



MINISTERO DELL'ECONOMIA E DELLE FINANZE

Combined Report on the Economy and Public Finance *for 2008*

COMBINED REPORT ON THE ECONOMY AND PUBLIC FINANCE FOR 2008

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AND PUBLIC FINANCE
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COMBINED REPORT ON THE ECONOMY
AND PUBLIC FINANCE

Presented by the Minister of the Economy and Finance

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Introduction

Using the convention adopted in 2007, again this year, the Ministry of the Economy and Finance is presenting to the Chambers the report on the estimate of the public sector borrowing requirement and the report on the outlook for the economy (estimates and forecasts) (Article 30, Paragraph 1, of Law n. 468 of 1978 and the subsequent modifications thereto) in the form of a single Combined Report on the Economy and Public Finance (RUEF).

The combining of the two reports, which has been endorsed by the Chambers, is part of an approach that the Government has attempted to apply in order to make the entire series of public finance documents more transparent and more efficient. The RUEF attempts to reconcile, to the best extent possible on the basis of data currently available, the macroeconomic framework and the public finance forecast. All of the forecast data with respect to the economy, revenues and expenditures refer to the political orientation of the Government and the Minister responsible.

This year's RUEF incorporates two changes. First, after outlining the scenario based on unchanged legislation, which contains the baseline forecast of the public accounts and the deficit-to-GDP ratio, the document presents two other hypothetical scenarios which are respectively more optimistic and more pessimistic with regard to the principal uncertainties that weigh upon the scenario based on unchanged legislation; the document thus reflects the use of proper forecasting techniques and it helps readers to place the baseline scenario in perspective. Second, by developing the themes that had been contained in the introductory note signed by the Minister in 2007, the RUEF sets out initial programming considerations in relation to both the main areas of expenditure and the actions that might be undertaken to continue on the path toward balancing the budget.

With the RUEF, the Ministry of the Economy and Finance aims to outline how the scenario will gradually unfold so as to prepare for the drafting, discussion and Parliamentary review of the next Economic and Financial Planning Document (DPEF), the first of the new legislature.

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*Il Ministro
dell'Economia e delle Finanze*

NOTE ON FINANCIAL AND ECONOMIC PROSPECTS

If one does not know to which port he is sailing, no wind is favourable

Seneca, «Lettere a Lucilio», LXXI

The public accounts for 2006 and 2007 recorded better-than-expected results. This is the outcome of an economic policy that rejected a two-step logic (fiscal consolidation first, and then economic growth) in favour of simultaneously pursuing three objectives: economic growth, fiscal consolidation, and social justice.

1. Public accounts move beyond the state of emergency

The situation that the Government of this very brief legislature had inherited could not be accepted lightly: it is a single country, regardless of who governs it. The primary surplus had practically zeroed out, and was lower than its 1992 level. The deficit had exceeded 4 per cent of GDP, thereby cancelling out the arduous public finance consolidation completed in the run-up to the euro in 1997. After having declined since 1994, the debt-to-GDP ratio had once again started to rise. The weight of the primary current expenditure had touched an historical high. Italy had entered the European excessive deficit procedure. With the accounts in the red, Italy was at risk of again facing a spiralling deficit.

The remedy could not be an indiscriminate tightening of the budget because Italy was not - and is not - suffering from its public accounts only. Social disparities and injustice were becoming more pronounced, and economic growth, though showing signs of greater momentum, appeared to be driven by strong global expansion rather than by strengths at a domestic level. A comprehensive series of measures was needed to address expenditure and revenue in detail and simultaneously work on different fronts, dealing with: efforts to prevent the waste of the taxpayers' money; refunding of underfinanced sectors (defence, public works, etc.); fight against tax evasion; and the need for tax relief and the streamlining of regulation. The economic-policy action thus had to be focused not only on bringing the deficit back to a compatible level; in other words, not only on fixing the gears but also on getting the entire car back in order, restoring strength to the economic fabric and solidarity to the social framework. Redistributing income is much more controversial than sticking to painful, but also limited, measures that only act as a brake: the measures need to address the realities of society, the vested interests that are harboured in the niches of tax evasion, in the pockets of inefficiency of public services, and in the den of the protected economy.

The measures taken in mid-2006 that went into effect that same year and the measures contained in the 2007 Finance Law were designed to bring about a rapid change in direction, to halt a deterioration in the accounts that would have led to a currency crisis in the past, and that was eroding the confidence of financial markets, the

European Union and international institutions, and simultaneously deepening the decline of our economy.

As of 2007, with the two budget packages introduced during the year and the drafting of the 2008 Finance Law, it was already possible to take into account that fiscal consolidation was proceeding even better than planned, and thus use the fruits of the success on each of the three fronts of action undertaken since 2006: new social initiatives, expansion of public investments, and greater reduction of the deficit.

The results are available for everyone to see. The net borrowing of the public administration - the most significant aggregate for European requirements - has been more than halved, going from 4.2 per cent of GDP in 2005 to 1.9 per cent in 2007. Italy has by far exceeded the objectives to which it had committed with the European Union, and is on its way to exiting the excessive deficit procedure, holding its head up high. The weight of the public debt has again started to fall.

Contrary to what some pundits have asserted, both revenues and expenditures contributed to the outcome, and in the case of revenues, the key contribution came from the results of the fight against tax evasion. The expansion of primary spending - the weight of which had climbed by almost 2.5 percentage points of GDP during the 2001-2005 five-year period - was stopped and the trend began to turn around. The tax burden on law-abiding taxpayers has not been increased. Simplification measures have reduced the red tape for vast groups of businesses and individuals. The increase in the overall tax burden that appears in the statistics is essentially the by-product of the recovery of revenues from tax evasion as a result of both more effective enforcement and increasing tax compliance. The rise in the tax burden also came from several very specific measures to step up the coverage of future pensions, particularly for people working on temporary contracts.

2. Not just fiscal consolidation

This Report, which marks the premature end of a plan conceived for an entire legislature, provides an account of what has been done for the simultaneous pursuit of social justice, development and fiscal consolidation. Only a few observations will be enough here.

With reference to *social justice*, the initiatives have included: the revival of social housing programmes; the increase of small pensions; the programme to help those situations of poverty that cannot be remedied via tax relief because the income of the individuals involved is already under the minimum thresholds for taxation (the so-called bonus to low-income families); the fiscal measures in favour of working women; and the creation of specific funds in order to assist individuals and families encountering difficulties in the labour market and in social integration.

With reference to *economic growth*, in addition to the reduction of the tax burden and social security contributions on labour (the so-called tax wedge), the measures also included the important reform of taxation on corporate income. Today, entrepreneurs in Italy know that any increase in their earnings will be taxed at a rate of 27.5 per cent, an internationally competitive rate. The resources to finance for several key infrastructures for the country - roads, highways, local transport - were also increased, in some cases sizeably.

With reference to *fiscal consolidation*, the Government addressed two issues left over from the previous legislature, against the backdrop of an ageing population and the consequent imperative of increasing the actual retirement age: the smoothing out of the sudden increase in the retirement age included in a 'delayed-action' measure (the so-

called ‘big step’) and the fixing of an essential aspect of the 1995 pension reform, namely, the revision of the transformation coefficients. The agreed solution, which was reached at the end of lengthy negotiations, increases the age at which individuals are eligible for retirement, while making the shift more gradual, and updates the coefficients, making their future revisions automatic.

3. Controlling expenditures: a different method

In perspective, perhaps the most important aspect of the actions undertaken by the Prodi Government is the position taken with respect to the key issue of public spending, particularly considering that the control over public spending had been seriously loosened in the preceding five-year period, more as a result of the swelling of the bureaucracy rather than the improvement of services to the country.

Increasing spending is easy, but turning back is a rather arduous task for any country. It is particularly arduous in Italy where the spending, net of interest payments on the debt and the outlays for pension benefits, is not excessively high. Local administrations, which have limited fiscal autonomy, account for the bulk of the spending; given that the misspending is sharply concentrated in the country's southern regions, any containment of expenditure risks being immediately perceived as a policy hostile to those regions.

According to the main budgetary and economic indicators, the *quality* and *quantity* of spending must respectively *improve* and *decline*, in order to allow public finance to become a source of economic development and optimism for the economy and society. They must and *they can*: the work completed over the past two years has demonstrated they can. But the experience of any country that has gone further than we have along this long and treacherous path shows that widespread acknowledgement of the issue and of the true nature of the remedies is *conditio sine qua non* for intervening effectively.

The commonplace expression ‘spending cuts’ should be replaced by a ‘bottom-up’ process that would start from an analysis of procedures, a serene and in-depth examination of that 98 per cent of the public budget that fails to command the attention of anyone obsessed by the relatively limited flows covered by the Finance Law. Spending control is not done by the bashing of impatient policymakers (most of which is only verbal), but by the perseverance of good administration, and, from the standpoint of ‘being informed in order to make a decision’, by examining in advance the detailed ways of spending and the organisation of the business units involved, by determining priorities, by reclassifying programme expenditures in order to provide for consistent initiatives, by identifying the best practices in order to make them models for all parts of the public administration, by patiently seeking out the possibilities - already inherent in existing laws and regulations - for setting in motion job mobility, training, and the redistribution of tasks and business units. In the 2007 and 2008 Finance Laws, the issue of control over spending is tackled from these humble, but essential, bases. Some basic indicators and strategies for intervention are already contained in the Green Book on spending and in the works of the Technical Commission on Public Finance; they are instruments that the Prodi Government leaves behind for the next Government.

Initial results seem to justify the method chosen. The growth of primary current expenditure has been slowed down notwithstanding the use of part of the incremental resources coming from the fight against tax evasion. A large part of public spending is decided at a regional and local level, and the provisions of the Internal Stability Pact and

the Healthcare Pact, which are backed by incentives and penalties, have led to a significant slowdown in budget outlays.

4. New clouds over the economy

The deterioration of the international economic cycle following the so-called ‘mortgage crisis’ has shown the extent to which the undeniable improvements logged by Italian industry are still fragile. Many producers are still repositioning themselves in segments with higher value added, and several stories of success show that the challenges of technology and globalisation have been accepted by part of the business world: the improvement of Italy’s trade balance is proof of it. Still, the old shortcomings remain in terms of research and human capital, and the current adjustment has not yet produced a ‘critical mass’. In the past, international turbulence typically negatively affected Italy more than other countries, with the country earning the reputation of being a ‘weak spot’. Today, thanks to its inclusion in the Euro Area, Italy has been spared the ‘nominal’ turbulence (inflation and devaluations) linked to interest- and exchange-rate movements; but it has not been saved from the ‘real’ turbulence (low growth and the standstill of productivity) associated with the country's productive specialisation overly exposed to the increase in competitive pressures stemming from globalisation, while consumer confidence has been dented by sharp increases in the most visible prices (energy and food products), and business confidence reflects the fears from the external environment (threats of recession) as well as those on the domestic front (political instability).

It is reasonable to argue that the current clouds over the global economic outlook reflect something more than a pause in the trend triggered by the sub-prime mortgage crisis. The present situation reflects the combination of two fundamental imbalances, whose correction is necessary and will take a long time: the state of the U.S. economy, which is accumulating foreign debt and is suffering from insufficient public and private savings; the movement of one-third of mankind (China and India) from poverty to prosperity, which is putting pressure on the availability and prices of food and energy products. In terms of the entire global economy, the first situation is causing stagnation, and the second, inflation.

The process of correcting these imbalances has triggered crises and losses in those parts of the financial system that had contributed the most to the excess of spending and debt. This process is anything but over, and the negative developments taking shape in the summer of 2007 could last for a long time, while the communicating vessels for the lack of confidence are amplifying the real effects. A country with a medium-size, open economy such as Italy, with structural weaknesses dating back many years in both the public and private sectors, with a precarious institutional setting, could be affected more than other countries by the turbulence that will inevitably continue to accompany the correction of these fundamental imbalances.

5. 2008 and beyond: the economy is slowing, but the accounts are holding and improving

This Report provides a detailed and transparent account of the changes taking place since the release of the last official projections, which were contained in the Forecast and Planning Report presented in September. The sudden change in the outlook for the international economy inevitably implies a sizeable impact on the country's domestic situation.

The forecast of Italy's growth has been sharply reduced with respect to only a few months ago, from 1.5 per cent to 0.6 per cent, in order to take fully into account the recent information about the international and domestic economy. The forecast is in line with the most up-to-date estimates of leading international institutions.

The new estimates for the current year bring to light the inevitable - albeit, generally marginal - impact of the cyclical slowdown on the public accounts. The deficit is expected to stabilise at 2.4 per cent of GDP. Even though the growth forecast has been cut by more than one-half, the deficit forecast is only slightly higher than that projected in September (2.2 per cent). It is worth looking back to 2005, when, with growth identical to that projected for this year, the deficit-to-GDP ratio was standing at 4.2 per cent. The figures for this year - and only this year - are also affected by the deferral of certain expenditures and some minor revenues previously planned for 2007. Net of these temporary factors (which should run their course in 2008), the negative impact of the slowing down of the economy, and higher interest rates, the 2.4 per cent figure mentioned above is equivalent to 1.9 per cent.

Two other important factors give us reasonable confidence in looking at the months ahead.

First: the estimates are very conservative. In the case of *revenues*, the figures incorporate the incremental taxes recovered during the past two years as a result of the fight against tax evasion, but they do not assume any substantial new recovery of the taxable base. This pessimistic assumption is in line with past practice, but the experience of the past two years shows that strong increases in tax revenues prompted by greater tax compliance are entirely possible if pursued with determination at the political and administrative level and in the form of communication to the public. On the *expenditure side*, the estimates embrace the cautionary assumption that the trend of the excellent results achieved in the past two years (for example, the exceptional containment of the intermediate consumption of the administration) will not only not continue, but will experience some setbacks. However, such a scenario is neither written into the law nor necessarily in the cards: it depends on the determination with which the Government and the administration will act in the new political term. Official projections are more pessimistic than I am on this point.

Considering the very conservative nature of the estimates based on unchanged legislation, the surprises during the year, if any, are likely to be mostly positive. The Report presents and documents an alternative scenario reflecting such a possibility, just as it presents an even less favourable scenario.

Second: based on currently known facts, the slight increase in the deficit projected for 2008 appears to be completely of a transitory nature. The trend based on unchanged legislation for the years after 2008, estimated with equally prudent criteria, shows a deficit with a sharply decreasing profile; indeed, the deficit should come down to well below 2 per cent of GDP. This applies also and more importantly to the structural deficit, which leaves aside the assumptions made about the position over the economic cycle. For the years of 2009, 2010 and 2011, the estimates based on unchanged legislation point to a decline in the structural deficit from 2.2 per cent of GDP (2008) to 1.2 per cent (2011).

Thus, a clear conclusion can be drawn from the new projections: the economic slowdown does not interrupt the fiscal consolidation process orchestrated by the Government. That result is solid and bound to last. Italy firmly remains in a safety zone, and is on the path to a balanced budget despite the end of a favourable economic period.

Additional resources could well emerge, as has regularly occurred during the past two years; but it will only be possible to assess that in the next few months with a careful analysis of the data. The budget completion in June will be the occasion for such verification.

6. An economic-policy dilemma?

Fiscal consolidation is still not completed, and already the deterioration of the cycle seems to present a dilemma for economic policy: should the efforts under way be interrupted with tax cuts and spending increases to prop up the economy, or should the emphasis on fiscal consolidation continue with the risk of further weakening an already weak economy?

Based on three fundamental economic considerations, it is possible to argue that this is a false dilemma.

- *Economic policy can spur growth, not only through public finance measures, but also with measures that enhance competitiveness and the strength of the business sector.* Today, deregulation and the streamlining of the bureaucracy are probably the issues that rank first in terms of fostering Italy's economic growth. If pursued with strength and determination, they will effectively be able to counter the recessionary impulses.
- *If continued, the fight against tax evasion can provide ample resources for reducing the tax burden on law-abiding taxpayers.* The detection of taxable income that is currently concealed from the tax authorities is a gradual process, far from being completed. It is thus possible to assume an elasticity of revenues to GDP such that, even though not as strong as that in the past two years, will be enough to finance the restitution to law-abiding taxpayers of the resources collected from tax dodgers. The effects of such restitution in supporting the economy (via the restoration of confidence and the ending of distortion to competition) would with all probability be greater than the deflationary effects linked to the reduction of the area of evasion. At the same time, such restitution does not conflict with the fiscal consolidation effort, which is linked to spending reductions.
- *The possible savings in primary expenditure would be enough to allow the continuation of the effort to reach a balanced budget.* Such effort means reducing primary expenditure by roughly two points of GDP between now and 2011; in other words, wiping out the increase that blurred the budget equilibrium in the previous political term.

At a *political* level, the commitment to a balanced budget by 2011 is not negotiable with respect to the European Union; public opinion in Italy would judge a relapse into the excessive deficit procedure of the Stability Pact very severely. But it would be an error to consider that commitment as excessively demanding at an *economic* level. The dilemma between rigour and economic growth is false. Just look at what occurred in 2001-2005, when the higher public spending was flanked by a five-year period with the slowest growth in Italy since World War II. The relationships between public spending and the economy are much more complex than what might appear from the notion (unfounded in economic theory as well) of spending as the coal thrown into the furnace of the productive boiler. In the Italian case, some streamlining of the spending that might improve the quality thereof and leave more resources available to the private sector would have supportive, and not restrictive, effects.

7. The road to recovery

The public debt is still more than 100 per cent of GDP, the highest among the countries of the European Union. Every Italian, including newborns, is annually shouldering an interest burden of €1,300; and we cannot even say that we owe the interest to ourselves since roughly one-half of the debt is in foreign hands. Taxes cannot be increased; on the contrary, they should be reduced for taxpayers complying with the law. The sale of assets of the state or territorial entities for the purpose of reducing the debt is still possible, but the major privatisation wave is over and the amounts are limited by now. A family can pawn its jewels and its land holdings, but this is not a solution when spending continues to exceed income.

The only way of pursuing fiscal consolidation is thus through ordinary management, and the challenge - which is today clearer and more compelling than ever - lies in containing and requalifying the spending of the state, the regions and local entities. This means achieving a profound transformation of the public administration.

The Green Book of last September has highlighted the leeway for achieving this objective. There is no need to borrow examples from abroad; in Italy, too, there are areas of excellence in almost every branch of the public administration that show how to supply services that are both better and less costly at the same time. The reclassification of the budget by missions and programmes that was effected last year supplies the knowledge base for initiating 'programme laws' that will streamline the use of resources by overcoming problems related to the lack of coordination, the overlap of responsibilities, and the issue of politically protected turf. At the same time, employing comparisons between the same types of services (hospitals, prefectures, ministerial offices, offices of local administrations and so forth) at the time of the allocation of the resources could contribute to aligning the less cost-effective services with those services that are more efficient. This would be beneficial to public spending, the citizens who are using the services, and the country's economic growth.

The reduction of the weight of primary expenditure must exclude infrastructure investment, which instead needs to be increased. It is also difficult to envision the curtailment of welfare spending targeted by recent measures. The need to focus the control on the remainder of the spending - the spending traditionally linked to the supply of public services - makes the challenge even tougher, particularly since it is an issue of keeping such spending at its current level in nominal terms between now and 2011. Any plan to cut spending must also address expenditures on personnel, inasmuch as they represent the biggest single expenditure category by far within a highly labour-intensive sector such as the public administration. Expenditures on personnel depend on the contracts, the organisation of the work, the distribution of personnel, and the structure of incentives. We must have the willingness, which has often been lacking in the past, to deal with all four aspects: wage containment, organisation without duplication, functional mobility to the services in need, and bonuses for whoever is producing more.

This Report focuses its attention on the public accounts, and thus on that part of economic policy that affects revenues and spending. But if we expand the picture to look at the entire range of actions through which the public sector influences the trend of the economy, then it appears clear that the point of reference, the key target must be raising the level of productivity within our economic system. Only in this manner will it be possible to accelerate growth in a society such as ours, where the population is ageing and not increasing.

Positive developments are already strengthening the warp and the weft of the productive fabric, but productivity increases will be extended to all sectors only if the

path to success is opened up to the more dynamic players by means of a level playing field: the pursuit of market deregulation is encountering resistance from those who operate in protected markets, but it yields immediate benefits to all citizens in the form of lower prices. The pressures for deregulation at home and those for globalisation from abroad are making it even more necessary to improve the social security net, in order to facilitate the shifting of resources from sectors on the decline to those that are expanding. From this perspective, the 2007 and 2008 Finance Laws have intervened with innovative instruments.

The objective of our economic policy cannot be anything but to get Italy's economic growth back to a level above, and not below, the European average. And it is hard to envision that this objective will be reached without the simultaneous pursuit of efficiency in the use of resources, social justice, and a clean bill of health for the public accounts.



Rome, 12 March 2008

1. SUMMARY AND KEY CONCLUSIONS

In one of the briefest administrations in its history as a republic, Italy is at the point of emerging from the excessive deficit procedure initiated by the ECOFIN Council in 2005, fully respecting the consolidation timetable agreed with its European partners and surpassing the objectives to which it had committed.

In 2007, the public deficit was equal to 1.9 per cent of GDP, dropping by 1.5 points compared with 2006 and at its lowest level of the present decade. Various factors contributed to this result: the positive trend of revenues; the containment of primary current expenditure; and the deferral to 2008 of small amounts of revenue and incremental expenditures initially planned for 2007. In 2006-2007, the structural deficit (i.e. net of one-off measures and the effects of the economic cycle) fell by almost 3 points of GDP. In order to see structural containment of this magnitude, one would have to look back to the 1995-1997 period.

At 3.1 per cent of GDP, the primary surplus is back around the levels seen at the start of the decade, thereby making it possible to get the public debt back on a downward trend as a percentage of GDP. The government was thus able to turn the tide of the increasing trend that took shape in 2005, though without having to resort to extraordinary measures.

The efforts to rebalance the public accounts have been pursued in parallel with actions to foster economic development and social justice.

For 2008, the public deficit estimate has been revised down slightly, and is now pegged at 2.4 per cent of GDP compared with the 2.2 per cent projected in September. The change reflects the impact of the significant slowdown in economic growth and the revenue and expenditure deferrals mentioned above. Net of these factors, the deficit-to-GDP ratio would be equal to 1.9 per cent in 2008, i.e. an improvement compared with the previous estimates published in September. From 2008 onwards, the deficit based on unchanged legislation should once again be falling as a percentage of GDP, thus indicating that the fiscal adjustment measures have long-term rather than transitory effects.

Fiscal consolidation is not yet completed. Balancing the structural public budget in 2011 is an indispensable goal for securing satisfactory reduction of the public debt, freeing up resources, and ensuring sustainable growth against an unfavourable demographic backdrop. It is also an objective that is not negotiable as far as the European Union is concerned¹.

In order to balance the budget, it will be necessary to achieve an additional correction of the deficit based on unchanged legislation of roughly half of one per cent of GDP per year during the 2009-2011 period, or around €20 billion, a figure that is well below that realised in two years by the departing government. The correction should be

¹ It should be noted first that the 2011 deadline was accepted by the ECOFIN Council in Berlin as an exception with respect to the commitment of the other countries to bring forwards the balancing of the budget to 2010.

achieved via the containment of the primary current expenditure in order to prevent the tax burden from increasing and to be able to continue reducing it for law-abiding taxpayers by using the incremental resources recovered through the fight against tax evasion.

In order to prevent negative repercussions on the delivery of public services, the containment of the spending will need to be accompanied by an increase in the quality and the efficiency of the expenditure. It would be desirable if certain initiatives already in process namely, the sweeping restructuring of the public budget, the spending review, and the progressive alignment of administrative management to best practices, will continue towards that end. Spending on public-sector payroll, which accounts for almost one-third of the primary current expenditure, should also be made consistent with the financial objectives, albeit without abandoning specific initiatives for improving labour productivity, including through further incentive mechanisms.

GDP grew by 1.5 per cent in real terms in 2007. Growth for the current year is projected at 0.6 per cent, and has been revised significantly downward with respect to the latest official estimates published in September. The downturn in the international economy, which became even more evident in the final months of 2007, is taking a greater toll on Italy's economy than on the economies of other European countries.

Several structural problems remain unresolved and are translating first and foremost into insufficient productivity growth. The economic slowdown can be short-lived provided that the country acts promptly to make use of its potential, continuing along the road of reform in order to open markets and increase competition, to augment the productivity of the private and public sectors, and to lighten the tax burden for law-abiding taxpayers, thereby bolstering income and household consumption.

Macroeconomic overview

Following the sharp acceleration in 2006, the Italian economy grew at a rate above its potential for the second consecutive year: GDP expanded by 1.5 per cent in 2007, thus remaining below the estimates contained in last September's Forecast and Planning Report (RPP) (1.9 per cent) and the Economic and Financial Planning Document (DPEF) published in June (2.0 per cent).

The prospects for the Italian economy are affected by the major uncertainty hovering over the international scenario, and especially the outlook for the financial markets. The turbulence that erupted in August as a result of the sub-prime mortgage crisis in the United States has not yet dissipated. After declining in the autumn months, the equity market's volatility became markedly more pronounced worldwide at the start of the year. The price of oil rose sharply in the second half of 2007, and has peaked at more than USD 100/barrel over recent weeks.

Recent turbulence in international financial markets could have indirect effects on the Italian economy that would add to the negative exogenous factors already at play, namely: (i) the substantial increase in the prices of energy products paired with strong dependence on energy imports; (ii) the appreciation of the euro against the world's other leading currencies; (iii) the increase in interest rates occurring during the past two years; and (iv) the international tensions on the prices of food products which, together with the tensions on oil products, have pushed inflation higher.

According to current projections, Italy's real GDP growth should be around 0.6 per cent in 2008, thus falling well below the 1.5 per cent estimated in the RPP in September. Instead, the growth profile for the medium term should be only slightly below previous projections: the average annual growth in 2009-2011 should be 1.5 per cent versus the previous forecast of 1.7 per cent.

TABLE 1.1: ITALY'S MACROECONOMIC OVERVIEW

	2005	2006	2007	2008	2009	2010	2011
MACRO DATA - ITALY (VOLUMES)							
GDP	0.6	1.8	1.5	0.6	1.2	1.5	1.7
Imports	2.2	5.9	4.4	3.0	3.7	4.0	4.4
Final consumption	1.2	1.0	1.4	0.8	1.1	1.4	1.6
- Households consumption	0.9	1.1	1.4	0.9	1.4	1.7	1.8
- Government and NPISH consumption	1.9	0.9	1.3	0.7	0.5	0.7	1.0
Gross fixed investment	0.7	2.5	1.2	0.7	1.4	1.7	1.9
- Machinery, equipment and other	0.9	3.5	0.2	0.4	1.8	2.3	2.8
- Construction	0.5	1.5	2.2	1.0	1.0	1.0	1.0
Exports	1.0	6.2	5.0	2.9	3.7	4.1	4.5
<i>Memo item: Current account of balance of payments as % GDP</i>	-1.5	-2.6	-2.2	-2.1	-1.7	-1.3	-1.1
COMPONENTS CONTRIBUTING TO GDP GROWTH							
Net exports	-0.3	0.1	0.1	0.0	0.0	0.0	0.0
Inventories	-0.2	0.5	0.0	0.0	0.0	0.0	0.0
Domestic demand, net of inventories	1.0	1.3	1.4	0.7	1.2	1.5	1.7
PRICES							
Import deflator	6.2	7.6	2.3	3.5	2.1	1.9	1.9
Export deflator	4.0	4.5	3.6	3.3	3.1	2.7	2.2
GDP deflator	2.1	1.7	2.3	2.9	2.1	2.0	1.9
Nominal GDP	2.6	3.6	3.8	3.6	3.3	3.5	3.6
Consumption deflator	2.3	2.7	2.2	2.7	2.1	1.9	1.8
Inflation (planned)	1.6	1.7	2.0	1.7	1.5	1.5	1.5
LABOUR							
Labour cost	3.2	2.5	1.9	4.1	1.8	2.1	2.1
Productivity (measured on GDP)	0.4	0.1	0.5	0.1	0.6	0.9	1.0
Unit labour costs (measured on GDP)	2.8	2.3	1.5	4.0	1.2	1.2	1.1
Employment (FTE)	0.2	1.7	1.0	0.5	0.6	0.6	0.7
Unemployment rate	7.7	6.8	5.9	5.7	5.6	5.5	5.3
Employment rate (age 15-64)	57.4	58.4	59.1	59.5	59.9	60.4	60.9
<i>Memo item: Nominal GDP (absolute value in Mn)</i>	1,428,375	1,479,981	1,535,541	1,590,366	1,642,717	1,700,769	1,761,518

Public finance in 2007

ISTAT estimates that the net borrowing for 2007 came down to €29.2 billion, or 1.9 per cent of GDP. It is the lowest value of the current decade, 0.9 points below the initial target agreed with the European Union, and 0.5 points below the forecasts published in September².

In 2006-2007, the overall reduction of the deficit-to-GDP ratio was 2.3 points of GDP (Table 1.4). In structural terms, the adjustment was 2.9 points of GDP.

² The target agreed with the European Union is indicated in the Update to Italy's Stability Programme published in November 2006.

Net of one-off measures, the deficit-to-GDP ratio declined from 3.0 per cent in 2006 to 1.7 per cent in 2007. If the impact of the economic cycle is also excluded, the ratio goes from 2.9 per cent to 1.6 per cent.

TABLE 1.2: GENERAL GOVERNMENT CONSOLIDATED ACCOUNT

	2006	2007		2008		2009	2010	2011
	Actual	Actual	RPP	RUEF	RPP	RUEF	RUEF	RUEF
Total revenues	679,840	724,246	722,260	746,458	749,145	767,556	794,837	821,102
% GDP	45.9	47.2	46.8	46.9	46.7	46.7	46.7	46.6
- taxes	433,714	459,888	458,254	470,810	472,487	484,004	503,636	521,389
% GDP	29.3	29.9	29.7	29.6	29.4	29.5	29.6	29.6
Total expenditures	729,474	753,425	758,618	785,181	784,554	802,432	823,893	846,630
% GDP	49.3	49.1	49.1	49.4	48.9	48.8	48.4	48.1
- current	655,466	684,932	691,023	719,086	722,002	731,681	753,590	775,234
% GDP	44.3	44.6	44.8	45.2	45.0	44.5	44.3	44.0
- current, net of interest	587,222	608,206	616,489	639,779	643,702	650,700	671,101	690,431
% GDP	39.7	39.6	39.9	40.2	40.1	39.6	39.5	39.2
- interest	68,244	76,726	74,534	79,307	78,300	80,981	82,489	84,803
% GDP	4.6	5.0	4.8	5.0	4.9	4.9	4.9	4.8
Primary balance	18,610	47,547	38,176	40,584	42,891	46,105	53,433	59,275
% GDP	1.3	3.1	2.5	2.6	2.7	2.8	3.1	3.4
Current account balance	19,900	34,700	26,677	22,264	22,376	30,323	35,652	40,232
% GDP	1.3	2.3	1.7	1.4	1.4	1.8	2.1	2.3
Deficit	-49,634	-29,179	-36,358	-38,723	-35,409	-34,876	-29,056	-25,528
% GDP	-3.4	-1.9	-2.4	-2.4	-2.2	-2.1	-1.7	-1.4
Deficit as % of GDP, net of one-off measures based on unchanged legislation	-3.0	-1.7	-2.6	-2.5	-1.9	-2.2	-1.7	-1.5
Cyclically adjusted deficit net of one-off measures as % of GDP, based on unchanged legislation	-2.9	-1.6	-2.3	-2.2	-1.7	-1.7	-1.4	-1.2
Public debt as % of GDP based on unchanged legislation	106.5	104.0	105.0	103.0	103.1	101.8	99.6	97.1
Nominal GDP	1,479,981	1,535,540	1,543,823	1,590,366	1,605,043	1,642,717	1,700,769	1,761,518

For the second consecutive year, the growth of revenues outpaced the growth of nominal GDP and other key economic aggregates. The tax burden reached 43.3 per cent of GDP.³

The increase in the aggregate tax burden in the most recent two years mostly reflects the success achieved with the efforts to fight tax evasion. Though exercising the caution due when making these types of assessments, it is possible to estimate that the incremental revenues in 2006-2007 not related to cyclical developments or to fiscal measures are equal to more than 1.0 per cent of GDP (or more than €20 billion)⁴. The increase is mainly due to the efforts directed towards both fighting tax evasion and securing a spontaneous increase in tax compliance.

³ The tax burden would decline to 42.5 per cent of GDP if the computation were to exclude (i) the deductions granted to low wage earners not paying taxes and the elimination of the payments made by tax collection agents, both of which were booked as incremental expenditures in accordance with the account principles applied; and (ii) the payments of severance indemnity pay to the social security administration, since they do not represent any additional burden for the taxpayer.

⁴ See the Report of the Minister of the Economy and Finance to Parliament about the results of the fight against tax evasion in 2007.

Since an estimate of the underground economy is already included in GDP, the recovery of revenues automatically translates into an increase in the aggregate tax burden as measured by the ratio of tax revenue to GDP. This is obviously a different type of increase vis-à-vis any increase resulting from changes in taxation policy (for example, by an increase of the legal income tax rates). It does not represent any increase of the tax burden as far as law-abiding individuals and businesses are concerned, but it simply reflects the higher revenues paid by those taxpayers who were paying only part of the taxes due or nothing at all.

In addition to economic growth and the revenue recovered from tax evaders, the trend of tax revenues and social security contributions has been influenced by: the detection of black-market labour; the increase in pension contributions for several categories of part-time and/or temporary workers; the application of the automatic mechanisms contemplated for those regions not in line with the Healthcare Pact objectives; and the independent decision by certain municipalities to raise local taxes (rather than reduce spending) in order to comply with the Internal Stability Pact.

For the second consecutive year, the growth of the current expenditure net of interest shows a slowdown with respect to the past. The aggregate grew by 3.6 per cent (the average annual growth for 2006-2007 was 3.4 per cent), and thus decelerated compared with prior years (the average for the 2001-2005 period was 5.1 per cent). In real terms, the average annual growth was 1.4 per cent for the most recent two-year period (and was thus less than GDP growth) whereas in the preceding five-year period, the corresponding figure was 2.2 per cent.

This significant result is the by-product of several factors, namely: the specific measures contained in the most recent Finance Laws; rigorous administrative control over disbursements; and the deferral of a portion of the contractual renewals for public sector workers.

Looking at the key components of public expenditure, the growth of public-sector payroll is a moderate 1.1 per cent. The trend reflects first and foremost the non-renewal during the year of a portion of the public sector contracts with reference to 2006-2007 (such contracts are to be finalised in 2008, with a large increase in the 2008 expenditure projected as a result). An estimated 0.5 per cent decrease in the number of public sector workers also contributed, and is the consequence of hiring limitations, measures to streamline the workforce in the schools, and the containment of employment in the healthcare field and on the part of local entities.

After coming to a sharp halt in 2006, intermediate consumption rose only modestly in 2007, mainly due to the containment of spending on healthcare, which was up overall by less than 1 per cent on an annual basis, thereby substantially in line with the Healthcare Pact objectives. Adjusting the figure for several accounting effects (mostly related to the accounting method used for booking the contractual charges), the average annual change for 2006-2007 would be roughly 4.0 per cent compared with roughly 6.5 per cent for 2001-2005. The moderation reflects the effectiveness of the measures for reinforcing the standards of accountability at a regional level and the regulations for ensuring compliance with the Healthcare Pact, including the disincentive of automatic fiscal adjustments should the regions not cover deficits in the healthcare sector.

The expenditure for interest on the public debt has risen sharply, going from 4.6 to 5.0 per cent of GDP, for the effect of the increase in interest rates in the Euro Area.

The structural conditions of public finance achieved through the containment of the deficit in 2006-2007 will make it possible to meet the challenges of the difficult cyclical situation by fully using the automatic stabilisers.

The outlook for public finance in 2008 based on unchanged legislation

The public finance scenario for 2008 incorporates the downward correction of estimated real growth of the Italian economy's GDP, which shifts from 1.5 per cent (as of September 2007) to the current projection of 0.6 per cent. Accordingly, based on estimates of the sensitivity of the public deficit to the economic cycle and the new growth projections, the deficit is expected to increase by roughly 0.5 percentage points of GDP exclusively as a result of the expected economic developments.

Despite this, the deficit is estimated to total 2.4 per cent of GDP, or just 0.2 points higher than the previous estimate published in September.

The current forecast reflects various factors. In terms of revenues, the figure incorporates an increase in taxes due to the greater level of tax compliance seen in the most recent two-year period, but, for the sake of keeping the forecast conservative, it does not include any further expansion of the taxable income base. The structural carryover of the higher revenues in the final quarter of 2007 should partially offset the reduction due to the cyclical slowdown of the economy and the decision of many businesses to defer the 2007 deductions for the regional tax on productivity (IRAP) to the 2008 balance. The rate of growth estimated for the current year is also affected by the reduction of real estate taxes (ICI) approved under the 2008 Finance Law. In terms of expenditures, the deferring of several items from 2007 to 2008, as provided by the September Decree-Law, is offset by a downward revision of the trend of primary current expenditure based on unchanged legislation.

The primary current expenditure is also influenced by the planned renewal of all outstanding public sector labour contracts, most of which refer to the 2006-2007 period and a few leftover from 2002-2005. The forecasts of public-sector payrolls already incorporate the effects of the contract renewals and the payment of the related amounts in arrears, also assuming a slight reduction (-0.1 per cent) of employment. Altogether, compensation to employees in the public sector for 2008 is forecast to grow by 6.3 per cent.

The estimate of the structural deficit remains unchanged, and is thus expected to equal 2.2 per cent of GDP for the current year. Compared with 2007, there is a slight deterioration of roughly 0.6 points of GDP. The increase is almost entirely due to the deferral of incremental expenditures and lower revenues to 2008, as previously mentioned; even though such amounts are classified as 'structural', they are non-recurring items. Net of such amounts, the structural deficit based on unchanged legislation would be unchanged in 2008 compared with 2007 (see Paragraph 3.1.3).

Thus, it is not a true structural setback inasmuch as the changes do not appear again in the years subsequent to 2008. Indeed, the projections based on unchanged legislation for the years thereafter show that the deficit-to-GDP ratio, including in structural terms, will gradually decline towards levels well below 2 per cent.

Forecasting uncertainties and possible expenditures for 2008

The estimation of revenues and expenditures based on unchanged legislation is subject to some elements of uncertainty, which vary according to the account involved. The forecast aims to be the best possible with the information available at present and the correct representation of the implications of the prevailing legislation, but it could be revised in light of new information that could emerge during the year.

Building on the main forecast based on unchanged legislation, it is possible to construct two alternative scenarios that highlight the elements of uncertainty and attempt to measure them. In one case (*continuity* scenario), it is assumed that there will be positive surprises, with a continuation in 2008 of the trends recorded in 2006-2007. In the other case (*rebound* scenario), it is assumed that those same trends will be reversed to an extent greater than that already incorporated - for the sake of prudence - in the main forecast based on unchanged legislation.

The *continuity* scenario specifically assumes:

- A recovery of tax revenue from the fight against evasion;
- A trend in public-sector payrolls that is more in line with that observed in the past five years with regard to the amounts not affected by contract renewals;
- Lower expenditure for interest as a result of a more favourable trend of interest rates;
- A more limited capacity for investment spending, in line with that observed in the past, in particular for the National Road Board (ANAS).

The rebound scenario specifically assumes:

- A further increase in expenditure for interest;
- A trend of intermediate consumption that is back at the levels seen during the first years of the decade.

TABLE 1.3: GENERAL GOVERNMENT NET BORROWING

	Continuity Scenario	Unchanged Legislation	Rebound Scenario
Total revenues	47.2	46.9	46.9
Total expenditures	49.2	49.4	49.5
Net borrowing	-2.0	-2.4	-2.6

In both scenarios, the macroeconomic framework assumed remains unchanged (see Paragraph 3.1.3 for a description as to how the scenarios were built). Therefore, the only changes considered are those impacting the structural deficit, namely, the deficit net of the effects of the economic cycle.

All of these revenue and expenditure elements when taken as a whole could cause the deficit-to-GDP ratio to shift to 2.0 per cent in the continuity scenario and to 2.6 per cent in *rebound* scenario.

A second type of element to be considered is 'possible expenditure'. Using the classification already presented in the 2008-2011 DPEF, such expenditures (or reductions

of taxes) may be placed into three principal groups: (i) 'signed commitments', for which there is reasonable certainty of the expenditure being realised; (ii) 'customary obligations', for which the amount is less certain, but which will presumably be acted upon, at least partially; and (iii) 'possible new initiatives'. If at present it is possible to rule out new initiatives that have been adequately planned so as to be able to be realised in 2008, and if there are no unfunded signed commitments, it is the customary obligations that need to be considered for possible additional expenditures. Such obligations primarily refer to service and programme contracts for the Italian State Railways. Though the quantification of the related expenditure is now being determined with the companies involved, the additional resources could amount to a maximum of €1.5 billion.

The renewal of contracts for public sector employees for 2008-2009 is an additional issue. The 2008 Finance Law has not made any advance appropriation of the resources needed for renewing the contracts. The decision is based on (i) the plan to negotiate with the unions in order to discuss the issue of financial resources together with the rules for their distribution, and (ii) the opportunity of finalising a contract agreement for a three-year period. The negotiations have been suspended in light of the recent political developments. As economic resources for public sector contract renewals must - by law - be funded by special appropriations contained in the Finance Law, it does not currently appear probable that there will be any additional expenditures to be incurred in 2008 for the contract renewals for the 2008-2009 period.

Taking into account all of the risk factors arising from the elements of uncertainty and possible expenditures, it can be concluded that there are no additional resources to be used in 2008 as based on the information currently available.

Trends and objectives for 2009-2011

Italy's public debt is still in excess of 100 per cent of GDP. If it were to be on a level par with that of other countries within the Euro Area, the country's interest burden would annually be some €30 billion less. Such savings could therefore be used for reducing taxes, making investments in infrastructures and research, the financing of social policies, and more rapidly reaching balanced budget. Completing the fiscal consolidation effort by 2011 is essential for: quickly reducing the debt-to-GDP ratio; tackling the upward pressure on healthcare/assistance spending caused by the gradual ageing of the population; and supporting economic growth.

At the same time, the new policy scenario will have to consider the current economic conditions. While the adjustment has been greater than contemplated in 2006 and 2007, the current, pronounced economic slowdown is a strong argument for refraining from introducing policies that could further depress economic performance in the near term.

Against this backdrop, and fully in accordance with the current interpretation of the Stability and Growth Pact, the public finance objectives need to be set in structural terms, i.e. net of one-off measures and cyclical effects. Economic policy therefore needs to be focused on structural adjustment, leaving the automatic stabilisers free to act on their own.

The projections for public finance based on unchanged legislation suggest incremental improvement of the deficit-to-GDP ratio in 2009-2011. The ratio is equal to 1.4 per cent in the final year of the forecast.

In terms of the policy scenario, the achievement of a structural balance for the public accounts in 2011 calls for an additional correction with respect to the unchanged legislation scenario; such correction is equal to roughly 0.4 points of GDP per year, or roughly €20 billion in total over the 2009-2011 period.

	2005	2006	2007	2008	2009	2010	2011
TABLE 1.4: PUBLIC FINANCE – POLICY SCENARIO AND SCENARIO BASED ON UNCHANGED LEGISLATION							
NEW FORECAST BASED ON UNCHANGED LEGISLATION							
Net borrowing (% of GDP)	-4.2	-3.4	-1.9	-2.4	-2.1	-1.7	-1.4
Net adjustment 2009-2011 (amount)					4.500	6.500	9.500
Net adjustment 2009-2011 (% of GDP)					0.3	0.4	0.5
UPDATED POLICY SCENARIO							
Net borrowing (% of GDP)	-4.2	-3.4	-1.9	-2.4	-1.8	-1.0	-0.2
Structural balance (% of GDP) (1)	-4.5	-2.9	-1.6	-2.2	-1.5	-0.7	0.0
Change in structural balance (% of GDP)		-1.6	-1.2	0.6	-0.7	-0.7	-0.7
Public debt (% of GDP)	105.8	106.5	104.0	103.0	101.5	98.7	95.0
<i>Memo item: POLICY SCENARIO IN 2007 RPP</i>							
Net borrowing (% of GDP)	-4.2	-4.4	-2.4	-2.2	-1.5	-0.7	0.0
Structural balance(% of GDP) (1)	-4.1	-2.8	-2.3	-2.1	-1.3	-0.6	0.1
Change in structural balance (% of GDP)		-1.3	-0.5	-0.2	-0.8	-0.7	-0.7
Public debt (% of GDP)	106.2	106.8	105.0	103.5	101.5	98.5	95.1
1) Structural: net of one-off measures and cyclical component.							

The measures required for such correction need to be considered alongside those for funding the likely new expenditures excluded from the forecast based on unchanged legislation. Considering the preliminary indications about items such as the renewal of the contracts for public sector workers and other expenditures that would be difficult to defer, it is possible to quantify the additional expenditures that will probably have to be covered at no less than €3-4 billion per year, or €10-12 billion for the three-year period.

Overall, therefore, budget policy will have to tap resources of between €20 billion and €30 billion for 2009-2011. Such sums exclude the effects of any measures to reduce the fiscal burden that are not financed with the proceeds from the fight against tax evasion.

Such a policy would map out a more virtuous path towards driving down the balance of the public debt, which would end up at 95.0 per cent of GDP at the end of the period.

A narrow path toward a balanced budget

Fiscal consolidation is facilitated by economic growth, and impeded by stagnation. Today, Italy is coping with a major slowdown in growth. The stagnation of income, accompanied by rising prices for commodities and food products, is mainly striking the weaker levels of society, which are already feeling the effects of several years without any change in real wages as a result of the standstill in productivity.

In such circumstances, an impulse to productivity growth is needed, however without interrupting the process of fiscal consolidation. The path towards a balanced

budget is narrow. The range of choices is limited by the already relatively high tax burden. Joint action is needed on three fronts:

- Perseverance in the fight against tax evasion, with the restitution of the amounts collected to law-abiding taxpayers;
- Containment of public spending, while also improving its quality;
- Resurgence of productivity, including through new income policy.

Fight against tax evasion and reducing the tax burden

The issue of taxation in Italy presents an underlying anomaly: the aggregate tax burden is in line with the average for other European countries while the tax burden on those taxpayers fully in compliance with the law is abnormally high. This anomaly can be explained by unusually high rates of tax evasion and tax avoidance in Italy. The actual tax burden is thus borne by a limited group of taxpayers. According to ISTAT estimates, the underground economy represents roughly 17 per cent of GDP, and the estimates of evasion available about different tax categories suggest even higher percentages. They are levels that are 2-3 times above those observed in the largest European nations, and up to 4 times higher than those of the best performing countries. Tax revenues lost through tax evasion and tax avoidance are at least equal to 7 per cent of GDP, meaning a loss of more than €100 billion per year. Despite the success obtained in the past two years (the estimates indicate the recovery of some €20 billion of revenues), getting evasion back to the levels prevalent in other countries would mean recovering tens of billions of euros overall.

Given the public finance constraints indicated above, it is clear that it is essential to continue fighting evasion with determination so that the tax burden can be significantly lowered and rebalanced.

With the widespread presence of small business in Italy and the existence of both dynamic and stagnant sectors, the tax policy needs to tackle jointly the issue of simplification of tax compliance and the pace at which to proceed, without moving too hastily. The point of equilibrium where the tax system needs to position the marginal firm is to be evaluated carefully, taking into account not only the necessary return to legality, but also economic sustainability.

In coming up with a policy to return the taxes collected from fighting tax evasion, two elements should be considered. First: getting evasion back to levels comparable to those of other countries is a medium-term objective, and it is improbable that the process of getting there can continue at the same pace of the past two years, since the fight becomes more difficult as the authorities get closer to the root of the problem. Instead, it is worth underscoring the difficulty alone in preserving the successes achieved to date; as shown by experience, such successes can be quickly erased. Second: the difficulties of estimating the recovery of taxes not paid as a result of evasion, even after the fact, means caution is needed in planning the related measures for returning such funds to the taxpayers at large, in order to avoid compromising the sustainability of public accounts.

Structural containment of expenditure

Proceeding with the containment and requalification of public spending is a difficult undertaking. It requires strong political will, continuity of action, perseverance in the activity of administrative control, the simplification and improvement of the transparency of the State Budget, and the cooperation of trade unions and local

government. The scope of the correction required is such that it makes it necessary to involve all levels of government (central, local and territorial administrations, and healthcare entities), coming up with regulations and control systems whose effects increase over time.

The containment of public spending in the short term is also difficult because a large part of the expenditure (interest on the debt) is not under the direct control of policymakers, is obligatory in nature and has only recently undergone structural change (social benefits), or is safeguarded in order to favour economic growth over the long term (investments and research).

Assuming no changes in social spending and public investments, and considering that the expenditure for interest is out of the government's control, the structural correction of €20-30 billion as outlined above would be applied to the remaining current expenditure: roughly €340-350 billion, that is divided between intermediate consumption (roughly one-half of the amount), public-sector payrolls (one-third), other current expenditures (15 per cent), and production subsidies (roughly 5 per cent). Such aggregate could experience only slight increases in nominal terms as from 2009. In order to appreciate the firmness of this approach, it is noted that the forecast growth of this component of expenditure based on unchanged legislation for the next three years is currently around 2.0 per cent (without considering any expenditures which the State cannot put off) while the average annual growth over the 2001-2005 five-year period was above 5.0 per cent.

A correction of the trend of current expenditure can be accompanied by improvement in the quality of public services, only if two guiding principles are followed simultaneously: the first is the gradual alignment to best practices; the second is reining in the trend of public-sector payrolls⁵. As far as the first principle is concerned, the analyses contained in the *Green Book on Public Expenditure* and the works carried out by the Technical Commission on Public Finance highlight the extent of the differences between administrative units within various areas (the State's peripheral administrations and local entities, universities, schools, courts, etc.). Increasingly aligning all units to the operating standards achieved by the units with the best performance in terms of operating efficiency and quality of the services offered means improving performance while spending less. As to the second principle, there are no examples of any countries that have effectively halted public spending without slowing the trend of the total compensation of public sector employees, the predominant element of any country's public expenditure. In addition to contract renewals, the trend of the compensation to public sector employees also depends on effective management of human resources, the level of the employment in the public sector, and the organisational structure of the administrations.

The actions outlined above can be facilitated by: continuing the effort to improve the planning and management of the resources available in the budget; making the budget more flexible; making spending centres more accountable; shifting to multi-year planning of the resources; and simplifying spending legislation. The new classification of the State Budget allows for (i) defining one or more 'programme laws' by unifying existing

⁵ Such issues are discussed in detail *Green Book on Public Expenditure*, MEF, September 2007.

financing regulations, and (ii) aligning spending programmes and administrative units through the identification of 'programme coordinators'.

In conclusion, the fight against tax evasion, the containment and requalification of public spending, tax burden reduction, and the revival of productivity represent the pivotal, but inseparable, elements of an economic policy that foster economic growth within a fiscally sustainable framework.

2. THE ECONOMY

2.1 OVERVIEW OF THE GLOBAL ECONOMY

In 2007 the world economy's GDP growth rates were still buoyant, mainly thanks to the strong expansion of China (11.4 per cent a year), Russia (8.1 per cent a year) and India (about 9.0 per cent a year).

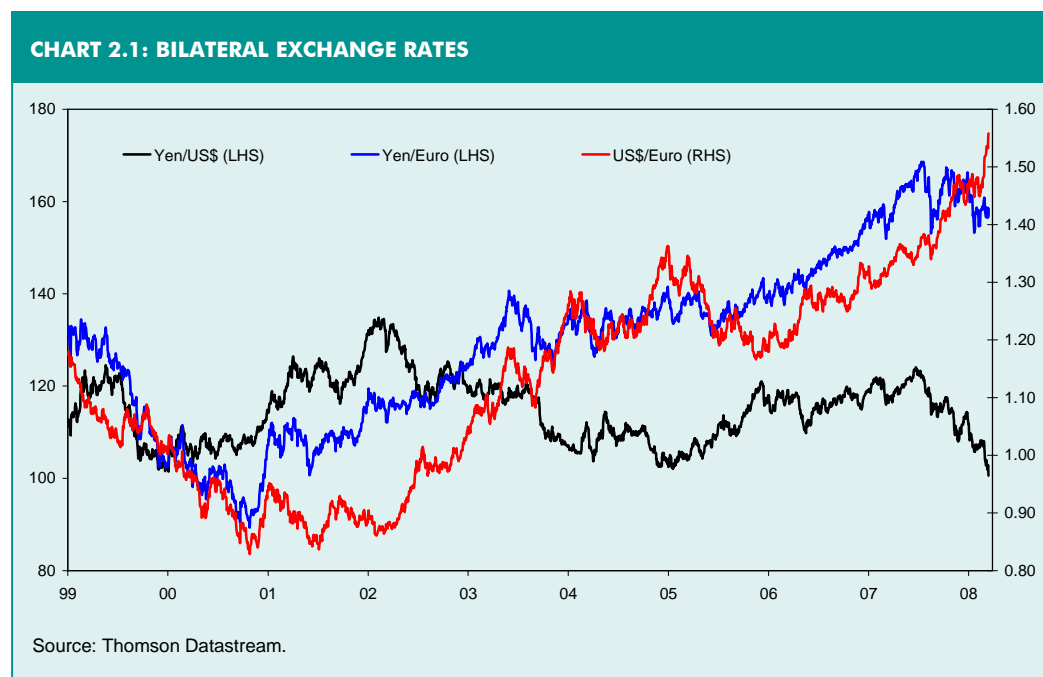
The strong growth of these countries contributed to pushing up oil prices that reached a yearly average of \$72.5 a barrel. Also food prices increased due to greater demand from newly industrialised countries, rising transportation costs and the use of certain varieties of grains for the production of biofuels. All this gave rise to inflationary pressures that were mainly felt at the end of 2007.

The economic scenario has been troubled since August by the subprime mortgage crisis that has contributed to a gradual slowdown, with economic and financial consequences for the whole world. Central banks have promptly stepped in to inject liquidity into financial markets.

According to estimates, the growth rate of the world economy stood at 4.9 per cent in 2007, slightly lower than in 2006. World trade is also reported to have suffered a marginal slowdown in 2007 (6.9 per cent as against 9.3 per cent in 2006).

Gross domestic product in the US grew by 2.2 per cent in 2007, thus recording a 0.7 percentage point reduction compared to the previous year as a result of three main factors: a drop in residential housing construction activity, the impact of a weaker housing market on domestic demand and the subprime mortgage crisis. The latter caused a home mortgage credit crunch. According to the *Senior Loan Officer Opinion Survey on Bank Lending Practices* of the *Federal Reserve*, 55.0 per cent of banks tightened mortgage lending standards and terms. On the demand side about 60 per cent of banks noticed a drop in the demand for home mortgage loans. In addition, between early June 2007 and the beginning of March the main US stock-market indicators showed a decreasing trend, with losses of over 10 per cent.

As a result, the Federal Reserve stepped in and reduced the fed funds rate from 5.25 per cent in September 2007 to 3.0 per cent at the beginning of 2008. The labour market recorded an increase in the unemployment rate and consumer prices exceeded 4.0 per cent compared to the previous twelve months. The dollar weakened vis-à-vis the euro reaching values slightly below 1.50 by the end of 2007.



In 2007 the euro area grew at a rate of 2.6 per cent, in line with 2006, despite the slowdown in the fourth quarter. In the first three quarters, the rate of growth of household consumption decreased, reflecting the drop in consumption in Germany, where retail sales in December 2007 went down by 7.0 per cent compared to the previous year, even though they recovered somewhat in January 2008. The modest growth in consumption in Germany was partly affected by the increase in VAT in January 2007 and by an upward trend in household savings. Conversely, manufacturing in the euro area grew by 3.4 per cent in 2007, despite the slowdown in the latest quarter. The unemployment rate decreased from 7.7 per cent in January to 7.1 per cent in December. As to prices, consumer-price inflation has exceeded 2.0 per cent since September as a result of the strong increase in food and energy prices.

The US subprime mortgage crisis has caused business credit tightening also in the euro area¹. Moreover, net demand for business loans has suffered only a modest slowdown, whereas household demand for both consumer lending and home mortgage loans has dropped remarkably. The euro area stock market has also recorded a significant slowdown compared to last June's highs (-20.0 per cent approximately).

The ECB has left its reference interest rate unchanged at 4.0 per cent since June 2007.

The Asian economies grew briskly, mainly led by China (11.4 per cent in 2007) following a pick-up in export and investment growth, and by India, where domestic demand was robust. However, that part of the world has also been affected by the US

¹ The index gauging net credit tightening went up from 31.0 per cent to 41.0 per cent in the fourth quarter of 2007, according to *The Euro Area Bank Lending Survey* of the ECB.

subprime mortgage crisis, as Asian stock markets have also been hit by the uncertainty caused by financial turbulence.

Growth in Japan was 2.1 per cent in 2007 thanks to the positive data of the latest quarter that were supported by factors that will not repeat themselves. Business investment and exports grew by 2.9 per cent compared to the third quarter. However, private residential investment suffered a marked drop (-9.1 per cent) due to the review last June of the *Building Standard Law*. Consumer-price inflation turned positive in October (0.3 per cent compared to the same month of the previous year) and then reached 0.7 per cent in December 2007 following the increase in energy prices. In the meeting of March 6, the Bank of Japan kept the target interest rate at 0.50 per cent; that percentage has remained unchanged since February 2007.

TABLE 2.1: INTERNATIONAL MACROECONOMIC FRAMEWORK

	2005	2006	2007	2008	2009	2010	2011
GDP							
Industrialised countries	2.5	3.0	2.6	1.8	2.4	2.5	2.5
United States	3.1	2.9	2.2	1.3	2.2	2.6	2.6
Japan	1.9	2.4	2.1	1.4	1.8	1.4	1.2
Euro Area	1.6	2.7	2.6	1.7	1.9	2.0	1.9
France	1.7	2.0	1.9	1.7	2.0	1.8	1.8
Germany	0.8	2.9	2.5	1.6	1.6	1.6	1.6
UK	1.8	2.9	3.1	1.7	2.4	2.7	2.5
Spain	3.6	3.9	3.8	2.7	2.4	2.7	2.5
World excluding EU	5.5	5.6	5.4	4.5	5.2	5.3	5.3
World	4.7	5.1	4.9	4.0	4.6	4.7	4.7
World trade	7.4	9.3	6.9	6.7	7.0	7.3	7.4

Source: MEF calculations based on IMF, OECD and European Commission data.

The main international organisations have revised downward growth estimates for 2008. The global economy is forecast to grow at a rate of 4.0 per cent, thus registering a 0.9 drop compared to 2007. Trade is expected to increase by 6.7 per cent, thus edging down compared to 2007. In 2009-2011, the economy and world trade are expected to increase by 4.7 per cent and 7.2 per cent a year respectively.

Oil prices are expected to remain high, despite the slowdown in the world economy, as a result of an expected robust demand for oil from Asia's emerging economies, the predicted supply limitations and possible geopolitical tensions.

The US economy is expected to grow by 1.3 per cent, with growth decreasing by 0.9 percentage points compared to 2007 as a result of the lingering impact of the crisis in the housing sector. Tighter credit could cause a further drop in residential housing construction and adversely affect consumption. However, the timely intervention of the Federal Reserve and a low unemployment rate could mitigate the negative impact on economic growth. In the following three years GDP is expected to grow by 2.5 per cent. In February, the dollar exceeded 1.50 vis-à-vis the euro, compared to the 1.37 average rate of last year.

The euro area economy is forecast to grow by 1.7 per cent, thus recording a 0.9 percentage point drop compared to 2007, despite the absence of major economic imbalances. In the labour market, the unemployment rate is expected to suffer a further drop in 2008 and 2009, even though more slowly than in 2007. Finally, consumer-price inflation is forecast to average 2.0 per cent in the next two years.

Asia's emerging economies should continue to drive the global economy even though at a slightly slower pace compared to the recent past, as China's growth rate is expected to average 10 per cent.

Japan's economy is expected to slow down in 2008, with GDP growth at 1.4 per cent. In the medium term, growth is expected to stand at 1.5 per cent.

The risks for the world economy in 2008 are linked to the possibility of a further spread of the effects of the US mortgage crisis and further increases in the prices of raw materials and food products.

The recent financial turbulence could ripple through the real economy mainly through two channels. Firstly through a financial channel. The losses on the investment portfolio and derivatives of major banks could lead to a further tightening of credit conditions. Secondly, business expectations could weaken and translate into a slowdown in the demand for consumption and investment and consequently in economic growth in general.

Energy market operators expect tension to linger on as a result of the strong demand from the emerging economies, the limited growth of supply and the small leeway provided by idle capacity.

A further increase in the demand for food products is also expected in the medium term. Other risks are linked to the persistence of global imbalances, even though there are signs that they are abating, and to the risk of disorderly corrections in the exchange rates between the main currencies. Finally, the recent frailty shown by the main stock market indices could be an additional dangerous risk factor compounding the predicted economic slowdown.

TABLE 2.2: INTERNATIONAL PRICES (% change)

	2005	2006	2007	2008	2009	2010	2011
Oil (Brent FOB dollar/barrel)	54.4	65.1	72.4	95.0	95.0	95.0	95.0
Non-energy commodities	-0.8	16.5	23.6	8.7	2.0	1.0	1.0
Manufactured goods	5.1	4.7	6.7	6.9	1.2	1.2	1.2

Source: MEF calculations on data supplied by the IMF, OECD and European Commission.

2.2 THE ITALIAN ECONOMY

2.2.1 Domestic demand

After the strong acceleration in 2006, Italy's economy grew at rates higher than the potential rate for the second consecutive year: GDP growth was 1.5 per cent.

In the Forecast and Planning Report published in September, GDP was forecast to grow by 1.9 per cent, whereas the Economic and Financial Planning Document drawn up in June predicted a 2.0 per cent growth rate.

The 2007 performance and the previous estimates, however, cannot be directly compared due to the extraordinary revision of national accounts by the Italian Statistical Office (ISTAT). The revision, based on the new foreign-trade indices (average unit values and volumes), pointed to a significant increase in import and export volumes, and a more modest trend in their deflators. The revision of volume series also affected some components of domestic demand, including, specifically, investment and general government and NPISH expenditure. With reference to price changes, the increase in deflators for general government and NPISH expenditure and investment is more modest (see box on national accounts revisions).

Despite the lack of updated data on quarterly national accounts, based on the increase in manufacturing recorded in the fourth quarter (-2.0 per cent compared to the previous quarter), it can be assumed that GDP suffered a drop in the last quarter of 2007. The slowdown can also be attributed to the slowdown in private consumption growth which was on a decreasing trend in 2007.

The lower-than-expected overall performance in 2007 is also linked to the marked slowdown in equipment investment which was only partly offset by an increasing trend in net exports.

In 2007 household consumption contributed 0.8 percentage points to GDP, 0.3 percentage points to investment and 0.3 percentage points to public consumption. Net foreign demand made a slightly positive contribution (0.1 percentage points), despite the gradual appreciation of the euro against the dollar. After the strong build-up in 2006, the contribution from inventories was nil.

Household consumption increased by 1.4 per cent in 2007, supported by the labour market's resilience and by the tax breaks envisaged in the 2007 Budget for car buyers purchasing a new vehicle. Spending on consumption abroad by residents showed a marked increase in 2007 (7.9 per cent compared to 2006) unlike spending on the national territory by non-residents, which increased by 1.3 per cent compared to 2006. The contribution to GDP growth made by the differential between these two components turned negative, reaching -0.1 percentage points in 2007 as against 0.1 percentage points in 2006.

Machinery and equipment, transport investment as well as investment in other components increased more modestly compared to 2006 (0.2 per cent as against 3.5 per cent) in line with the increasingly more moderate use of equipment (which in the fourth quarter went down to 76.8 per cent) and despite strong increase in export volumes. Investment in construction was still quite sustained: it increased by 2.2 per cent compared to 2006. However, the slowdown in residential housing construction that started at the end of the year will probably have repercussions on the performance of the next quarters.

The growth in export volumes recorded a slight slowdown compared to 2006 (5.0 per cent as against 6.2 per cent), also due to moderate consumption in Germany, which is one of Italy's main trading partners. Upward reviews of export volumes show that Italy's export firms have been able to restructure their business and stay competitive despite the loss in price competitiveness.

Export prices measured by the relevant deflator still show a relatively high growth, even though more moderate compared to 2006. This significant increase could be linked to the quality upgrading of Italian exports.

The export deflators showed a 4.2 per cent increase, while services rose by 1.2 per cent.

Growth in import volumes slowed down compared to 2006 (4.4 as against 5.9 per cent in 2006) and import deflators showed a much more modest increase in 2007 (2.3 per cent as against 7.6 per cent in 2006).

The trade deficit, measured on a fob/cif basis, more than halved compared to 2006 (-0.6 as a percentage of GDP compared to -1.4 per cent), benefitting from the strong growth in export value.

After the growth recorded in 2006 (1.2 per cent), value added in industry excluding construction increased by 0.8 per cent. The modest growth in industrial (excluding construction) value added in 2007 can partly be ascribed to the progressive structural change in the economy: according to the old national accounts series, the incidence of industry excluding construction on the total was 24.9 per cent in 1995, whereas in 2007 it was 21.5 per cent.

The slowdown is partly accounted for by the modest growth in industrial production, which in 2007 registered a 0.2 per cent reduction compared to the previous year, also as a result of the worsening in the latest quarter.

Private sector services proved to be the most dynamic sector of the economy increasing by 2.2 per cent.

Employment, measured in full-time equivalent workers, continued to grow briskly in 2007 (1.0 per cent) even though at a lower rate compared to the euro area. As to the performance of individual sectors, employment in industry excluding construction and in private-sector services grew by 0.9 and 1.5 per cent respectively; employment in construction grew significantly (2.4 per cent). Dependent employees have increased more than the overall labour units of the economy (1.5 per cent as against 1.0 per cent).

Employees' gross earnings per full-time equivalent dependent worker recorded moderate growth at 2.1 per cent, slightly less than the private consumption deflator (2.2 per cent). At the end of 2007 about half of expired employment contracts (nearly six million employees or 47.4 per cent) was awaiting renewal.

Wage moderation and a modest increase in productivity contributed to slowing down the increase in unit labour costs (1.5 per cent as against 2.3 per cent in 2006, as a percentage of GDP). As firms partly regained their profit margins, domestic inflation measured by the GDP deflator proved to be increasing more rapidly compared to 2006 (2.3 per cent as against 1.7 per cent). The deflator of private consumption recorded an increase of 2.2 per cent, with a strong acceleration in the second part of the year due to the increase in the price of imported raw materials (energy and agricultural products).

Italy's economy grew at different rates in the various regions. Even though the recovery that had started in the Mezzogiorno in 2006 continued, after four years of

substantial stagnation, in 2007 the South should have recorded GDP growth about 1.0 per cent lower than the rest of the country.

After the 2006 increase, employment in the South remained substantially stable in the first nine months of 2007 (-0.1 per cent compared to the same period in 2006), whereas in the Centre and the North it rose by 1.3 per cent. Even though in 2007 the unemployment rate showed a moderately positive trend throughout Italy, growth in the Mezzogiorno did not seem to tap into the potential labour supply. As a matter of fact, the gap in the employment rate compared to the Centre and the North (about 19 percentage points) is still wide, especially as far as female employment is concerned.

Prospects for the Italian economy

The prospects for the Italian economy reflect the high uncertainty of the international scenario, especially the uncertainty in financial markets. As described in the previous section, the turbulence that rocked markets last August following the US subprime mortgage crisis has not vanished yet. Volatility in international markets, after abating in the Autumn months, increased significantly at the beginning of the year reaching levels close to last summer's highs.

Oil prices increased significantly in the second half of 2007, reaching peaks of over \$100 a barrel in the last weeks of the year.

International financial turbulence could ripple through the Italian economy, which would compound the already existing mainly exogenous negative effects, such as specifically: (i) the surge in energy prices combined with Italy's strong dependence on foreign imports²; (ii) the appreciation of the euro against the main currencies; (iii) increasing interest rates over the past two years; (iv) international tensions affecting food prices, which together with oil prices, pushed up inflation.

The latest surveys on bank lending by the Bank of Italy show that there is currently no significant tightening of both business and consumer credit in Italy, contrary to the findings of surveys for the euro area.

As for businesses, there was a slight tightening in credit as a result of changes in risk perceptions, while the demand for loans recorded a marginal increase. This was partly due to the need for funding for inventories and working capital as well as for mergers, acquisitions and restructuring, while fixed investment did not contribute to increasing demand.

Household borrowing seems to be sustainable, as the ratio between non-performing loans and debt is within acceptable limits and was even edging down in the last quarter of 2007 (it decreased from 3.1 per cent in the previous quarter to 3.0 per cent). Italian households are less indebted compared to those of the euro area: according to Bank of Italy data, the ratio of debt to disposable income was 50 per cent in September 2007, as against a euro average of approximately 90 per cent³.

The bursting of the speculative bubble in the US housing market so far seems to have had a comparatively smaller direct impact on Italy. The spillover of financial turbulence into Italy's banking system seems to have been more limited than that suffered

² The proportion of imported energy products to total imports increased notably in the past four years from about 11.0 per cent to about 14.5 per cent in 2007.

³ See Bank of Italy, Economic Bulletin, January 2008, page 20.

in the euro area. The reasons for this seem to be the apparent lower exposure of Italy's financial system to the financial activities that have been hardest hit by price fluctuations.

The Bank of Italy⁴ ascribes Italy's lower exposure to the crisis also to a more limited use of the *originate-to-distribute* model and a widespread reliance on deposits for funding. This is why when tensions emerged in financial markets, Italian banks could control risks better than American, British, French and German banks. In addition, the profitability of Italian banks was rather good in the first nine months of 2007, decreasing by only one percentage point compared to the first nine months of 2006.

Finally last summer's developments did not seem to have comparatively strong repercussions on the balance sheets of Italian banks⁵. The stock market indices of Italy's financial sector were adversely affected, but to a lesser extent than in the rest of the euro area, despite higher degree of interrelation among the various international stock markets since the beginning of the crisis in the summer of 2007. Overall, Italy's financial sector seems to have been hit less severely than the rest of the euro area, especially in the insurance sector.

Growth estimates for the main macroareas developed by international institutions have been revised downwards.

Following the weakening of the international cycle, GDP growth in Italy is forecast to decrease to 0.6 per cent in 2008, down from the 1.5 per cent growth estimate of the Forecasting and Planning Report (*Relazione Previsionale e Programmatica*, RPP) published in September. Also in the medium term, growth is expected to be lower than that estimated in the Forecasting and Planning Report: average growth in the next three years is expected to be 1.5 per cent as against the previous 1.7 per cent forecast.

In 2008 household consumption is expected to slow down compared to the previous year (0.9 per cent), as a result of increasing inflation and worsening confidence. In the Mezzogiorno household confidence went back past low levels.

Equipment investment is expected to be on a trend similar to that of 2007 as a result of the worsening international cycle. In February manufacturing confidence reached the very low values recorded in October 2005 (89.8).

Construction investment is expected to grow by 1.0 per cent compared to 2007. The real-estate cycle that started in 2001 sustained growth in the past five years, but the latest indicators show that it is petering out. According to Bank of Italy data, the stock of over-five-year mortgages suffered a setback, with a €3 billion drop in December compared to the previous months. On the supply side, production in this sector showed signs of a slowdown: in the fourth quarter of 2007, production increased by 1.1 per cent compared to the same period of the previous year as against a 6.7 per cent increase recorded in the third quarter. According to ISAE, the level of confidence in January was also low. A decrease in house prices is expected in the next few months, especially in big cities such as Rome and Milan, where prices in the past have tended to be higher.

⁴ See. Anna Maria Tarantola (Bank of Italy), *'Crisi di liquidità e futuro dei mercati. Aspetti operativi e regolamentari'*, January 18, 2008.

⁵ See Bank of Italy, *Economic Bulletin*, January 2008, page 25.

As to foreign demand, exports are forecast to slow down in 2008 (2.9 per cent as against 5.0 per cent in 2007), following the slowdown in domestic demand from Italy's main trade partners and in world trade. The contribution made by net exports is nil. The current account of the balance of payments is expected to edge down compared to 2007 (from 2.2 to 2.1 per cent).

In the following three-year period, thanks to growing world demand, exports should go back to growing briskly. However, the contribution made by net exports is expected to be nil in the medium term as a result of the parallel increase in imports.

The current account deficit of the balance of payments is expected to edge down to 1.1 per cent of GDP in 2011.

In 2008 the value added of industry excluding construction is expected to grow by 0.2 per cent as a result of difficulties in the accumulation process, while the construction industry is expected to grow only modestly (0.5 per cent).

Unemployment, in terms of full-time equivalent, is expected to slow down significantly (0.5 per cent as against 1.0 per cent), whereas employment is forecast to grow significantly in private-sector services. Industry excluding construction is expected to register a modest increase in labour.

Assuming the labour supply will continue to increase compared to 2007 (0.6 per cent), the unemployment rate is expected to decrease marginally and reach 5.7 per cent.

In the medium term, employment measured in terms of full-time equivalent workers is forecast to grow at average rates of 0.6 per cent; the unemployment rate is expected to edge down to 5.3 per cent in 2011, thanks to a gradual increase in the supply of labour.

In 2008 per capita gross wages for the whole economy are forecast to grow by 4.1 per cent, more rapidly than the previous year due to the temporary effects of the renewal of employment contracts in the public sector envisaged in the 2008 Budget. The increase in unit labour costs is expected to be stronger, also a result of a virtually nil growth in productivity because of the unfavourable cyclical developments.

Domestic inflation measured by the GDP deflator is expected to reflect the strong increase in unit labour costs and to hover above the prevailing levels in 2007.

The surge in the price of raw materials and tariffs is expected to affect consumer-price inflation: the NIC index including tobacco is estimated to stand at around 2.6 – 2.7 per cent. In the medium term the moderate increase in nominal wages, around 2.0 per cent, together with a gradual increase in productivity, is forecast to contain the expected rises in unit labour costs and domestic inflation. Consistently with moderate external inflationary pressures, inflation measured by the private consumption deflator is expected to hover slightly below a 2.0 per cent average.

TABLE 2.3: ITALY'S MACROECONOMIC PROJECTIONS BASED ON UNCHANGED LEGISLATION

	2005	2006	2007	2008	2009	2010	2011
INTERNATIONAL VARIABLES							
International trade	7.4	9.3	6.9	6.7	7.0	7.3	7.4
Oil prices (Brent FOB dollar/barrel)	54.4	65.1	72.4	95.0	95.0	95.0	95.0
USD-EUR exchange rate	1.245	1.255	1.371	1.475	1.475	1.475	1.475
MACROECONOMIC PROJECTIONS (VOLUMES)							
GDP	0.6	1.8	1.5	0.6	1.2	1.5	1.7
Imports	2.2	5.9	4.4	3.0	3.7	4.0	4.4
Final consumption	1.2	1.0	1.4	0.8	1.1	1.4	1.6
- Household consumption	0.9	1.1	1.4	0.9	1.4	1.7	1.8
- Government and NPISH consumption	1.9	0.9	1.3	0.7	0.5	0.7	1.0
Gross fixed capital formation	0.7	2.5	1.2	0.7	1.4	1.7	1.9
- Machinery, equipment and other investment	0.9	3.5	0.2	0.4	1.8	2.3	2.8
- Construction	0.5	1.5	2.2	1.0	1.0	1.0	1.0
Exports	1.0	6.2	5.0	2.9	3.7	4.1	4.5
<i>Memo item: Current account of the balance of payments as % of GDP</i>	-1.5	-2.6	-2.2	-2.1	-1.7	-1.3	-1.1
CONTRIBUTIONS TO GDP GROWTH							
Net exports	-0.3	0.1	0.1	0.0	0.0	0.0	0.0
Inventories	-0.2	0.5	0.0	0.0	0.0	0.0	0.0
Domestic demand	1.0	1.3	1.4	0.7	1.2	1.5	1.7
PRICES							
Import deflator	6.2	7.6	2.3	3.5	2.1	1.9	1.9
Export deflator	4.0	4.5	3.6	3.3	3.1	2.7	2.2
GDP deflator	2.1	1.7	2.3	2.9	2.1	2.0	1.9
Nominal GDP	2.6	3.6	3.8	3.6	3.3	3.5	3.6
Consumption deflator	2.3	2.7	2.2	2.7	2.1	1.9	1.8
Planned Inflation	1.6	1.7	2.0	1.7	1.5	1.5	1.5
LABOUR							
Labour cost	3.2	2.5	1.9	4.1	1.8	2.1	2.1
Productivity (calculated on GDP)	0.4	0.1	0.5	0.1	0.6	0.9	1.0
Unit labour costs (calculated on GDP)	2.8	2.3	1.5	4.0	1.2	1.2	1.1
Employment (FTE)	0.2	1.7	1.0	0.5	0.6	0.6	0.7
Unemployment rate	7.7	6.8	5.9	5.7	5.6	5.5	5.3
Employment rate (15-64 age bracket)	57.4	58.4	59.1	59.5	59.9	60.4	60.9
<i>memo item.: Nominal GDP (in Mn)</i>	1,428,375	1,479,981	1,535,541	1,590,366	1,642,717	1,700,769	1,761,518

2.2.2 Foreign trade

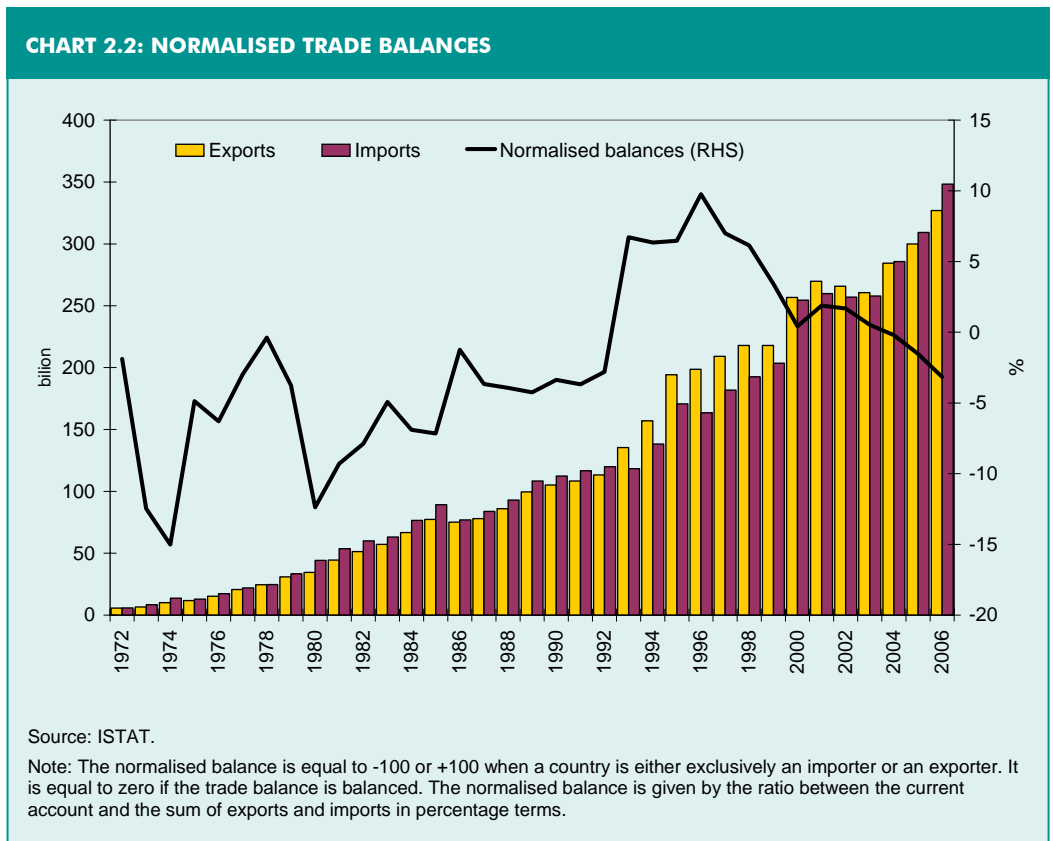
In 2007 foreign trade improved notably, with a deficit balance of €9.5 billion compared to a deficit of €21.4 billion in 2006.

However, the standardised balance of trade has been in deficit since 2004, reflecting Italy's higher propensity to import. In 1993-2003, the standardised balance was in surplus (see note - Chart 2.2).

Overall, exports grew by 9.7 per cent year-on-year, thus continuing their robust trend (9.0 per cent in 2006). Imports decreased modestly by 5.7 per cent as against 12.6 per cent in 2006.

Both exports to EU countries (9.1 per cent with an increase of 1.6 percentage points compared to the previous year), and to non-EU countries (10.5 per cent showing a slight slowdown compared to 11.4 per cent in 2006).

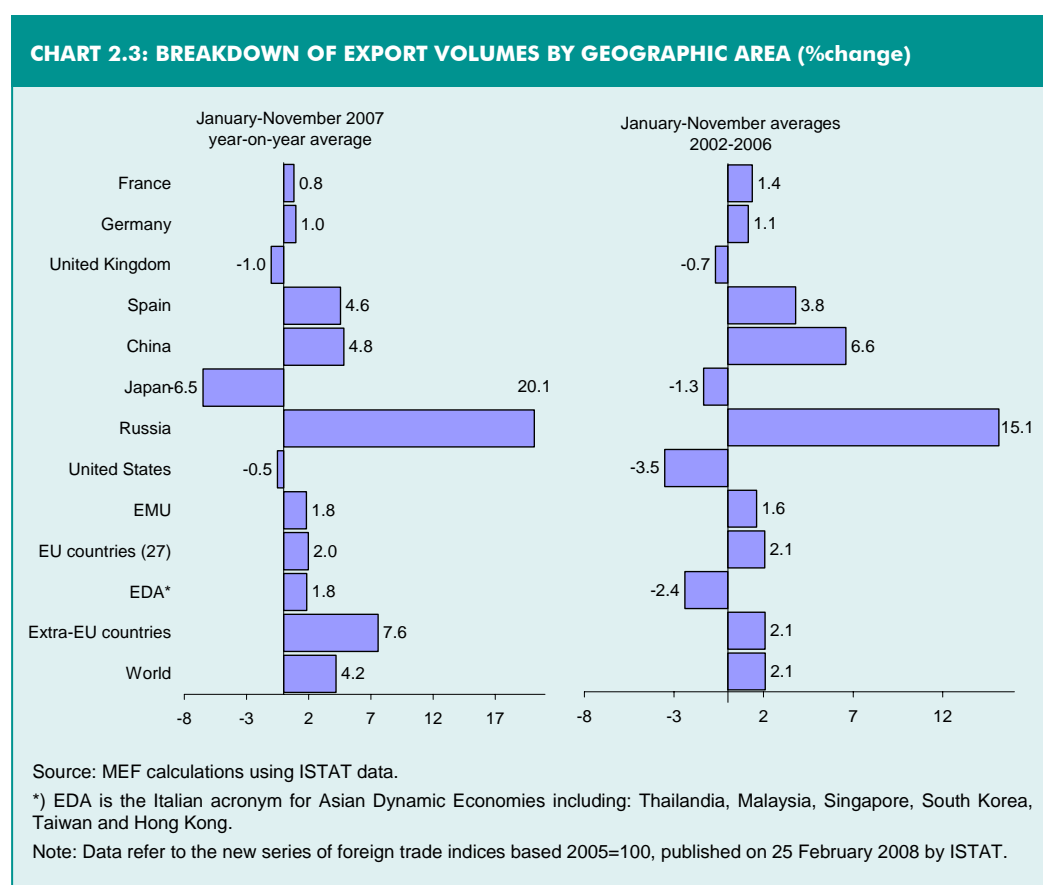
Imports from both EU and non-EU countries were less buoyant, compared to the previous year, with imports from EU countries growing by 5.9 per cent (a 2.0 percentage point reduction compared to 2006) and imports from non-EU countries growing by 5.5 per cent (much less compared to the 19.7 percentage of the previous year).



The trade balance with EU countries shows a surplus of €5.7 billion, as against a deficit balance of €738 million in 2006. Trade with non-EU countries showed a deficit of about €15.2 billion, slightly smaller compared to the €20.6 billion deficit of 2006.

Overall, in the first eleven months of 2007 export volumes⁶ showed an increase of 4.2 per cent compared to the same period of the previous year, as against an average increase of 2.1 per cent in 2002-2006. Among EU countries, Italy's exports to Spain performed well once again.

Among non-EU countries, Russia and China showed the largest increases among the main countries to which Italy exports its products. Exports to Japan and the US contracted, as was the case in 2002-2006.

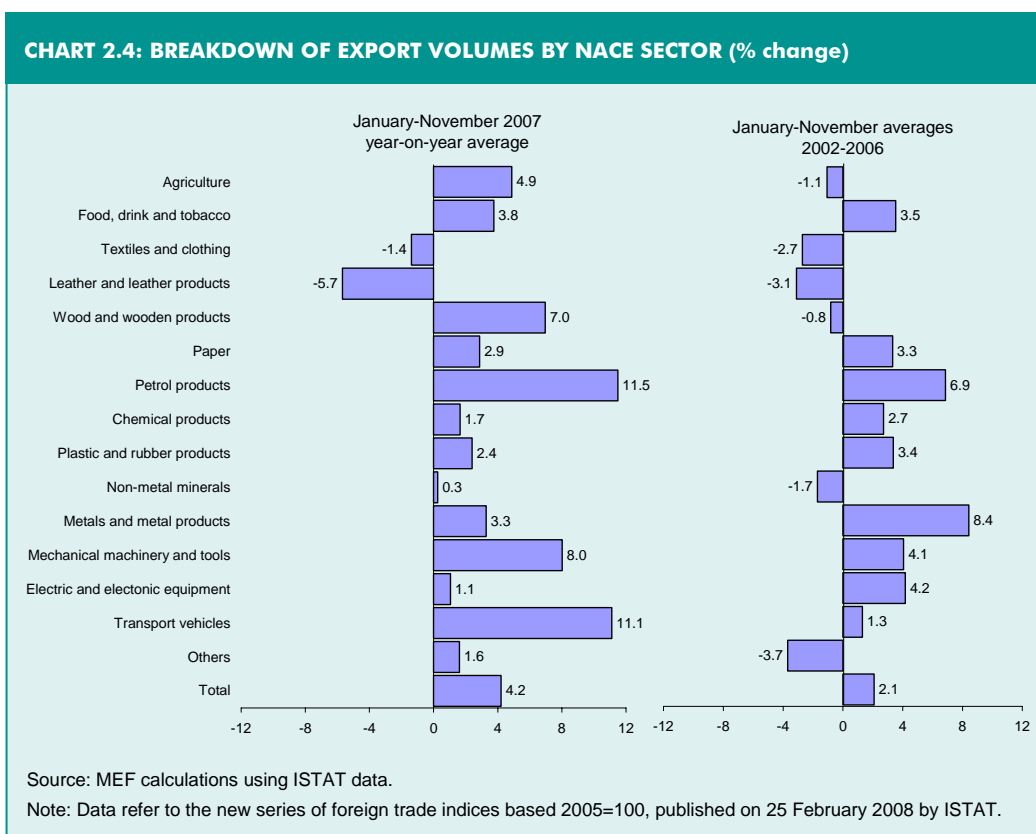


In the first eleven months of the year, an analysis of export volumes by sector shows a good performance of the various Italian-made products. Exports grew at higher rates in transportation (11.1 per cent), mechanical equipment (8.0 per cent), wood

⁶ On February 28 ISTAT released the new series of foreign trade indices for 2000-2007, in which the baseline year is 2005. In the previous series the baseline year was 2000. Imports and exports indices are available up to November 2007.

products (7.0 per cent), agricultural and food products (4.9 and 3.8 per cent) and metals (3.3 per cent). The only two sectors suffering a drop were leather and textile products.

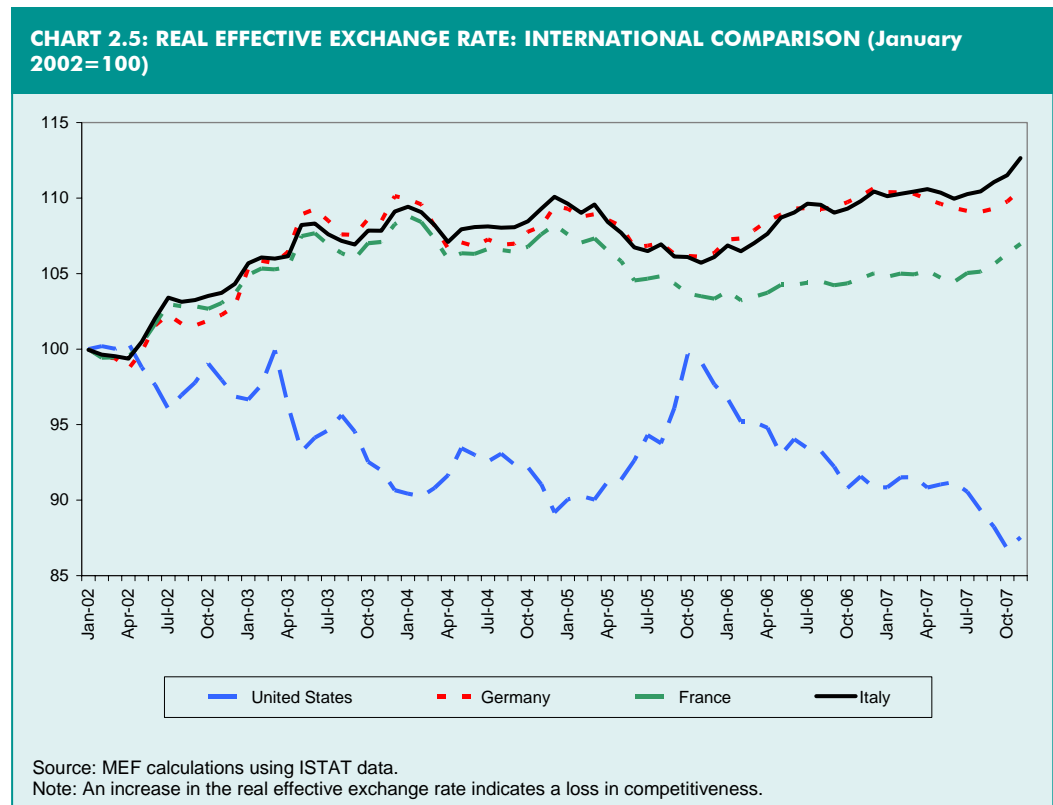
Similarly, in 2002-2006, metals, oil products, electric machines and mechanical equipment recorded notable increases in exports; however, in this four-year period the sectors performing badly were more numerous.



Comparing the trend in the real effective exchange rate, one can see Italy's loss of price competitiveness, which was larger than that of France or Germany.

Overall, the performance of Italian exports in 2007 was good: the growth rate was robust and the market share increased in terms of value (3.8 per cent in the first seven months of the year)⁷.

⁷ ICE (Foreign Trade Institute), Ministry of International Trade, 'Scambi con l'estero', Update note, Year 14, No. 4/2007.



These results have been achieved despite the higher incidence of the cost of raw materials and the 9.2 per cent appreciation of the euro against the US dollar in 2007 compared to the average of the previous year.

In January 2008, exports to non-EU countries continued to increase by 18.3 per cent compared to January 2007. This data seems to confirm an improvement in competitive factors other than price, linked to a re-positioning of Italian products towards higher quality standards.

2.2.3 Labour market

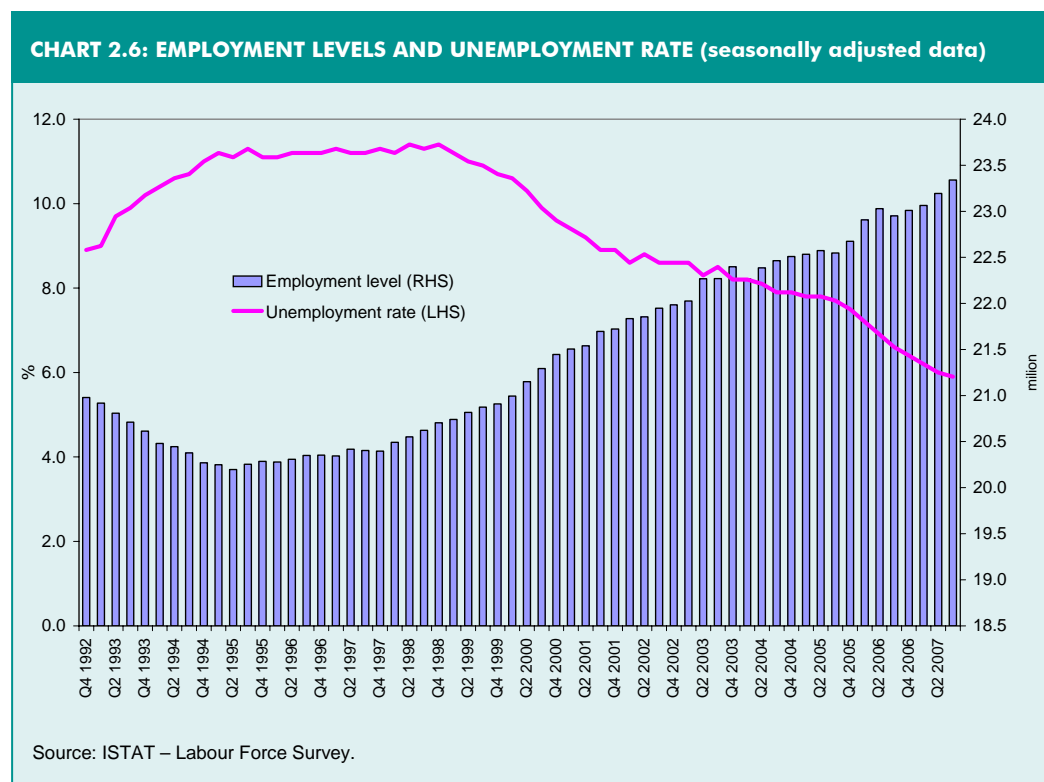
In 2007 Italy's labour market performance was again similar to that of the past few years. In the third quarter the seasonally-adjusted unemployment rate declined to 5.9 per cent, an all-time low since the early 1990s. The number of jobseekers was 1.5 million, about 10 per cent less compared to the same quarter of 2006. The unemployment rate dropped in all areas of the country. In the South the year-on-year decrease was 1.0 percentage point, but the rate is still only slightly below 11 per cent. The youth unemployment rate, which in the first 9 months of 2007 was 19 per cent, continues its downward trend.

The seasonally adjusted yearly average growth of employment – calculated in the first three quarters of the year – was 1.0 percentage point (equivalent to 237,000 new jobs) which pushed the (non-seasonally adjusted) employment rate to 59.0 per cent in the third quarter of 2007. The activity rate of the working age population was 62.7 per cent and continues to be heterogenous in terms of age and gender, due to the low participation rate of women and workers over 55 in the labour force (50.7 and 35 per cent respectively).

As for employment composition in terms of types of contract and working hours, there was a slight increase – from 13.5 to 14.0 per cent – on average in the proportion of part-time workers among employees in the first three quarters of 2007 compared to the same period of 2006. Even though male employment grew more than female employment, part-time work is more widespread among female employees, accounting for 27 per cent of all employment contracts.

The average growth of temporary employment, equal to about 3.0 per cent, mainly involves female employees (5.4 as against 1.1 per cent for male employees). Overall employment mainly grew in the Regions of the North and East and especially in industry excluding construction. Temporary work accounted for 16.0 per cent of female employment and 11.2 per cent of male employment.

As to hourly wages, the 2007 average rate of growth increased by 2.3 per cent, slightly above the rate of inflation. The highest increase was in construction (4.4 per cent). Over half of the total number of contracts expired at the end of the year. According to the OROS survey (Employment, Pay and Social Security Contributions), in the first nine months of 2007 gross earnings per full-time equivalent worker increased on average by 2.8 per cent in industry and 1.7 per cent in private-sector services.



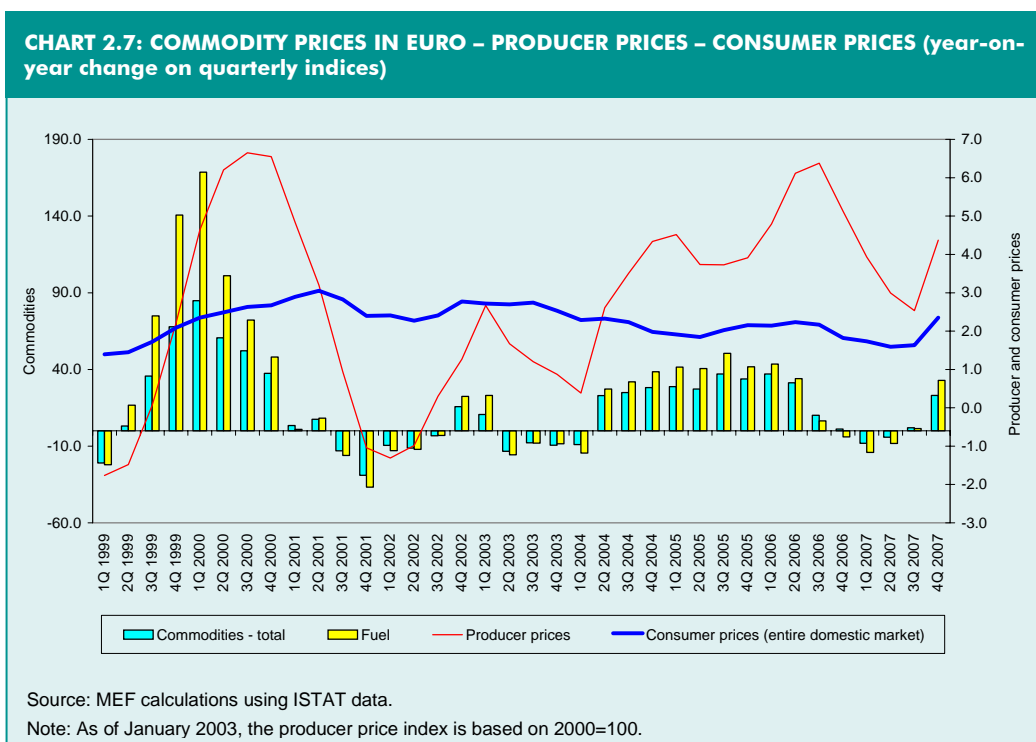
2.2.4 Prices

2007 price trend

In 2007 average consumer prices slowed down compared to 2006, despite the surge in the past few months.

The annual increase in the index for the entire resident population (NIC) averaged 1.8 per cent, while that for workers' and employees' households (FOI; both including and excluding tobacco products) 1.7 per cent, and the harmonised HICP index 2.0 per cent.

The time-varying inflation trend is the opposite of that of the previous year. In 2006 the turning point in price increases, which were pushed up by energy prices, came after the summer, while in April and May 2007 inflation went down to a low (1.5 per cent) that had not been reached for a decade. In the second part of the year the trend reversed: inflation reached 2.6 per cent as a result of the pressures exerted by energy prices for consumers.



Between the end of 2006 and the beginning of 2007, the drop in the prices of crude oil affected the price of raw materials causing a lower average yearly growth.

The general raw-material index in dollars calculated by Confindustria (Confederation of Italian Industry) registered an average increase of 12.6 per cent in 2007, thus showing a clear slowdown compared to the 20 per cent rise in 2006. In addition to decreasing fuel prices (11.9 per cent as against 19.2 per cent in 2006), this was also due to non-food products (15.8 per cent compared to 27.0 per cent in 2006). Food prices, however, surged dramatically (10.9 per cent as against 9.9 per cent in 2006), especially in the second half of the year.

The appreciation of the euro caused a more marked slowdown in the raw-material price index expressed in euro (from 18.5 per cent in 2006 to 2.8 per cent in 2007).

Producer prices recorded a 3.4 per cent growth in 2007 (5.6 in 2006). Among the main categories, the strongest increase was in intermediate goods (5.1 per cent). Among the sectors of economic activity, metals and metal products recorded substantial increases (6.9 per cent) as well as food products, beverages and tobacco (4.9 per cent). The net energy index was up 3.5 per cent (3.2 per cent in 2006). Producer prices were 0.6 percentage points higher than those in the euro area.

TABLE 2.4: ADMINISTERED PRICES IN THE NIC BASKET (average % changes)

	2003	2004	2005	2006	2007
TOTAL TARIFFS	1.9	2.2	2.6	3.4	1.4
TOTAL TARIFFS (net of energy rates)	1.4	3.2	1.8	1.6	1.4
including: Tariffs controlled by the government (1)	-2.1	0.8	-1.9	-1.4	-2.3
Tariffs controlled by regulatory authorities (2)	2.2	-1.4	4.2	7.3	1.2
Tariffs controlled by local authorities (3)	3.5	3.8	3.1	3.4	4.8
Tobacco products	8.3	9.9	8.9	6.3	4.2
TOTAL LIBERALISED GOODS & SERVICES	3.3	3.4	4.0	2.9	2.1
including: Lead-free gasoline	1.4	6.3	9.3	5.5	0.9
Heating fuel	2.9	6.1	16.6	6.6	0.1
Liquid propane gas - cylinders	6.8	3.5	4.0	7.4	1.7
Liquid propane gas - cars	4.5	-1.3	5.3	14.4	-3.8
Diesel fuel - cars	2.8	6.3	18.1	5.3	-0.1
Liability car insurance	5.0	0.9	1.7	2.3	1.5
TOTAL LIBERALISED GOODS & SERVICES, NET OF PETROLEUM PRODUCTS	3.6	2.6	2.0	1.9	2.3
CONSUMER PRICES (including tobacco products)	2.7	2.2	1.9	2.1	1.8

Source: MEF calculations using ISTAT data.

1) Railway and seaboard transport, highway, post, National Health Service drugs.
2) Electric power, gas, call rates.
3) Waste, water, local public transport, taxes.

The slowdown in inflation during the first stage of price formation partly affected the trend in consumer prices. Tariffs moderately contributed to pushing up prices. The controlled price aggregate increased on average 1.4 per cent in 2007 (3.4 per cent in 2006). The stronger increase in rail fares (7.1 compared to 0.2 per cent in 2006, that may be ascribable to fares having remained basically unchanged since 2003) as well as in waste collection prices (9.2 per cent as against 4.8 per cent of 2006) was offset by a decrease in energy prices (electricity down to 4.8 per cent from 12.6 per cent in 2006 and gas down to -0.1 per cent from 9.6 per cent in 2006) and in medicines provided by the National Health Service (-7.7 per cent in 2007 as against -4.4 per cent in 2006).

Oil products (0.7 per cent in 2007 down from 6.1 per cent in 2006) and private-sector services (2.5 per cent as against 2.7 per cent in 2006) also contributed to reducing inflation.

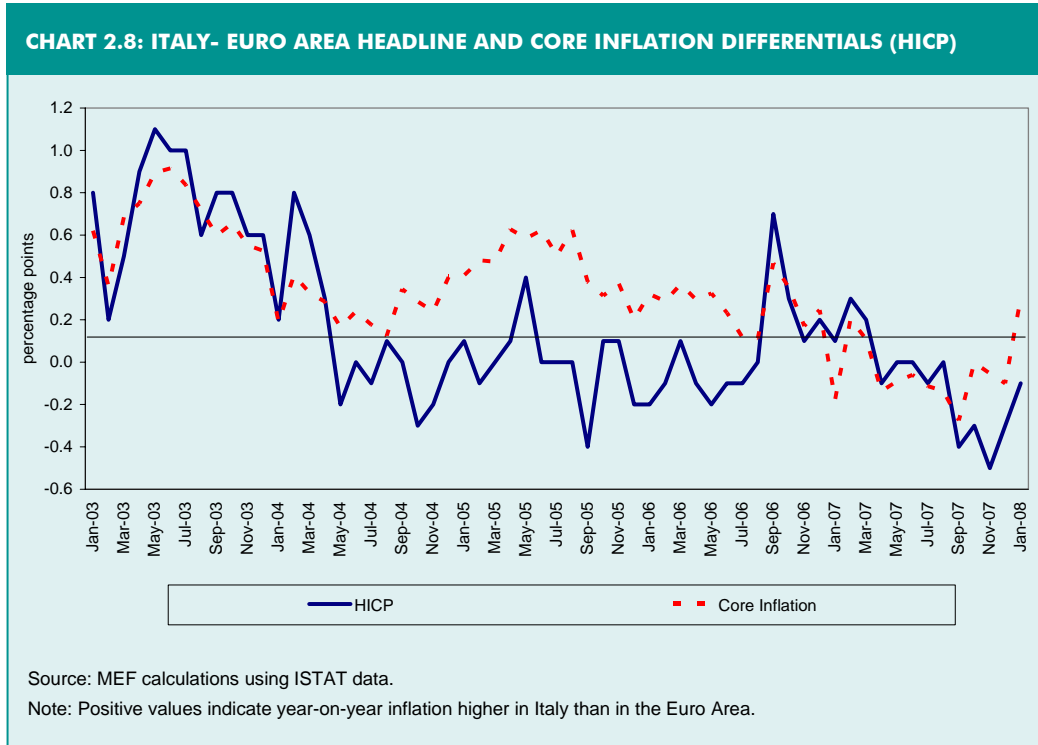
The slowdown in the price increases of private-sector services is linked to insurance services (1.5 per cent compared to 2.3 per cent in 2006) and mobile telephone services (-12.0 per cent compared to no change in 2006 due to the lifting of charges for recharging pre-paid cards).

In 2007 Italy's harmonised consumer-price index rose 2.0 per cent (2.2 per cent in 2006), compared to 2.1 per cent in the euro area (2.2 per cent in 2006). The differential measured on core inflation (excluding energy and fresh food) showed a similar trend.

Inflation convergence results from an acceleration of non-food products on the one hand (due to the indirect effects of more expensive oil) and the increase in the prices of household products, vehicles and motorcycles on the other (due to the increase in the prices of metal products and the slowdown in financial services).

The VAT increase in Germany played an important role in causing the rise in inflation in the euro area. In the past few months, higher inflation in the euro area (3.2 per

cent in January and February in the euro area as against 3.1 per cent in Italy) reflects a comparatively more rapid impact of oil price hikes on overall indices.



Forecasts for 2008

Oil prices increasing more rapidly since the second half of 2007 combined with hikes in food prices had a greater impact on the carry-over effect (equal to 1.3 per cent) than on the yearly average. These increases are expected to continue in the first part of 2008 and to slow down in the second half.

The prices of private-sector services are also expected to increase more rapidly compared to 2007, as a result of the impact on final prices of transportation costs and the dwindling impact of one-off measures adopted in 2007 (such as the lifting of recharging charges of prepaid cards).

No major changes are expected in public tariffs compared to 2007. In the early months of 2008 government supervision of possible speculative phenomena led to the establishment of a price watchdog.

In the light of these considerations and the provisional inflation rate of February, which was 2.9 per cent, in 2008 inflation measured by the NIC index will likely accelerate to 2.6 – 2.7 per cent.

TREND OF THE INCOME AND THE PRODUCTIVITY OF LABOUR IN ITALY

From 2000 to 2007, real wages increased only modestly in Italy: 0.7 per cent was the yearly average calculated on gross earnings per employee deflated by consumer prices. In 2007 wage increases were even more modest (0.2 per cent)⁸. An analysis shows major differences between the public⁹ and private sector¹⁰: the average yearly growth in 2000–2007 was 1.9 per cent and 0.3 per cent respectively. However, in 2007 real wages of civil servants decreased by 0.5 per cent compared to 2006 while private sector earnings increased (0.6 per cent).

The increase in the level of household income may be analysed through the results of surveys on the financial situation of Italian households published by the Bank of Italy last January. The latter shows that real household net income increased differently depending on whether the householder is an employee or self-employed. In 2000–2006, the average increase in the real income of households where the breadwinner is an employee is very modest (0.96 per cent), as a result of a 4.3 per cent increase between 2004 and 2006 which offsets the reduction in the 2000–2004 period. Conversely, in households where the breadwinner is self-employed, income growth was buoyant, 13.86 per cent in 2000–2006; between 2004 and 2006 the income of these households remained stable. Self-employed workers, however, are not a homogenous group: from 2004 to 2006 the incomes of families whose breadwinner is an entrepreneur or a craftsman increased by 11.2 per cent, whereas real income of free-lance professionals, atypical workers and partners of companies decreased¹¹. The growth gap in real terms between the two types of income examined (of employees and self-employed workers) could also be influenced by tax evasion which is not evenly distributed among the various income groups.

According to a recent OECD report¹², real wages in Italy are lower than in other industrialised countries. In a household with one breadwinner and two children the net wage was 15.9 per cent lower than the OECD average in 2007, 34 per cent lower than in Germany and 17 per cent lower than in France.

Low wage growth in Italy is basically the result of poor productivity growth. The latter has decreased constantly in the past two decades: from an average yearly growth of 2.4 per cent in the second half of the 1990s it went down to an average of 1.1 per cent in the second half of the 1990s until it reached zero growth in the 2001–2006 period¹³.

⁸ Source: ISTAT, national accounts. Gross earnings per employee are determined by the ratio of gross earnings of employees to full-time equivalent workers.

⁹ Source: ISTAT, national accounts. The public-sector data include: 'General government services and mandatory social insurance', 'Education' and 'Health and welfare services'.

¹⁰ Source: ISTAT, national accounts. The private sector is the whole economy minus the public sector as defined in the above footnote.

¹¹ Households where the breadwinner is self-employed account for 12.3 per cent of total families, households where the breadwinner is an employee account for 47.2 per cent of the total, while households whose breadwinner is not engaged in any professional work (pensioners and other people who are not in employment) account for 40.5 per cent.

¹² OCSE 'Taxing Wages', October 2007. Data is in dollars using purchasing power parity.

¹³ Source: European Commission, AMECO Database. Labour productivity was calculated in terms of GDP as against standard labour units.

A slowdown in productivity growth has been a feature of all major countries of the euro area, however in these countries the slowdown was less marked, except in Spain where the average growth rates were similar to Italian rates.

A comparative analysis of productivity levels shows that Italy's rate of productivity growth was 26.0 per cent lower than in France and 20.0 per cent lower than in Germany¹⁴.

A look at labour cost increases from the point of view of competitiveness reveals that what is most important for a single-currency area such as the euro area is the comparison among nominal growth rates. This comparison, made by the European Central Bank, shows that from 1999 to 2006 the cumulative labour cost increase per civil servant in Italy has been higher than the average in the euro area (33.8 per cent as against 21.6 per cent average of the euro area). In the private sector (14.8 per cent) the cumulative labour cost increase is basically in line with that of the average in the euro area (14.7 per cent). What was particularly significant in this period was the competitiveness gain achieved by Germany, where the cumulative growth rate between 1999 and 2006 was less than half the euro-area average both in the private and public sector¹⁵.

With very modest productivity growth, labour cost increase, even though not far from the European average in the private sector, directly affects competitiveness and hence the growth prospects for Italy's GDP and especially household incomes.

Productivity gains need therefore to be leveraged to increase household incomes. These productivity increases in turn require a greater ability to innovate the economic system and improve education and training. The 2005 Eurostat data shows that Italy spends little on research and development: 1.1 per cent of GDP as against 2.13 per cent in France and 2.48 per cent in Germany. In Italy the share of corporate-funded research and development is modest, it was about 40 per cent in 2006, as against an OECD average of about 63 per cent and a 54 per cent average in the EU; Italy ranks 26th in the OECD ranking for corporate-funded R&D, followed only by Greece, Portugal, Slovakia and Poland¹⁶. In addition, in 2005 graduates in scientific subjects in Italy were 0.97 per cent as against an average of 0.13 per cent in the euro area¹⁷. Among European countries, France and Ireland are those with the highest numbers of graduates in scientific subjects (0.225 per cent and 0.245 per cent).

A more direct link between wages and business performance can spur productivity growth. This is why a reform of wage bargaining between social partners is needed. Only greater reliance on the so-

¹⁴ Source: European Commission, AMECO Database.

¹⁵ ECB, Monthly Bulletin June 2007, which uses the OECD *Economic Outlook* database December 2006. Using ISTAT data on compensation of employees and standard labour units, the cumulative compensation per civil servant is believed to be higher than that per private-sector employee, but the differential is believed to be lower compared to ECB data. In the 1999-2006 period (baseline year is 1999), the cumulative increase stood at 31.5 per cent in the public sector and 20.4 per cent in the private sector.

The ISTAT data used refer to the national accounts series published in 2007, for the purposes of better comparability of the data with that in the OECD database.

Compensation of employees in the private sector is calculated as the difference between compensation of employees for the whole economy minus that for the public sector.

Private-sector employees are calculated as employees in the whole economy minus public sector employees and the self-employed.

¹⁶ OECD, 'Main Science and Technology Indicators' (MSTI): 2007/2 edition.

¹⁷ Source Eurostat; Graduates in scientific subjects per 1,000 inhabitants aged between 20 – 29.

called second-level bargaining, that is to say company-level bargaining, may make wage increases respond to the actual conditions of companies and prevent a low-productivity firm from being penalised by national agreements which may undermine its competitiveness and jeopardize jobs. National-level bargaining should ensure the protection of purchasing power eroded by inflation, which is a general phenomenon; whereas productivity, being a company-specific phenomenon, should be addressed entirely by second-level bargaining. Bargaining arrangements more in line with productivity trends were already envisaged in the 1993 agreements.

In order to achieve these objectives and establish a more direct link between wage increases and productivity gains, greater differentiation among areas, sectors and firms is needed. In addition, following Germany's example, mechanisms to opt out of national bargaining could be tested in the country's more disadvantaged areas, sectors or firms, preferably in exchange for commitments in terms of investment, research and innovation.

Compensation per employee in the public and private sector 1999-2006, cumulative growth rates in nominal terms

	Compensation per government employee	Compensation per private employee
Euro Area (12 countries)	21.6	14.7
Belgium	25.3	18.8
Germany	8.3	7.5
Ireland	67.0	42.2
Greece	64.9	44.7
Spain	22.1	12.2
France	20.4	23.0
Italy	33.8	14.8
Luxembourg	34.6	43.7
Netherlands	24.8	26.2
Austria	16.0	15.8
Portugal	25.3	31.9
Finland	28.2	28.0

Source: ECB, Monthly Bulletin June 2007.

As far as wage levels are concerned, the main role of economic policy is to promote productivity gains and to help maintain and strengthen bargaining power through measures affecting price increases. The role played by Government in the dialogue between social partners should aim to achieve these goals. The need to review the 1993 agreements with a view to placing not inflation and stability at the heart of wage bargaining, but productivity and growth, has been stressed by the Government since September 2006, but so far it has not received any substantive feedback from social partners.

The 2007 and 2008 Budgets have already contributed to increasing incomes through tax policy, especially low and medium ones. Further action on tax rates and tax deductions should be taken, bearing in mind the overall financial constraints. Along the path leading to a balanced budget in 2011, avoiding further increases of aggregate taxation is compatible with lower tax rates or increasing deductions for employees, provided the fight against tax evasion continues to be effective, relentless and ultimately successful.

Economic policy may improve purchasing power and the country's overall productivity, also by removing further barriers to the entry of new and more innovative individuals and firms in all sectors of economic activity, turning the South and the country as a whole into a network capable of attracting Italian and foreign capital, improving the education system so as to have a highly qualified workforce.

However, the most important step the Government and the public sector as a whole can take to increase overall productivity, competitiveness and growth is to improve efficiency in the provision of public services and enhance their quality. In order to improve the productivity of civil servants, performance-related pay and incentives need to be introduced. Greater efficiency must be the criterion to stop the increase in civil servants' total compensation, which is a drag on the economy when it is not matched by adequate growth in productivity and in the quality of services. The Memorandum of Understanding for the civil service set the stage to take important steps forwards by acknowledging, among other things, the importance to reward not just collective but also individual performance by enhancing employee performance assessment tools. Strengthening the accountability, ability and awareness of the role of civil service executive officers is essential for a full and complete implementation of the reform.

The main actors that can increase productivity, and hence wages and competitiveness, are social partners, in whose hands lie the growth prospects of Italy's economy and therefore the possibility to increase the country's welfare and living standards. Only social partners can reverse the downward spiral of low productivity/low earnings. While the pressure coming from greater domestic and international competition should push firms to innovate and renew their products, a more decentralised bargaining system is essential to spread the results of such innovation more evenly and to reward work where productivity is higher.

NATIONAL ACCOUNTING REVISIONS AND COMPARISON OF FORECASTS

ISTAT revised national accounts series in terms of volumes starting from 2001 on the basis of: (i) the use of a new method to deflate aggregates through supply-use tables (ii) the new indices of average unit values of foreign trade. The new method implies greater consistency of national accounts aggregates in real terms and an independent estimate of changes in inventories as well as a more accurate estimate of intermediate consumption.

Methodological innovation has thus led to extraordinary revisions of volume series which are now no longer comparable to the previous ones. For 2004–2006, in addition to extraordinary revisions, national accounts series also underwent ordinary revisions which take into account the update of statistical sources used. The table below shows the differences between the two series for the main items of resources and uses of income.

Comparison between new and old ISTAT's series

	2002		2003		2004		2005		2006		2007	
	NS	OS	NS	OS	NS	OS	NS	OS	NS	OS	NS	OS
MACROECONOMIC PROJECTIONS (VOLUMES)												
GDP	0.5	0.3	0.0	0.0	1.5	1.2	0.6	0.1	1.8	1.9	1.5	1.7
Imports	0.2	-0.5	1.2	0.8	4.2	2.7	2.2	0.5	5.9	4.3	4.4	2.3
Household consumption	0.2	0.2	1.0	1.0	0.7	0.7	0.9	0.6	1.1	1.5	1.4	1.8
Final consumption expenditure of general government and NPISHs	2.5	2.2	1.9	2.1	2.3	1.6	1.9	1.5	0.9	-0.3	1.3	0.1
Gross fixed capital formation	3.7	4.0	-1.2	-1.7	2.3	1.6	0.7	-0.5	2.5	2.3	1.2	2.8
Machinery, equipment and others	1.9	3.4	-4.6	-4.1	2.3	1.8	0.9	-1.2	3.5	2.6	0.2	1.9
Construction	5.9	4.8	2.4	1.4	2.2	1.5	0.5	0.3	1.5	2.1	2.2	4.0
Exports	-2.9	-4.0	-2.0	-2.4	4.9	3.3	1.0	-0.5	6.2	5.3	5.0	2.1
CONTRIBUTIONS TO GDP GROWTH												
Net exports	-0.8	-1.0	-0.8	-0.8	0.2	0.2	-0.3	-0.3	0.1	0.3	0.1	-0.1
Inventories	0.0	0.0	0.1	0.2	-0.1	-0.1	-0.2	-0.2	0.5	0.3	0.0	0.1
Domestic demand	1.3	1.3	0.7	0.6	1.4	1.1	1.0	0.5	1.3	1.3	1.4	1.7
PRICES												
GDP deflator	3.3	3.4	3.1	3.1	2.6	2.9	2.1	2.2	1.7	1.8	2.3	2.4
Import deflator	-0.3	0.4	-1.3	-0.9	2.7	4.2	6.2	7.9	7.6	9.1	2.3	4.4
Consumption deflator	2.9	2.9	2.8	2.8	2.6	2.6	2.3	2.4	2.7	2.7	2.2	1.8
Government and NPISHs consumption deflator	2.6	2.8	3.7	3.6	2.8	3.4	3.3	3.6	2.0	3.4	0.4	0.8
Gross fixed capital formation deflator	2.9	2.6	1.6	2.0	2.7	3.2	2.9	3.1	2.6	2.4	2.6	3.6
Exports deflator	1.4	2.6	0.4	0.9	2.6	4.2	4.0	5.6	4.5	5.2	3.6	6.4

Note: NS (new series); OS (old series). For 2007, the old series represent the annual rate of growth which would prevail on the basis of the first three quarters and in case of a null growth in the fourth quarter (seasonally and working day adjusted data).

The official growth estimates for 2007 included in the Forecasting and Planning Report for 2008 of last September and the final issue published by ISTAT on February 29 cannot be directly compared. As shown in the Table below, between October 2007 and February 2008 the main research institutions and international organisations estimated a growth rate for 2007 ranging between 1.7 and 1.9 per cent, in line with the estimates of the Forecasting and Planning Report.

Comparison of Italy's growth projections

REAL GDP (y-o-y %)	Release date	2006	2007
Forecast and Planning Report for 2008 (RPP 2008)	Sep-07	1.9	1.9
Prometeia	Jan-08	1.9	1.7
Bank of Italy	Jan-08	1.9	1.7
Confindustria	Dec-07	1.9	1.8
REF.IRS	Nov-07	1.9	1.8
CER	Nov-07	1.9	1.8
ISAE	Oct-07	1.9	1.8
IMF (WEO)	Oct-07	1.9	1.7
European Commission	Feb-08	1.9	1.8
OECD (EO82)	Dec-07	1.9	1.8
Consensus Economics	Jan-08	1.9	1.8

Notes: Projections by OECD, ISAE and Bank of Italy refer to seasonally- and working day-adjusted data. At their release date, projections by both ISAE and Bank of Italy for 2007 were 1.9 per cent for 2007 in terms of unadjusted data.

3. PUBLIC FINANCE

3.1 GENERAL GOVERNMENT

3.1.1 2007 Outcome

According to ISTAT data, in 2007 general government net borrowing was €29.2 billion, equal to 1.9 per cent of GDP, the lowest in a decade. Despite lower-than-expected GDP growth, the deficit is much smaller than the target set for Italy in 2005 under the excessive deficit procedure (2.8 per cent) and the target set last July in the Economic and Financial Planning Document (2.5 per cent) later revised in the Forecasting and Planning Report (2.4 per cent).

The procedure envisaged in the Maastricht Treaty was started in July 2005 after the ECOFIN Council had certified a deficit-to-GDP ratio of over 3.0 per cent since 2003. The procedure will be repealed in May once Eurostat certifies the final data and the European Commission publishes its new estimates.

The final data for 2007 show an improvement of 0.5 percentage points of GDP over the September forecasts, which was achieved thanks to higher revenues (€2 billion, mainly in tax revenues) and a significant reduction (€8.3 billion) of current expenditure net of interest.

A homogeneous comparison of actual data versus forecasts must therefore take into account the tax measures in favour of those whose income does not entitle them to benefits, envisaged by the Decree Law No. 159/2007 that had been entirely booked in 2007 as a measure to reduce direct taxation on the basis of the amount that had originally been forecast (€1.9 billion). In the ISTAT final data this measure had been booked as an increase in welfare benefits other than in kind. A comparison based on homogeneous elements between the September estimates and the final data shows that the increase in revenues is partly due to choices made by private-sector firms to postpone to their 2008 tax returns the IRAP (regional economic activity tax) deductions envisaged by the 2007 Budget (the so-called tax wedge). It is approximately 1 billion worth of fewer revenues not collected in 2007, but which will affect the 2008 accounts. The further additional revenue is the net effect of fewer social security contributions (€2.9 billion) mainly correlated to the statistical base of 2006 (for this year the correction made by ISTAT on the basis of the actual data of the Social Security Agencies was €2.4 billion), and ‘other additional current revenues’ mainly due to better overall management (€1.2 billion), more interest received (€0.9 billion), higher than expected international aid (€0.5 billion) mainly linked to funds received from the EU, more revenues from leased land and rights granted to exploit mineral fields (€0.4 billion).

On the expenditure side, compared with the estimates in the Forecasting and Planning Report the reduction also takes into account the impact of postponing to 2008 some measures agreed in the Decree Law of September, estimated at 0.2 per cent of GDP (including the deferred payment of the allowance envisaged for those whose income does not entitle them to benefits – so-called ‘incapienti’ – for most employees and self-employed individuals).

TABLE 3.1: GENERAL GOVERNMENT ACCOUNT AT UNCHANGED LEGISLATION – RESULTS VERSUS FORECASTS (in million of euro)

	2007		2008		2009		2010		2011	
	RPP sec.II	RUEF	RPP sec.II	RUEF	RPP sec.II	RUEF	RPP sec.II	RUEF	RPP sec.II	RUEF
EXPENDITURES										
Compensation of employees	166,031	164,645	177,442	175,050	176,789	174,931	178,957	177,901	181,984	180,877
Intermediate consumption	124,420	121,460	128,827	127,744	132,235	131,645	134,432	136,077	138,992	141,226
Welfare benefits (1)	267,120	265,284	278,315	278,340	284,679	284,570	294,998	294,640	305,520	305,210
Other current expenditures, net of interest	58,918	56,817	59,118	58,645	59,647	59,554	60,296	62,483	61,068	63,118
Total current expenditures, net of interest <i>(as % of GDP)</i>	616,489 39.9	608,206 39.6	643,702 40.1	639,779 40.2	653,350 39.4	650,700 39.6	668,683 38.9	671,101 39.5	687,564 38.7	690,431 39.2
Interest <i>(as % of GDP)</i>	74,534 4.8	76,726 5.0	78,300 4.9	79,307 5.0	81,388 4.9	80,981 4.9	84,101 4.9	82,489 4.9	86,109 4.8	84,803 4.8
Total current expenditures	691,023	684,932	722,002	719,086	734,738	731,681	752,784	753,590	773,673	775,234
Total capital account expenditures	67,595	68,493	62,552	66,095	66,229	70,751	66,578	70,303	66,911	71,396
including: Gross fixed capital formation	42,231	36,134	40,255	39,277	42,533	41,256	43,132	41,595	42,951	42,225
Contributions in capital account	23,389	24,769	20,721	24,632	22,103	26,414	21,847	25,189	22,341	26,359
Other transfers	1,975	7,590	1,576	2,186	1,593	3,081	1,599	3,519	1,619	2,812
Total expenditures, net of interest	684,084	676,699	706,254	705,874	719,579	721,451	735,261	741,404	754,475	761,827
Total expenditures	758,618	753,425	784,554	785,181	800,967	802,432	819,362	823,893	840,584	846,630
REVENUES										
Total taxes	458,254	459,888	472,487	470,810	484,235	484,004	501,424	503,636	517,485	521,389
including: Direct taxes (1)	231,839	233,660	241,228	241,102	246,789	245,846	257,359	258,842	265,973	269,752
Indirect taxes	225,532	225,928	230,903	229,476	237,413	237,926	244,035	244,562	251,482	251,405
Capital account taxes	883	300	356	232	33	232	30	232	30	232
Social contributions	207,710	204,772	218,141	214,141	224,640	220,450	230,847	226,833	237,871	233,790
including: Cash contributions	204,108	200,911	214,429	210,143	220,917	216,406	227,091	222,721	234,080	229,605
Non-cash contributions	3,602	3,861	3,712	3,998	3,723	4,044	3,756	4,112	3,791	4,185
Other current revenues	52,619	55,272	54,106	56,631	55,109	57,782	56,329	59,005	57,561	60,519
Total current revenues	717,700	719,632	744,378	741,350	763,951	762,004	788,570	789,242	812,887	815,466
Capital account revenues	3,677	4,314	4,411	4,876	4,837	5,320	4,864	5,363	4,890	5,404
Total revenues	722,260	724,246	749,145	746,458	768,821	767,556	793,464	794,837	817,807	821,102
<i>Memo item: Tax burden</i>	43.1	43.3	43.0	43.1	42.7	42.9	42.6	42.9	42.5	42.9
BALANCES										
Primary balance <i>(as % of GDP)</i>	38,176 2.5	47,547 3.1	42,891 2.7	40,584 2.6	49,242 3.0	46,105 2.8	58,203 3.4	53,433 3.1	63,332 3.6	59,275 3.4
Current account balance <i>(as % of GDP)</i>	26,677 1.7	34,700 2.3	22,376 1.4	22,264 1.4	29,213 1.8	30,323 1.8	35,786 2.1	35,652 2.1	39,214 2.2	40,232 2.3
Net borrowing <i>(as % of GDP)</i>	-36,358 -2.4	-29,179 -1.9	-35,409 -2.2	-38,723 -2.4	-32,146 -1.9	-34,876 -2.1	-25,898 -1.5	-29,056 -1.7	-22,777 -1.3	-25,528 -1.4
Nominal GDP	1,543,8 23	1,535,5 40	1,605,0 43	1,590,3 66	1,659,6 15	1,642,7 17	1,717,4 45	1,700,7 69	1,776,2 98	1,761,5 18

1) The values of 'allowances to low-income families' (incapienti) reported in the Forecast and Planning Report for 2008 are reclassified according to the ISTAT definition adopted in its new release published 29 February 2008. The estimated amount of 1,900 million is reclassified as social transfer instead of being deducted from direct taxes.

Cuts in current spending, amounting to about €6.1 billion, are the result of: (i) lower spending on compensation of employees (€1.4 billion) also linked to the savings in education and the partial postponement to 2008 of the hiring of new staff that was envisaged for 2007; (ii) lower intermediate consumption (about €3 billion) due to lower central government expenditure now undergoing rigorous monitoring and lower health care expenditure¹; (iii) lower disbursement under 'other current expenditure' (about €2.1 billion) mainly as a result of smaller contributions to the EU budget.

The cuts were offset by higher debt servicing costs (about €2.2 billion).

Capital expenditure is higher (by about €0.9 billion) due to a combination of several factors: (i) higher extraordinary burdens (amounting to €4.939 billion)² concerning the writing off of advances from tax concessionaires envisaged by the year-end Decree Law and a different system of imputing VAT refunds as a result of the ruling on company cars (amounting to €0.847 billion)³; (ii) higher contributions to investment (about 1.5 billion); (iii) lower increases in gross fixed investment (about €6.1 billion) resulting from fewer programmes implemented by the National Road Board - ANAS (about €2.1 billion)⁴ and by regional and local authorities as well as the postponement of some programmes to be financed mainly by Central Government agencies⁵.

THE EFFECT OF THE METHODOLOGICAL REVISION OF THE CRITERIA FOR APPLICATION OF VAT RULING ON AUTO VEHICLES

The methodology followed initially in evaluating the impact of the EU ruling on VAT refunds for cars considered the date of the ruling as the time of registration and made an indirect estimate of the potential number of taxpayers and the potential sum to be refunded, assuming all of the people entitled would file a refund request.

The adoption of some regulatory measures (introduction of a lump-sum taxation regime) and the limited number of requests filed for the lump-sum procedure provided new information on the possible behaviour of individuals entitled to the refund and set the stage for a downward revision of the burden the State would have to bear as a result of the ruling. In light of this and in agreement with Eurostat, a direct statistical methodology already used for other types of refunds was adopted, whereby the debt for the State is booked at the time when the requests for refunds are accepted after examination by the relevant financial administration.

Hence the extraordinary burden on the State resulting from the EU ruling on VAT refunds for company cars imputed in 2006 and estimated at €16 billion was eliminated, while VAT refunds

¹ The information provided by the Regional Authorities, showing lower health expenditure, will have to be based on evidence and analysed by the Regional Authorities in the technical fora institutionally established to verify the structural nature of the spending cuts and the contributions made by the individual Regional Authorities to slowing down increases. To this end, meetings have been scheduled for the second half of March.

² Following the transformation of the collection system through concessionaires that have been taken over by a company totally owned by the State, the positive development in public accounts enabled the refund of the tax originally levied on private concessionaires (D.L. n.248/2007).

³ See related Box below.

⁴ Spending cuts also affect programmes to be financed through additional funds amounting to €215 million appropriated by the Decree Law No. 159/2007.

⁵ Postponement of some disbursements resulting from funds allotted in Decree Law No. 159/2007 contingent upon verification of contributions towards severance pay.

for company cars amounting to €847 million were booked in the 2007 accounts for the first time, based on the requests filed on line by those under the lump-sum regime only.

After entering in the 2007 accounts the sums claimed under the lump-sum procedure, an estimate was made for the 2009-2011 period on the basis of the normal validation and settlement procedure of ordinary claims that have been filed and will be filed: refunds have been estimated to amount to €400 million for each year of the period considered.

Compared to the 2006 actual data, net borrowing decreased by 1.5 percentage points. The 2006 figure has been significantly readjusted to take into account the new imputation criteria for VAT refunds which led to a downward revision of net borrowing to 3.4 per cent of GDP. In the 2006-2007 period, the overall decrease in nominal terms in the deficit-to-GDP ratio was 2.3 percentage points. In structural terms the adjustment is even more marked: 2.9 per cent of GDP. A structural adjustment of a similar size has not been achieved since the 1995-1997 period.

One-off measures have not been used to improve the deficit for the second consecutive year, and they have mainly had a negative impact on the accounts. Net of these measures, the deficit-to-GDP ratio decreased from 3.0 per cent to 1.7 per cent in 2007. Excluding the impact of the economic cycle on public accounts, the structural deficit decreased from 2.9 per cent in 2006 to 1.6 per cent in 2007.

The primary surplus improved by 1.8 per cent of GDP, hovering around 3.1 per cent thanks to the 1.3 per cent GDP increase in revenue-to-GDP ratio (from 45.9 per cent to 47.2 per cent). It was the result of a significant increase in the tax base (it has been estimated that additional revenues in the 2006-2007 period amount to over €20 billion)⁶ and a 0.6 per cent reduction in primary expenditure as a proportion of GDP (from 44.7 to 44.1 per cent).

The current balance, which turned positive last year, increased its surplus reaching 2.3 per cent of GDP.

Current expenditure grew by 4.5 per cent, increasing by three tenths of a percentage point as a proportion to GDP as against the previous year (44.6 per cent in 2007 as against 44.3 per cent in 2006). This trend reflects the net increase in debt servicing (12.4 per cent as against 5.5 per cent recorded in 2006) which caused its proportion to GDP to rise by 4 tenths of a point (from 4.6 to 5.0 per cent). Debt servicing costs reflected increased interest rates in the first part of the year when most of the new issuances of State securities are placed in the market (about 70 per cent are placed in the first seven months).

Most of the increase in expenditure is related to Regional and Local Authorities, that mainly have variable-rate debt.

Net of debt service, current expenditure increased by 3.6 per cent, slightly below the growth rate of nominal GDP, thus allowing a marginal reduction in the GDP ratio for the second consecutive year (39.6 per cent in 2007 compared to 39.7 per cent in 2006 and 39.8 per cent in 2005). This is the best result since 2004. In the 2006-2007 period, the

⁶ See Box on the results of the fight against tax evasion.

average yearly increase was equal to 3.4 per cent, lower than the 5.1 per cent recorded in the 2001-2005 period. In real terms, the increase was 1.8 per cent in 2007 (1.4 per cent on average in 2006-2007), which was also smaller than that recorded in the previous five-year period (2.2 per cent a year on average). This result was achieved also thanks to the specific measures envisaged in the 2006 and 2007 Budgets, rigorous administrative monitoring of disbursements and the postponement of the renewal of some civil-service contracts. The effort to curb current primary expenditure would be even stronger if welfare benefits of a mandatory nature were excluded in the short term.

TABLE 3.2: CURRENT PRIMARY EXPENDITURE

	Nominal growth rate	Real growth rate
1991-1995	5.5	0.6
1996-2000	5.0	2.2
2001-2005	5.1	2.2
2006-2007	3.4	1.4

Compensation of employees increased by 1.1 per cent as against 4.1 per cent recorded in 2006. In addition to the failure to renew some of the expired contracts, the slowdown is also the result of an effort to curb hiring which partly offset the burden stemming from the 2006-2007 contract renewal round for employees working in the main Government sectors.

The growth in intermediate consumption, after the strong restraint in 2006, was moderate (2.1 per cent). It was thus possible to keep it below that of nominal GDP and to continue reducing it in terms of its ratio to GDP. Welfare benefits in kind (which mainly include spending for health care provided by private entities that have a special agreement with the national health service) increased much more slowly at a 0.9 per cent rate as against the 2.7 per cent increase of the previous year.

Health spending rose by 0.9 per cent, after growing by 5.4 per cent in 2006. Lower health expenditure was achieved thanks to the effectiveness of the measures taken to strengthen regional accountability and the mechanism used to book contractual obligations and reallocate resources according to a new accounting methodology. Net of these effects, the average yearly change in the 2006-2007 period has been estimated to be about 4.0 per cent compared to the yearly average change of about 6.5 per cent in the 2001-2005 period; all this occurred in spite of higher inflation pushing up the cost of benefits.

Overall, the increase in spending on final consumption continued to slowdown, recording a 1.6 per cent increase compared to 2.8 per cent in 2006 and to 5.3 per cent in 2005. Hence its gradual decrease as a proportion of GDP (from 20.4 per cent in 2005 to 20.2 per cent in 2006 and 19.8 per cent in 2007).

Conversely, expenditure on welfare benefits in cash increased by 5.2 per cent, thus reaching 17.3 per cent of GDP. This increase reflected the rise in welfare benefits other than pensions, especially as a result of increased family benefits expenditure (a burden of

€900 – 1,000 million)⁷ and the payment of the allowance to those whose income does not entitle them to benefits (amounting to about €560 million)⁸. Spending on pension benefits increased more modestly as a result of i) their adjustment to inflation (indexation to prices as from January 1 2007 is 2.0 per cent), ii) the redefinition of pension benefits currently paid and the payment of arrears, iii) the balance between new pension benefits to be paid and those whose payment has been discontinued, and iv) the disbursement of lowest pension benefits (amounting to €900 million approximately)⁹. The figures published by ISTAT on 2007 expenditure on welfare benefits in cash (€265,3 billion) are basically in line with the forecasts included in the Forecasting and Planning Report for 2008 (amounting to €265,2 billion). In making such a comparison it should be noted that the imputation criteria concerning allowance in favour of those whose income does not entitle them to benefits are different from those used in previous estimates¹⁰. Given that in the 2007 National Accounts allowance has been made for this tax-benefit programme assuming a cost of €560 million, overall expenditure on welfare benefits other than in kind was in line with forecasts for 2007.

Capital expenditure has decreased by 7.6 per cent thanks to the net effect of an increase in investment expenditure (3.9 per cent) and contributions to investment (11.1 per cent) as well as a reduction in other capital expenditure. The estimates include some extraordinary transactions (booked as ‘other capital expenditure’), which had a significant impact in 2006 and 2007, which would therefore result in a non-homogeneous comparison. Specifically, forecasts for 2007 imply the abolition of the advance paid by concessionaires of tax collection and the re-classification of VAT refunds, for a total amount of €5.8 billion. The 2006 accounts were also burdened by the writing-off of State receivables vis-à-vis TAV (the high-speed train company) for funding the high-speed train project (about €13 billion), as well as the burden resulting from the payment of social-security contributions receivables from agricultural workers to a securitisation firm (about €0.7 billion) and resulting from the refund of taxes paid by telecom operators (about €0.7 billion)¹¹. Net of these extraordinary transactions, overall capital expenditure increased by 5.2 per cent.

Total General Government receipts increased by 6.5 per cent and amounted to 47.2 per cent of GDP.

Tax revenues were €459,9 billion, thus growing at a yearly rate of 6.0 per cent, higher than the increase in nominal GDP (3.8 per cent) and resident household

⁷ The increase in family allowances is laid down by Law No. 296/2006 (2007 Budget).

⁸ The benefit share of the allowance (envisaged by Decree Law No. 159/2007, confirmed into Law No. 222/2007) was booked in the 2007 Budget and was automatically paid at the end of the year through withholding agents (mainly welfare agencies and to a very small extent through employers in the case of employees) whereas the benefit share for the self-employed was not entered (see article 2, paragraph 8 of the Ministerial Decree of November 8, 2007) and those in dependent employment, for whom withholding agents could not automatically pay off the amounts wholly or partly due at the end of 2007.

⁹ Decree Law No. 81/2007, confirmed into Law No.127/2007.

¹⁰ See the relevant note on Table 15 of the Forecasting and Planning Report for 2008- Section Two and the footnotes 8 and 9 on pages 15-16 of the Update of the Stability Programme of November 2007.

¹¹ Awarded by a ruling of the TAR del Lazio (Latium’s Regional Administrative Tribunal).

consumption (3.6 per cent)¹². Revenues net of *one-off measures* (amounting to about €6.0 billion in 2006 and €1.1 billion in 2007) grew at a much higher rate, 7.2 per cent.

Compared to the estimates contained in the Forecasting and Planning Report for 2008 and taking into account the different classification of the allowance for those whose income does not entitle them to benefits, tax revenues were €1.6 billion higher than expected, despite the sharp economic slowdown at the end of the year. This is yet an additional correction after the consecutive upward revisions made during 2007, in the 2008-2011 Economic and Financial Planning Document and in the Forecasting and Planning Report for a total amount of €10.7 billion.

The increase in tax revenues in 2007 was due both to more taxes paid at central level (the State budget) and local levies that have grown at much higher rates¹³. Specifically, gross tax revenues of the State were €417.4 billion (€422.2 billion if for the sake of a homogeneous comparison one does not rule out the impact of the writing off of the advance of concessionaires of tax collection which was included in 2006 but not in 2007), which means they are increasing at an annual rate of 5.4 per cent (which goes up to 6.7 per cent net of one-off measures). Particularly buoyant was the revenue from personal income tax (IRPEF) which grew at a yearly rate of 5.7 per cent, and from direct taxes paid through self-assessment (IRES – a corporate income tax – and part of IRPEF – the personal income tax) which grew by 24.1 per cent, as well as the registration tax and stamp duty, sustained by the additional budget measures for 2007. VAT grew by 4.0 per cent, partly curbed by a decrease in the consumption of oil products (which negatively affected the revenues from excise duties). Net of the oil industry, VAT on domestic trade increased by 5.7 per cent, well above the growth rate of resident household consumption (3.6 per cent).

According to estimates, the tax revenues of local authorities (about 20 per cent of total tax revenues) grew by 6.8 per cent (official data will be disseminated by ISTAT in the next few months). The higher growth rate of local tax revenues is linked to the surge in the add-on to personal income tax (*addizionale IRPEF*) both at regional and municipal level, whose revenues in 2007 increased by 19.5 and 43.0 per cent respectively as a result of local tax rate increases. More specifically, in 2007 about 43 per cent of municipalities increased the add-on rate of the personal income tax, 56 per cent of municipalities left it unchanged and few reduced it as against 2006 rates. Generally speaking, the increase in local taxes reflects the choice of Local Governments to comply with the Health Agreement and the Internal Stability Pact by modifying taxes and levies rather than taking action on spending.

¹² 2007 revenues do not include the impact of the so-called allowance for those whose income does not entitle them to benefits (Decree Law No. 159/2007, €1.9 billion). See note 10.

¹³ Central and Local Government revenues are before refunds, adjustments and any other corrective item in the national accounts.

TABLE 3.3: TAX REVENUES

	Jan-Dec 2007		
	In Mn	% change on 2006	as % of Total
Direct Taxes	223,301	7.2	52,9
IRE	153,683	5.7	36,4
IRES	50,712	27.3	12,0
Others	18,906	-17.9	4.5
including: Substitution of Capital Income	10,775	21.2	2.6
Indirect Taxes	198,864	3.5	47.1
Registration tax	5,810	10.8	1.4
VAT	120,140	4.0	28.5
- Domestic Trade	105,749	4.7	25.0
- Imports	14,391	-0.4	3.4
Excise duty	39,552	-1.0	9.4
Other Indirect Taxes (Stamp duty and others)	21,975	5.9	5.2
Others (Games)	11,387	5.6	2.7
Total revenues (gross of one-off measures) (1)	422,165	5.4	100.0
Total revenues (net of one-off measures)		6.7	

1) Including the advance of tax collection concessionaires.

Social security contributions increased by 8.0 per cent as a result of the increase in the statutory tax rate for the self-employed and the revenues from contributions resulting from the choice made by individuals working for companies with more than 50 employees to keep their severance-pay funds with INPS in 2007¹⁴ rather than entrusting them to supplementary pension funds.

The tax burden reached 43.3 per cent of GDP¹⁵. In the 2006-2007 period the portion of revenues not to be attributed to the economic cycle and to tax measures was estimated - even though conservatively - to amount to over 1.0 per cent of GDP. Some of these higher revenues were used to finance 10 billion worth of tax cuts in favour of households and firms¹⁶. This increase reflects the results achieved through the fight against tax evasion and the increase in voluntary tax compliance. In line with international standards, data on tax burden includes the new severance-pay provision paid to INPS by firms whose employees did not opt for supplementary pension funds, but does not include the tax refund to payers who do not pay any net taxes (the so-called allowance for those who do not earn enough to pay net taxes). The first phenomenon is not an actual payroll burden while the second is an actual tax break, booked as welfare benefit other than in kind.

¹⁴ The fund collecting the social security contributions of workers in companies with less than 50 employees was set up within INPS as of January 1st 2007 under Law No. 296/2006 and is referred to as 'Fund for disbursement of severance pay to private-sector employees under Article 2120 of the Civil Code'.

¹⁵ Tax burden would decrease to 42.5 per cent of GDP if the following items were non included: i) deductions granted to those who do not earn enough to pay direct taxes, ii) the advances paid by collection concessionaires, which in compliance with accounting principles, were recorded as an increase in expenditure and iii) the severance-pay provision paid to INPS, which is not a burden on taxpayers.

¹⁶ See box on the results achieved in the fight against tax evasion.

3.1.2 ISSUANCE POLICY AND TRENDS IN PUBLIC DEBT STOCK

In 2007 public debt management ensured the funding of the public sector borrowing requirements¹⁷ on the basis of criteria aimed at containing costs and interest rate risk (both in nominal and real terms) and refinancing risks. Despite strong instability due to the impact of the US sub-prime mortgage crisis on monetary and bond markets, the Treasury's issuance and debt management policies have further reduced exposure to risks related to debt servicing. In the first half of 2007, bond market interest rates have continued to increase for all maturities, while the upward trend stopped in July causing a further increase in the volatility of the yield curve shape. Interest rate trends for Italy's government bond market were similar to those of other Euro-area government securities, with wide price fluctuations also over short periods of time.

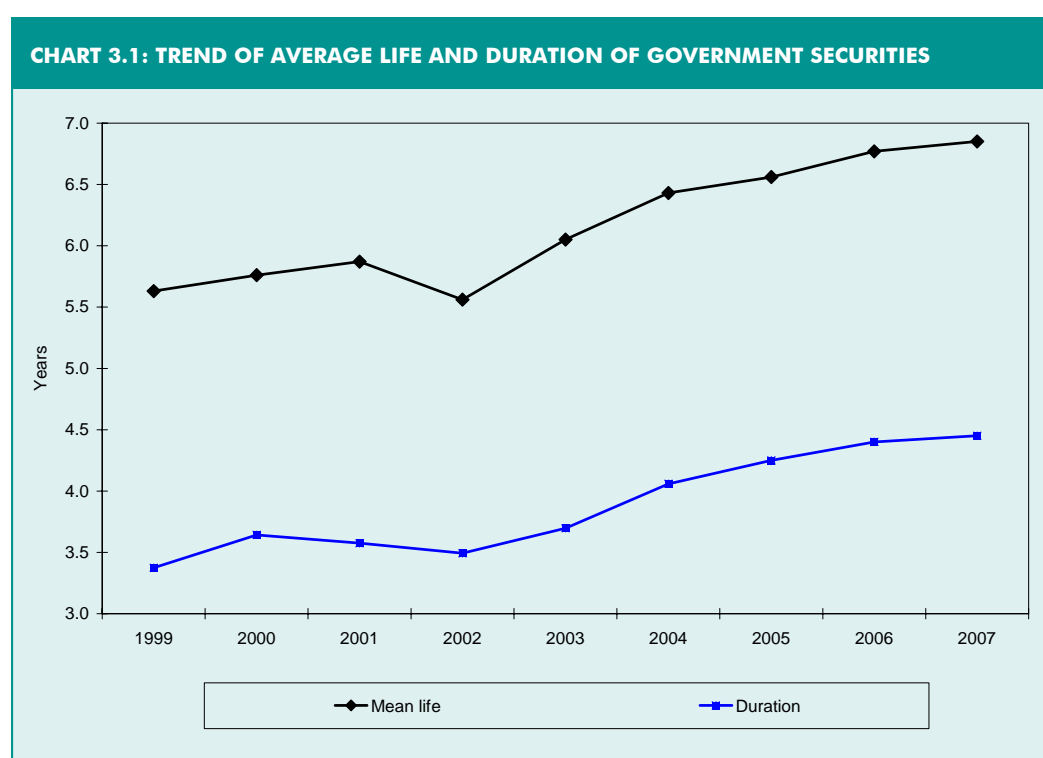
Exposure to the refinancing risk decreased, as measured by the overall average life of all government bonds, which moved from 6.77 years at the end of 2006 to 6.85 years at the end of 2007. This was achieved thanks to an increase in the proportion of bonds with residual maturity of over 5 years, which was 44 per cent in 2007 as against 43 per cent in 2006, and a simultaneous gradual decline in very short-term securities (with maturity of less than a year) which decreased from 13 per cent in 2006 to 12 per cent in 2007. Financial duration, which measures the risk of exposure to interest rate fluctuations, stood at around 4.45 years at the end of December 2007, thus recording an increase compared to 4.40 years at the end of 2006. A similar result was achieved in terms of *Average Refixing Period (ARP)*¹⁸, which measures the average time in which debt responds to changes in market interest rates, which for government bonds of the domestic programme alone was 5.68 years in 2007, about 0.7 years more than in 2006.

The average weighted yield of 2007 issuances reached 4.14 per cent as against 3.32 per cent in 2006, as a result of the across-the-board increase in market interest rates in the first seven months of the year, when over 70 per cent of the yearly issuances was placed. In 2007, General Government expenditure for interest as a proportion of GDP, calculated on the basis of the SEC95 accruals criterion, went up from 4.6 per cent in 2006 to 5.0 per cent, also following the surge in interest rates in the first half of the year. This surge, whose consequences were already taken into account in the July forecasts for debt servicing costs included in the Economic and Financial Planning Document and in its September Update, has had a significant impact on the interest paid on Government and Local Authorities bonds. As to interest payments on Government bonds, which have gone up by about 6.1 billion compared to 2006, it should be noted that the increase in market yields which continued uninterrupted during the first seven months of the year, affected a substantial part of all 2007 issuances, as most of them were placed on the market precisely in the first seven months of the year, also because of expectations of further increases in rates which did not materialise due to the unexpected international financial crisis. What compounded the impact of market rates on interest paid on

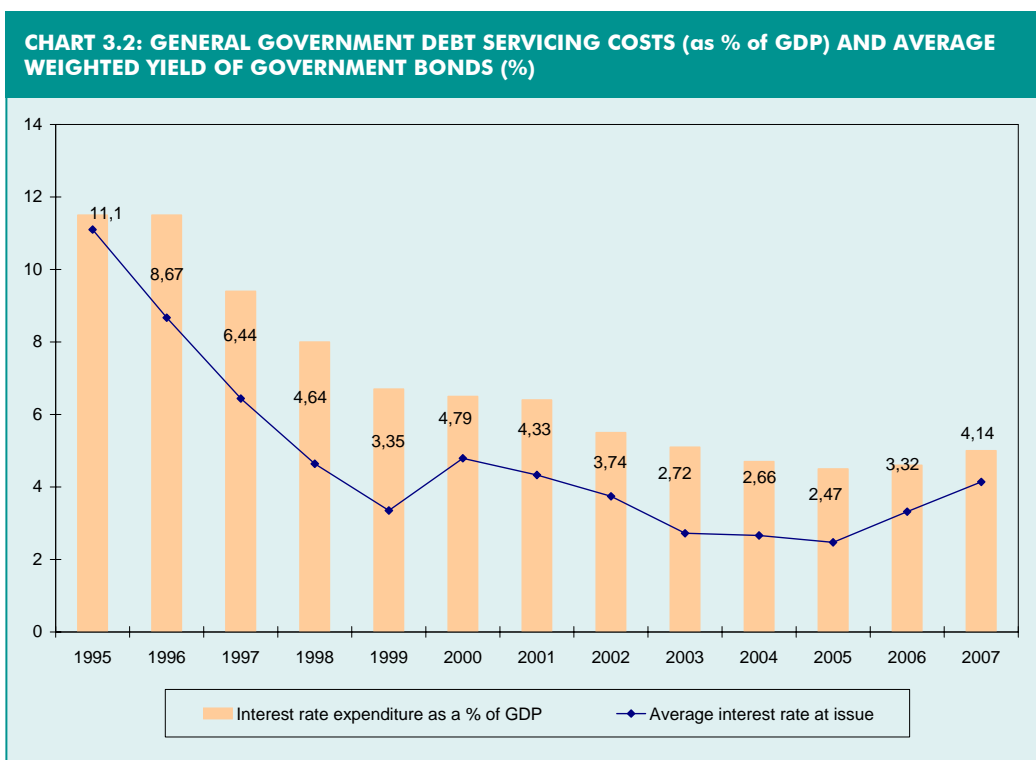
¹⁷ It should be noted that in 2007 the Treasury's issuances ensured funding to cover the financial impact of Art. 1 paragraph 630 of the 2007 Budget which mandated the use by the State Treasury of the funds raised by Poste Italiane SpA through banking activities for private clients.

¹⁸ The *Average Refixing Period (ARP)* measures the average time in which bond coupons are refixed. For zero-coupon bonds and fixed coupon bonds it corresponds to the residual life of bonds. For floating coupon bonds it corresponds to the time left until the fixing of the next coupon.

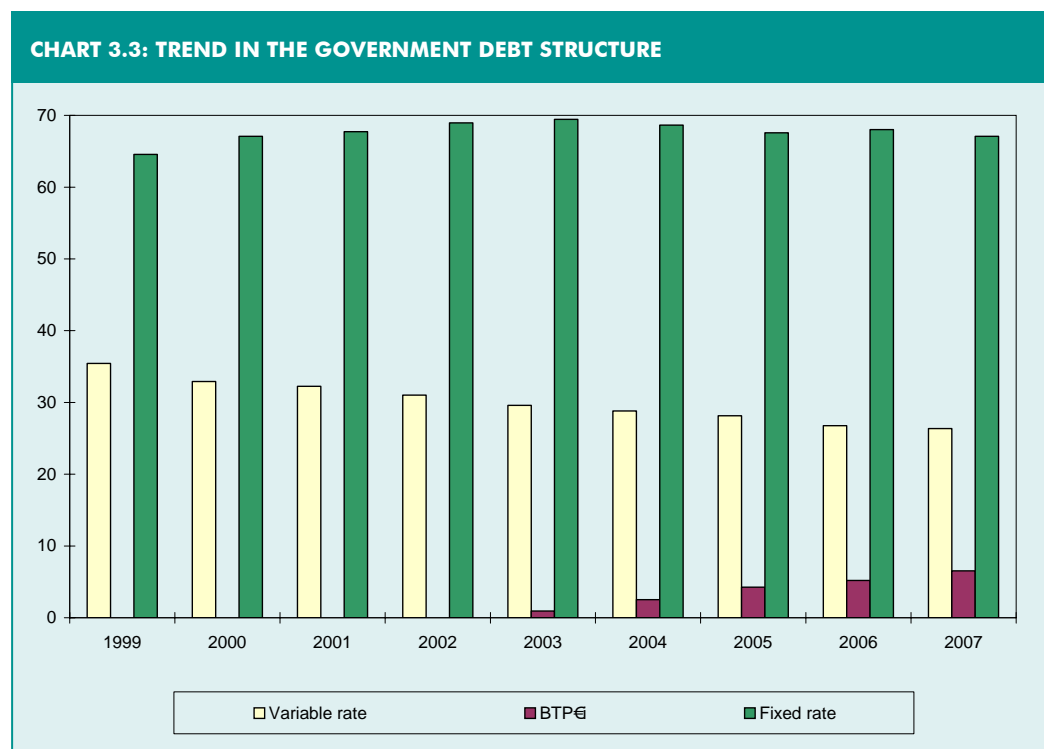
Government bonds was also the fact that the Treasury relied on short-term and very short-term securities (and did so to a greater extent than in 2006) issued during the year to make up for the greater daily and monthly volatility of the State sector borrowing requirements. These effects have compounded the overall natural increase in debt servicing costs caused by the growth in the nominal value of the overall outstanding debt stock. As for Local Authorities, whose debt service has increased by about 1.1 billion, even though net borrowing has not significantly increased compared to the previous year, it should be noted that a significant share of outstanding debt is at variable rates and thus exposed to spending increases if there is a significant rise in market rates, as was the case in 2007¹⁹.



¹⁹ It should be noted that a significant decrease (of about 0.8 billion) in the cost of financial brokerage (so-called FISIM, financial intermediation services indirectly measured) also had an impact on the final figure for General Government debt servicing costs for 2007 compared to 2006. These costs are deducted from the figure for debt service paid by General Government and booked as *intermediate consumption*.



In 2007, debt management decisions were characterised by consistency, transparency and regularity of issuance. In order to ensure greater penetration in international portfolios, securities were issued also on the basis of an accurate analysis of demand trends. At the end of 2007, the share of fixed-rate securities remained stable at 63 per cent (BTP 59.61 per cent and CTZ 3.34 per cent); short-term variable rate securities (BOT 9.96 per cent and CCT 14.79 per cent) decreased slightly to about 24.75 per cent (as against 24.95 in 2006); foreign-currency securities went down to 6.31 per cent from 6.79 per cent in 2006. The issuance decrease in the main international currencies is mainly caused by the fact that foreign-currency securities had not offered any advantage over domestic securities as a means of financing the debt. European-inflation linked securities show a notable increase, from 4.85 per cent in 2006 to 6.14 per cent in 2007. In the medium term, domestic securities are characterised by: i) a gradual reduction in the proportion of variable or short-term securities; ii) the stability of fixed-rate nominal securities (about 67 per cent); iii) the consolidation of the proportion of index-linked securities to meet the need to diversify the nominal and real exposure of the debt. This was also achieved through stock exchange and buyback operations, planned with a view to readjust future maturities and to support liquidity in the secondary market.



The value of the debt-to-GDP ratio at the end of 2007 stood at 104.0 per cent of GDP, thus recording a 2.5 percentage points decrease compared to 2006 (106.5 per cent). The figure is significantly below the official forecasts published in the Update of the Economic and Financial Planning Document for 2008-2011 of last September and in the Update of the Stability Programme released in November. One of the reasons for the improvement is the recent revision in GDP series by the Italian Statistical Office (ISTAT)²⁰ for the years 2001-2007. The revision has had a significant impact on 2005 and 2006. As to 2005, the upward revision of nominal GDP reduced the debt-to-GDP ratio by about 0.4 percentage points, while for 2006 the review improved the debt-to-GDP ratio by 0.3 percentage points. Conversely, changes in the year-end nominal debt stock for both years were not significant.

For 2007, the revision of GDP series (with forecasts of the nominal value of debt used in the latest official documents remaining unchanged) would have caused a similar reduction (of about 0.3 percentage points) in the debt-to-GDP ratio, if nominal growth had remained in line with the forecasts of the latest Update of the Stability Programme (4.6 per cent). In 2007, nominal GDP growth turned out to be lower (3.8 per cent); this offset the impact of the GDP upward revision in the debt-to-GDP ratio of previous years.

For the year 2007, the 1.0 percentage point difference as against forecasts of debt-to-GDP ratios is almost entirely related to a lower-than-expected increase in the debt stock. This result was mainly achieved thanks to a higher-than-expected drop in the Public Sector Borrowing Requirements (of about 0.4 percentage points per cent of GDP)

²⁰ See update of the national accounts published by ISTAT on 29 February 2008.

and the notable decrease (compared to expectations) in the balance of the Treasury's account with the Bank of Italy (of about 1.0 percentage point of GDP). The decrease was possible because at the end of 2006 the funds deposited in the account were kept at a relatively high level (22,300 million) to cover any current liabilities of the Treasury in the first months of the following year. During 2007 the need was felt to keep similar, though somewhat smaller, deposits also for the end of 2007. Debt management strategies over the year were aimed at meeting this target and were implemented on the basis of forecasts for the Public Sector Borrowing Requirements, which, until few weeks before year-end, seemed to be significantly lower than in September. However, in the last few days of the year, there was a sudden acceleration in cash payments of General Government, both at central and local level, that had to be financed through the funds on the Treasury's account as it was no longer possible to resort to new issuances of Government bonds. This caused a higher-than-expected decrease in funds, resulting in a final balance of 9.680 million.

CHART 3.4: TREND IN PUBLIC DEBT AS % OF GDP



The whole approach to debt management and issuance policy in 2008 will remain broadly consistent with that of 2007. A substantial part of issuances will follow a regular and predictable pattern. Transparent placement will be ensured as well as an issuance policy enhancing market liquidity of all issued bonds. Based on market conditions and demand trends, the Treasury will continue to tap the market with different securities with a view to containing financing costs against a backdrop of prudent risk management, especially as to refinancing and interest rate risks.

3.1.3 Trends for 2008 and the following years

The public finance scenario for 2008 and the following years takes into account the changes in real growth prospects for the Italian economy. Forecasts were revised downwards for 2008 from 1.5 per cent (September 2007) to the current 0.6 per cent. In addition the forecast includes: (i) the carry-over effects of the good results achieved in 2007 both in terms of revenues and expenditure; (ii) the postponement to 2008 of some programmes envisaged in the Decree Law No. 159/2007; (iii) the changes made to the current regulatory framework as against the budget measures submitted to Parliament.

The new forecasts, developed assuming no changes in the existing legislation are made, are based on cautious assumptions both on the revenues and on the expenditure side: they predict net borrowing of 2.4 per cent of GDP for 2008. Despite the substantial revision of growth estimates and the postponement of some burdens from 2007 to 2008, net borrowing is forecast to be only slightly higher than last September's forecasts (2.2 per cent of GDP). Projections for the following years show net borrowing of 2.1 per cent of GDP in 2009, 1.7 per cent of GDP in 2010 and 1.4 per cent in 2011. Compared to the percentages in the Forecasting and Planning Report for 2008, net borrowing as a proportion of GDP is forecast to increase by an average 0.1-0.2 percentage points more each year in the 2009 -2011 period.

Compared to the data reported in the Forecasting and Planning Report of last September the new forecasts for 2008 include a whole series of factors that are summed up in Table 3.4; some of their effects will be felt until 2008, others also in the following years.

TABLE 3.4: ANALYSIS OF NET BORROWING FORECASTS FOR 2008

	In Mn	% GDP	GDP
RPP 2008 Net borrowing	-35.409	-2.2	1.605.043
- Macroeconomic projections' effect net of interest	-3.587		
including: Taxes	-2.392		
Social contributions	-950		
- Interest	-1.007		
- Postponements D. L. 159	-3.090		
including: allowance to low-income families ('incapienti')	-782		
- 'Mille proroghe' Decree, ICI and IRAP postponement (tax wedge)	-2.531		
including: IRAP and ICI postponements	-1.600		
'Mille proroghe'	-931		
- 2007 carry-over and ISTAT revision	6.901		
RUEF NET BORROWING	-38.723	-2.4	1.590.366
RPP - RUEF Difference	-3.314	-0.2	

The following are the differences on the revenue side from the September forecasts (see Table 3.1):

- net tax revenues decreasing by €1,677 million (mainly direct taxation decreasing by €1,427 million) as a result of: i) the downward revision of growth for 2008 with an estimated overall effect of €2,392 million; ii) the postponement to 2007 of a share of the reduced tax revenues following the reduction (of about €1,000 million) in the 'tax wedge'; iii) the adjustment of the cadastral coefficients to calculate ICI (Imposta Comunale

Immobili – the local property tax) (approximately €600 million). The lower tax revenues are partly offset by the carry-over effect of higher receipts in 2007. Forecasts assume that the higher revenues from improved tax compliance (over €20 billion) in the past two-year period is something that will also occur in the future; however, to err on the safe side, forecasts do not include a further increase in taxable income. More specifically, considering the differential impact on revenues of the 2007 and 2008 budgets, the one-off measures and other occasional phenomena, the basic elasticity of tax revenues to GDP for 2008 is estimated to hover around 1.0 percentage point²¹. This figure reflects on the one hand the stabilisation of the impact of the fight against tax evasion, and, on the other, new macroeconomic projections. The growth rate of compensation per employee (which is relevant to high-elasticity taxes such as IRE) and higher GDP growth push up the overall elasticity of revenues to GDP.

- Contributions decreasing by 4,286 million as a result of the revision in macroeconomic projections (€950 million) while the remaining part is mainly the result of new ISTAT estimates on the devaluation coefficient of social-security contribution inspections.

- ‘other current receipts’ increasing by €2,525 million as a result of an adjustment of forecasts following higher receipts in 2007.

On the revenue side, a moderate increase of €627 million is estimated as the net effect of higher capital expenditure totalling €3,543 million and higher interest totalling €1,007 million, partially offset by lower current expenditure net of interest payments worth €3,923 million.

Specifically under current expenditure mention should be made of:

- A lower burden in terms of compensation of employees (€2,392 million) as a result of the carry-over effect of the more moderate increase recorded in 2007, according to actual data. The estimate not only takes into account the signing of all contracts that had to be renewed in the 2006-2007 period (about €7,500 million, €3,570 of which as arrears), but also the final signing of all contracts expired in the 2002-2003 and 2004-2005 periods (about €260 million) and the payment only of the allowance foreseen for the current two-year period between the old contract expiry and the new contract enforcement dates. Contract renewals account for 5.1 percentage points of the growth rate of compensation of employees, which is 6.3 per cent. The remaining part reflects both the impact of a limited increase in employment (forecast to decrease by 0.1 per cent in 2008), and factors affecting the increase in compensation of employees other than contract renewals, including the shoring up of short-term and temporary jobs;
- intermediate consumption decreasing by 1,083 million as estimated on the basis of the lower increases in 2007, only partially assumed in the forecasts of the Forecasting and Planning Report in order to err on the safe side. As far as State administration is concerned, fewer spending cuts are expected in 2008 both as a result of a slight increase in expenditure after a year of rigorous discipline and the

²¹ Basic elasticity of tax revenues to GDP is calculated considering the differential effects of all budget measures (including the impact of past budgets and one-off measures) on the 2008 tax revenues compared to 2007.

- costs of the general and local elections that will be held in 2008 (about €700 million);
- the estimate reported in the Forecasting and Planning Report for 2008 for welfare benefits has been basically confirmed, despite the postponement of a share (about €780 million) of the burden due to the allowance in favour of those who do not earn enough to pay direct taxes (so-called ‘incapienti’);
- ‘other current expenditure’ is expected to be €473 million less than the forecast included in the Forecasting and Planning Report. The forecast for 2008 also reflects the postponement of some expenditure for transfers to families and to private as well as foreign social institutions authorised by Decree Law No. 159/2007.

The new estimate of capital expenditure, net of divestment, shows lower direct investment decreasing by €778 million (the savings achieved in 2007 amounted to €5,840 million) and increasing contributions (€3,911 million) to investment (the rise in investment spending in 2007 was €1,380 million).

Overall, the cut in net capital expenditure reflects the impact of the €4,939 million tax refund in 2007 to concessionaires of tax collection: net of this one-off refund the increase rate is 3.5 per cent, as it implies, *inter alia*, the implementation in 2008 of some programmes authorised by Decree Law No. 159/2007 that had not been carried out by December 31 as expected and under the full operation of the mechanisms envisaged to release the appropriations contingent upon prior verification of contributions towards the severance-pay fund.

More specifically, it should be noted that:

- The savings achieved in direct investment in 2007 relate to direct investment funded out of the State budget (approximately €1,260 million), ANAS programmes (amounting to €2,100 million approximately) and local authorities (about €2,300 million). Lower investment to be funded out of the State budget is due to the postponement of some programmes authorised by Decree Law No. 159/2007 and other programmes to be funded through appropriations contingent upon prior verification of contributions towards the severance-pay fund. As to ANAS, despite urgent requests for liquidity, the Company proved to have a smaller-than-expected operational capacity, even though growing compared to the the past. As a result, for 2008 investment spending is expected to be €3,500 million, about 1,100 million less than the ANAS forecast, but still higher than the actual expenditure of the previous years.
- The savings achieved in local government expenditure are mainly due to expenditure levels which are lower than the limits set for compliance with the Internal Stability Pact. This potential expenditure, assumed in the forecasts of the Forecasting and Planning Report, took 2004 as the benchmark year. In 2004 expenditure was much higher than in later years (gross fixed investment by Municipal Authorities, totalling €16,651 million in 2004, was €15,272 million in 2005, €15,151 million in 2006, €15,529 in 2007).
- As to contributions to investment, higher spending in 2007 (higher than estimated in the Forecasting and Planning Report) was mainly funded out of the :

State budget and investments were made despite the postponement of some expenditure authorised by the Decree Law No. 159/2007 or made contingent upon verification of contributions towards the severance pay fund, which are then taken into account in the forecast for 2008.

- the item ‘other capital expenditure’ is expected to rise by €610 million after increasing by €5,481 million in 2007.

TABLE 3.5: GENERAL GOVERNMENT ACCOUNT AT UNCHANGED LEGISLATION (Mn)

	2005	2006	2007	2008	2009	2010	2011
EXPENDITURES							
Compensation of employees	156,542	162,889	164,645	175,050	174,931	177,901	180,877
Intermediate consumption	118,823	118,992	121,460	127,744	131,645	136,077	141,226
Social benefits	242,346	252,119	265,284	278,340	284,570	294,640	305,210
Other current expenditures net of interest	51,188	53,222	56,817	58,645	59,554	62,483	63,118
Total current expenditures net of interest	568,899	587,222	608,206	639,779	650,700	671,101	690,431
Interest	64,700	68,244	76,726	79,307	80,981	82,489	84,803
Total current expenditures	633,599	655,466	684,932	719,086	731,681	753,590	775,234
Total capital expenditures	58,377	74,008	68,493	66,095	70,751	70,303	71,396
including:							
Gross fixed capital formation	33,711	34,792	36,134	39,277	41,256	41,595	42,225
Contributions in capital account	21,988	22,292	24,769	24,632	26,414	25,189	26,359
Other transfers	2,678	16,924	7,590	2,186	3,081	3,519	2,812
Total expenditures net of interest	627,276	661,230	676,699	705,874	721,451	741,404	761,827
Total expenditures	691,976	729,474	753,425	785,181	802,432	823,893	846,630
REVENUES							
Total tax revenues	394,422	433,714	459,888	470,810	484,004	503,636	521,389
including:							
Direct taxes	189,815	213,308	233,660	241,102	245,846	258,842	269,752
Indirect taxes	202,736	220,181	225,928	229,476	237,926	244,562	251,405
Taxes in capital account	1,871	225	300	232	232	232	232
Social contributions	183,445	189,683	204,772	214,141	220,450	226,833	233,790
including:							
Cash contributions	179,972	186,072	200,911	210,143	216,406	222,721	229,605
Non-cash contributions	3,473	3,611	3,861	3,998	4,044	4,112	4,185
Other current revenues	49,600	52,194	55,272	56,631	57,782	59,005	60,519
Total current revenues	625,596	675,366	719,632	741,350	762,004	789,242	815,466
Capital account revenues	4,081	4,249	4,314	4,876	5,320	5,363	5,404
Total revenues	631,548	679,840	724,246	746,458	767,556	794,837	821,102
BALANCES							
Primary balance	4,272	18,610	47,547	40,584	46,105	53,433	59,275
Current account balance	-8,003	19,900	34,700	22,264	30,323	35,652	40,232
Net borrowing	-60,428	-49,634	-29,179	-38,723	-34,876	-29,056	-25,528
Nominal GDP	1,428,375	1,479,981	1,535,540	1,590,366	1,642,717	1,700,769	1,761,518

Compared to the 2007 actual data, the new forecasts for 2008 show receipts and expenditure growing by 3.1 and 4.3 per cent respectively.

Tax revenues are forecast to grow by 2.4 per cent (as a result of direct taxation which is expected to grow by 3.2 per cent and indirect taxation estimated to increase by 1.6 per cent), whereas social security contributions are expected to increase by 4.6 per cent. The growth rate of revenues compared to the previous two-year period reflects: i) the cyclical trend, ii) the postponement of a share of the burden for the reduction of the so-called ‘tax wedge’, iii) the impact of the measures envisaged in the Budget and iii) the

assumption that there will be no further increase in the tax base as a result of the fight against tax evasion and tax avoidance.

Tax burden is forecast to decrease from 43.3 of 2007 to 43.1 per cent in 2008.

TABLE 3.6: GENERAL GOVERNMENT ACCOUNT AT UNCHANGED LEGISLATION (as % of GDP)

	2005	2006	2007	2008	2009	2010	2011
EXPENDITURES							
Compensation of employees	11.0	11.0	10.7	11.0	10.6	10.5	10.3
Intermediate consumption	8.3	8.0	7.9	8.0	8.0	8.0	8.0
Social benefits	17.0	17.0	17.3	17.5	17.3	17.3	17.3
Other current expenditures net of interest	3.6	3.6	3.7	3.7	3.6	3.7	3.6
Total current expenditures net of interest	39.8	39.7	39.6	40.2	39.6	39.5	39.2
Interest	4.5	4.6	5.0	5.0	4.9	4.9	4.8
Total current expenditures	44.4	44.3	44.6	45.2	44.5	44.3	44.0
Total capital expenditures	4.1	5.0	4.5	4.2	4.3	4.1	4.1
including: Gross fixed capital formation	2.4	2.4	2.4	2.5	2.5	2.4	2.4
Contributions in capital account	1.5	1.5	1.6	1.5	1.6	1.5	1.5
Other transfers	0.2	1.1	0.5	0.1	0.2	0.2	0.2
Total expenditures net of interest	43.9	44.7	44.1	44.4	43.9	43.6	43.2
Total expenditures	48.4	49.3	49.1	49.4	48.8	48.4	48.1
REVENUES							
Total tax revenues	27.6	29.3	29.9	29.6	29.5	29.6	29.6
including: Direct taxes	13.3	14.4	15.2	15.2	15.0	15.2	15.3
Indirect taxes	14.2	14.9	14.7	14.4	14.5	14.4	14.3
Taxes in capital account	0.1	0.0	0.0	0.0	0.0	0.0	0.0
Social contributions	12.8	12.8	13.3	13.5	13.4	13.3	13.3
including: Cash contributions	12.6	12.6	13.1	13.2	13.2	13.1	13.0
Non-cash contributions	0.2	0.2	0.3	0.3	0.2	0.2	0.2
Other current revenues	3.5	3.5	3.6	3.6	3.5	3.5	3.4
Total current revenues	43.8	45.6	46.9	46.6	46.4	46.4	46.3
Capital account revenues	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Total revenues	44.2	45.9	47.2	46.9	46.7	46.7	46.6
<i>Memo item: Tax burden</i>	<i>40.5</i>	<i>42.1</i>	<i>43.3</i>	<i>43.1</i>	<i>42.9</i>	<i>42.9</i>	<i>42.9</i>
BALANCES							
Primary balance	0.3	1.3	3.1	2.6	2.8	3.1	3.4
Current account balance	-0.6	1.3	2.3	1.4	1.8	2.1	2.3
Net borrowing	-4.2	-3.4	-1.9	-2.4	-2.1	-1.7	-1.4
Nominal GDP	1,428,375	1,479,981	1,535,540	1,590,366	1,642,717	1,700,769	1,761,518

Current expenditure net of interest is forecast to increase by 5.2 per cent, whereas capital expenditure is projected to decrease by 3.5 per cent. Debt servicing costs are projected to decrease to 3.4 per cent.

The increase in current expenditure net of debt service implies a 6.3 per cent rise in compensation of employees (a total of €10,410 million, which, among other things, reflects the higher expenditure for contract renewals related to the 2002-2003, 2004-2005, and 2006-2007 periods).

Both the increase in intermediate consumption (5.2 per cent) and that in welfare benefits in cash (4.9 per cent) are prudentially estimated to stand at rates higher than the average recorded in the 2006-2007 period, which are more consistent with the pay rises of the past few years.

The cut in net capital expenditure reflects the 2007 refund to the concessionaires of tax collection (€4,939 million): net of this one-off tax refund the rate of increase has been calculated at 4.2 per cent, as forecasts imply the implementation in 2008 of some programmes authorised by Decree Law No.159/2007 (which were not implemented within December 31 as scheduled) and the full operation of mechanisms to release appropriated funds contingent upon verification of payments towards the severance pay fund.

TREND IN STRUCTURAL NET BORROWING

Compared to the Forecasting and Planning Report of September 2007, the trend in structural net borrowing between 2007 and 2008 has changed from an initial expected improvement of 0.2 per cent of GDP (from 2.3 to 2.1) to a 0.6 per cent worsening (from 1.6 per cent of GDP in 2007 to 2.2 per cent of GDP in 2008). The trend is almost entirely due to the mentioned postponements to 2008 of higher expenditure and lower receipts which, even though conventionally reclassified at EU level as 'structural', are of a non-recurring nature. Slightly less than a tenth of a GDP percentage point relates to benefits to reduce the tax wedge and slightly more than two tenths of a GDP percentage point relate to the postponement of some programmes envisaged by the Decree Law of September 2007. Net of this expenditure, the trend in structural borrowing between 2007 and 2008 would remain unchanged at 1.9 per cent of GDP.

Therefore there is no actual structural worsening in 2008, as these changes will not occur in later years. Year-on-year trends projected for the next three-year period show a gradual decrease in the deficit-to-GDP ratio in structural terms, well below 2.0 per cent.

Structural net borrowing: from the Forecasting and Planning Report (RPP September 2007) to the Combined Report on the Economy and Public Finance (March 2008, data as % of GDP)

	2007	2008
RPP (September 2007)	-2.3	-2.1
Nominal net borrowing change	0.5	-0.2
<i>including: Postponement to 2008 of tax wedge deduction</i>	<i>0.06</i>	<i>-0.06</i>
<i>Postponement Decree Law 159/07 (September)</i>	<i>0.22</i>	<i>-0.22</i>
<i>Permanent change</i>	<i>0.2</i>	<i>0.1</i>
Revision to potential GDP	-0.2	0.1
Revision to one-off measures	0.4	0.0
RUEF (March 2008)	-1.6	-2.2
Net borrowing net of one-off measures, cyclically- and postponement-adjusted	-1.9	-1.9

Scenarios and possible additional expenditure

The public-finance scenario that assumes that no changes to the existing legislation are made is built on the basis of the macroeconomic information available at the time when data is processed and assuming the full implementation of current legislation on Government spending. Estimates are made on the rate at which residual deficits are eliminated²².

Within the macroeconomic scenario, public finance trends reflect the behaviour of the economic actors concerned. On the revenue side the notion of ‘unchanged legislation’ assumes the current system of taxes and contributions and the same levels of tax compliance (no further benefits on this side).

The forecast in the scenario at unchanged legislation of receipts and expenditure is therefore influenced by *uncertain* elements which affect individual items to varying degrees. It is believed to be the best possible estimate that can be made with the available information, but it has to be reviewed as new data becomes available during the year.

What should also be taken into account are *possible expenditures*, normally not included in the scenario at unchanged legislation, but that could materialise in the near future. This item was already reported in the Economic and Financial Planning Document for 2008-2011. Building upon the effort of these past two years which made the transparency in public finances a matter of common interest, an assessment is made of how the trend could evolve during the year including both uncertainties and possible additional expenditures.

As far as uncertainties are concerned, two alternative scenarios can be assumed in addition to the baseline scenario at unchanged legislation. In the first case (*continuity* scenario), many of the trends that developed in the 2006-2007 period are assumed to continue; in the second (*rebound* scenario), a reversal of these trends is assumed, stronger than the one included in the scenario at unchanged legislation.

In both cases the macroeconomic outlook underlying the scenario at unchanged legislation is assumed to remain the same. Obviously, the downward revisions of GDP of the last few months point to how rapidly the scenario is changing and to the fact that unwelcome surprises cannot be ruled out. A 0.5 percent of GDP decrease in the growth rate, which falls within the realm of possible uncertainties, could raise the the deficit-to-GDP ratio by approximately 0.2-0.3 per cent.

The *continuity* scenario assumes the following:

- On the revenue side, taxable income that previously went unreported and untaxed will continue to increase²³. The experience of the 2006-2007 period show how difficult it is to estimate changes in taxpayer behaviour following the introduction of legislative and administrative measures to fight tax evasion and avoidance. More generally, in addition to the changes in taxpayer behaviour induced by the tax system, the uncertainties over the forecast also stem from

²² In addition to the timeframe of the past, new measures were introduced by the 2008 Budget on the time limit for writing off residual capital deficits. These provisions have an impact on the potential expenditure of Central Government and may cause changes in the administrative and management practices compared to the past.

²³ Estimates already include a physiological slowdown in tax revenues as a result of the fight against tax evasion.

changes in legislation and the degree of stability of tax regulations perceived by taxpayers. Taxpayer behaviour is dictated by expectations of how taxpayers will be treated by the tax authorities following economic decisions made today. The degree of perceived certainty of tax regulations and the subjective evaluation of the risks of tax inspections and sanctions by the financial authorities affect the level of tax compliance. Based on the rates of previously unreported and untaxed income that was subsequently taxed in the past two years one can project an increase in tax revenues of about 0.3-0.4 per cent of GDP for 2008.²⁴

- On the expenditure side, it is more difficult to make assumptions as there are many items to be considered and volatility has been very high in the past. This scenario assumes that:
 - the increase in compensation of employees is more moderate than forecast, assuming there will be the same cut in the number of civil servants as in 2007 and a rise in staff salaries and wages due to career progression in line with that of the past five years. The current estimate of the *wage drift* at unchanged legislation is based on the average of the last 6 years, including a rather less virtuous year such as 2002, and assuming a marginal decrease in employment also following the postponement to 2008 of the recruitment of some new staff envisaged for 2007 (notwithstanding legal provisions) and the full implementation of the other recruitment exemptions envisaged by the 2008 Budget. The lower overall increase, compared with the scenario at unchanged legislation, could hover around 1-1.3 billion;
 - there is an unexpected interest rate volatility that may cause savings in debt servicing costs of approximately 1 billion;
 - given the past volatility of capital expenditure forecasts (which often undergo major reviews), fixed capital investment may grow at a notably lower rate compared to the forecast at unchanged legislation (about 1 billion). More specifically, this item is affected by the actual spending capacity of the National Road Board (last year about half of the funds requested by ANAS was included in the forecasts of the Forecasting and Planning Report - RPP).

The *rebound* scenario assumes that the behaviour of taxpayers will remain unchanged and that therefore there will be no loss of revenues as against the baseline forecast. As to expenditure, in addition to interest rate volatility causing a 1 billion increase in debt service as against the baseline estimates, intermediate consumption is assumed to surge by about 1.5 billion as against the assumption made in the scenario at unchanged legislation.

²⁴ See Box in this document on ‘Results of the fight against tax evasion’ and the “Report by the Minister of the Economy and Finance on the results of the fight against tax evasion”, 2007.

TABLE 3.7: PUBLIC FINANCE SCENARIOS (AS % OF GDP)

	'Continuity'	Unchanged legislation	'Rebound'
Total revenues	47.2	46.9	46.9
Total expenditures	49.2	49.4	49.5
Net borrowing	-2.0	-2.4	-2.6

The combination of these elements on the receipts and the expenditure side is expected to determine a deficit-to-GDP ratio of 2.0 per cent in the *continuity* scenario and of 2.6 per cent in the *rebound* scenario for 2008. For the following years only the scenario at unchanged legislation is maintained because uncertainty grows as one moves further and further away from the time of forecast. It should be noted, however, that these are hypothetical and merely descriptive scenarios, useful for analytical purposes only. The possibility that all of the negative or all of the positive assumptions will come to pass at the same time is remote.

A second set of elements to be considered relates to the '*possible expenditures*'. All expenditure items posted on the 2008 State Budget and envisaged by the Budget Law are sufficiently funded and are included in the scenario at unchanged legislation. However, there are some expenditure items that might materialise during the year as a result of political decisions. Based on the taxonomy already used in the Economic and Financial Planning Document for 2008-2011, '*possible expenditures*' may be divided into three main groups: i) signed commitments, whose implementation is reasonably certain; ii) customary obligations, whose amount is less certain, but that will likely be at least partly implemented; (iii) assumptions about new initiatives.

The current institutional framework rules out the possibility that new fully-fledged initiatives or any action may be taken at this stage, except in the cases specifically envisaged in the Constitution. In addition, no previously signed commitments have to be settled in the mid-year budget completion²⁵. There remains the second group – customary obligations. These mainly concern the Gruppo FS (the railway company). Even though the amounts are still being discussed, the funding requests of Gruppo FS currently total 1.5 billion approximately for the purchase of trains for local transport services, the restructuring of the freight-train sector, and the service contract between Trenitalia and the Regional Authorities and finally for the signing of the programme agreement – concerning services to lease the network so as to allow other operators to use the railway lines²⁶.

²⁵ To err on the safe side and even though it is not exactly the 'unchanged legislation scenario', the approximately 600 million to be allotted to Municipal Authorities following the reduced efficacy of the provision on the reclassification of rural property have already been included in scenario at unchanged legislation.

²⁶ Other elements to be included under 'customary obligations' are the replenishment of the fund for commitment limits (about €800 million relating to constraints fixed in 2005 for the use of general government own resources exceeding a given threshold), the resources needed for the completion of infrastructure programmes envisaged as part of the celebrations to mark the 150th anniversary of Italy's unification (about €200 million to be spread over 2008 and 2009) as well as additional requests for slightly over €130 million for the service contract of the National Road Board (ANAS).

Finally, there is the issue of the civil-service contract renewal for the 2008-2009 period. While the 2008 Budget appropriated funds for the allowance foreseen for the period between the old contract expiry and the new contract enforcement dates, it did not beforehand appropriate the funds necessary for contract settlements. The reason for this choice lies in the willingness to start negotiating with the unions so as to address both the issue of financial resources and the rules for their distribution. In addition, as the will was expressed to postpone by a year the effects of the economic regulations of the contract, this must lead to an agreement between the parties. Spreading pay rises over a three-year period aims at bringing the actual bargaining schedule into line with the time periods it relates to, leaving some leeway between one negotiating round and the next for reviewing improvement in efficiency standards envisaged in the Agreement on civil service.

As a result of the current institutional situation the bargaining process has now come to a halt. However, given that by law the economic resources to renew the contracts of civil servants must be appropriated in the Budget, at present no additional expenditure seems likely to be envisaged this year for the renewal of contracts in the 2008-2009 period.

RESULTS OF THE FIGHT AGAINST TAX EVASION

Buoyant revenues caused taxation to be 29.9 per cent of GDP in 2007 in line with the percentages of the early years of the new millennium. At the same time, the overall tax burden (including taxes and levies as well as social security contributions) was 43.3 per cent of GDP. The percentage is lower than that of countries such as France and Belgium and approximately 2 percentage points higher than the European average²⁷.

Over two thirds of the increased taxation of the last couple of years is the result of the fight against tax evasion which has caused a substantial rise in revenues. The over €20 billion increase in revenues (slightly over €11 billion in 2006 and over €9 billion in 2007) in the 2006-2007 period has been estimated to stem from the fight against tax evasion and a spontaneous improvement of tax compliance. More specifically, based on the 2007 gross receipts (net of one-off revenues and before the elimination of the advance payments of tax concessionaires) it has been estimated that 55 per cent of the approximately €27 billion increase in receipts is the result of macroeconomic developments, whereas 11 per cent is the result of tax measures and the remaining 34 per cent (slightly more than €9 billion) is due to i) the stronger-than-estimated impact of new tax regulations, ii) general government action against tax evasion and avoidance to improve tax compliance, and iii) other unidentified causes. Several international research institutions agree that part of the increase in tax revenues of the past few years stems from newly discovered taxable income that previously went unreported.

²⁷ 2006 Eurostat data.

Causes for the increase in gross State tax revenues in 2007

	Mn	As % of total
Total increase, net of one-off revenues *	27,2	100
GDP growth	14,9	55
Permanent estimated measures (excluding anti-tax avoidance/evasion measures)	3,0	11
Residual amount and tax compliance	9,3	34
- 2007 Anti-tax avoidance/evasion measures	5,3	20
- Other gain in taxable base /Tax compliance	4,0	15

Note: Pre-final balance ISTAT data before the elimination of concessionaires advance and net of one-off measures and occasional events.

Higher revenues and tax cuts

Part of the higher revenues of the last few years has been used to finance €10 billion worth of tax cuts for households and businesses. The biggest cuts include breaks for home-owners (ICI – local property tax reductions) and tenants (rents to be deducted from personal income tax – IRPEF), rebates to small firms and concessions to firms increasing investment and the number of permanently employed staff in disadvantaged areas of the country as well as investment in innovation. Given the current slowdown of the economy, these measures will help sustain household demand and business investment domestically.

Main measures to reduce taxation on households and firms (in Mn)

	2007	2008	2009	2010
Total	-4,753	-11,938	-10,613	-10,122
Households	-769	-4,608	-3,095	-3,400
Deduction of rents and for young people housing and tax benefits	-171	-452	-373	-844
Other personal income tax (Irpef) deductions	-32	-971	-740	-466
Allowance for low-income individuals ('incapienti')	-565	-782		
Tax deduction on first-dwelling houses ('ICI')		-904	-904	-904
Companies/ Self-employed workers	-3,433	-7,014	-7,248	-6,578
- Tax wedge deduction and incentives for female employment in underutilised areas (Irap)	-2,702	-4,780	-5,060	-4,590
R&D tax credit		-536	-623	-654
Investments and employment tax credit		-577	-963	-925
Tax regime for minimum taxpayers		-207	-376	-143
Others	-731	-914	-227	-267
Other tax benefits	-552	-316	-270	-144
Incentives for renewing car fleets	-190	-183	-180	-33
Excise duties tax breaks	-362	-133	-90	-111

REGULATIONS ON SUPPLEMENTARY PENSION FUNDS AND SEVERANCE PAY

The 2007 Budget envisages:

- bringing forwards to 2007 the new regulations on supplementary pension funds, whose introduction was scheduled for 2008. *In the first six months of 2007 private-sector employees through tacit consent expressed their will about the possible transfer of severance pay entitlements accrued as from 2007 to supplementary pension funds. As part of this procedure the residual fund FONDINPS was set up to collect the severance pay accruals of employees who did not expressly opt for supplementary pension funds and that do not have a contractual pension scheme;*
- the establishment of a Fund within the State Treasury for the disbursement of severance pay to private-sector employees in firms with at least 50 employees who opt for maintaining their severance pay either partly or wholly. *INPS is entrusted with managing the above Fund. As of January 1, 2007 employers with at least 50 employees are required to pay 100 per cent of the severance pay entitlements that have accrued as of the above date and are not meant for supplementary pension schemes into this Fund held by the Treasury. The pay-as-you-go pension fund established within the Treasury pays severance pay benefits amounting to the contribution paid into the Fund pursuant to the relevant regulations of the civil code. Resources initially built up in the Fund, net of benefits paid and any compensation to firms for the loss of a low-cost self-financing mechanism such as severance pay provision, are earmarked for development programmes. The fact that severance pay entitlements are no longer administered by firms has given workers more freedom in choosing whether to opt for supplementary pension funds.*

The available information shows that:

- according to the still provisional data published by COVIP (*Commissione di Vigilanza sui fondi Pensione – Supervisory Board on Pension Funds*) on February 28, 2008, as a result of the introduction of the new regulations, the rate at which private-sector employees join occupational pension funds increased to about 25 per cent at the end of 2007 compared to 15 per cent at the end of 2006. These rates stand at 21 and 31 per cent respectively, if one considers only those employees who have occupational funds or the so-called already existing funds, i.e. those established before 1992. This data considers neither those who joined FONDINPS, nor any other individuals who joined supplementary pension schemes at the end of the year. A report by Parliament on the implementation of regulations on supplementary pension funds drafted by the Ministry of Employment points out that so far the employees who have joined in substantial numbers are those working in better organised economic sectors and in established firms. More specifically, the largest number of workers joining supplementary pension funds relates to companies with more than 50 employees that are affected by the enforcement of the new rules on the Severance Pay Fund established within the State Treasury. Again on the basis of the available information, COVIP has pointed out that the total number of subscribers of supplementary pension funds has increased by 43 per cent (from 3,269,244 to 4,675,321) and by 66 per cent in the case of private-sector employees alone (from 1,829,131 to 3,032,281);

– as to 2007, according to the provisional data in monthly reports submitted by employers, the Fund resources are said to stand at €5 billion net of benefits and contribution concessions to offset losses incurred by firms, which basically confirms the assessment made when the 2007 Budget was passed.

4. FISCAL CONSOLIDATION, SOCIAL JUSTICE AND ECONOMIC GROWTH: STRUCTURAL MEASURES IN 2006-2007

This chapter of the Combined Report on the Economy and Public Finance summarises several structural measures put into place during 2006-2007. The government's policies have indissolubly embraced fiscal consolidation, economic growth, and social justice, and have been implemented through a broad range of initiatives. The intent of this brief summary is to highlight only some of the initiatives, and more specifically, those deemed particularly significant with regard to control of expenditures, public investments, and social welfare.

The trend in labour income has been modest over the past few years. The slowdown in growth has prompted, among other things, a widespread feeling of impoverishment on the part of many Italian households, and a call for economic policy measures that can offset these recent trends. The efforts to counter the decline in purchasing power cannot overlook the factors causing that decline nor the general conditions for public finance. The leeway for effective actions to support growth and to relieve conditions of economic hardship will remain limited as long as the huge public debt, in generating a very large expenditure for interest, continues to absorb a high percentage of the resources available in the public budget. Continuing fiscal consolidation is therefore crucial not only for guaranteeing fiscal sustainability in the long run, but also, and more importantly, for freeing up resources to be used for achieving the objectives of social justice and economic growth.

The first cause for the decline in labour income regards the gradual and continuing slowdown of the Italian economy's productivity growth. The second cause, which is more complex to quantify, is represented by the changes in the primary distribution of income, with the salaries-to-added-value ratio declining for the entire decade of the nineties and only being partially offset by a slight increase thereafter. Finally, a third cause for growing economic hardship is represented by the significant increase in house prices and in the cost of rental housing. Each of these three factors underlying the decline in labour income has necessitated specific economic policy measures.

As known for some years, reviving productivity growth remains the key issue. In the short term, selective support can come from greater use of second-level bargaining. Thus, the government met with the unions to explore the possibility of revising the agreements signed in 1993 (when the socio-economic context was radically different), and fiscal incentives were provided for productivity-enhancing contracts. The market deregulation efforts under way since the start of the legislature will produce the most extensive benefits for all citizens in the medium term, under the form of lower prices and expansion of activities, and without any costs from a public finance perspective. However, in order to be effective over the long term, the actions to sustain growth have

necessitated the strengthening of tangible and intangible infrastructures, as well as enhancements to the services of education and research.

The fiscal adjustment measures (the recovery of funds from tax evaders and their restitution to law-abiding taxpayers) was used first, in order to support those situations involving the greatest hardship, and to correct excessive changes in the primary distribution of income. In view of the extensive tax evasion concentrated in a few types of income, the situation in Italy requires measures that are more complex than the simple modification of tax rates and deductions. Indeed, nominally low levels of income refer to both situations of actual economic hardship and situations marked by extensive tax evasion. In order to be effective, measures aimed at ensuring greater social justice must therefore incorporate actions to obviate tax evasion and avoidance.

Finally, with regard to the hardship caused by the high cost of housing, significant progress toward solving the problems has already been made through provisions of the 2008 Finance Law that set aside substantial financial and material resources for supporting subsidised building programmes. It is now a question of fully and promptly implementing the measures that have already been approved.

The containment and requalification of public spending, the fight against tax evasion, tax relief, and the revival of productivity are thus the pivotal, but inseparable, elements of an economic policy that is capable of producing stable growth for the country within a fiscally sustainable framework.

4.1 PROCEDURES AND INSTRUMENTS FOR CONTROLLING EXPENDITURES

The achievement of a balanced budget is a necessary condition for allowing rapid reduction of the weight of the public debt. Italy has committed to its European partners to achieve a balanced budget by 2011. Rigorous and continuous control over primary current expenditure (i.e. net of interest) is thus necessary for this purpose. In order to achieve long-lasting results, the actions for the containment of expenditures must be accompanied by requalification measures, with the objective of elevating the quality of public services and, consequently, the productivity of the Italian economy.

The government's actions have focused on:

- reforming the procedures for the determination of the resources allocated to the administrations;
- developing instruments for evaluating the efficiency of such resources in use and the effectiveness of the policies for which they are employed;
- identifying the best practices to be used as a standard of reference for all of the public administrations.

Budget reform

The Ministry of the Economy and Finance (MEF) has introduced a critical review of the structure of the Italian budget, also by taking advantage of the cooperation of the International Monetary Fund (IMF). An IMF delegation of experts visited the MEF during the spring of 2007 in order to analyse, including in comparative terms, the structure of the budget and the organisation of several ministries.

Two main problems were identified:

- the difficulty to trace, in the budget documentation, the relationship between the resources employed and the objectives pursued, with consequent difficulties in making decisions consistent with the priorities defined during the planning phase;
- the fragmentation of the expense items serving as the basis for Parliamentary decisions, which leads to excessive rigidity of the budget in the operational phase.

Also in light of the contribution provided by the IMF experts' report, the MEF inaugurated a long-term process for improving the assessment, planning and management of public expenditure (a so-called 'spending review').

First of all, the MEF revised the classification system for the State Budget, basing the system on the functions that the administrations are required to carry out, rather than on the units that manage the resources. The change required the involvement of the administrations and the Prime Minister, and was implemented in close collaboration with the House and Senate Budget Commissions.

In order to ensure the rapid implementation of the new classification, the modifications were made with respect to a scenario based on 'unchanged legislation': the structure of the budget continues to be based on Law n. 468 of 1978, as amended by Law n. 94 of 1997. The new classification has already been used in the 2008 Budget presented to Parliament.

The pivotal aspect of the new classification is represented by 'missions' which are carried out via one or more 'programmes'. The missions represent the main functions and the strategic objectives pursued with public spending. The programmes represent homogeneous groups of activities carried out within each ministry in pursuing the specific objectives of the missions. The new structure improves the three main functions of a budget, namely, serving as an instrument for: information reporting; political-government decision-making; and the management of financial resources.

TABLE 4.1: 34 BUDGET MISSIONS – RESOURCES FOR 2008

	Mn	% of Total
1 Financial relationships with autonomous territorial entities	105,123	22.6
2 Public debt (1)	83,541	18.0
3 Social security policies	68,403	14.7
4 Education	41,645	9.0
5 Italy in Europe and in the world	25,048	5.4
6 Social rights, social solidarity, and families	24,497	5.3
7 National defence and security	19,086	4.1
8 Funds to be subdivided	16,846	3.6
9 Public order and security	9,412	2.0
10 Economic-financial and budget policies (2)	8,875	1.9
11 University education	8,168	1.8
12 Mobility right	7,960	1.7
13 Justice	7,275	1.6
14 Competitiveness and development of businesses	5,574	1.2
15 Territorial development and rebalancing	4,545	1.0
16 Research and innovation	3,964	0.9
17 Public infrastructures and logistics	3,778	0.8
18 Civil emergencies	3,688	0.8
19 Constitutional bodies, bodies with constitutional significance, and the office of the Prime Minister	3,233	0.7
20 General and institutional services of the public administrations	2,911	0.6
21 Labour policies	2,701	0.6
22 Immigration, refugees hospitality and guarantee of rights	1,427	0.3
23 Cultural and environmental heritage protection and value enhancement	1,380	0.3
24 Farming, agro-food policies and fishing	1,225	0.3
25 Housing and urban structure	1,060	0.2
26 Young people and sports	902	0.2
27 Communications	896	0.2
28 Safeguarding health (3)	711	0.2
29 General administration and support to general representation of the government and the state across the nation	353	0.1
30 International trade; internationalisation of the productive system	234	0.1
31 Tourism	113	0.0
32 Sustainable development; land and environmental protection	101	0.0
33 Energy and diversification of energy sources	59	0.0
34 Market regulation	16	0.0

1) Net of reimbursements of state debt.

2) Net of accounting settlements, returns and tax reimbursements.

3) Excluding the resources of the regions.

Altogether, the entire public budget now consists of 34 missions and 168 programmes. The new budget allows for promptly identifying the resources appropriated for each of the missions. From a cursory look at the budget, it is clear that: (i) the most significant mission (accounting for almost one-fourth of total resources) is represented by the co-financing of the activities carried out by local and territorial entities; (ii) interest expenses are still high, with their reduction dependent on the ability to reduce the balance of the public debt; and (iii) the expenditure for social-welfare policies is equally high, with its control having already required structural measures (such as those recently implemented with respect to the mechanisms for the automatic actuarial revision of pension payments) and subject to further monitoring in the future in light of the current demographic trends.

Expenditure assessment and organisational changes

The new budget can be an effective information tool for facilitating the more efficient allocation of resources and for stimulating the more efficient use of the resources within the individual expenditure programmes. However, in order to make the most of such potential, it will be necessary to proceed with (i) the development of a system for measuring the results obtained, and (ii) the assignment of specific responsibility for individual programmes.

The implementation of all of the programmes depends on adequate analytical ability. Such analysis, in turn, depends on information consistency and the possibility of processing the same information. In this regard, some disparities have been noted at the central, local and territorial levels, as well as in the communication, content, and format of the data.

Two major initiatives have been undertaken to overcome these difficulties: the institution of the Technical Commission on Public Finance within the MEF and the creation of a research department within the State general accounting department.

Already after its first few months of activity, the Commission detected several distortions in financial allocation and in the administrative organisation; these were evidenced in the 'Green Book on Public Expenditure' (6 September 2007) and in the 'Interim Spending Review Report' (13 December 2007), which were prepared with the input of the administrations involved. In the coming months, the Commission, working in close cooperation with the State general accounting research department, will focus its activity on preparing performance indicators and standardising the spending-review activity, which will be gradually extended to all of the administrations.

It also became clearly evident that the control over public spending would not only be incomplete, but also absent of any real effectiveness, if the monitoring were not also to be implemented with regard to the spending of the local and territorial entities, for which the Commission has likewise initiated a review.

As far as the operational aspects are concerned, the emphasis at present is on perfecting the new classification, and on re-thinking several organisational questions, so as to place the responsibility for the programmes currently involving two or more administrations under a single ministry, and within the ministry, under a single coordinator. It is furthermore essential to attain greater operational flexibility; this will require regulatory measures as well as a step-up in monitoring activity.

'Best practices'

The reference to best practices represents a crucial tool in the public expenditure containment and requalification effort. The government's orientation has been that of evaluating the best practices in the most significant areas of public spending, with the perspective of making those practices the standards of reference for all entities. All entities would then be required to move gradually closer to those standards, identifying the incentive methods and mechanisms therefor. Compared with regulatory measures aimed at the broad-based reduction of resources available to the administrations, the reference to best practices makes it possible to introduce selective measures directed towards those entities that are the farthest away from the best performers.

In the education sector, the 2008 Finance Law has provided for the start-up of an experiment with a three-year term for the purpose of identifying a system organisational model capable of improving the quality of the service and increasing the efficiency and effectiveness of spending, that is to be extended gradually to all academic institutions. Such organisational model, which has been defined in relation to a target teacher-student ratio, will be continuously monitored and subject to an *ex post* verification of the results on an annual basis. As an incentive for responsible behaviour, the programme provides that the cost savings actually achieved during the three-year test period are to be re-distributed to the public institutions which contributed to the achievement of the objectives, with the constraint that the appropriations are to be used only for the improvement of the quality of the public education sector.

Selective measures have also been introduced with regard to the healthcare sector and are explained in Section 4.2.

The efforts to control public spending do not need to be limited to the State Budget which, as can be seen, is mostly a transfer budget. Increasing the effectiveness of public sector intervention and the quality of the spending has thus required the preparation of measures with respect to other entities within the public administrations.

The Internal Stability Pact between the local and territorial entities and the State has represented, for example, not only an essential method for achieving equilibrium in public finance, but also a useful tool for the correction of financial imbalances between the different local entities. Still, the Pact, in and of itself, does not impact the substantial underlying phenomena that generate a different mix and quality of spending between the various entities and the economic difficulties of some of the entities. An in-depth analysis of best practices in collaboration with local and territorial entities was inaugurated and was to have allowed for making the organisation of the Internal Stability Pact more selective, and in so doing, for assuring, albeit indirectly, the gradual improvement of the quality of spending. As a result of the interruption of the legislature, the project could not be completed.

Finally, the method of using best practices for the requalification of spending has been applied to the university sector. The analysis of university spending recently implemented by the Technical Commission on Public Finance ('University system: measures for financial adjustment and incentives for the effectiveness and efficiency', 31 July 2007) evidenced sharp disparity between the various universities in the mix between current and capital spending, and in some cases, the lack of compliance with regulatory limitations on spending. The government's objective has been passed into law with the 2008 Finance Law which calls for the introduction of incentive mechanisms for the disbursement of state financing to universities, providing bonuses for those institutions that achieve current expenditure containment, particularly with regard to expenditures for personnel.

Outlook

The initiatives described above are part of a series of projects in numerous sectors, all of which are aimed at maintaining the balance of public sector revenues and expenditures. Some of the initiatives have been completed. Others, whose execution required a longer term, have been interrupted as a result of the early termination of the

legislature. They are nonetheless related to actual needs, regardless of what the new objectives of the future government's economic policy turn out to be.

BUDGET PROCEDURES AND EUROPEAN RULES

With the Maastricht Treaty, the deficit of the public administrations has become the key indicator of reference for the fiscal policy of the EU Member States. The Stability and Growth Pact establishes that the Member States must avoid excessive public deficits, and in particular, that the ratio between the general government net borrowing and the gross domestic product must not exceed 3.0 per cent of GDP (unless exceeding that level is only exceptional and temporary, and the ratio remains close to the reference value). The Member States must also commit to moving progressively closer to a balanced budget in the medium term.

In order to facilitate the governance of public finance in line with this directive, Italian lawmakers approved several amendments to the regulatory framework defined by Law n. 468 of 1978 and the subsequent amendments and additions thereto¹. In particular, according to the current regulatory framework and procedures:

- the government annually prepares an economic and financial planning document for the three-year period thereafter, which contains the forecasts of the trends of general government revenues and expenditures (based on unchanged legislation), the corresponding objectives, and thus, the necessary corrective measures;*
- the data contained in the planning document must be formulated with regard to both the general government net borrowing (the main fiscal target), and the net balance to be financed for the State Budget (the balance directly controlled by the national government and Parliament)²; the data in relation to the two balances must obviously be consistent;*
- the government submits the planning document to Parliament for adoption by a special approving resolution;*
- thereafter, the government comes up with a proposed budget law which reports (in Article 1) the planned value of the net balance to be financed as indicated in the planning document, and together with any related provisions, defines the measures needed for the achievement of such target;*
- once the net balance to be financed is approved, amendments, if any, to the measures outlined in the proposed budget law that adversely change the fiscal effects must indicate the necessary offsetting measures, so as to leave unchanged the overall effect on the net balance to be financed and on the net borrowing (requisites established for procedures, within the framework of the criteria for the admissibility of the amendments, by the Chairmen of the House and Senate Budget Commissions, consistent with the guidelines contained in the Directives of the Prime Minister dated 23 December 2004 and 6 June 2006)³.*

With reference to the process described immediately above, it is obviously crucial that the valuations in relation to both the general government net borrowing projections based on unchanged legislation and the financial effects caused by provisions of the law must be both reliable and transparent.

¹ Law n. 208 of 25 June 1999.

² The planning document also refers to the State sector's borrowing requirement, the figure that was the key indicator of Italy's fiscal policy prior to the Maastricht Treaty.

³ Similar offsetting requirements also apply to the provisions that introduce new or incremental charges during the year.

Indeed, such valuations form the framework within which policy decisions about public finance can be formulated.

The difficulties are greater for the valuations related to the net borrowing than those referring to the net balance to be financed:

- the net balance to be financed refers to a budget managed by a single entity (the MEF), whereas the net borrowing is the consolidated balance of the accounts of all of the entities making up the public administrations (central administrations, local administrations and social security entities), which have independent decision-making powers and sometimes, partial financial autonomy;*
- the net borrowing is calculated by ISTAT on the basis of the European System of Accounts (SEC95), which is a statistical system that is based on accounting criteria that are different from those adopted for the State Budget and for most of the budgets of the public entities⁴.*

It follows that the control of the net borrowing of the general government cannot be carried out using the same techniques used for controlling the net balance to be financed. This situation is even more evident when considering the different legal nature of the State Budget vis-à-vis the general government national account. With regard to the net balance to be financed, the procedures described above are aimed at introducing a constraint on the State Budget's overall authorising function, within which the cash phase also enters into play. The same procedures with respect to the net borrowing are aimed at guaranteeing the solidity and sustainability of public finance, consistent with the rules agreed at a European level.

In order to reinforce the reliability of the net borrowing-related valuations that go together with the budgeting process, it is first necessary to develop instruments and techniques available to the units responsible for their formulation. Initiatives undertaken in the past have been directed towards this objective (for example, the SIOPE for monitoring the public entities' cash accounts and the inter-institutional work groups set up by the MEF, ISTAT and the Bank of Italy on public finance statistics). This legislature built on that momentum, with the creation of a research department within the State general accounting department and the institution of the Technical Commission on Public Finance.

Some reflection is also needed about the timing for making such important valuations. The typically large number of amendments presented upon Parliament's review of the budget law and the timing for their presentation may adversely affect both the quality of the valuation and the transparency with which the valuation is made. One possibility is to reduce the number of 'micro-amendments' in percentage terms; the reclassification of the State Budget by missions and programmes is a step in this direction, as is the consequent possible reduction of the budget items.

The possibility of further improvements needs to be studied, with the input of all of the institutions involved and with reference to the best practices accepted internationally. The results of this activity will reflect upon the transparency and the accountability of the policy decisions impacting public finance, and consequently, the quality of the institutions' performance.

⁴ The SEC95 uses the accrual accounting criterion as a reference; the State Budget is drafted according to legal responsibility and by cash flows. In addition, in classifying transactions among the various sections of the accounts, the public budgets place the priority on legal/formal aspects, while the priority for the SEC95 is economic substance.

4.2 PLANS TO REIN IN HEALTHCARE SPENDING

The Healthcare Pact was drawn up with the aim of coming to agreement with the regions on series of spending cuts that would be consistent with the objectives of providing essential levels of assistance and guaranteeing financial equilibrium, leaving it up to the regions to cover any additional expenditure.

With the 2006 Healthcare Pact addressing the 2007-2009 three-year period, the State and the regions agreed on:

- an increase in the level of ordinary financing provided by the State for 2007 (€96 billion compared with the roughly €90 billion contemplated for 2006) and the change of the same in the future years computed in relation to GDP growth;
- a transitional, accompanying reserve to support the regions executing structural deficit reduction plans, for an amount equal to €1 billion for 2007, €850 million for 2008 and €700 million for 2009;
- the reinforcement of the obligation contemplated by the 2005 Finance Law in relation to the agreement between the State and the regions with high structural deficits that contains a spending-reduction plan in order to achieve economic-financial equilibrium;
- the extension of the mechanism covering the automatic increase of tax rates in the event of any deficit not being funded, so as to ensure that the financial planning instruments remain stable, consistent with the principle of vesting responsibility with the regions and in respect of budget requirements;
- the reinforcement of the instruments used for vesting responsibility with the regions aimed at ensuring appropriate use of the healthcare resources, with reference to both the standards established at a national level and best practices.

During 2007, seven regions⁵ signed agreements containing structural deficit reduction plans. The individual plans, which refer to the 2007-2009 period, identify and selectively tackle the structural causes of the significant deficits, and are thus actually business restructuring plans which address spending factors having escaped the control of the regions. With the exclusion of Sardinia, all of the plans contain the following essential points:

- the adoption of measures to rebalance the profile for delivery of essential levels of assistance (ceilings on spending for pharmaceuticals and the procurement of services from the private sector, compliance with the standards set for beds, i.e. 4.5 for every 1,000 inhabitants and the rate of hospitalisation, i.e. 180 admissions for every 1,000 inhabitants), with the identification of the following for each critical spending factor: target reductions, concrete actions that can be carried out for achieving the targets, and the related financial impact;
- in general, the automatic increase of tax rates up to the maximum level established by prevailing law;
- a provision for covering some of the deficits (up to €3 billion) only in the case of those regions that (i) have embraced the plans and (ii) have adopted additional fiscal measures with respect to the healthcare sector vis-à-vis the maximum

⁵ Abruzzo, Campania, Latium, Liguria, Molise and Sicily. Sardinia signed the plan only for the purpose of recovering the state financing not disbursed following the non-compliance for the year of 2001, and thus, with respect to the other regions, a less demanding plan was requested of Sardinia.

- increase in the regional tax on productivity (IRAP) and the regional supplement to personal income taxes (IRPEF);
- the obligation to proceed with the restructuring of any healthcare liabilities contracted on the financial markets;
- the support of an accounting expert for making administrative and accounting procedures stronger and certifying previous liabilities, and the support of a financial advisor.

In the case of regions not meeting the programmed objectives, the funding of the incremental financing provided by prevailing legislation will be suspended, and the tax rates will be increased to levels above the maximum limit provided by prevailing legislation until the objectives are met. Finally, the Decree-Law n. 159 of 2007 contemplates administration by an external commissioner for the regions not meeting the programmed objectives, so as to reinforce the actual possibilities of the realisation of the same.

The trend of spending for all of the regions and the implementation of the deficit reduction plans are currently being monitored on a quarterly and annual basis, with the aim of addressing any corrections needed and resorting to regional taxation if necessary.

Such regulatory instruments have vested significant responsibility with the regions executing the deficit reduction plans as well as the other regions. On the basis of preliminary budget data, those instruments are also making it possible to keep the spending within the planned limits at a national level.

Compared with the €103.6 billion projection of total healthcare spending in 2007 contained in the 2008 Forecast and Planning Report (RPP), the actual spending for 2007 is estimated to be roughly €1 billion lower, partly due to (i) the re-allocation of various accounting items over a longer term and (ii) actual cost reduction (with the figure thus essentially in line with the original forecast contained in the 2007 RPP). Meetings are planned for the second half of March in order to ascertain the structural nature of the cost reduction and the contribution that the individual regions made towards the achievement of this result.

The following should be noted for the purposes of evaluating the 2007 result in percentage terms:

- The change in healthcare spending compared with 2006 is 0.9 per cent;
- The aforementioned 0.9 per cent is also the consequence of (i) the recording used to account for contractual charges (inasmuch as 2006 reflects contractual arrears for 2004-2005 for roughly €2,300 million and 2007, on the other hand, does not contain the cost accrued for 2006-2007, equal to roughly €1,500 million, deferred to 2008), and (ii) the re-allocation over various years of several accounting items, equalling roughly €700 million. Restating the figures to remove the accounting changes mentioned above, the average annual change for 2006-2007 would be an increase of roughly 4.0 per cent compared with the average annual change of roughly 6.5 per cent over 2001-2005.

In any event, the lower level of spending estimated for 2007, even though below the level indicated in the RPP, is still above the level of financing provided by the State. The funding of the excess is guaranteed, in terms of balances of the general government's accounts, by regional resources.

TABLE 4.2: HEALTHCARE SPENDING 2001-2007 (Mn)

	2001	2002	2003	2004	2005	2006	2007
Healthcare spending	74,745	79,106	81,816	89,924	96,141	101,349	102,290
year-on-year % change		5.8	3.4	9.9	6.9	5.4	0.9

Note: The amounts reported represent an estimate of the consolidated healthcare account whose publication by ISTAT is forthcoming.

As far as investment policy is concerned, in order to streamline the use of resources for the implementation of the healthcare building programme, the most recent programme agreements provide that a significant amount of resources will be earmarked for making the hospital networks more efficient and for upgrading healthcare facilities across the nation.

The year of 2007 was also a crucial year for the upgrading of the Healthcare ID-Card System, which will become fully operational in all regions in 2008. The system is an important tool at a regional level for the proper planning and management of healthcare services, because it provides prompt and timely information about all medical, pharmaceutical and specialist prescriptions provided in a region, identifying the prescribing physicians and the beneficiaries of the services, and is therefore capable of identifying the areas of spending having the greatest critical impact for the region and the related instigating factors. In addition, through the definition of specific indicators, it is possible to evaluate the margins of inappropriateness and inefficiency compared with the services included in the essential levels of assistance (LEA), for the purpose of rationalising the use of the resources.

4.3 SOCIAL-WELFARE MEASURES

The reforms of the welfare system during the years of 2006, 2007 and 2008 have addressed all of the areas of benefits and assistance – pensions, employment, housing, income supplements – with the objectives of more adequately protecting situations entailing greater hardship and risk, and improving the system so as to provide for more equitable treatment from generation to generation. With regard to pensions and employment, the provisions of the Protocol on Welfare, Employment and Competitiveness signed by the government and the unions were ratified after a long period of discussion and debate about its problems and the tools suitable for solving them.

On the pension front, the measures approved have been oriented:

- in the near term, towards the identification of a plan for gradually increasing the age at which individuals are eligible for retirement (the ‘big steps’ change) and for increasing the level of benefits provided. The amounts of the smallest pensions were increased, with the priority placed on those individuals who had made the highest levels of contributions to the pension system. The mechanisms for adjusting pensions to the trend of inflation were also improved.
- in the long term, towards creating a stronger relationship between the age at which a person retires and the amount of his pension (the updating of the transformation coefficients through 2010 was done in 2007, and the coefficients will then be automatically updated every three years), and facilitating the possibilities for young people to accumulate sufficient savings for retirement. The payment of pension contributions for the years of university study has been made easier; the option of accumulating contributions paid into different pension programmes has been enhanced; the contribution and computation rates have been raised for individuals being *de facto* employed and having no other forms of pension coverage; reserves have been set up so as to facilitate access to credit to pay for professional education and training during periods of unemployment.

From the standpoint of *employment*, the objective has been to define rules for giving incentives in order to raise the workforce's participation and reorganise the social security net for a more efficient use, extending the net to categories of workers not currently covered and linking it to training and recruitment programmes. For the time being, both the amount and term of ordinary benefits and benefits based on reduced requirements have been increased, and the percentage used for the revaluation of long-term and regular unemployment benefits has been raised.

In order to tone down the number of people working on temporary contracts - a situation that affects not only young people, but also many individuals over 50, a tax credit has been made available to companies hiring personnel through open-ended contracts, and the rules applying to non-permanent employment relationships have been modified. The reform process will need to be completed by making public employment services more efficient and creating a better system of employment incentives with the aim of strengthening monitoring activity, achieving synergies between public services and private agencies, and enhancing the value of training and placement programmes.

The policies addressing housing-related hardship and shortages of family services, particularly with regard to low-income families, have represented other important objectives in the area of social justice.

The personal income tax system and the system of family allowances have been significantly reformed to as to guarantee a re-distribution of income, thereby favouring *large families, families with medium/low income, minor children without parents, and families with at least one disabled individual*. Added support has been implemented through the tax allowance for low wage earners, i.e. individuals whose income is below the minimum threshold for taxation.

In order to ease the costs that families have to sustain for *housing*, some initiatives have been aimed at increasing the housing supply by the reactivation of public building programmes. The initiatives in this area have been flanked by the creation of national and regional observatories for monitoring the property market. Fiscal policy was also employed as a tool in this area, with the introduction of tax relief for individuals and families occupying rental housing and the reduction of the taxation on owner-occupied homes. A solidarity fund has also been established for mortgage loans for first-home purchases.

Important resources have been earmarked for the creation of funds to be used for specific types of *assistance to individuals and families* (e.g. the Fund for the Non Self-Sufficient, Fund for Social Inclusion of Migrants, and the Fund for Family Policies). Other initiatives worth noting are: the plan for socio-educational services for infants; the extension of maternity benefits to female workers on temporary contracts who are enrolled in separately managed funds of the Social Security Administration (INPS); the adjustment of parental leave time for adoptive/foster parents to make it equal to that for biological parents; and the expansion of employment opportunities in favour of the disabled.

TABLE 4.3: PENSIONS, EMPLOYMENT, HOUSEHOLDS AND SUPPORT TO HARDSHIP 2007-2011 (Mn)

	2007	2008	2009	2010	2011
PENSIONS					
Small retirement pensions	900	1,156	1,156	1,156	1,156
Small disability pensions		44	44	44	44
Revaluation at the prices provided by D.L. 81/2007		33	66	100	100
Revaluation at the prices provided by L. 247/2007		-135	-136	-136	-136
Retirement pension requisites (and related effect on severance pay for public-sector workers)		59	640	1,690	2,150
Actual retirement age		-270	-126	383	272
Cumulation of contribution paid under different pension programmes and payment of social security contributions for the period of university studies		200	200	200	200
Employment benefits - asbestos cases		18	21	24	29
Reversible pensions - disabled persons		25	25	25	25
<i>Total</i>	<i>900</i>	<i>1,130</i>	<i>1,890</i>	<i>3,486</i>	<i>3,840</i>
EMPLOYMENT					
Social security net		692	695	734	750
Credit fund for young people		150			
Tax relief fund for second level bargaining (and related eligibility for pension benefit) - additional resources vis-à-vis unchanged legislation		310	310	310	310
Tax deduction for performance allowances		150			
<i>Total</i>	<i>0</i>	<i>1,302</i>	<i>1,005</i>	<i>1,044</i>	<i>1,060</i>
HOUSEHOLDS					
Socio-educational services	125	170	100		
Family policies fund	220	190	190		
Maternity and illness	68	70	72	74	76
Family allowances	966	1,000	1,000	1,000	1,000
<i>Total</i>	<i>1,379</i>	<i>1,430</i>	<i>1,362</i>	<i>1,074</i>	<i>1,076</i>
HARDSHIP SUPPORT					
Low-wage earners whose income is below minimum tax threshold	565	782			
Funds (*)	665	890	638	3	
Housing		2,875	2,375	2,943	2,933
- tax benefits	171	2,855	2,355	2,933	2,933
<i>Total</i>	<i>1,401</i>	<i>4,547</i>	<i>3,013</i>	<i>2,946</i>	<i>2,933</i>
TOTAL	3,680	8,409	7,270	8,550	8,909
INCREASES IN CONTRIBUTIONS (net of fiscal driven effects)					
Increases provided by 2007 Finance Law	4,000	3,100	3,350	3,320	3,220
Increases provided by Law 247/2007		243	326	459	873
<i>Total</i>	<i>4,000</i>	<i>3,343</i>	<i>3,676</i>	<i>3,779</i>	<i>4,093</i>
<i>Net effect</i>	<i>-320</i>	<i>5,066</i>	<i>3,594</i>	<i>4,771</i>	<i>4,816</i>

*) It refers to newly established funds for non self-sufficient individuals, disabled mobility right, social inclusion of migrants, youth groups, rights and opportunities for women and raising Fund for youth policies.

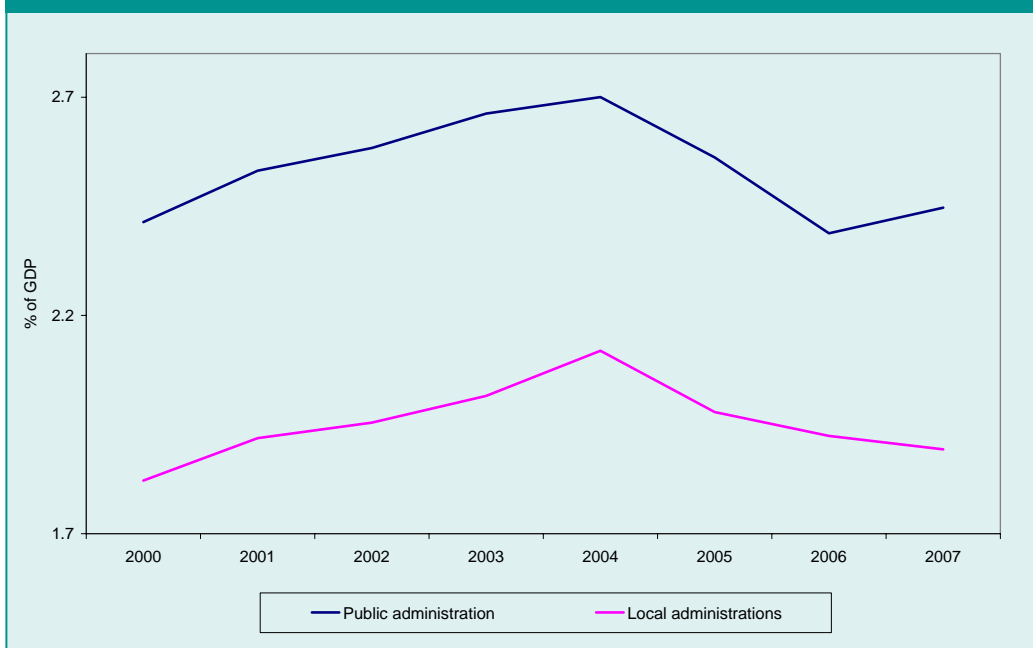
Note: for measures in favour of families through tax deductions, compare also the table on main measures to reduce taxation on households and firms in the Box on Results of fight against tax evasion (Ch. 3).

4.4 PUBLIC SPENDING ON INVESTMENTS

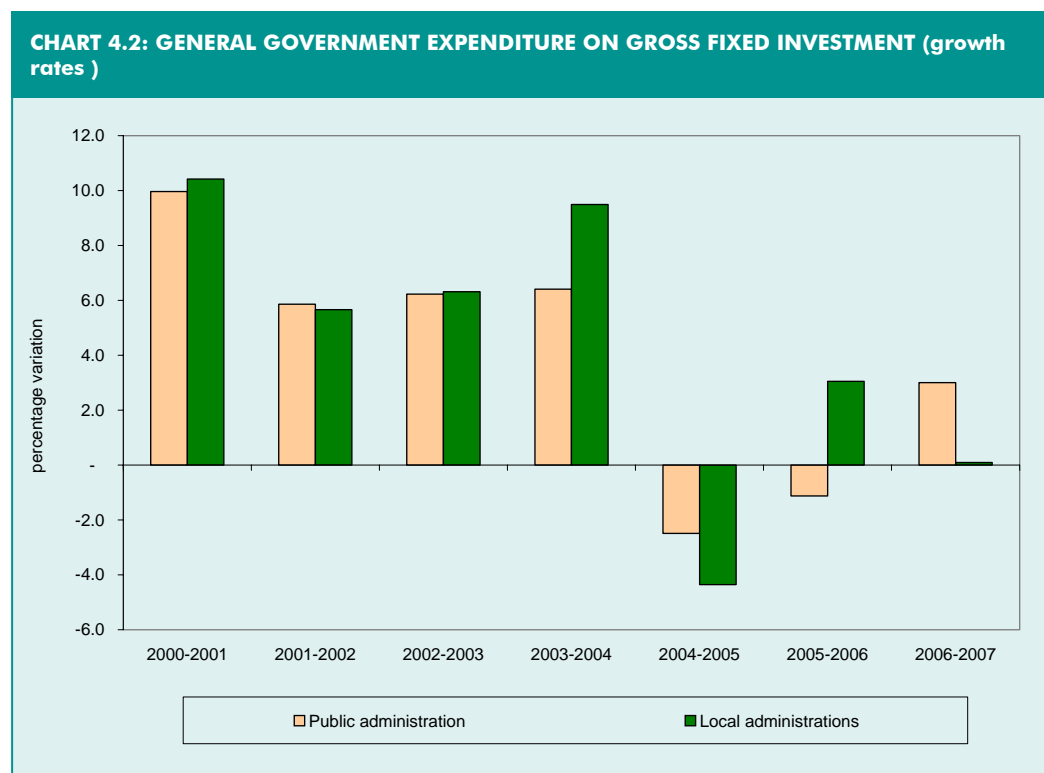
Italy has suffered for some years from insufficient infrastructure investment. Among the government's first economic-policy initiatives in the summer of 2006, infrastructure development ranked as one of the priorities. The efforts to reinforce the nation's infrastructures were pursued further through the 2007 and 2008 Finance Laws, as well as with Decree Law n. 159 of September 2007. More specifically, huge amounts of resources were appropriated mainly for: national and local routes for road and maritime transport; residential building; urban renewal; expansion of the Fund for Underutilised Areas; and the financing of applied and industrial research.

Between 2000 and 2007, the spending of general government on gross fixed investment averaged 2.6 per cent of GDP⁶. After growing steadily between 2000 and 2004 (7.1 per cent per year on average), the appropriations decreased in the two-year period thereafter, moving back below 2.5 per cent of GDP in 2006 (including for the effect of several provisions of the Finance Law that sharply limited the spending of the National Road Board (ANAS) and the expenditures of the State Budget). In 2007, the spending as a percentage of GDP remained virtually unchanged.

CHART 4.1: GENERAL GOVERNMENT EXPENDITURE ON GROSS FIXED INVESTMENT (% of GDP)

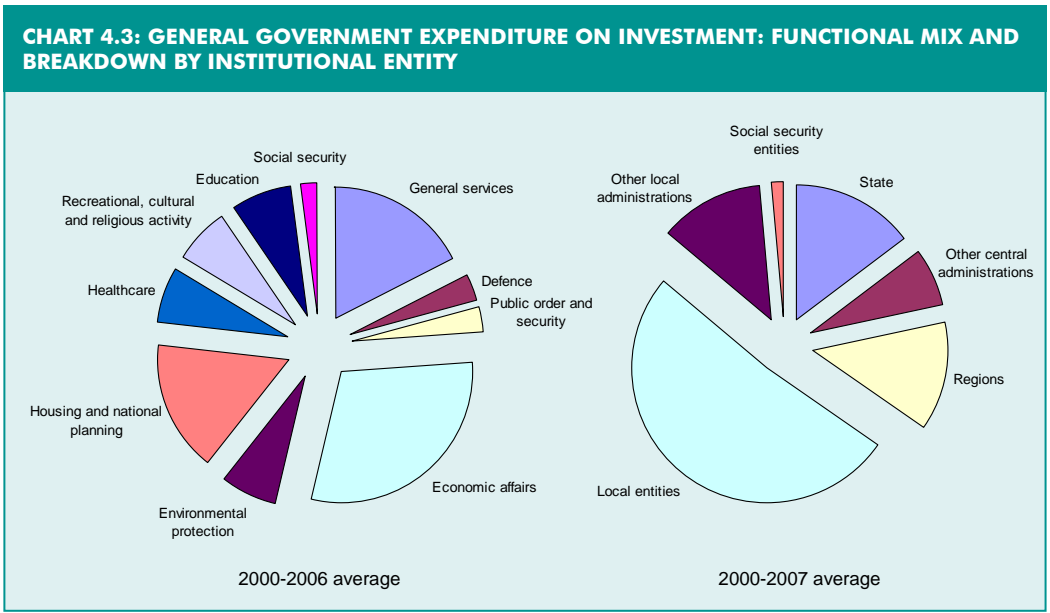


⁶ The data reported in the text do not take into account the income from the sale of real property which is subtracted from investment in the national accounts.

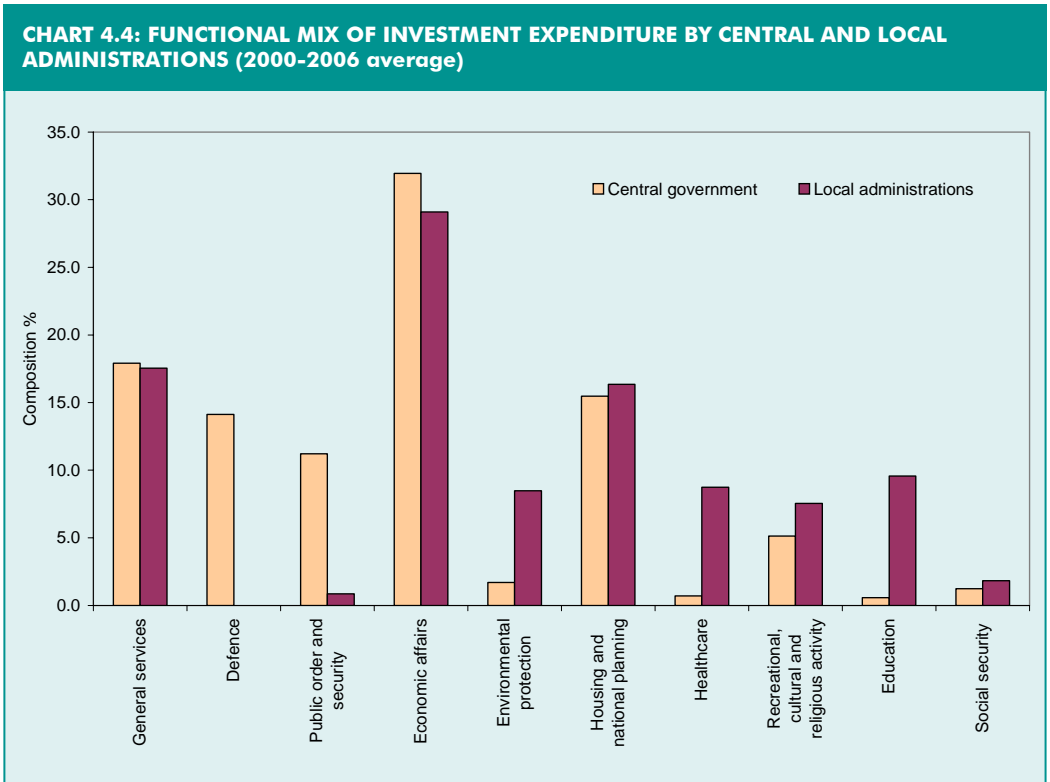


Almost 80 per cent of the spending is done by the local administrations. The spending of provinces and municipalities on investments is more than 1.3 per cent of GDP, whereas direct spending in the State Budget does not even amount to 0.4 per cent of GDP.

The functional mix of spending on investments remained virtually constant over the period considered. Roughly 30 per cent goes to economic affairs (farming, manufacturing activity, transport, telecommunications, etc.). Each of the general services, housing, and national planning areas commands over 15 per cent of the appropriations, while healthcare, the environment, education and recreational, cultural and religious activity account for around 7 per cent each.



Economic affairs and general services account for most of the spending both at the central and local level. A significant portion of state spending is earmarked for defence (14 per cent) and public order and security (11 per cent). At the local level, the bulk of the spending is for education (10 per cent), healthcare (9 per cent) and protection of the environment (8 per cent).



Even though the State's direct spending is less than one-fifth of the total, the State Budget finances most of the disbursements, transferring resources to the entities that then actually take care of carrying out the spending initiatives. The sum of the budget payments for gross fixed investment and for investment subsidies accounted for roughly 77 per cent of the general government's gross investment spending between 2000 and 2007. The State Budget also finances investments made by entities outside of the general government, but these investments are still aimed at building up the nation's infrastructures (with one of the largest items being contributions to the Italian National Railways' investments, equal to € 3.5 billion per year on average for the 2000-2007 period).

TABLE 4.4: SPENDING ON GENERAL GOVERNMENT GROSS FIXED INVESTMENT¹ AND INVESTMENT SUBSIDIES² (Mn)

Year	Gross Fixed Investment	Investment Subsidies - State Budget	Total	General Government Account	%
2000	3,540	17,850	21,390	28,749	74.4
2001	4,820	23,836	28,656	31,613	90.6
2002	4,794	23,716	28,510	33,466	85.2
2003	5,727	23,825	29,552	35,551	83.1
2004	5,554	21,824	27,378	37,546	72.9
2005	5,456	18,755	24,211	36,461	66.4
2006	3,527	19,913	23,440	35,236	66.5
2007	6,555	22,398	28,953	37,571	77.1

1) State Budget and General Government Total.
2) State Budget.

The total amount of the State Budget's payments during the 2000-2007 period is similar to the total amount of the related appropriations within the State Budget, with an acceleration seen in the most recent two-year period. It should be noted in any event that the payments are to be made in accordance with both the appropriations in the current budget and the residual account (i.e. to be applied with respect to appropriations in relation to prior years). On average, the spending on gross fixed investment is equal to roughly 35 per cent of the budget appropriations; another roughly 60 per cent is to be spent in the three years thereafter.

TABLE 4.5: STATE BUDGET APPROPRIATIONS, COMMITMENTS AND PAYMENTS FOR GENERAL GOVERNMENT GROSS FIXED INVESTMENTS & INVESTMENT SUBSIDIES (Mn)

Year	Gross Fixed Investments			Subsidies to General Government Investments			Total		
	Approp.	Comm.	Paid	Approp.	Comm.	Paid	Approp.	Comm.	Paid
2000	5,136	4,831	3,540	23,331	22,537	17,850	28,467	27,368	21,390
2001	5,917	5,526	4,820	27,927	25,817	23,836	33,844	31,343	28,656
2002	5,786	5,265	4,794	25,756	23,389	23,716	31,542	28,654	28,510
2003	5,848	5,747	5,727	24,095	23,270	23,825	29,943	29,017	29,552
2004	5,763	5,524	5,554	24,989	22,984	21,824	30,752	28,508	27,378
2005	6,198	6,145	5,456	20,225	18,637	18,755	26,423	24,782	24,211
2006	4,196	4,138	3,527	16,124	14,612	19,913	20,320	18,750	23,440
2007	6,424	5,949	6,555	20,620	19,324	22,398	27,044	25,273	28,953

Budget appropriations for infrastructures

With reference to the spending laws covering multiple years (Table F of the Finance Law), and in particular, to the part of such laws that refers to infrastructural development, the total amounts appropriated between 2007 and 2008 came to roughly € 88 billion (€ 38 billion earmarked for the 2007-2010 four-year period and € 50 billion for the years thereafter). Of this amount, roughly € 54 billion is made up of additional resources, authorised with specific spending provisions and with the most recent budget measures of the two-year period.

TABLE 4.6: BUDGET APPROPRIATIONS AUTHORISED FOR 2007 AND SUBSEQUENT YEARS FOR MULTIPLE-YEAR INFRASTRUCTURAL INVESTMENT (Mn)

	2007	2008	2009	2010	2011 & thereafter	Total
Framework Law (<i>Legge Obiettivo</i>)	1,204	1,404	1,703	1,703	16,956	22,970
<i>Including: resources authorised by previous laws:</i>						
Traditional railways & high-speed railways AV/AC:	1,104	1,104	1,104	1,104	9,571	13,987
<i>Including: resources authorised by previous laws:</i>						
Underground railway systems	459	280	3,603	3,253	11,931	19,525
National Road Board (ANAS)	810	20	30	30	120	1,010
Land and sea routes	1,762	1,560	1,560	0	0	4,882
Urban areas	170	53	27	12	88	350
Ports and airports	498	242	199	4	0	943
State building	3	143	20	32	20	218
Fund for Underutilised Areas (30% share)	245	281	1,271	1,656	20	3,473
Other initiatives	30	330	1,320	2,750	14,884	19,314
TOTAL	155	106	84	84	111	540
<i>Including: resources authorised by previous laws</i>	9,195	7,443	11,517	10,024	49,630	87,809
	1,563	1,384	4,707	4,357	21,502	33,513

Framework Law (Legge Obiettivo)

The 2007 and 2008 Finance Laws authorised additional resources, in terms of 15-year investment spending for € 8,982 million starting from 2007 and the years thereafter.

With the resources provided by the 2007 Finance Law, long-term financing in the total amount of more than € 1,390 million was finalised for the planning and completion of the works included in the strategic infrastructure programme.

With the 15-year investment spending set aside by the 2008 Finance Law, some € 1,044 million of projects have been financed against a total investment volume that can be estimated at around € 2,950 million.

The total financing granted regards the following areas of investment:

TABLE 4.7: FINANCING BY AREA OF INVESTMENT

	Mn	%
Railways	69	3
Roads	184	8
Water sector	638	26
Underground railways	643	26
MOSE (infrastructure to safeguard Venice)	100	4
Ports	800	33
TOTAL	2,434	100

Railways

The total resources set aside for the Italian State Railways for 2007 and the years thereafter are €34.1 billion, including € 24.6 billion earmarked for the traditional network and €9.5 billion for the Turin-Milan-Naples high-speed/high-capacity ('AV/AC') network. The additional resources provided by the 2007 Finance Law and by Decree Law n. 81 and 159 of 2007 amount to € 14.6 billion, including € 6.5 billion for the completion of the traditional network and € 8.1 billion for the Turin-Milan-Naples AV/AC.

STATE RAILWAYS

The support that the State, not only in Italy, has been called on to provide to the State Railways (Ferrovie dello Stato (FS)) can be linked: i) for the most part, to infrastructural work (investment in both the traditional network and the AV/AC network, as well as payments into the operating account for the service of running the network); and ii) for the remainder, to the supply of services for transporting passengers and cargo both at a local level (regional transport) and a national level (medium/long distances).

Insufficient investment by the State will not only end up causing a slowdown in Italy's effort to close the country's infrastructure and economic growth gap with the rest of Europe, but it will also risk compromising the quality and the reach of the service to the public and to businesses.

From the very start of the legislature, the government has had to arrange for major financial support of the FS, which had experienced a substantial slowdown in funding in previous years,

with the significant risk of an interruption of the work already in process. A total of just under € 10 billion was appropriated for investments in the national railway network for 2006-2008, with roughly 60 per cent going into the traditional network and the remainder allocated to the AV/AC project; a large part of the sum was allocated towards the financing of infrastructural work in southern Italy.

The State has furthermore taken on roughly € 13 billion of the Italian Railway Network/High-Speed Train (RFI/TAV) debt in order to allow the FS Group to finance the roughly € 6 billion needed for the completion of the Turin-Milan-Naples AV/AC project on an independent basis and without the guarantee of the State.

In the past 20 months, the government has also provided a total of € 2.3 billion to the FS Group (RFI) as a payment into the operating account for the service of running the rail network.

During the same period, another € 4.6 billion was provided to the FS Group (Trenitalia) as a payment towards services for transporting passengers and cargo both at a local level (regional transport) and a national level (medium/long distances).

The various initiatives add up to more than € 16 billion at the level of the State Budget for the three years considered, without counting the additional € 13 billion of RFI/TAV debt taken on by the State. For the most part, the investments are expected to produce positive effects in the coming years in terms of the efficiency of the service to public at large and the nation's businesses.

	INVESTMENT			OPERATING ACCOUNT		
	Traditional Network	AV AC Network	AV AC (debt)	Trenitalia	RFI	Total
2006	0.1	1.8 (a)				1.9
2007	3.8 (b)	0.5	13.0	2.7	1.2	21.2
2008 (c)	1.9	1.4		1.9	1.1	6.3
Total	5.8	3.7	13.0	4.6	2.3	29.4 (d)

- a) The amount indicated refers only to appropriations approved by the Decree Law passed in June 2006.
 b) The amount includes €1.035 billion authorised by the DL 159/2007 (a law related to the 2008 Finance Law).
 c) The sums indicated are inclusive of the provisions (19.5 per cent) provided by Article 1, Paragraph 507 of the 2007 Finance Law. An ad-hoc order needs to be issued for the disbursement of such amount.
 d) It should also be noted that the 2006 and 2007 Finance Laws provided for multiple-year contributions to be set aside, including in later years, for the implementation of 2007-2011 programme contract and for the financing of the Turin-Milan-Naples AV/AC line (see TABLE 4.6: railway transport).

Reviewing the appropriations of the State in favour of the FS Group in recent years, it is noted that roughly € 14 billion was made available for infrastructural investment in the network from 2002 to 2006 (Finance Laws), while the resources allocated from June 2006 to the present amount to roughly € 10 billion (without taking into account, as indicated, the amount of the RFI/TAV debt taken on by the State).

While this trend highlights the State's commitment despite the constraints of public finance, it should nonetheless be noted that the resources allocated to date are still insufficient to cover the requirements projected during the year by the company.

Taking the FS Group's most recent estimates as a reference (some of which reflect recalculation of the amounts contemplated for 2008 in the 2007-2011 Business Plan), requests for some € 1.5 billion have been submitted in relation to:

- the purchase of trains for local transport: roughly € 200 million;

- a capital injection of € 500 million as the first tranche of a total € 2 billion capital injection, with the funding to be used for restructuring the cargo transport business;
- the renewal of the service contract (which expired in December 2007) between Trenitalia and the ordinary-statute regions: roughly € 400 million;
- the execution of the services part of a programme contract concerning the activity of managing the railway network so as to allow for the execution of the services part of a programme contract between the Ministry of Infrastructures and the RFI: € 400 million.

The new government will be called upon to decide the size of any further resources to be allocated to the FS Group after an evaluation of the Group's requests and further analysis of the matter with the local administrations responsible.

National Road Board (ANAS)

The additional resources set aside for the years of 2007, 2008 and 2009 in favour of ANAS amount to almost € 4.9 billion, including the transfer of € 426.5 million authorised by the Decree Law n. 81/2007. The Interministerial Economic Planning Committee (CIPE) approved the programme contract for 2007, the investment plan for 2007-2011 attached thereto, and a subsequent additional act, with which the roughly € 1.3 billion of resources set aside for 2007 were officially allocated to the works. The Ministry of Infrastructures has already presented a proposal to CIPE for the updating of the contract for the year of 2008; the proposal outlines the additional works to be financed with resources equal to € 1.5 billion appropriated for such year. With the resources for 2009 (whose amount is also equal to € 1.5 billion), it will be possible to address new investment needs.

Port system

The € 218 million of transfers from the State Budget to the port system constitute only a minimum portion of the financing that will contribute to the planning and execution of the works. Indeed, the procedures for financing the port authorities were modified with the 2007 and 2008 Finance Laws in order to complete the process of making the authorities financially independent. The transfers handled through the State Budget have been substituted by the allocation of a percentage of revenues collected in the territorial areas. In essence, such revenues incorporate an increase in the amount of value-added and excise taxes collected on port and interport transactions and used for investment to build up the infrastructural network and services, as well as road and rail links to the ports.

Fund for Underutilised Areas

With its resolution n. 166 of 21 December 2007 for the implementation of the 2007-2013 National Strategic Framework, CIPE ordered the programmed distribution of the overall amount of the additional resources of € 63.273 billion for the Fund for Underutilised Areas provided by the 2007 Finance Law (and reformulated by the 2008 Finance Law) for the 2007-2015 period. Pursuant to prevailing regulations, at least 30 per cent of such resources, or € 19.3 billion, must be allocated towards the financing of infrastructures and transport services of strategic importance for the regions of southern Italy.

Other expenditures

Other significant expenditures include:

- State building, and in particular, building for the healthcare sector, for which total expenditures of € 2.6 billion have been authorised;
- Underground railway systems whose overall financing is more than € 1.0 billion; Decree Law 159/07 contributes € 800 million to the financing of the underground railway systems for the cities of Rome, Naples and Milan, for the completion of the lines currently under construction, whose projects had already been approved by CIPE;
- Urban renewal initiatives that include the refinancing of the laws on 'Roma Capitale' (€ 595 million over 2007-2009), the safeguarding of Venice (€ 147 million from 2007 to 2010), and the pursuit of the MOSE system (€ 170 million in 2007, see Table 4.7). The last of the three initiatives is already in process, and considering its technical characteristics, it will not be possible to delay financing. Against an overall cost for the MOSE system of roughly € 4.2 billion, the State has thus far financed € 2.2 billion and additional resources of roughly € 2 billion will be needed in coming years.

4.5 INVESTMENT AND DEVELOPMENT IN SOUTHERN ITALY

In 2007, with the adoption of the 2007-2013 National Strategic Framework (NSF)⁷ on the part of the European Commission (EC) in July⁸ and the related CIPE resolution for implementation thereafter during the month of December⁹, the planning, financial aspects and structure of the single regional policy has been mapped out for the next few years. The actual implementation of the NSF is expected to provide a new impulse to investment in southern Italy, with regard to both (i) the renewal of the commitments for incremental spending for the government's social-integration policies, and (ii) the activation of new investment programmes. Alongside the measures financed by new operational programmes associated with 2007-2013 EU resources (which by now have

⁷ The 2007-2013 NSF constitutes the general strategy document for regional-policy initiatives in Italy that are financed by both structural funds of the EU with national co-financing, and by national resources from the Fund for Underutilised Areas.

⁸ See European Commission decision of 13 July 2007.

⁹ See CIPE Resolution n. 166 of 21 December 2007.

already been approved by the EC and provide total resources of € 47.3 billion for southern Italy), CIPE has also definitively approved the allocation of additional resources for the Fund for Underutilised Areas¹⁰ as established for regional policy under the 2007 Finance Law. The additional resources earmarked for southern Italy amount to € 53.8 billion, and are to be channelled into investment programmes in coordination with and/or complementary to those EU programmes being implemented as part of a common strategic agenda aimed at building up infrastructures, innovative capacity and human capital, as well as resources set aside for allowances and incentives (€ 3 billion) for the achievement of public service objectives particularly significant for development (education, social services, efficient management of water resources and waste).

The aggregate of additional resources for southern Italy, equal to more than € 100 billion (with those from the EU to be employed by 2015, and those from national sources to be used no later than the three-year period thereafter) implies a significant occasion for the qualitative reorientation of total spending, though it does not diminish the public investment commitment that will also make use of ordinary resources, as required by the aforementioned commitments for additional funding.

TABLE 4.8: RESOURCES EARMARKED FOR SOUTHERN ITALY UNDER 2007-2013 NSF (Structural funds with co-financing and Fund for Underutilised Areas – Mn)

Provisions to Fund for Underutilised Areas (1)	8,211
Programming Reserve for Fund for Underutilised Areas	7,923
Implementation of programmes regarding the Priorities of the 2007-2013 NSF (2)	84,951
incl: Programmes of national strategic interest - Central administrations	30,612
Programmes of regional strategic interest - Regions	49,940
Interregional programmes	4,399
Total	101,085

1) Incentives for 'service objectives', fund for innovative and quality projects, special strategic projects.

2) EU structural funds with national co-financing and Fund for Underutilised Areas.

In support of the plan for relaunching investment, a regulatory framework was also perfected with regard to the measures for relief to businesses that are complementary to public investment being made for the development of the area. In November 2007, the EC¹¹ approved the 'Italian Charter of State Aid for Regional Purposes for 2007-2013', a document considered essential for implementing relief measures referring to specific areas of the nation as well as other regional aid.¹² In order to promote private investment in

¹⁰ Law 296/2006 (2007 Finance Law) approving the implementation of the decision to 'unify' the planning of additional resources has aligned the budget positioning on the Fund for Underutilised Areas to that contemplated by the EU budget for 2007-2013 structural funds. Law n. 244 /2007 (2008 Finance Law) explicitly formulated the financial resources available for the 2007-2015 period, thereby rounding out the regulatory framework needed in order to follow up on the needs for the joint programming of the EU structural fund resources and the Fund for Underutilised Areas.

¹¹ See European Commission decision of 28 November 2007.

¹² The State aid for regional purposes for 2007-2013 can be granted to the areas covered by the 'Convergence initiative', as an exception to Article 87.3.a) of the European Union Treaty (namely, all of the area in the regions of Calabria, Campania, Apulia, Sicily, and Basilicata) and in the areas covered by the 'Competitiveness initiative', as an exception to Article 87.3.c) until 31 December 2013, or for the purpose of the phasing out until 31 December 2008.

southern Italy and to support the innovation efforts of businesses in the country, two important fiscal incentive mechanisms recently went into effect¹³: (i) the new tax credit for businesses that make investments ‘through the acquisition of new capital goods in areas of southern Italy’ which is effective from 2007 to 2013¹⁴; and (ii) ‘the general tax credit available nationwide for investments in research and development’ through 2010.

A specific emphasis has gone the promotion of initiatives that are aimed at both development and social justice. A three-year tax credit has been introduced for new jobs created in southern Italy in 2008¹⁵, with a greater incentive in the case of the hiring of women. With an accent on combating social exclusion and favouring economic activity in urban areas marked by critical socio-economic situations, an experiment involving measures to support urban zones could be launched with the planned resources of € 100 million for 2008-2009. Following the 2008 Finance Law's reformulation of the provisions and CIPE's approval of the criteria for identifying the areas, it will be possible to finance investment and fiscal/welfare benefits in favour of new economic activities launched by small and micro businesses.

¹³ Measures provided by Law 296/2006 (2007 Finance Law) and amendments or modifications by Law 244/2007 (2008 Finance Law).

¹⁴ The measure was approved by the EC at the end of January 2008.

¹⁵ See Article 2, Paragraph 539-54 of Law 244/2007 (2008 Finance Law).