures are realised entirely and exclusively on the expenditure side, inasmuch as the regions could also intervene with other measures, e.g. coverage of budgets outside of the healthcare sector.

[14] The measure provided by Decree Law No. 78/2009 calls for a corresponding increase in the financing of the National Healthcare Service so as to cover the charges stemming from the regularisation of non-EU immigrants as provided by Article 1-ter of the same decree. The charges stemming from this measure amount to € 67 million in 2009 and € 200 million starting in 2010.

[15] Such measure increases financing for the National Healthcare Service by € 584 million in 2010 and € 419 million in 2011, modifying the corresponding amount provided by the 2008 Budget Law (Decree Law No. 112/2008).

[16] The refinancing of the fund for employment is provided by Decree Law No. 185/2008.

[17] The initial refinancing of the *ammortizzatori sociali in deroga* is provided by Decree Law No. 112/2008. In addition, with the implementation of Article 18 of Decree Law No. 185/2008, additional refinancing was approved by the State-Regions Agreement of 12 February 2009 in which it was established to set aside a corresponding portion of the Funds for Underutilised Areas for the 2009-2010 period.

[18] The measures assume: i) a gradual increase of one percentage point in the student/teacher ratio during the 2009-2011 period so as to reduce the gap vis à vis European standards; ii) a revision of the criteria and parameters for the definition of human resources needs for administrative, technical and support personnel

TABLE 13: PUBLIC EXPENDITURES ON PENSIONS, HEALTHCARE, LONG-TERM CARE, EDUCATION AND UNEMPLOYMENT BENEFITS (2005-2060)[1]

	2005	2010	2015	2020	2025	2030	2035	2040	2045	2050	2055	2060
						% of GDP						
Total expenditure (2)	48.2	51.4	48.3	47.5	47.0	47.2	47.5	48.0	48.1	47.4	46.8	46.0
of which: age-related expenditure	26.1	28.3	27.6	27.5	27.7	28.4	29.1	29.7	29.9	29.4	29.1	28.6
Pension expenditure	14.0	15.2	14.8	14.7	14.8	15.3	15.7	16.0	15.7	14.9	14.3	13.8
of which: seniority and old-age pensions	13.4	14.7	14.4	14.2	14.4	14.9	15.3	15.7	15.4	14.6	14.0	13.5
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 (3)	6.7	7.4	7.4	7.6	7.8	8.0	8.3	8.5	8.7	8.9	9.0	8.9
Long-term care expenditure	0.8	1.0	1.0	1.0	1.1	1.1	1.2	1.3	1.4	1.5	1.6	1.7
Education expenditure (4)	4.2	4.2	3.9	3.7	3.6	3.5	3.5	3.6	3.7	3.7	3.8	3.8
Unemployment benefits	0.4	0.6	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Interest expenditure	4.5	4.9	5.2	4.5	3.8	3.3	2.9	2.7	2.6	2.5	2.2	1.8
Total revenues (2)(5)	43.8	46.5	46.8	46.8	46.8	46.7	46.7	46.7	46.7	46.7	46.7	46.7
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	0.5	1.1	1.3	1.6	1.7	1.7	1.7	1.7	1.7	1.7	1.7	1.7
Real GDP growth rate	0.7	1.1	2.5	2.0	1.7	1.3	1.1	1.0	1.2	1.4	1.2	1.3
Male participation rate (20-64)	79.2	78.6	80.8	81.8	82.3	82.5	83.1	83.7	83.8	84.0	83.6	83.4
Female participation rate (20-64)	53.6	55.3	58.3	60.2	60.9	61.2	61.4	61.5	61.7	62.0	61.5	61.5
Total participation rate (20-64)	66.4	66.9	69.6	71.0	71.7	71.9	72.4	72.8	73.0	73.3	72.8	72.7
Unemployment rate	7.7	8.4	7.0	5.9	5.6	5.6	5.6	5.6	5.6	5.6	5.6	5.6
Population aged 65 and over total population (6)	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]) (6)	31.7	33.5	36.2	38.3	41.1	45.9	52.1	58.4	62.6	64.2	64.5	64.5

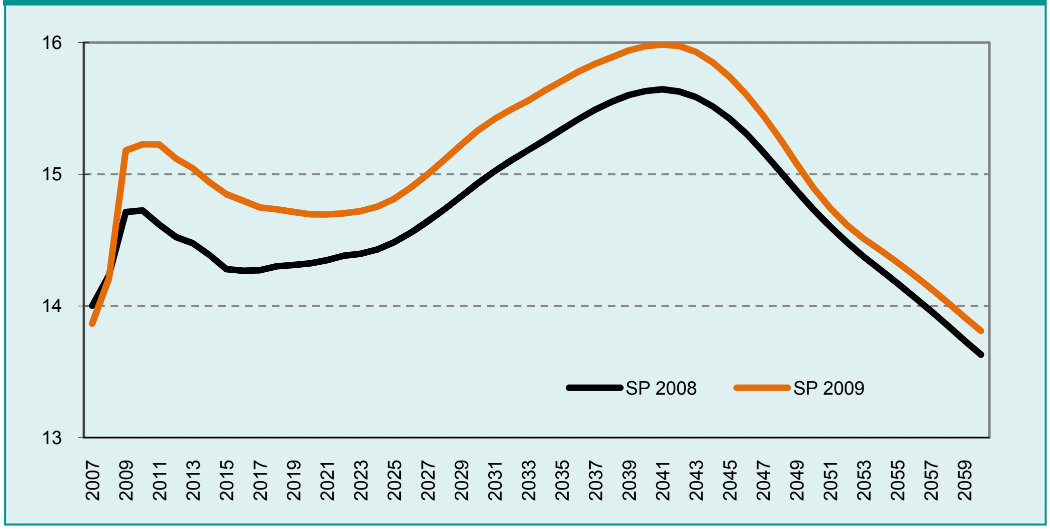
1) Given rounding to the first decimal point, the individual figures added together may not equal the totals shown.
2) For technical reasons, it has been assumed that the amount of the programmed additional budgetary interventions, equal to 0.4 per cent of GDP in 2011 and 1.2 per cent of GDP in 2012, will be entirely implemented through expenditures cuts.
3) Includes public healthcare spending for the assistance of the elderly.
4) Does not include public spending for adult education (continuous training) and pre-primary school.
5) Inclusive of property income.
6) Source: Eurostat, baseline scenario, base year 2007.

Overall, the ratio of age-related expenditure to GDP should increase by 2.5 percentage points during the 2005-2060 period (Table 13). However, the bulk of the increase is concentrated in the 2008-2009 period, and is mainly triggered by the contraction of GDP due to the crisis. In the years after 2010, the age-related expenditure decreases slightly and then starts to increase again in 2020, continuing to rise through 2040-2045 (corresponding to the retirement of the so-called baby-boom generation), with the figure reaching almost 30 per cent of GDP around 2045. Finally, toward the end of the projection horizon, the age-related expenditure declines significantly, with the ratio to GDP moving back to levels just above those reported for 2010.

in public schools so as to achieve a total reduction of 17 per cent of the work force when compared with the level of the 2007/2008 academic year; and iii) the use of 30 per cent of the resulting savings for financing initiatives aimed at the enhancement of the human capital and professional career of public school personnel (starting in 2010). The expenditure savings are expected to be approximately €460 million in 2009, €1,240 million in 2010, €1,875 million in 2011 and €2,230 million as of 2012.

After initially decelerating slightly, the ratio of pension expenditure to GDP starts rising as of 2024 to reach a high of 16.0 per cent in 2041 and a final figure of 13.8 per cent in 2060 (Figure 4). Compared with the forecast contained in the 2008 Update of the Stability Programme, the ratio is positioned at a higher level across the entire projection period, entirely as a consequence of the lower GDP growth in the 2008-2009 period. This difference nonetheless shrinks, going from 0.6 percentage points in the initial years to 0.35 percentage points at the peak (2041), and then falling to less than 0.2 percentage points at the end of the projection period. Part of the effect on the expenditure/GDP ratio caused by the contraction of the economy during the initial period of projection is gradually offset over the medium/long term by a reduction of the expenditure due, in turn, to a weaker trend of productivity and by acceleration of GDP growth as employment levels converge to the structural values for the medium/long term.

FIGURE 4: PENSION EXPENDITURE (percentage of GDP)



The projection of healthcare expenditure reflects a growing profile in relation to GDP over most of the forecast horizon, stabilising at around 8.9 per cent of GDP during the final decade of the forecast period. With the healthcare expenditure profile remaining virtually unchanged, the figure projected for 2060 is slightly above that indicated in last year's Stability Programme Update due to weaker growth of nominal GDP during the initial 2009-2010 period.

The ratio of education expenditure[19] to GDP stands at around 4.2 per cent in 2010, or 0.2 percentage points higher than the figure presented in the 2008 Update of the Stability Programme, essentially due to the deepening of the recession during the 2008-2009 period. Including the effects of public school reform, which reduces expenditure by approximately 0.1 percentage points of GDP as from 2012[20], the outlays for education decrease during the subsequent 30-year period and then begin to rise moderately at the end of the projection period, reaching 3.8 per cent of GDP in 2060.

The expenditure for social services and assistance to the elderly[21] as a ratio of GDP presents a growing profile over the entire projection period, ending up at 1.7 per cent in 2060. The projection of unemployment benefits as a percent of GDP goes from 0.4 per cent in 2008 to 0.6 per cent in the 2009-2010 period, mainly as a result of higher expenditure due to the impact of the economic crisis on employment. In the next three years, in line with the expected phasing out, based on current legislation, of financing of the supplementary wage supplementation schemes (*ammortizzatori sociali in deroga*) in 2011, the ratio moves back to the 0.4 per cent of GDP, a value that remains broadly stable for the remainder of the projection period.

VII.2 DEBT SUSTAINABILITY

On the basis of the assumptions regarding the long-term demographic and macroeconomic trends and the projections for the age-related expenditures as described in the preceding section (Table 13), the sustainability of public finances is analysed both through the projection of the debt-to-GDP ratio over the 2013-2060 horizon, and through the calculation of a number of sustainability indicators, such as sustainability gaps (S_1 and S_2) and the required primary balance (RPB).

The debt-to-GDP ratio and the structural primary surplus, net of one-off measures, indicated for 2012 represent the starting point for the exercise. It is also assumed that the real rate of interest (3.0 per cent per year) is kept constant over the

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[19] The definition of education expenditure as agreed by EPC-AWG includes the International Standard Classification of Education (ISCED) levels 1-6. Therefore, the aggregate does not include adult education (continuous training) and pre-primary school.

[20] The expenditure savings provided by Decree Law No. 112/2008, converted with Law No. 133/2008, have been attributed in full to the ISCED 1-6 expenditure aggregate on the basis of the information reported in the 'Programme plan of measures aimed at rationalising the human and material resources of the education system' presented by the Government.

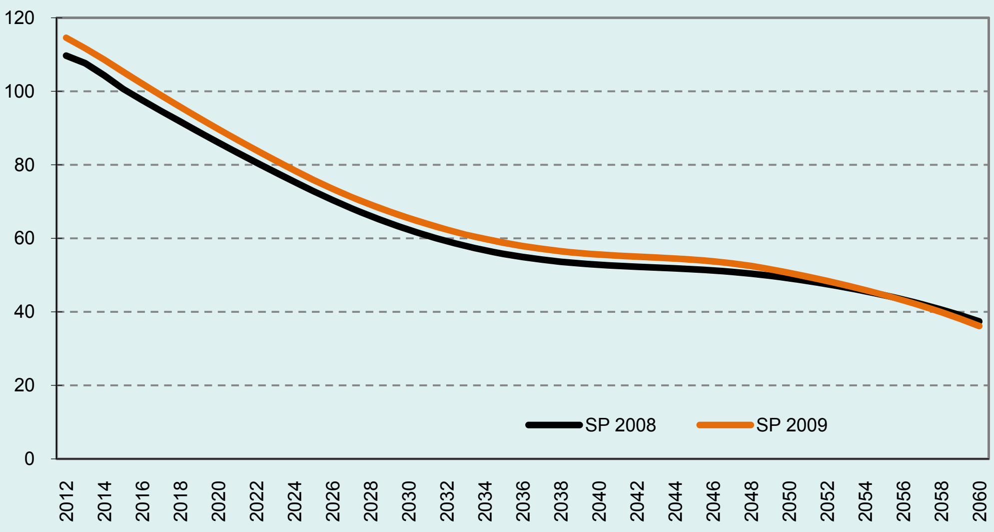
[21] The public expenditure for social services and assistance for long-term care is split between cash benefits (approximately 80 per cent) in the form of disability allowances and services (approximately 20 per cent) which are provided at a local level. The projection of the ratio between such expenditure item and GDP was carried out by adopting the assumption of the so called reference scenario methodology. With reference to disability allowances, the projections were performed in line with the methodological indications agreed by the EPC-AWG, with the amount of the benefit linked to the trend of per capita GDP.

entire projection period (2013-2060), while the structural primary surplus changes depending on the paths of age-related expenditure and property income[22].

In line with the 2008 Update of the Stability Programme, the results of the simulation show a decreasing debt-to-GDP ratio over the entire projection period for the baseline scenario. Debt falls to below the threshold of 60 per cent of GDP in 2034, with a delay of two years compared with the profile outlined in the 2008 Update, and then continues declining to hit 36.1 per cent of GDP in 2060 (Figure 5).

The main differences between the current projection and the one in the 2008 Update of the Stability Programme are: (i) the deterioration of initial debt conditions due to the deepening of the economic crisis during 2009 and the worsening of medium-term growth prospects; and (ii) a slight upward revision in the trend of age-related expenditures. In particular, during the 2008-2011 period, the debt-to-GDP ratio is approximately 3.6 percentage points higher than that indicated in the preceding Update. The age-related expenditures are equal, on average, to 28.7 per cent of GDP over the 2012-2060 time horizon, compared with the 28.1 per cent reported in the 2008 Update of the Stability Programme.

FIGURE 5: PUBLIC DEBT PROJECTION COMPARED TO THE PROJECTION IN THE 2008 UPDATE OF THE STABILITY PROGRAMME (percentage of GDP)



[22] Property income corresponds to investment income (bonds and stocks) and annuities from ownership of natural resources. The long-term trend of such income for the 2008-2060 period is projected on the basis of the methodology agreed by the EPC-AWG.

As in the preceding updates of the Stability Programme and on the basis of the methodology agreed at EU level, the indicators considered for obtaining a summary measure of the degree of long-term sustainability of public finances for the baseline scenario are the sustainability gaps (S_1 and S_2) and the required primary balance (RPB) [23].

S_1 measures the permanent adjustment of the structural primary balance (as a percentage of GDP) needed for achieving a debt level of 60 per cent of GDP in 2060. S_2 measures the permanent adjustment of the structural primary balance needed so that the dynamic of the public debt fulfils the inter-temporal budget constraint over an infinite time horizon. Finally, the required primary balance (RPB) measures the average primary surplus during the first five years of the projection period (in this case, from 2013 to 2017) consistent with the adjustment suggested by the value of S_2.

S_1 and S_2 may also be broken down into sub-components that provide useful information about the origin and the timing of the fiscal adjustments needed to guarantee the sustainability of the debt over the long term (Table 14).

The first sub-component, the initial budgetary position, measures the distance between the structural primary surplus as of 2012 (equal to 3.5 per cent of GDP) and the structural primary surplus needed to keep the debt-to-GDP ratio constant at the initial level (114.6 per cent of GDP) ceteris paribus[24]. The second sub-component, the debt requirement in 2060, which is specific of the S_1 indicator, shows the adjustment needed to ensure that the debt goes from the initial level to 60 per cent of GDP in 2060. Finally, the third sub-component, the long-term changes in the primary balance, quantifies the cost of ageing, namely, the additional adjustment needed in order to cover the increase in expenditures related to the ageing of the population.

The results of the two sustainability gaps show negative values in both cases. It follows that the fiscal consolidation planned in this Stability Programme Update for 2012 would be sufficient to ensure sustainable public finances over the long term. This result is confirmed by the required primary balance which, with a value of 2.8 per cent, is less than the primary surplus projected for 2012.

Compared with the 2008 Update of the Stability Programme, the S_1 sustainability gap remains unchanged, while S_2 improves by 0.1 percentage points. Still, in both cases, it is possible to note a change in the mix between the relevant sub-components of the sustainability gap that leads to a deterioration of approximately 0.2 percentage points in the value of the initial budget conditions (represented by the components of the initial budgetary position), which is more than offset by a reduction of more than 0.3 percentage points in the contribution of the cost of ageing.

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[23] For a thorough description of the indicators, see Annex I of the 'The Long Term Sustainability of Public Finances' report by the Commission services, European Economy No. 4/2006.
[24] Age-related expenditures are kept constant as a percentage of GDP at the 2012 level.

The deterioration of the initial budgetary conditions is mainly attributable to a level of debt for 2009-2012 that is higher than that of the 2008 Update of the Stability Programme and to the reduction of the structural primary balance due to the effects of the economic crisis. However, the fact that the value of the initial budgetary position remains negative for both S_1 and S_2 (-1.8 and -1.6 per cent, respectively) is an indication that Italy's public finances, given the budget conditions planned for 2012, will easily be able to accomodate the build-up of interest expenditure in relation to GDP (snowball effect) expected over the long term.

On the other hand, the reduction in the cost-of-ageing parameter is absolutely in line with the reduction in the velocity of growth of age-related expenditure (as a percentage of GDP) implicit in the lost-decade scenario[25].

TABLE 14: LONG-TERM SUSTAINABILITY INDICATORS

	S_1	S_2	RPB
Value	-0.3	-0.9	2.8
of which:			
Initial budgetary position	-1.8	-1.6	-
Debt requirement in 2060	0.8	-	-
Long-term changes in the primary balance	0.7	0.7	-

VII.3 ANALYSIS OF THE SENSITIVITY OF PUBLIC DEBT DYNAMICS OVER THE LONG TERM WITH RESPECT TO MACROECONOMIC AND PUBLIC-FINANCE ASSUMPTIONS

The exit strategies for crisis-related policies should include an appropriate mix of reforms and fiscal-consolidation measures respectively aimed at boosting the economy's potential GDP and reducing the debt-to-GDP ratio before the costs of ageing materialise. In this regard, the sensitivity analysis presented in this chapter is aimed at (i) testing the robustness of the results in view of the uncertainty surrounding long-term demographic

[25] The long-term changes in the primary balance which quantify the cost of ageing may be defined as the present value (as of 2012) of the cumulative changes in age-related expenditure as a percentage of GDP. Technically speaking, with the lost-decade scenario serving as a basis for the projections of this Update of the Stability Programme, the age-related expenditure increases during the first part of the forecast period, and then converges toward the values projected in the original baseline scenario. Accordingly, this results in a reduction in the cost of ageing. Such findings are in line with those published by the European Commission in the 2009 Ageing Report and the 2009 Sustainability Report. In the lost-decade scenario presented in the Ageing Report, the age-related expenditure for Italy increases on average by 1.1 percentage points compared with the baseline level for the 2007-2020 period and then converges toward the level indicated by the baseline scenario until the end of the projection period. As confirmation thereof, it is noted that the increase in age-related expenditures in the lost-decade scenario relative to the baseline scenario over the entire forecast period (2007-2060) is, on average, only 0.5 percentage points.

and macroeconomic projections and (ii) verifying under which reform assumptions and on the basis of which budgetary conditions, debt sustainability can be guaranteed.

Accordingly, in the following sections two types of sensitivity analysis related to permanent changes to the assumptions used for the baseline scenario are presented. The sensitivity of public debt is tested with regard to (i) several macroeconomic assumptions, and (ii) the change in the initial level of the primary surplus.

The sensitivity analysis with respect to macroeconomic variables

The sensitivity analysis with respect to macroeconomic variables aims at testing the robustness of the results of the baseline scenario vis-à-vis different scenarios that assume alternative trends for labour productivity, the activity rate of women and the real interest rate.

With regard to the first two variables, the simulation assumption may be considered as the result of reforms in the market for goods or in the labour market that favour respectively greater competitiveness and higher employment.

With reference to productivity, the simulation exercise assumes an alternative scenario in which the growth rate of labour productivity is increased by 0.2 percentage points over the baseline scenario starting in 2020. The convergence to the new level is achieved gradually over the 2010-2020 period. The impact on sustainability of a stronger trend of labour productivity is significant (Figure 6). In particular, a more favourable assumption about productivity growth produces a more rapid reduction of the debt-to-GDP ratio, which falls below 60 per cent as early as in 2030.

The prospects for an increase of the rate of participation of older workers and women in the central range of the age distribution imply that it is likely that total participation rates will be higher in the coming decades.

While a higher rate of participation of older workers could be the result of a later exit from the labour market due, among other things, to the effect of the tightening of minimum requirements for retirement, in the case of female population, empirical evidence suggests that as the level of education increases so does the propensity to participate in the labour market permanently once schooling is completed[26].

In order to take this factor into account, the probability of entry into the labour market is appropriately adjusted so as to imply that the female activity rate for the 15-64 age bracket increases gradually up until a value that is 5 percentage points higher than the baseline scenario in 2060 . The simulation discounts the effects on productivity caused by the stronger trend of employment implied by the properties of the production function

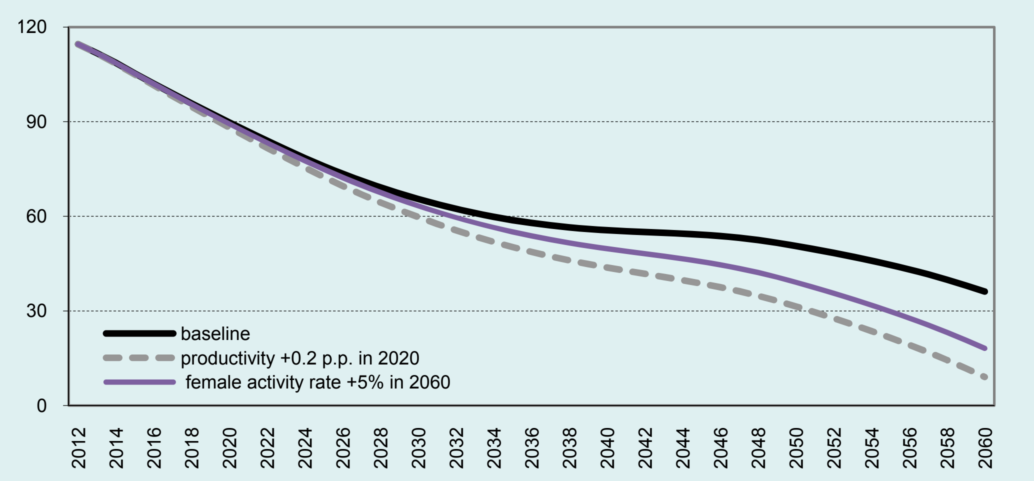
[26] In this regard, see: *Ragioneria Generale dello Stato* (2006), 'The Medium-/Long-Term Trends of the Pension and Healthcare System', Report No.7.

and the assumptions about the evolution of the stock of capital as adopted by the EPC-AWG[27].

As far as the projection of the debt-to-GDP ratio (Figure 6) is concerned, the effects are equal to approximately two-thirds of those estimated under the assumption of an increase in productivity.

It follows that the adoption of structural reforms capable of (i) promoting stronger medium-term labour productivity and (ii) encouraging labour-market participation for segments of the population that have been currently excluded would, *ceteris paribus*, automatically improve the long-term sustainability of public finances.

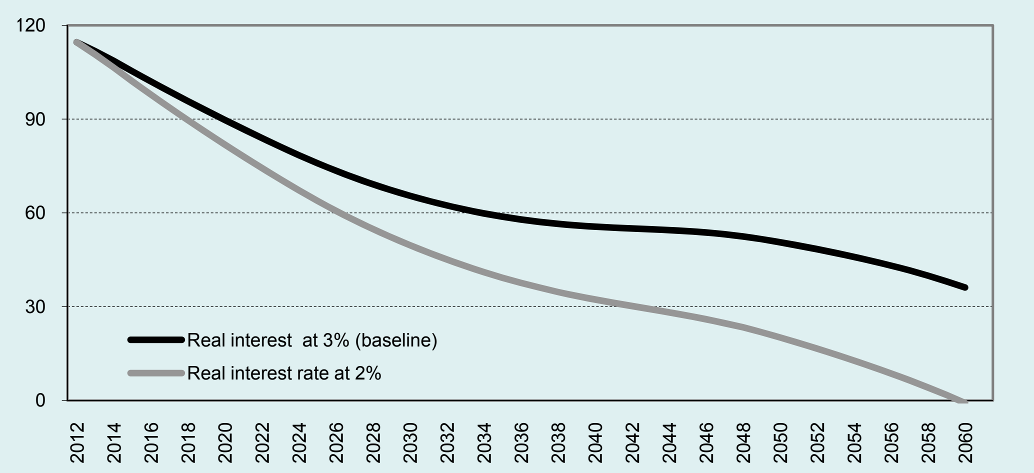
FIGURE 6: SENSITIVITY OF PUBLIC DEBT TO MACROECONOMIC ASSUMPTIONS: PRODUCTIVITY AND FEMALE ACTIVITY RATE (percentage of GDP)



The sensitivity of public debt to the real interest rate is analysed through an alternative scenario that assumes a constant fixed rate at 2 per cent for the 2012-2060 period compared with the baseline scenario assumption of a constant rate at 3.0 per cent across the entire projection horizon (Figure 7). The alternative scenario is compatible with a more favourable trend of the debt vis-à-vis the baseline scenario. The debt-to-GDP ratio decreases below the threshold of 60 per cent as early as 2027, and falls at a much faster pace than in the baseline scenario.

[27] The simulation discounts the effects on productivity prompted by the different trend of employment, according to the capital formation rule indicated as a 'transition rule (compromise scenario)' by the EPC-AWG and incorporated into the baseline scenario (European Commission-EPC-AWG (2008), The 2009 Ageing Report - Underlying Assumptions and Projection Methodologies, page 100).

FIGURE 7: SENSITIVITY OF PUBLIC DEBT TO MACROECONOMIC ASSUMPTIONS: REAL INTEREST RATE (percentage of GDP)



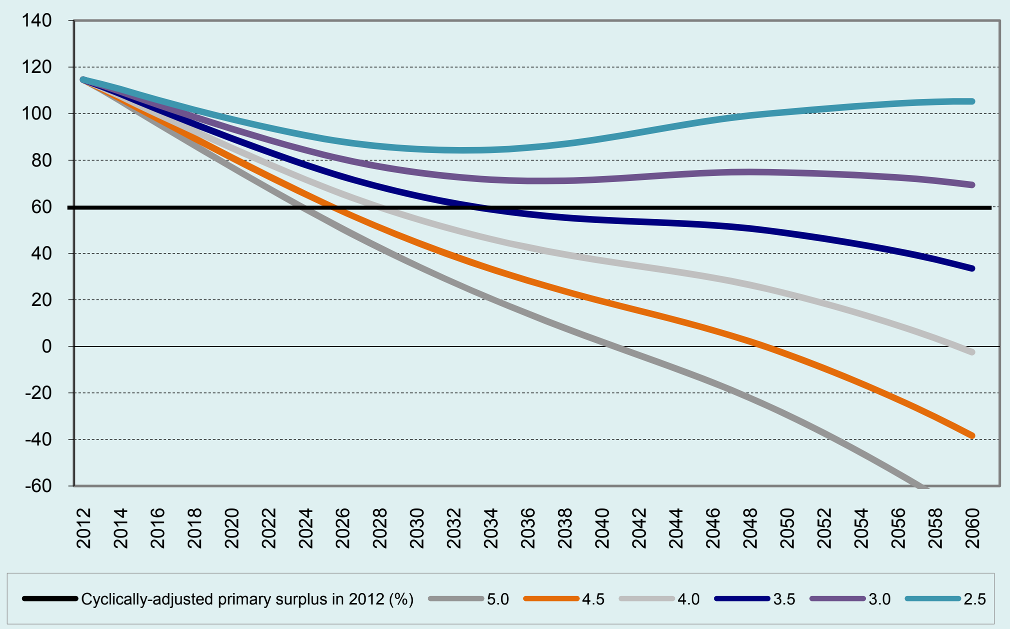
The sensitivity analysis with respect to the primary surplus

The final simulation exercise is aimed at testing the robustness of the results for the sustainability of the public finances with respect to different objectives for the structural primary surplus as of 2012. With different economic-policy scenarios being simulated, the initial value of the structural primary surplus as a percentage of GDP is lowered by 0.5 percentage points in each subsequent case, with the initial value going from a high of 5.0 per cent to 2.5 per cent (Figure 8).

The trend of public debt is altered significantly with the change of the primary surplus as of 2012. In structural terms, for levels of the primary surplus above 3.5 per cent of GDP, the debt-to-GDP ratio decreases monotonically and reaches the threshold of 60 per cent (Figure 8) before 2060. In the case of primary surplus values below 3.0 per cent of GDP, the debt-to-GDP ratio is instead projected to grow over the long term.

The sustainability of public finances thus appears guaranteed in the baseline scenario and by the public finance targets described in this Update.

FIGURE 8: SENSITIVITY OF PUBLIC DEBT TO CHANGES IN THE PRIMARY SURPLUS (percentage of GDP)



VII.4 IMPACT ON SUSTAINABILITY OF THE PENSION REFORMS IMPLEMENTED IN RECENT YEARS

As shown by the sensitivity tests presented in the preceding section, even in the presence of macroeconomic or fiscal conditions different from those reflected in the baseline scenario, the sustainability of Italy's public debt over the long term is not expected to be put at risk by the dynamics of age-related expenditures. It should be noted, however, that this result is the consequence of a series of pension reforms adopted during the last 20 years that significantly contributed to reducing the burden of ageing on Italian public finances.

In order to fully assess the gains in terms of the sustainability of public finances resulting from the adoption of several pension reforms in the recent past, the effects of the measures approved during the 2004-2009 period with reference to pension eligibility have been isolated from the long-term trend of pension expenditure, based on existing legislation. More specifically, the effects of the so-called Maroni Reform[28] (which

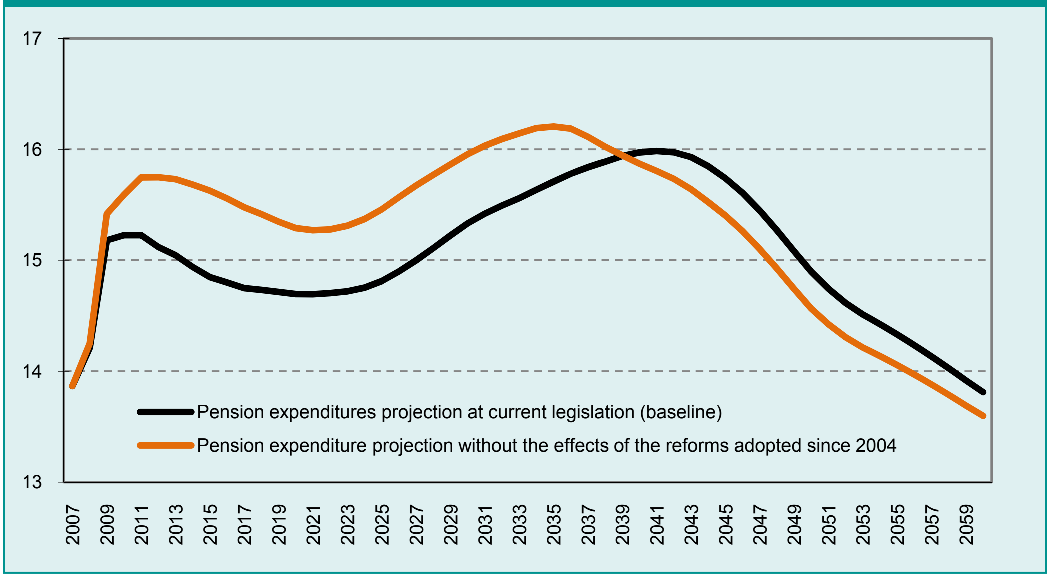
[28] Law No. 243/2004.

increased the minimum age required for early retirement) the Welfare Protocol[29] (which overhauled the system for early retirement), and the increase in the eligible retirement age for women employed in the public sector[30] are isolated from the trend of pension expenditure, based on current unchanged legislation.

Figure 9 compares the trend of pension expenditure as a percentage of GDP for the baseline scenario and the trend that would result in the absence of such reforms. As demonstrated by the graph, the adoption of the pension reforms contributed to reduce the ratio of pension expenditure to GDP by an average of approximately 0.6 percentage points during the first 40 years of the projection period.

The implications of the different reforms on the dynamics of the debt-to-GDP ratio are reported in Figure 10. The debt-to-GDP ratio would continue to fall in the scenario excluding the effects of the reforms adopted since 2004, but it would still permanently be at levels higher than those projected for the baseline scenario and it would not converge to 60 per cent of GDP during the projection period.

FIGURE 9: THE IMPACT OF PENSION REFORMS ADOPTED SINCE 2004 (percentage of GDP)



[29] Law No. 247/2007.
[30] Law No. 102/2009, Article 22-ter, Paragraph 1.

FIGURE 10: THE IMPACT OF PENSION REFORMS ADOPTED SINCE 2004 ON PUBLIC DEBT (percentage of GDP)