Ministero dell'Economia e delle Finanze

Italy's Stability Programme

Update December 2006

The final approval of the Financial Law for 2007 is still pending.
The Update describes budget measures as presented by the Government in early October.

CONTENTS

1. INTRODUCTION

The Update of Italy's Stability Programme is issued in accordance with Article 4 of the European Council Regulation 1466/97, taking into account the modifications introduced by Regulation 1055/2005 issued on 27 June 2005 and the guidelines on the application of the new Stability and Growth Pact.

This year's Update is based on the Update to the Economic and Financial Planning Document (DPEF) for the period 2007-2011 issued on 30 September 2006, the Forecasting and Planning Report (RPP) for 2007 presented to Parliament on 29 September 2006, as well as the Finance Bill for 2007 and Law Decree 262/2006,[1] both submitted to Parliament on 1 and 3 October 2006 respectively.

The present Update outlines the macroeconomic framework for the period 2007-2011 and indicates the Government's public finance objectives for the above years as well as the strategy selected to achieve such objectives. The Budget Law for 2007 envisages a 1 per cent correction of Gross Domestic Product (GDP), consistent with the 12 July 2005 Ecofin Council Recommendation on the excessive deficit procedure launched against Italy, and allows achieving both the reduction of the deficit to below the-3-per-cent-of-GDP limit in 2007 and a balanced budget in the medium term.

Over the period 2006-2007, the cyclically-adjusted correction, net of one-off measures, is in line with the Recommendation thus totalling 1.6 per cent of GDP. In the years following 2007 the consolidation process allows for an annual reduction of the cyclically-adjusted deficit net of one-off measures equal at least to the 0.5 per cent of GDP required by the Recommendation, and is consistent with the objective of achieving a balanced budget position in the medium term. At the end of the period considered in the present Update, the deficit should settle within the minimum benchmark that guarantees a safety margin against excessive deficit in normal cyclical conditions and taking into account the budget sensitivity.

[1] Now Law 286/2006

As a continuation to the ongoing budget consolidation process, the current document describes the expected decline in the debt-to-GDP ratio.

The Update contains a specific section on the budgetary implications of the structural measures included in the National Reform Programme (NRP), in line with the Code of Conduct and decisions by the Ecofin Council. The section addresses the need of strengthening the link between the operating instruments of the new Stability and Growth Pact and the Lisbon strategy.

Furthermore, the document includes a review of national fiscal rules and institutions governing the conduct of budgetary policy and also provides sensitivity analysis of public finances according to different macroeconomic scenarios.

Finally, the document analyses the impact of the Italian ageing population on sustainability of public finances.

2. THE MACROECONOMIC FRAMEWORK

Italy's GDP increased by 0.8 and 0.6 per cent quarter on quarter respectively in the first and second quarters of 2006, and then growth slightly slowed down to 0.3 per cent in the third quarter. Over the same period, industrial production showed a significant recovery.

In light of such a trend and cautious growth estimates for the fourth quarter, the 1.6-per cent GDP growth forecast for 2006 (unadjusted) indicated in the latest RPP should be attained - a slightly lower figure than forecast by main International Organisations.[2]

Consistently with the expected recovery in economic activity, employment, as measured by full-time equivalent jobs, should increase by 1.0 per cent - a clear trend inversion compared to the negative performance recorded in 2005. The unemployment rate is projected to decline to 6.9 per cent.

As measured by the GDP deflator, domestic inflation is expected to decrease from the 2005 average (1.9 per cent versus 2.1). External pressures, linked to the oil price increases of the first part of the year, should push the private consumption deflator to 2.6 per cent (2.3 per cent in 2005).

As in the rest of Europe, GDP growth is expected to slightly slow down in 2007 compared to the previous year, thus reaching 1.3 per cent. Growth will likely be supported mainly by domestic demand, although some slowdown in public and private consumption is anticipated. Albeit somewhat easing, investment growth should continue to broadly follow the overall trend of demand.

In spite of the less dynamic trend of world trade and the euro appreciation, exports should decelerate by 1 percentage point compared to 2006, although still showing a positive trend. The contribution from the external sector should remain slightly positive

[2] International variables of the Forecasting and Planning Report (RPP) for 2007 are broadly in line with the European Commission's Forecasts, Autumn 2006. Differences in growth rates are within 1 decimal point. In particular, 2006 real GDP growth is slightly lower in the RPP than in the Autumn Forecast 2006. In light of such a difference and taking into account the latest economic indicators, the 2006 GDP growth estimate described in this Report is to be considered cautious.

(0.2 percentage points). The current account deficit as a percentage of GDP is projected to improve from -2.4 to -2.1 per cent, as a result of a decrease in the previously heavy losses in terms of trade.

In 2006, the deficit in the balance of payments has been strongly affected by the negative trend in its energy component. The cif-fob trade balance shows a 18.6-billion-euro deficit for the first nine months of 2006. Net of the energy component, however, the balance would be positive and close to 19.5 billion euros.

Courtesy of continuing economic expansion, employment is projected to further increase by 0.5 per cent in 2007, although at a somewhat slower pace than in 2006. The unemployment rate should continue to decline, and reach 6.7 per cent if the labour supply were to grow in line with the latest trends.

Benefiting from the effects of the expected stabilisation in oil prices, the GDP deflator measure of inflation is expected to sharply decline to 1.5 per cent, and the private consumption deflator measure of inflation to moderately ease.

Over the period 2008-2011, Italian GDP growth is forecast to accelerate, reaching an average of 1.7 per cent per year. Thanks to higher disposable income and improvement in the labour market, private consumption should increase by an average of 1.6 per cent over the same period. Investment is forecast to increase by an average of 3 per cent, driven by machinery and equipment growth. Exports should expand by an average of 3.5 per cent over the same period, as a result of a gradual improvement in competitiveness and the broadly favourable international economic scenario. At the same time, stronger domestic demand should boost imports, expected to grow by 3.4 per cent.

As for the labour market, employment is expected to enjoy on average a 0.7 per cent growth. Consequently, the unemployment rate should decline to 5.7 per cent at the end of the period.

The GDP deflator is forecast to remain below 2 per cent in 2008-2011, thanks to contained unit labour cost dynamics resulting from the expected persisting moderation in wages and productivity gains.

Table 1a. MACROECONOMIC PROSPECTS

	2005		2006	2007	2008	2009	2010	2011
	Level (1)	% change	% change					
Real GDP	1,229.6	0.0	1.6	1.3	1.5	1.6	1.7	1.7
Nominal GDP	1,417.2	2.0	3.6	2.8	3.4	3.4	3.6	3.6
Components of real GDP								
Private consumption expenditure	727.2	0.1	1.6	1.0	1.5	1.6	1.7	1.6
Government consumption and NPISH expenditure (2)	246.0	1.2	0.7	0.0	0.0	0.2	0.2	0.2
Gross fixed capital formation	257.6	-0.6	2.8	2.3	2.8	3.0	3.1	3.0
Changes in inventories (% of GDP)	9.2	0.1	-0.1	0.1	0.0	0.0	0.0	0.0
Exports of goods and services	313.2	0.3	5.3	4.2	3.5	3.4	3.4	3.5
Imports of goods and services	323.8	1.4	4.8	3.5	3.4	3.5	3.4	3.3
Contributions to real GDP growth								
Final domestic demand		0.1	1.7	1.1	1.5	1.6	1.7	1.7
Changes in inventories		0.1	-0.1	0.1	0.0	0.0	0.0	0.0
External balance of goods and services		-0.3	0.1	0.2	0.0	0.0	0.0	0.0

(1) Billion euros (2) NPISH = Non Profit Institution Serving Household

Table 1b. PRICE DEVELOPMENTS

	2005	2006	2007	2008	2009	2010	2011
				% change			
GDP deflator	2.1	1.9	1.5	1.8	1.8	1.9	1.8
Private consumption deflator	2.3	2.6	2.0	1.9	1.9	1.9	1.8
HICP	2.2	2.2	2.1	1.7	1.5	1.5	1.5
Public consumption deflator	3.2	3.4	-0.9	1.5	1.0	1.2	1.2
Investment deflator	2.5	2.8	1.9	1.8	1.7	1.7	1.7
Export price deflator	5.7	5.4	2.4	1.9	1.9	2.0	2.0
Import price deflator	7.7	9.2	2.2	2.0	2.0	2.0	2.0

Table 1c. LABOUR MARKET DEVELOPMENTS

	2005	2006	2007	2008	2009	2010	2011
Employment (1)	-0.4	1.0	0.5	0.7	0.7	0.7	0.7
Unemployment rate (2)	7.7	6.9	6.7	6.3	6.0	5.9	5.7
Labour productivity (1)	0.4	0.7	0.8	0.8	0.9	1.0	1.0
Compensation of employees (1)	4.3	4.6	2.7	2.7	3.0	2.9	3.0

(1) Percentage change. (2) Percentage.

Table 1d. SECTORAL BALANCES

	2005	2006	2007	2008	2009	2010	2011
				% of GDP			
Net lending/borrowing vis-à-vis the rest of the world (1)	-1.6	-2.3	-2.0	-2.0	-2.0	-1.9	-1.8
Balance on good and services	-0.1	-0.9	-0.7	-0.7	-0.8	-0.8	-0.8
Balance of primary incomes and transfers	-1.5	-1.4	-1.4	-1.3	-1.2	-1.2	-1.1

(1) Capital account not included

3. NET BORROWING AND PUBLIC DEBT

3.1 General Government net borrowing

Public finance forecasts indicated in the 2005 Stability Programme Update have been revised over 2006. In April, the Quarterly Cash Report raised the estimate for the 2006 net borrowing requirement from 3.5 to 3.8 per cent of GDP. The new estimate took into account lower-than-expected GDP growth, more favourable revenue developments and higher government sector and health care expenditures. The primary balance was reduced to 0.6 per cent of GDP as a consequence of the new criteria adopted by ISTAT for the classification of financial services.

In May, the *due diligence* requested by the new Government when it took office showed higher expenditures for 5.8 billion euros and higher revenues for 2.5 billion euros. The deficit-to-GDP estimate was raised to 4.1 per cent. Furthermore, the *due diligence* highlighted some risk factors related to an increase in current expenditure by local authorities and the implementation of the 2006 Budget, especially as to the so-called fiscal planning and predefined tax liabilities schemes.

In July, the Economic and Financial Planning Document (DPEF) defined the new Government strategy designed to produce a significant structural budget consolidation and stimulate economic growth. The 2006 net borrowing requirement and primary balance were indicated at 4.0 and 0.5 per cent of GDP respectively. New estimates reflected the upward revision in economic growth from 1.3 to 1.5 per cent and the considerable increase in tax revenues recorded in the first half of the year. Furthermore, the effects of the corrective measure adopted by the Government in July (*Law Decree 223/2006* – now *Law 248/2006*) were included.

In September, following the Forecasting and Planning Report (RPP) and the Update to the DPEF, the estimate of the net borrowing requirement changed again as a result of an unexpected further rise in tax revenues. The new projections were notably affected by the sentence issued by the European Court of Justice on VAT deductibility for motor vehicles[3] (Annex 2). Net borrowing was re-estimated at 4.8 per cent of GDP and the primary balance at -0.3 per cent. Nevertheless, net of higher burdens related to payment of arrears, net borrowing and the primary balance would have amounted to 3.6 and 0.9 per cent respectively.

Table 2. DIFFERENCES FROM PREVIOUS UPDATE

	2005	2006	2007	2008	2009	2010	2011
GDP growth							
Stability Programme 2005	0.0	1.5	1.5	1.7	1.8		
Stability Programme 2006	0.0	1.6	1.3	1.5	1.6	1.7	1.7
Difference	0.0	0.1	-0.2	-0.2	-0.2		
Net borrowing (% of GDP)							
Stability Programme 2005	-4.3	-3.5	-2.8	-2.1	-1.5		
Stability Programme 2006	-4.1	-4.8	-2.8	-2.2	-1.5	-0.7	0.1
Difference	0.2	-1.3	0.0	-0.1	0.0		
Public debt (% of GDP)							
Stability Programme 2005	108.5	108.0	106.1	104.4	101.7		
Stability Programme 2006	106.6	107.6	106.9	105.4	103.5	100.7	97.8
Difference	-1.9	-0.4	0.8	1.0	1.8		

Overall, the difference between last year's forecast for the 2006 net borrowing requirement and the current Update amounts to 1.3 percentage points of GDP (Table 2). Leaving aside the subsequent revisions over the year, the difference is mostly due to the effects of the sentence on VAT deductibility, which amount approximately to 1.2 percentage points of GDP. Economic growth proved in line with the forecasts indicated in the previous Stability Programme Update.

The current forecast for 2006, net of higher burdens due to the VAT sentence, shows a decrease of 0.5 percentage points in the deficit-to-GDP ratio (Table 3).

[3] On an accrual basis, the effects are estimated to amount to 17.1 billion euros in higher expenditures for payment of arrears from 2003 to 13 September 2006, and approximately 1.5 billion in lower revenues for the end of 2006.

Table 3. GENERAL GOVERNMENT BUDGETARY PROSPECTS (1)

	2005		2006	2007	2008	2009	2010	2011
	level	% of GDP						
Net borrowing by sub-sector								
1. General Government	-58,163	-4.1	-4.8	-2.8	-2.2	-1.5	-0.7	0.1
annual correction (2)					0.7	0.5	0.5	0.6
2. Central Government	-53,170	-3.8	-4.4	-2.8	-2.9	-2.8	-2.4	-2.1
3. State Government	-52,855	-3.7	-4.5	-2.8	-3.0	-2.9	-2.6	-2.5
4. Local Government	-10,291	-0.7	-0.8	-0.6	-0.6	-0.5	-0.5	-0.4
5. Social Security Funds	5,298	0.4	0.4	0.6	0.6	0.6	0.5	0.5
General government								
6. Total revenue	623,482	44.0	45.0	46.2	46.0	45.9	45.7	45.4
7. Total expenditure (3)	681,645	48.1	49.9	49.0	48.9	48.6	48.0	47.5
annual correction (2)					0.7	0.5	1.6	0.6
8. Net borrowing	-58,163	-4.1	-4.8	-2.8	-2.2	-1.5	-0.7	0.1
9. Interest expenditure (incl.FISIM) (4) (5)	67,948	4.8	4.8	5.0	5.0	5.0	5.0	5.0
Memo item: FISIM	3,399	0.2	0.2	0.2	0.2	0.2	0.2	0.2
10. Primary balance	9,785	0.7	0.0	2.3	2.8	3.5	4.3	5.1
Selected components of revenues								
11. Total taxes	392,719	27.7	28.8	29.4	29.2	29.1	28.9	28.8
11a.Taxes on production and imports	201,859	14.2	14.5	14.5	14.4	14.3	14.2	14.0
11b.Current taxes on income etc.	189,052	13.3	13.9	14.8	14.7	14.8	14.8	14.8
11c.Capital taxes	1,808	0.1	0.4	0.1	0.0	0.0	0.0	0.0
12. Social contribution	182,416	12.9	12.8	13.5	13.5	13.4	13.3	13.2
13. Property income	8,118	0.6	0.6	0.6	0.6	0.6	0.6	0.6
14. Other	40,229	2.8	2.8	2.8	2.8	2.8	2.8	2.7
15. Total revenue	623,482	44.0	45.0	46.2	46.0	45.9	45.7	45.4
Memo item: Tax burden		40.6	41.6	42.9	42.6	42.5	42.3	42.0
Selected components of expenditure								
16. Collective consumption	116,023	8.2	8.3	8.1	8.1	8.0	7.9	7.8
17. Total social transfers	409,828	28.9	29.0	29.0	29.1	28.8	28.5	28.3
17a.Social transfers in kind	168,136	11.9	11.8	11.4	11.4	11.3	11.1	11.0
17b.Social transfers other than in kind	241,692	17.1	17.2	17.5	17.7	17.5	17.4	17.4
18. Interest expenditure (incl.FISIM) (4) (5)	67,948	4.8	4.8	5.0	5.0	5.0	5.0	5.0
19. Subsidies	13,201	0.9	1.0	1.0	0.9	0.9	0.9	0.9
20. Gross fixed capital formation	33,499	2.4	2.6	2.8	2.8	2.9	2.8	2.7
21. Other	41,146	2.9	4.2	3.1	3.1	3.0	2.9	2.8
22. Total expenditure (3)	681,645	48.1	49.9	49.0	48.9	48.6	48.0	47.5
Memo item: Compensation of employees	155,533	11.0	11.1	10.8	10.8	10.6	10.5	10.3

Methodological Note: Primary balance and interest payment data cannot be directly compared to estimates of planning reports: in the above Table interest payments include FISIM (0.2 per cent of GDP per annum) and exclude swaps (0.15 per cent of GDP in 2005), as required by the new Code of Conduct.

(1) Components may not add as to total revenues and expenditures, due to decimal rounding.
(2) The cumulated adjustment amounts to 1.2 in 2009, 1.7 in 2010, and 2.3 in 2011 respectively.
(3) The 2006 figure is inclusive of higher burdens due to payment of arrears for the period 2003 - September 2006 arising from the sentence of the European Court of Justice on VAT deductibility.
(4) Net of swaps, which amounts to 2,092 million euros in 2005.
(5) The interest payment profile differs from Table 6, as it takes into account only the impact of the 2007 Budget.

Total revenues are expected to increase by one percentage point of GDP, mainly on account of the favourable developments in tax revenues (increased by 1.1 percentage points) and specifically direct taxes (increased by 0.6 percentage points).

Within total expenditure, primary expenditure – net of the impact of the VAT sentence and real estate sales – is expected to increase by 0.4 percentage points of GDP compared to 2005.

The 4.8 per cent estimate of the deficit-to-GDP ratio does not consider the effects of the recent decision by the Government to consolidate the ex-ISPA debt by year-end (Annex 3). The decision leads to the end of a period in which different financing systems have overlapped (since the inception of the Project in 1991). ISPA liabilities were already included in the public debt, and the decision to allow changes in liabilities so as to affect deficit data enhances the transparency of the accounting treatment. At the moment, such liabilities are formally present in the balance sheet of RFI/TAV, an institution external to the Public Administration. The new accounting treatment will worsen the general government net borrowing requirement by approximately 13 billion euros in 2006 (0.9 per cent of GDP).

For 2007, the deficit-to-GDP target is confirmed at 2.8 per cent, as indicated in the previous Stability Programme Update – consistently with the deficit consolidation path indicated in the excessive deficit procedure.

Net borrowing is expected to decrease steadily over the period 2008-2011 and be consistent with the expected economic development, thus declining on average by 0.7 per cent a year and reaching a balanced budget position in 2011.

The measures adopted with the 2007 Budget will involve an annual structural correction equal to one percentage point of GDP in 2008-2011. The annual targets indicated by the DPEF 2007-2011 will be achieved year after year through the implementation of required additional measures as specified by the coming Budget Laws. On account of the permanent nature of the interventions adopted in the current year, the size of additional measures will be small. The 2007 adjustment allows maintaining the deficit below the target of 3 per cent of GDP for the whole projection period (Table 4). Finally, contrary to past behaviour, temporary measures are not envisaged (Annex 4).

Table 4. PROJECTION OF GENERAL GOVERNMENT BUDGETARY PROSPECTS INCLUDING THE 2007 FINANCIAL MANOEUVRE (Percentage of GDP)

	2006	2007	2008	2009	2010	2011
Net borrowing (before budget correction)	-4.8	-3.8	-3.9	-3.8	-3.5	-3.3
Primary balance adjustment		1.0	0.9	1.0	1.0	1.0
Interest savings on budget adjustment		0.0	0.1	0.1	0.1	0.1
Net borrowing (after budget correction)		-2.8	-2.9	-2.7	-2.4	-2.2

3.2 Cyclically-adjusted budget

Table 5 shows the evolution of macroeconomic and public finance variables relevant to the calculation of the cyclically-adjusted budget balance in the period 2003-2011.

Compared to the zero growth of 2005, the pick-up in GDP growth tends to positively affect potential growth, which is expected to slightly increase to 1.4 per cent in 2006.

By analysing the contribution of the three main factors affecting potential GDP dynamics, half of the potential growth should result from the contribution of the labour factor, with the remaining part attributable to capital endowment. In line with the previous three years, no contribution is assumed to result from total factor productivity (TFP).[4]

Given a net borrowing requirement of 4.8 per cent of GDP for 2006, the cyclically-adjusted budget, net of one-off measures, should improve from the 2005 3.7 per cent to 3.6 per cent.

It is in 2007, however, that public finances show a significant structural fiscal consolidation. Notwithstanding a slight deceleration in GDP growth (1.3 per cent) and a broadly unchanged potential growth compared to 2006, fiscal adjustment will involve a

[4] In 2005, following the proposal put forward by the Working Group on Output Gaps, the Economic Policy Committee (EPC) approved the use of the series of hours worked for calculating potential GDP according to the production function methodology. However data on hours worked are still not available at the moment and it is therefore not possible to incorporate the new variable in the estimate of potential GDP

reduction of the cyclically-adjusted budget, net of one-off measures, equal to 1.4 percentage points – namely from 3.6 per cent of GDP in 2006 to 2.2 per cent in 2007 (Table 5).

Table 5. CYCLICAL DEVELOPMENTS (Percentage change) (1)

	2003	2004	2005	2006	2007	2008	2009	2010	2011
GDP at constant prices	0.0	1.1	0.0	1.6	1.3	1.5	1.6	1.7	1.7
Net borrowing	-3.4	-3.4	-4.1	-4.8	-2.8	-2.2	-1.5	-0.7	0.1
Interest payments	5.1	4.7	4.8	4.8	5.0	5.0	4.9	4.9	4.9
Potential output (2)	1.3	1.4	1.3	1.4	1.3	1.4	1.5	1.6	1.7
Contributions:									
Labour	0.7	0.7	0.6	0.7	0.6	0.6	0.5	0.5	0.5
Capital	0.7	0.7	0.6	0.7	0.7	0.7	0.7	0.7	0.7
Total Factor Productivity	0.0	0.0	0.0	0.0	0.0	0.1	0.2	0.3	0.4
Output gap(2)	-0.2	-0.5	-1.8	-1.6	-1.5	-1.4	-1.2	-1.1	-1.1
Cyclical budgetary component (2)	-0.1	-0.3	-0.9	-0.8	-0.8	-0.7	-0.6	-0.5	-0.5
Cyclically adjusted budget balance (2)	-3.4	-3.2	-3.2	-4.1	-2.1	-1.5	-0.9	-0.1	0.7
Cyclically adjusted primary balance (2)	1.8	1.6	1.6	0.7	3.0	3.5	4.0	4.8	5.5
One-off measures	1.7	1.2	0.5	-0.5	0.1	0.1	0.0	0.0	0.0
Cyclically adjusted budget balance net of one-off meausures (2)	-5.1	-4.4	-3.7	-3.6	-2.2	-1.6	-0.9	-0.1	0.7
Cyclically adjusted primary balance net of one-off meausures (2)	0.1	0.3	1.0	1.2	2.8	3.4	4.0	4.8	5.5
Changes in cyclically adjusted primary balance net of one-off meausures (2)			-0.7	-0.2	-1.4	-0.6	-0.7	-0.8	-0.8

(1) Decimals may not add, due to rounding.
(2) Potential output takes into account the smoothing of the active population series to reduce the 2004 hike caused by legalisation of immigrant workers.

Therefore, the consolidation of public finances is consistent with the Ecofin Council Recommendation of July 2005, which called for a permanent adjustment in the cyclically-adjusted deficit, net of one-off measures, amounting to 1.6 percentage points of GDP over 2006-2007.

Starting from 2008, the cyclically-adjusted budget should steadily decline by approximately 0.7 percentage points per year. In 2011 – the last year of projections – the balance will be positive, thus allowing for fulfilment of the provisions established by the New Stability and Growth Pact with regard to the achievement of the medium-term

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provided by the present Update. Nevertheless, by using the series of hours worked, we can presume a slightly positive contribution of total factor productivity to potential GDP.

objective. Consistent with such dynamics, the cyclically-adjusted primary balance would again increase significantly, and in the last two years reach 4.8 and 5.5 per cent of GDP respectively - values that would guarantee a rapid decline of the debt-to-GDP ratio notwithstanding further population ageing (see par. 6).

3.3 Public debt

In 2005 the debt-to-GDP ratio increased by 2.7 percentage points compared to 2004, namely from 103.9 to 106.6 per cent. The forecasts of the 2005 Stability Programme Update had instead indicated a 2-percentage point reduction of the debt-to-GDP ratio. However, last year's forecasts and actual data cannot be immediately compared. The GDP series revised by ISTAT in 2005 revealed a remarkable difference compared to the 2004 and 2005 debt-to-GDP ratio levels. The impact of such revisions for the year 2004 amounted to 2.8 percentage points: the debt-to-GDP ratio declined from 106.5 per cent to 103.7 percent and subsequently increased to103.9 percent[5] as a result of a revision of the nominal value for 2004.

With regard to 2005, given the same level of nominal debt forecast in that year's Update, the GDP series revision would have produced by itself a reduction of the ratio by approximately 3 percentage points, thus reducing it to approximately 105.5 per cent. Nevertheless a further upward revision of the nominal debt value for 2005 amounting to 0.2 points of GDP was performed, due to ordinary banking statistical revisions and the effects of securitisation of local authorities' health sector debts[6]. A lower-than- predicted

[5] According to Eurostat's recommendation, the renegotiation of trade debts followed by securitisation brings about a different financial instrument no longer classifiable as a trade debt but, instead, as a loan. Trade debts are by nature not included in the liabilities that make up Maastricht debt. Including local authorities' trade liabilities subsequently securitised by creditors has increased total debt by circa 700 million euros – respectively 400 million euros for ordinary banking statistical revisions regarding local authorities' debts, and 2.1 billion euros for the adoption of a better method of recording postal deposits held by the private sector.

[6] Following ordinary banking statistical revisions, the 2005 nominal debt includes 600 million euros of local authorities' liabilities and approximately 2.7 billion euros of local authorities' health sector debt securitisation (the cumulated amount is due to the abovementioned 700 million euros of 2004 plus an additional 2 billion euros in new transactions).

nominal growth (2 per cent instead of 2.4, due to a lower-than-expected increase in the GDP deflator) and a more dynamic trend of the public sector's cash borrowing requirement, only partly compensated by slightly lower-than-expected net borrowing,[7] caused the 2005 debt-to-GDP ratio to reach 106.6 per cent.

For 2006 the debt-to-GDP ratio is expected to reach 107.6 per cent, as a consequence both of the reclassification of the abovementioned health sector debt securitisation and the impact, over the same year, of the European Court of Justice's decision on the deductibility of VAT paid for motor vehicles.

With regard to health sector debt securitisation, besides the impacts produced until 2005, the effects resulting both from the securitisation operations performed in the current year and those expected to be completed by the end of this year have been considered, and should result in an additional 2.2 billion euros.

Without taking into account the financial burden deriving from the VAT decision, the debt-to-GDP ratio would be equal to 106.8 per cent[8] – i.e. 0.2 percentage points higher than in 2005. Last year's Update envisaged a debt-to-GDP ratio of 108 per cent for 2006 – whilst if the new GDP series is considered as the reference, the figure would have amounted to approximately 105.5 per cent.

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[7] The shift of the 2005 net borrowing from the 4.3 per cent forecast in the 2005 Update to the actual value posted (4.1 per cent) is due for 0.1 percentage points to the upward revision in GDP data by ISTAT.

[8] The impact of the VAT decision makes it rather difficult to draw a direct comparison with the dynamics of the debt-to-GDP ratio forecast in the latest Update to the Stability Programme. Indeed, in accordance with ESA95 accounting principles, the impact of the decision is directly recorded in the net borrowing of the year in which the sentence is issued. Instead, its cash settlement – which impacts on the debt dynamics – occurs when the claiming, checking and refunding procedures are carried out in favour of the beneficiaries. The debt-to-GDP forecasts reported in Table 6, besides including such effects for the years 2007, 2008 and 2009, assume the spreading of the impact on the aforementioned decision over time. Such forecasts assume a partial pre-funding of the resources required to cover reimbursement claims for an amount equal to 8.6 billion euros in 2006 – namely approximately half of the total estimated burden deriving from the sentence. The pre-funding will be spent from 2007 onwards to cover the reimbursement claims assumed to affect the total state sector's cash borrowing requirement by 5.7 billion euros for each year in the period 2007-2009. In other words, the forecast for 2006 includes the assumption that the current extra liquidity deposited in the account held by the Treasury at the Bank of Italy would not be earmarked to reduce the 2006 debt - instead it would constitute coverage for the VAT reimbursements foreseen for the next years.

Net of the effects of the VAT decision, a moderate increase in the debt-to-GDP ratio also for the current year results from the impact of the mentioned reclassification, coupled both with the absence of the privatisation proceeds envisaged in the 2005 Update and an estimated overall lower nominal GDP growth rate. Furthermore, it is worth noting that last year's Update considered a slightly lower net borrowing (3.5 instead of 3.6[9]).

Table 6. DEBT-TO-GDP RATIOS (1)

	2005	2006	2007	2008	2009	2010	2011
Government debt							
Debt (% GDP)	106.6	107.6	106.9	105.4	103.5	100.7	97.8
Change in debt (% GDP)	2.7	1.0	-0.7	-1.5	-1.9	-2.8	-2.9
Contributions to change in Government debt							
Primary balance (accrual basis)	-0.7	0.0	-2.2	-2.8	-3.4	-4.2	-5.0
Snow-ball effect	2.8	1.1	2.1	1.5	1.4	1.2	1.4
of which: Interest expenditure (accrual basis and incl. FISIM) (2)	4.8	4.8	5.0	5.0	4.9	4.9	4.9
Stock-flow adjustment	0.7	-0.2	-0.5	-0.2	0.1	0.1	0.7
of which:							
Difference between cash and accrual basis	-0.4	-1.1	-0.5				
Net accumulation of financial assets	1.2	0.8	0.0				
of which privatisation proceeds	-0.3						
valuation effects and others	-0.1	0.2	0.1				
Memo item: Implicit interest rate on debt	4.7	4.7	4.8	4.8	4.9	4.9	5.0

(1) Decimals may not add, due to rounding to the first decimal place.
(2) Interest payment profile differs from Table 3, as it takes into account the impact of the additional adjustments assumed for the Budget Laws of the coming years.

The debt-to-GDP ratio shows a significantly downward trend starting from 2007, reaching a level below 100 per cent in 2011. Compared to the 2005 Update, a slower downward trend occurs, as the assumptions on privatisation proceeds are cautiously not included. Therefore, the debt-to-GDP dynamics show room for further improvement. In the final part of the period covered by the current Programme, the reduction becomes more and more evident due to the effect of faster growth in the primary balance, expected to reach 5 per cent of GDP in 2011. Compared to the forecasts of the 2005 Stability Pact Update, the dynamics of the primary balance abundantly offset the less remarkable economic growth expected for the following years.

[9] Taking the new GDP series as the reference, the net borrowing for 2006 forecast in the 2005 Update would decrease from 3.5 to 3.4 per cent

4 SENSITIVITY ANALYSIS

In line with the Code of Conduct, this Chapter describes simulations that consider alternative hypotheses of GDP growth rate and interest rates.

4.1 Sensitivity to growth

Two alternative scenarios to the baseline macroeconomic forecast have been considered for the period 2007-2011. In the high-growth scenario the GDP growth rate is assumed to increase by further 0.5 percentage points per annum compared to the baseline scenario, whereas in the slow-growth scenario it is reduced by 0.5 percentage points. The higher or lower growth scenarios depend on the assumed different evolution of some key international economic variables.

In the high-growth scenario the Italian economy would grow more rapidly, benefiting from oil prices remaining below 60 dollars per barrel which would lead to stronger US domestic demand, world economic growth and international trade.

In the low-growth scenario, the Italian economy would grow by 0.5 per cent less per annum due to oil prices close to 80 dollars per barrel, which in turn would reduce world economic growth and international trade.

Both scenarios are based on the assumption that different GDP growth rates can permanently affect potential output. Consequently, the output gap also varies in accordance with the new actual and potential GDP growth profiles.[10]

Changes in GDP growth impact public finances through a shift in the structural and cyclical components of primary surplus.[11]

The cyclically-adjusted primary surplus is measured by distinguishing between structural revenues and expenditures, estimated in accordance with the EU-agreed

[10] In the high-growth scenario, the 2007 output gap proves higher than in the baseline case. This apparent anomaly disappears in the following years.

[11] In line with the 2005 Update, the future measures for 2008, 2009, 2010 and 2011, which will be defined by the forthcoming Budget Laws, have been broken down into higher revenues and lower expenditures proportionally to the ratio of current revenues and expenditures on GDP for the same period.

methodology. Public debt is estimated on the basis of the assumption that stock flow adjustments and implicit interest rates do not change in the alternative scenarios compared to the baseline (Table 7).

Table 7. SENSITIVITY TO GDP GROWTH [1] (Percentage change)

		2007	2008	2009	2010	2011
Nominal GDP	*High-growth scenario*	3.2	3.7	3.8	3.9	3.9
	Baseline scenario	2.8	3.4	3.4	3.6	3.6
	Low-growth scenario	2.5	3.1	3.2	3.3	3.2
GDP at constant prices	*High-growth scenario*	1.8	2.0	2.1	2.2	2.2
	Baseline scenario	1.3	1.5	1.6	1.7	1.7
	Low-growth scenario	0.8	1.0	1.1	1.2	1.2
Potential output	*High-growth scenario*	1.5	1.7	1.8	1.9	2.0
	Baseline scenario	1.3	1.4	1.5	1.6	1.7
	Low-growth scenario	1.1	1.1	1.1	1.3	1.4
Output gap	*High-growth scenario*	-1.7	-1.4	-1.1	-0.7	-0.5
	Baseline scenario	-1.5	-1.4	-1.2	-1.1	-1.1
	Low-growth scenario	-1.8	-1.9	-1.9	-1.9	-2.1
Net borrowing	*High-growth scenario*	-2.6	-1.8	-0.8	0.3	1.3
	Baseline scenario	-2.8	-2.2	-1.5	-0.7	0.1
	Low-growth scenario	-3.1	-2.7	-2.3	-1.7	-1.2
Cyclically-adjusted budget balance	*High-growth scenario*	-1.8	-1.1	-0.3	0.6	1.6
	Baseline scenario	-2.1	-1.5	-0.9	-0.1	0.7
	Low-growth scenario	-2.2	-1.8	-1.3	-0.8	-0.2
Primary balance	*High-growth scenario*	2.4	3.2	4.0	5.1	6.1
	Baseline scenario	2.2	2.8	3.4	4.2	5.0
	Low-growth scenario	2.0	2.3	2.7	3.3	3.8
Cyclically-adjusted primary balance	*High-growth scenario*	3.2	3.9	4.5	5.4	6.3
	Baseline scenario	3.0	3.5	4.0	4.8	5.5
	Low-growth scenario	2.9	3.3	3.6	4.3	4.9
Public Debt	*High-growth scenario*	106.7	104.4	101.5	97.5	93.2
	Baseline scenario	106.9	105.4	103.5	100.7	97.8
	Low-growth scenario	107.5	106.7	105.8	104.2	103.0

(1) Variables may be inconsistent, due to decimal rounding.

In the lower-growth scenario the budget balance for 2007 would worsen by around 0.3 percentage points compared to the baseline figure. Over the following years the net borrowing would continue to decrease, although at a slower pace than in the reference scenario, from 3.1 per cent in 2007 to 1.2 in 2011 (Figure 1) – the deficit improves significantly also in this less favourable scenario (see par. 4.2). The cyclically-adjusted deficit for 2007 would be around 2.2 per cent, whilst in 2008 it would continue to decrease by 0.5 percentage points. The structural deficit would be equal to 1.3 per cent – namely with sufficient budgetary safety margin – already in 2009. In the high-growth scenario, the cyclically-adjusted deficit for 2007 would amount to 1.8 per cent, 0.3 percentage points lower than in the baseline scenario. Over the following years the cyclically-adjusted deficit would decrease significantly so as to reach a surplus of 1.6 per cent in 2011.

Figure 1. SENSITIVITY OF THE BUDGET BALANCE TO GDP GROWTH (Percentage of GDP)

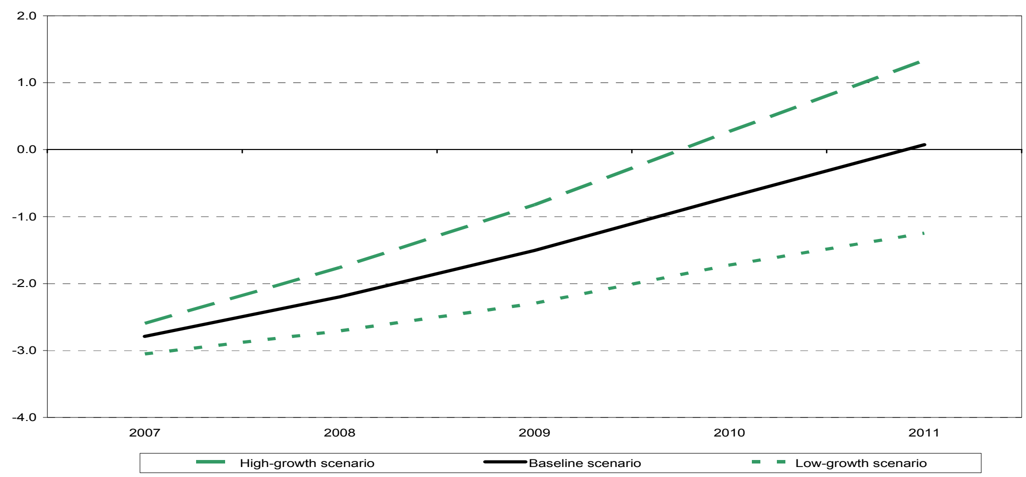
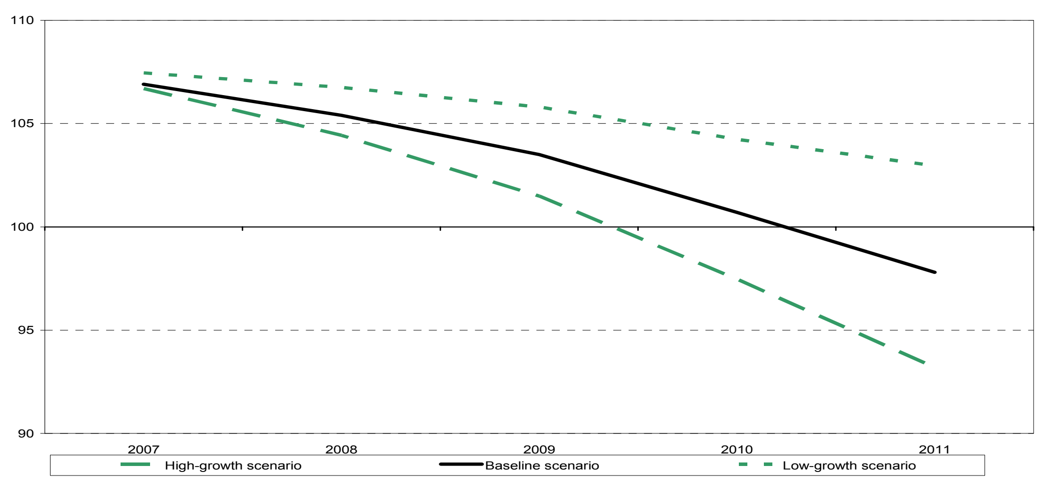


Figure 2. SENSITIVITY OF PUBLIC DEBT TO GDP GROWTH. (Percentage of GDP)



The above analysis shows the debt-to-GDP ratio would continue to decline in both alternative scenarios (Figure 2). The fall is obviously more pronounced in the 'optimistic' scenario, whereby the ratio would decline from 106.7 per cent in 2007 to 93.2 per cent in 2011. In the lower growth scenario, instead, the ratio would reach 103 per cent in 2011.

4.2. Sensitivity to interest rates

This section examines the effects of an alternative interest rate scenario on interest expenditure.

At the end of October 2006 (Figure 3) the tradable public debt[12] consisted of fixed-rate bonds (circa 67 per cent of the total), Euro Area inflation-linked bonds (circa 5 per cent), and short-term and floating rate securities[13] (28 per cent).

The average maturity of all Government bonds hovered around 6.58 years (6.56 years at the end of 2005), whilst the duration was equal to 4.33 years (4.25 years at the end of 2005).

Over 2006, and in line with previous years, the share of fixed rate bonds has remained high, whilst the share of Euro Area inflation-linked bonds has slightly increased, in line with the medium-term objective of firmly establishing their presence within the debt structure.[14] The ratio of short-term and floating rate securities has been kept broadly in line with the levels recorded at the end of 2005.

Consistently with the previous years' debt management choices, the issuance policy has allowed the Treasury to maintain the debt cost under control while taking into account both interest rate and refinancing risks.

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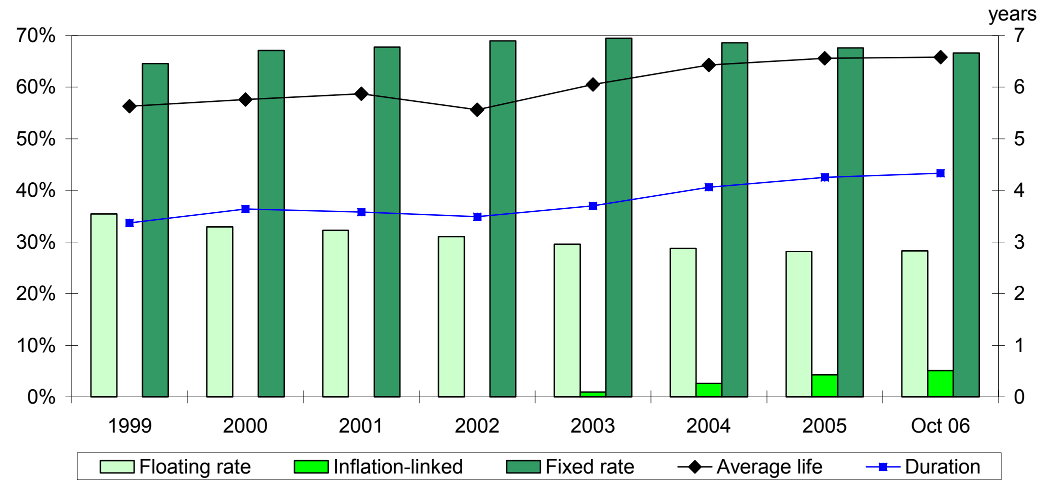
[12] Referring only to Government securities issued in euros in the domestic market.

[13] As of 31 October 2006, fixed-rate bonds accounted for 62.4 per cent of the total stock of tradable Government securities, short-term and floating rate securities for 26.5 per cent, Euro Area inflation-linked bonds for 4.8 per cent, and bonds issued in foreign currency under international law for 6.3 per cent.

[14] The increase in the share of inflation-linked bonds could have proved even higher in absence of the strong reduction in funding needs occurred in the second part of the year - which triggered the decision to postpone a part of the issuance activity initially planned for the current year.

Figure 3. STRUCTURE AND AVERAGE MATURITY DEVELOPMENT OF PUBLIC DEBT IN EURO (Percentage change) (1)



(1) The variable rate includes the amount of BOTs (Treasury Bills) and CCTs (Floating Rate Notes).

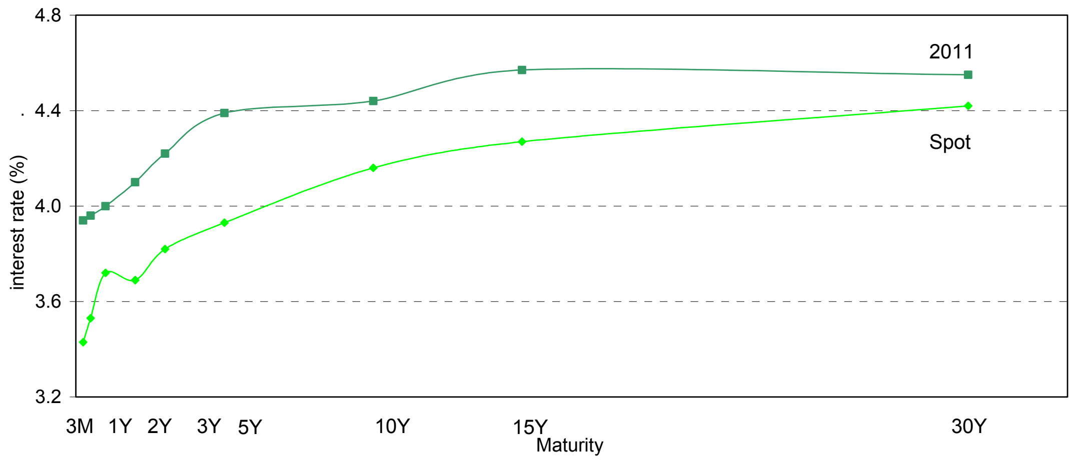
The interest expenditure estimates contained in the present document are based on the implicit rates of the Italian government bonds yield curve recorded over recent weeks (Figure 4), which take into account the recent interest rate increases by the European Central Bank and the effect of possible additional hikes over the coming months.

The recent changes in Italy's debt structure have further reduced the exposure to interest rate fluctuations. In case of a sudden and permanent one-percentage-point increase in all the yield curves underlying the estimates contained in this document, the impact on the interest expenditure-to-GDP ratio is estimated to be equal to 0.19 percentage points in 2007, 0.35 in 2008, 0.44 in 2009, and 0.51 in 2010.[15] The full impact of rate increases on the interest burden would occur in approximately 5.56 years. In order to test the quality of such results, the exercise was repeated using yield curves with

[15] This exercise focuses on interest expenditure gross of withholding tax. More specifically, the effects of interest rate changes on economic activity and tax revenues deriving from financial investment income were not taken into account (tax revenues on interest income from fixed rate bonds and bank deposits are indeed positively correlated to interest rate levels). Therefore the sensitivity of the overall budget balance to interest rate changes cannot be directly derived from the figures presented in this document.

different degrees of steepness. The results obtained were broadly in line with the initial result, with differences no higher than 0.01.

Figure 4. GOVERNMENT BOND YIELDS PROJECTED BY THE CURRENT YIELD CURVE



5. QUALITY OF PUBLIC FINANCES

The budget strategy indicated in the DPEF and confirmed in the Note reconciles different aims: structural consolidation of public finances along with fostering economic growth and introducing measures to enhance social equity.

The objective of the 2007 Budget is to bring the public finance trends – notably current expenditure – back on a balanced and sustainable path in the medium-to-long-term, introducing important elements for future reforms of the main expenditure sectors.

Leaving aside the offsetting of the effects of the sentence of the European Court of Justice regarding the deductibility of VAT on motor vehicles,[16] the 2007 Budget provides resources amounting to 34.7 billion euros, of which 15.2 aimed at reducing the deficit and 19.5 at fostering economic growth.[17] The net budget correction is 1 per cent of GDP. Such a correction allows Italy to comply with the Ecofin Council Recommendations for a cyclically-adjusted correction, net of one-off measures, of 1.6 per cent of GDP in 2006-2007, and achieve a deficit-to-GDP ratio of 2.8 per cent in 2007.

5.1 The 2007 Budget.

Corrective measures, both on the expenditure and revenue sides, provide resources amounting to 2.3 per cent of GDP.

The expenditure measures are aimed at reducing and rationalising public expenditure. In line with the DPEF indications, such interventions are focused on four main expenditure sectors: Public Administration, via a reorganisation process; Local Government, via the re-negotiation of the Internal Stability Pact; Health Care Spending, in line with a new specific Pact; and Pensions, via a revision of the pension system.

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[16] Offsetting already included in trend projections.

[17] The 2007 Budget consists of provisions established by the Financial Law and Law Decree 262/2006 (which became Law 286/2006), mainly regarding fiscal measures. Government amendments, currently being examined in Parliament, are not included in the following description of the manoeuvre and do not impact on the budgetary deficit.

Table 8. THE 2007 BUDGET (million/euro) (1)

	2007	2008	2009	2007	2008	2009
	million euros			in % GDP		
CORRECTIVE MEASURES	**34,692**	**38,285**	**42,650**	**2.3**	**2.4**	**2.6**
Lower expenditures	**9,627**	**13,103**	**14,986**	**0.6**	**0.8**	**0.9**
- Staff costs (net values)	500	882	1,114	0.0	0.1	0.1
- Intermediate Consumptions	5,633	7,607	8,244	0.4	0.5	0.5
of which:						
- Internal Stability Pact (Local Government)	3,271	4,152	4,601	0.2	0.3	0.3
- State Budget (Central Government)	2,362	3,455	3,643	0.2	0.2	0.2
- Health (health care sector measures)	2,034	2,430	3,244	0.1	0.2	0.2
- Pensions (credit guarantee fund)	0	424	424	0.0	0.0	0.0
- Other current expenditures	250	100	150	0.0	0.0	0.0
- Other capital expenditures	1,210	1,660	1,810	0.1	0.1	0.1
Higher Revenues	**25,065**	**25,182**	**27,664**	**1.6**	**1.6**	**1.7**
- Tax policy	4,178	4,010	4,264	0.3	0.3	0.3
- Changes to direct taxes (motor vehicle VAT compensation)	84	-20	1	0.0	0.0	0.0
- Sectoral studies revision	3,288	3,753	4,864	0.2	0.2	0.3
- Current taxes on income (2)	2,469	2,968	2,897	0.2	0.2	0.2
- Taxes on production and imports	649	622	612	0.0	0.0	0.0
- Capital incomes	1,100	2,000	2,000	0.1	0.1	0.1
- Non-tax revenues (State property)	500	957	1,436	0.0	0.1	0.1
- ICI (municipal property tax) and additional municipal PIT	1,109	768	819	0.1	0.0	0.1
- Additional regional taxes extension	1,023	876	980	0.1	0.1	0.1
- Social contributions	4,369	3,295	3,627	0.3	0.2	0.2
- Severance payment fund (TFR)	5,446	5,373	5,464	0.4	0.3	0.3
- Regularization of immigrants	765	495	615	0.1	0.0	0.0
- Other	85	85	85	0.0	0.0	0.0
GROWTH MEASURES	**19,492**	**24,385**	**26,249**	**1.3**	**1.5**	**1.6**
Lower Revenues	**5,514**	**9,085**	**9,418**	**0.4**	**0.6**	**0.6**
- Tax wedge	5,507	7,558	7,900	0.4	0.5	0.5
- IRAP reduction	2,540	4,589	4,872	0.2	0.3	0.3
- PIT deduction revision	1,567	1,569	1,628	0.1	0.1	0.1
- Family benefits increase	1,400	1,400	1,400	0.1	0.1	0.1
- Tax credits (under utilised areas, research and innovation)	0	796	1,250	0.0	0.1	0.1
- Tax detractions	7	731	268	0.0	0.0	0.0
Higher Expenditures	**13,978**	**15,300**	**16,831**	**0.9**	**1.0**	**1.0**
- Staff costs	1,133	3,089	3,149	0.1	0.2	0.2
- Employment	922	459	545	0.1	0.0	0.0
- Severance benefits (TFR)	429	1,256	1,998	0.0	0.1	0.1
- Tax extensions	1,124	-17	61	0.1	0.0	0.0
- Investments in railways	2,427	2,927	1,227	0.2	0.2	0.1
- State road agency (ANAS)	190	190	190	0.0	0.0	0.0
- Legge obiettivo	0	200	500	0.0	0.0	0.0
- Military expenditure and peace missions	1,400	1,500	1,500	0.1	0.1	0.1
- Public enterprise fund	500	500	500	0.0	0.0	0.0
- Under utilised Fund refinancing (FAS)	0	100	1,000	0.0	0.0	0.1
- Investiment fund for research and tecnology (FIRST)	150	200	300	0.0	0.0	0.0
- Competitiveness and development	100	200	300	0.0	0.0	0.0
- School re-launching	340	370	420	0.0	0.0	0.0
- Household policies fund	80	150	200	0.0	0.0	0.0
- Other	5,183	4,176	4,941	0.3	0.3	0.3
Net impact on primary balance	**15,200**	**13,900**	**16,401**	**1.0**	**0.9**	**1.0**

(1) The Table presents the 2007 Budget in its original version. The approval by one of two Houses did not modify budget balances.
(2) Includes PIT revision of 2 billion euros in 2007, and 2.6 both in 2008 and 2009.

Public employment measures are aimed at a better control of staff costs while safeguarding the functioning of the Public Administration. Such measures extend the obligation of reducing civil service staffing to other areas of the Public Administration, replacing only one out of every five employees leaving the service, and beginning a gradual stabilisation process for temporary staff with specific qualifications. The measures should result in savings of approximately 0.5 billion euros.

Furthermore, net of higher revenues, savings amounting to 5.6 billion euros are expected from the containment of intermediate consumption at different levels of government.

At central government level the measures introduce the principle of flexible management, which allows moving resources from less strategic to more important objectives. Reforming the Public Administration also involves a process of reorganization, transformation and suppression of public entities, which will result in greater efficiency, lower costs and better services. As a whole, the measures should produce savings amounting approximately to 2.4 billion euros.

At local government levels the new Internal Stability Pact aims to involve decentralised administrations in the consolidation process of public finances, in full respect of their decisional autonomy (par. 5.3). Expected total saving amounts to approximately 4.4 billion euros.

As far as health care expenditure is concerned, financial rebalancing should be achieved through a reorganization and re-qualification of expenditure. In line with the new Health Pact of last September, the measures aim to increase both the level of efficiency in resource management and the quality of the services offered. Incentives aimed at entrusting higher responsibility to Regions are maintained also by extending the automatic levying of the highest tax rates in the deficit Regions. At central level, cuts in pharmaceutical prices are confirmed, and citizens' responsibility in health consumptions is increased through greater co-payment. As a whole the measures, should result in savings of approximately 3.1 billion euros (Annex 5).

On the revenue side, Budget measures aim to enhance public administrations' efficiency, countering tax evasion, and enhancing returns on public real estate assets.

Fiscal policy measures aiming to better control and counter tax evasion notably focus on the field of indirect taxation so as to broaden the taxable base. The new rules also modify the current legislation on deductibility of instrumental assets purchased through leasing agreements, mortgage registration taxes, and fiscal regime for donations and inheritance. As a whole such regulations should lead to higher revenues amounting to about 4.2 billion euros.

Further measures aimed at enhancing tax administrations' efficiency introduce new regulations on sectoral studies so as to render them more consistent with territorial or company characteristics, and each firm's business trends. Such interventions should lead to further revenues amounting to approximately 3.3 billion euros.

In order to achieve greater social equity, a process of rationalization of tax levels and brackets is also provided so as to reduce tax burden on lower incomes. The income tax reform (IRE) is accompanied by a revision of the support to families' incomes and replacement of deductions with tax allowances, in line with each specific type and level of income. The total impact on fiscal revenues amounts to circa 0.4 billion euros.

So as to render the tax system equitable, and in line with European standards, a revision of the tax regime for capital gains is provided through harmonization of tax rates for any type of investment savers may make. The expected additional revenues amount approximately to 1.1 billion euros.

Further measures concern indirect taxes' sectors (tobacco, video games, cars) thus producing additional revenues of circa 0.6 billion euros.

In order to encourage supplementary pension schemes, the Budget regulates the destination of severance benefits as of 1 January 2007. Henceforth, severance benefits' annual flows not channelled through supplementary schemes will be entirely transferred to a special Fund managed by INPS for firms with at least 50 employees. The above flows will be used to finance growth-enhancing measures. Firms with less than 50 employees, instead, will retain flows not channelled through supplementary schemes. The compensatory measures already envisaged will be advanced to 2007. As a whole, net of the effects of fiscal and social security contributions resulting from the higher number of employees joining supplementary pension schemes and compensatory effects, such measures produce additional revenues amounting to 5 billion euros (Annex 6).

Further measures regarding the pension system are aimed at improving social fairness of the system through changes in social security contributions of both employees and self-employed, bringing the rate actually paid in line with the rate used for calculating pensions. The net impact on revenues amounts to 4.3 billion euros.

Finally, in order to create value from public real estate assets, specific measures are envisaged to improve their returns, also involving local administrations in their management, and resulting in additional revenues of approximately 0.5 billion euros.

Within the Budget, the measures aimed at achieving greater social equity and promoting economic growth (circa 1.3 per cent of GDP) consist in lower revenues of approximately 5.5 billion and higher expenditure for circa 14 billion euros.

The most significant measure concerns the reduction of tax and social security contribution wedge for firms. The measure reduces labour cost through a cut in IRAP by introducing two new deductions. The first consists in a *forfait* reduction of the taxable base according to territorial areas (5,000 and 10,000 euros annually respectively for Centre-North and Southern Italy for each full-time employee), with a 3-percentage-point tax cut. The second refers to social contributions to be borne by employers, with a 2-percentage-point reduction.

The Budget also includes some provisions that are significantly relevant for economic policy even although they are effective on the accounts only as of 2008. They include tax relief schemes in the form of tax credits for investment in disadvantaged areas and industrial research, as well as aiming to foster competitiveness.

On the expenditure side, additional resources for over 2.5 billion euros are provided so as to finance investments in railways (mainly aimed at improving the traditional railway system and, to a lesser extent, injections of capital into *Ferrovie SpA* (FS) and financing of the high-speed railway lines from 2008 onwards), in the road network (modifying the system of financing *ANAS*, the State road agency), and ports. As of 2008, specific resources will also be allocated to finance the projects included in the "Legge Obiettivo".

Further measures aim to favour investment in research and development of business networks. A new Fund for competitiveness and development is envisaged with additional resources for approximately 0.1 billion euros. Furthermore the Fund for Investments in Scientific and Technological Research (FIRST), which incorporates three existing funds, will receive additional resources for circa 0.3 billion euros. As of 2008, the refinancing of the Fund for Under-utilised Areas is also envisaged (Annex 7).

Finally, fresh resources are allocated to: social interventions, by increasing the Employment Fund and Unemployment Benefits by approximately 0.9 billion euros; labour stabilisation, by transforming temporary contracts into permanent contracts; and funding the renewal of public sector contracts for 2006-2007 for a total amount of 1.1 billion euros.

5.2 Budget implications of structural measures included in the National Reform Programme (NRP) 2006-2008.

In the Budget Law for 2007, part of the resources has been allocated so as to meet the Lisbon Strategy goals included in the National Reform Programme (NRP) submitted to the EU Commission in November. The main objectives are related to promoting growth, increasing employment, as well as reducing regional disparities and social exclusion.

In the period 2006-2008 the overall financial resources allocated for the implementation of the measures included in the NRP are estimated at 60,748 million euros – of which 29,005 million euros from regional policy funds.

The national priority of “extending the area of free choice for enterprises and citizens” consists of intermediate objectives aimed at improving existing regulation[18] and advancing the liberalisation process.

The 2007 Budget Law allocates 300 million euros per year for the next three years to finance tax credits for industrial research and the Fund for Investments in Scientific and Technological Research (FIRST). Furthermore funds have been set up for the special three-year hiring plan in research, financing of grants (157 million euros), upgrading of university buildings and residences (147 million euros), and for the *Accademie delle Belle Arti* and Conservatories (20 million euros).

Table 9. 2006-2008 NRP PRIORITIES

	Number of measures	**Funds allocated until 2008 (million euros)**
Extending the area of free choice	27	411
Research and technological innovation	51	10,674
Increasing education, strengthening training and social inclusion, reducing disparities.	59	14,876
Infrastructure	11	34,330
Environmental protection	18	458
Long-term fiscal sustainability	7	0
Total	**173**	**60,748**

Source: “National Reform Programme 2006-2008”, 18th October 2006.

Modernisation of the Public Administration foresees development of broadband applications, administrative streamlining and further development of one-stop shops, electronic management of public registers and documents with legal validity, and accessibility to websites. Support to the development of new technologies will be based on reducing the digital divide and ensuring greater inter-connection between traditional and high-tech sectors and the public research system.

As for infrastructure upgrading, great attention has been devoted to transport, notably to the Trans-European Transport Networks (TEN-T) Project and upgrading of existing

[18] Legislative Decree 5/2006.

transport networks in Southern Italy. The National Operating Plan (PON) has confirmed the railway network as a priority. The updated financial framework currently envisages resources amounting to 173.4 billion euros – of which 58.4 billion euros have already been set aside. The "Sea Highways" Project has been financed for an amount of 10 million euros via the funds allocated for the TEN-T networks and the Marco Polo Programme.

Table 10. 2006-2008 REGIONAL POLICY RESOURCES: ESTIMATED EXPENDITURES BY PRIORITY

Priorities	Estimated expenditures	
	(million euros)	(% of total)
Extending the area of free choice	77	0.3
Research and technological innovation	3,316	11.4
Strenghtening education (1)	3,963	13.7
Infrastructure	8,654	29.8
Environmental protection	6,076	20.9
Increasing employment, strenghtening social inclusion, reducing disparities	6,918	23.9
Total for Lisbon priorities	**29,005**	**100.0**

(1) The total includes training expenditures, mostly recorded as current expenditures and thus not included in the "Quadro Finanziario Unico" (QFU).

Source: Quadro Finanziario Unico – Economic and Financial Planning Document 2007-2011 and estimates from data on Structural and Under-utilised Areas Funds monitoring.

Environmental sustainability will be pursued through research projects aimed at improving energy efficiency and use of renewable fuels. In this field, a crucial contribution will be provided by the reorganisation of environmental regulation, through the introduction of environmental accounting in the national budget, environmental management systems in SMEs, as well as the promotion of urban mobility plans and "green" public tenders.

Regional policies provide an important contribution to the attainment of the Lisbon Strategy goals, notably structural funds and the Fund for Under-utilised Areas. For the period 2006-2008, resources for 29,005 million euros from regional policies have been allocated in order to meet the Lisbon Strategy priorities.

5.3 Fiscal rules

The process selected to define the budget policy and the financial reference framework, as well as set the objectives for the Public Administration, is disciplined by procedural steps and regulated by national accounting laws.

The Economic and Financial Planning Document (DPEF), the Finance Law (herewith referred to as Budget for simplicity) and the actual Budget Law are the main instruments of the budget process. The 2007-2011 DPEF outlines guidelines to render the budget structure more effective and consistent with the structure of local administrations. To this end, over the current year the DPEF has set up effective monitoring and control instruments, including for local administrations (development of the Information System for operations related to public entities, SIOPE). With a view to better coordinate and control public finances, the 2007 Budget Law sets up the Technical Commission for public finances.

With regard to fiscal rules currently in force, two are particularly significant. The first is expressly set out in the Constitution and is aimed at preventing local authorities from having access to the debt for reasons other than investment financing. This permanent rule is not a “golden rule”, as it does not allow local authorities to use debt financing within the investment ceiling. Instead, it plays a constraint function for local decision-making, as it does not permit recourse to debt for financing current expenditure. The rule is thus consistent with central government’s functions of coordination and control over the entire public finance through the definition of further constraints on local authorities. Indeed, the aim is to make the budget policy at local level consistent with the general objectives set by the DPEF and Budget Law.

The instrument selected to attain such an objective is the Internal Stability Pact, the latter of the two aforementioned rules. The Pact consists of a set of rules aimed at reinforcing the budget constraint through the setting of financial targets for local authorities – specific sanctions are envisaged in the case of non-compliance. The 2007

Budget Law has revised such rules, modified over time, and has established budget balance as the key parameter to ensure the contribution of local finances to national objectives – rather than using, as in the past, ceilings on individual expenditure items. The use of budget balance for budgetary policy allows bringing together the principles of autonomy in decision-making and accountability within a set of stable rules, in line with an orderly development of fiscal federalism.

The new approach is applied to Regions, Provinces, and Municipalities. For Regions, however, the shift to the balance as the reference for the Internal Stability Pact is merely experimental, due to the simultaneous enforcement of specific provisions controlling financial balances in the health care sector. For the above administrations, the 2007 objective will still be defined as a limit to expenditure growth net of health care expenditure, and will be replaced by the budget balance rule in the case of positive feedback in the experimental period.

For Municipalities and Provinces, the target right from the beginning lies in improving the balance. The effort required from each local government is individually calibrated, considering both distance from balanced budget and the average current expenditure recorded over 2003-2005.

The adoption of the three-year average smoothes out the annual balance variability produced by investment expenditures and real estate sales, thus enabling a longer term approach for applying the rule. Each local government is expected to show compliance with the rule solely in terms of improvement versus the balance in the reference period. To this end, a local administrator can both reduce expenditures and/or increase revenues.[19] In order to increase administrations' accountability, the rule has introduced a more stringent enforcement mechanism envisaging the levying of sanctions in the case of non-compliance.

[19] The rule indicates the IRE municipal add-on and the provincial registration tax as the taxes that can be increased. In addition, municipalities can now introduce specific taxes to finance public works, as well as direct management and revision of real estate property registers.

6. SUSTAINABILITY OF PUBLIC FINANCES

Italian population's ageing is the most marked amongst all EU Countries. This Chapter describes the long-term trends of those components of public spending that are most strongly affected by demographic changes and their implications on public debt in accordance with the methodology agreed at EU level.

6.1 The impact of the population ageing on public spending (2005-2050).

Table 11 and Figure 5 show the most recent projections of public expenditure for pensions, health care, long-term care, education, and unemployment benefits for 2005-2050[20] consistently with the methodology agreed within the Ageing Working Group of the Economic Policy Committee (EPC-AWG) and published in an *ad-hoc* Report[21] issued by the Economic Policy Committee (EPC) and the European Commission, and approved by the Ecofin Council on 14 February 2006.

The projections are based on the new demographic scenario provided by EUROSTAT – which refers to 2004 as the base year – along with the macroeconomic framework defined by the EPC-AWG. As in the previous projections, a "no-policy change" approach has been adopted so as to highlight only the effects of demographic pressure on various components of public expenditures. The key assumptions underlying the exercise concern participation rate, unemployment, productivity and GDP growth rates (Table 11).[22] Projections have been updated in accordance with the regulatory

[20] Education expenditure includes all education levels, with the only exception of adult education (the so-called permanent training). On the contrary, expenditure for unemployment benefits does not include some important labour policies (e.g. active labour market policies).

[21] The most recent expenditure forecasts for the 25 EU Member States have been calculated in accordance with the methodology agreed at EU level; see *Economic Policy Committee (EPC) and the European Commission (2006), "The impact of ageing on public expenditure: projections for the EU 25 Member States on pensions, health care, long-term care, education, and unemployment transfers (2004-2050)", Special Report n. 1/2006*.

[22] Macroeconomic assumptions are in line with the baseline scenario agreed by the EPC-AWG. Such assumptions have been adopted for the period 2007-2050, whereas for 2006 the overall macroeconomic scenario is based on the Forecasting and Planning Report (RPP) for 2007. In particular, differently from the

framework in force in September 2006, and take into account the effects of the measures adopted in the Budget Law[23] for 2007.

Table 11. LONG-TERM SUSTAINABILITY OF PUBLIC FINANCES (2005-2050) (1)

	2005	**2010**	**2015**	**2020**	**2025**	**2030**	**2035**	**2040**	**2045**	**2050**
Total primary expenditure (2)	-	-	41.7	42.0	42.4	43.2	44.0	44.6	44.4	43.8
Of which: age-related expenditures (2)	**26.2**	**25.9**	**25.9**	**26.3**	**26.7**	**27.6**	**28.5**	**29.1**	**29.0**	**28.5**
Pension expenditure (2)	14.0	14.0	13.9	14.1	14.4	15.0	15.5	15.7	15.3	14.5
Of which: old age and early pensions (2)	13.7	13.7	13.6	13.9	14.2	14.8	15.4	15.6	15.1	14.4
Of which: other pensions (disability, survivors) (2)	0.3	0.3	0.2	0.2	0.2	0.2	0.1	0.1	0.2	0.1
Health care (2) (3)	6.7	6.8	7.0	7.2	7.4	7.7	8.0	8.2	8.5	8.6
Long term care (2)	0.8	0.8	0.8	0.9	0.9	1.0	1.1	1.1	1.2	1.3
Education expenditure (2) (4)	4.3	3.9	3.8	3.8	3.7	3.6	3.6	3.6	3.7	3.7
Other age related expenditures (2)	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Interest expenditure (2)	4.6	4.7	4.1	3.0	2.1	1.2	0.4	-0.2	-0.8	-1.6
Total revenue (2)	-	-	47.0	47.0	47.0	47.0	47.0	47.0	47.0	47.0
Assumptions:										
Labour productivity growth	0.4	1.1	1.7	1.7	1.8	1.7	1.7	1.7	1.7	1.7
Real GDP growth	0.0	1.9	1.8	1.6	1.3	0.9	0.8	0.8	1.1	1.2
Partecipation rate males (20-64)	79.2	81.7	83.1	82.9	82.9	83.2	83.7	84.1	84.6	84.4
Partecipation rate females (20-64)	53.6	57.4	60.3	61.7	62.1	62.3	62.6	63.5	64.3	64.7
Total partecipation rate (20-64)	66.4	69.6	71.8	72.3	72.5	72.8	73.3	73.9	74.6	74.7
Unemployment rate	7.7	6.7	6.5	6.4	6.4	6.4	6.4	6.4	6.4	6.4
Total population aged 65+ over total population	19.5	20.6	22.0	23.2	24.7	27.1	29.9	32.3	33.7	33.9
Old age dependency ratio (65 and above/[20-64])	31.9	33.9	36.9	39.4	42.5	48.0	55.0	62.1	66.5	67.4

(1) Figures may not add, due to first decimal rounding.
(2) Percentage of GDP.
(3) Inclusive of public health-care expenditure for assistance to the elderly.
(4) Does not include adult education expenditure (permanent training).

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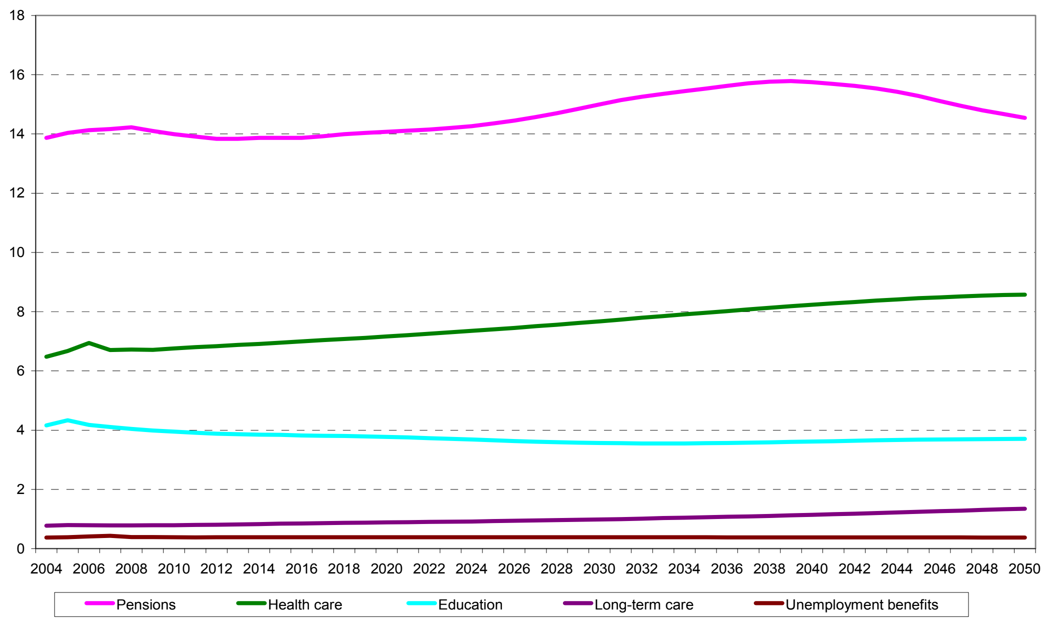
agreed scenario, the employment rate for working age population (20-64) for 2006 is higher than expected in the original scenario adopted by the EPC-AWG, due both to a higher participation rate and a lower unemployment rate. An additional element ensuring a fully comprehensive representation of the various expenditure components expressed as a percentage of GDP lies in the statistical revision of the GDP time series recently carried out by ISTAT and officially communicated via a specific notification on 1 March 2006, and whose effects on public finance variables were particularly significant in 2004.

[23] More specifically, it has to be pointed out that: (a) health care costs take into account the expenditure reduction expected in the Budget Law for 2007, whose impact should be equal to 0.2 per cent of GDP for the first three years of the forecast and should then remain stable until the end of the projection period; (b) the effects on pension expenditure are more limited and of opposite sign, as essentially linked to the higher pension payments resulting from the increase in the contribution rates of *parasubordinati* workers; finally, (c) as for social security spending, projections include the effects of some provisions of the Budget Law related to the increase in ordinary non-farm unemployment benefits and their allowed length period from 1 January 2007 onwards.

Based on the assumptions described above, pension expenditures would hover around 14 per cent of GDP up to 2016 and then begin to rise from 2018 onwards, reaching a peak of 15.8 per cent in 2039 before decreasing again to 14.5 per cent in 2050. Health care expenditure would increase by 1.9 percentage points, from 6.7 per cent of GDP in 2005 to 8.6 per cent in 2050. With regard to the other two components of age-related expenditure, education costs should decline from the current 4.3 per cent to 3.7 per cent in 2050, while unemployment benefits should settle at around 0.4 per cent of GDP (Figure 5).

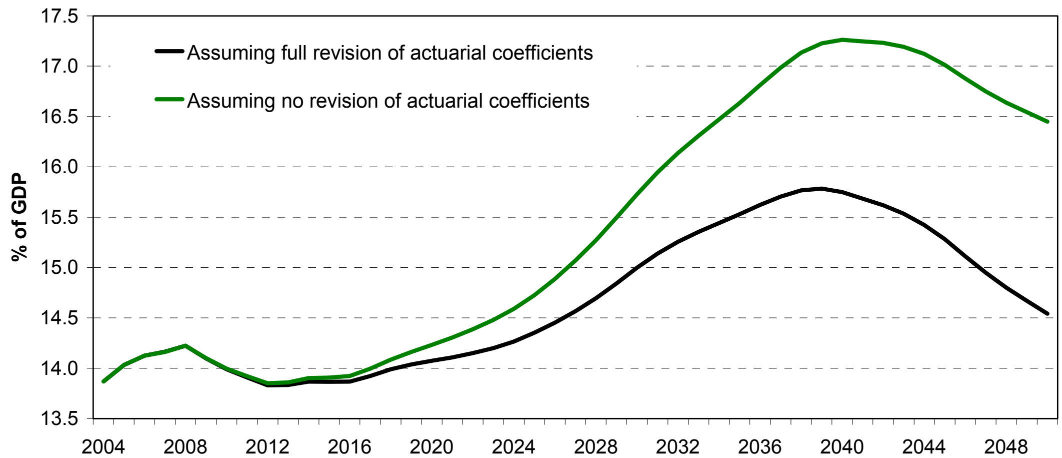
Figure 5. EXPENDITURE ON PENSIONS, HEALTH CARE, LONG-TERM CARE, EDUCATION, UNEMPLOYMENT BENEFITS (Percentage of GDP)



In the period 2005-2050, the overall age-related public expenditure as a percentage of GDP should increase by 2.3 percentage points, reaching 28.5 per cent at the end of the projection period. The ratio should at first decline to around 25.7 per cent in 2012, thereafter increase to a peak of 29.1 per cent in 2042, whereupon once again begin to decline.

It should also be noted that in spite of the changes in the reference demographic and macroeconomic framework, the forecasts presented in this Update do not differ substantially from those presented in last year's Update, mainly due to the fact that the average GDP growth and demographic projections for the period 2007-2050 have remained broadly unchanged.

Figure 6. EFFECTS OF THE REVISION OF ACTUARIAL COEFFICIENTS ON PENSION EXPENDITURE (Percentage of GDP)



In particular, with respect to the previous Update the following considerations emerge:

- Pension expenditure as a percentage of GDP starts from a lower level of about 0.4 percentage points in the period 2004-2006, essentially due to the statistical revision of GDP time series.
- The projection of the long-term care expenditure is for the first time considered in accordance with the methodology agreed at the EPC level.[24]

[24] In Italy long-term care expenditure is composed for about 4/5 of cash benefits and for 1/5 of social welfare components provided at local level (Ministry of Economy and Finance, RGS, Report n. 7, Chap. 4, 2005). As for cash benefits, it has not been possible to apply the same methodology used by the European Commission, as there would be no link to demographic changes. Therefore projections of cash benefits have been obtained by linking the number of recipients to demographic trends in accordance with the

- The expected dynamics of expenditure for health care, unemployment benefits and education do not show any substantial change from last year's projections.

Pension expenditure projections assume a full revision of the actuarial coefficients that link pension benefits to life expectancy at time of retirement, as indicated by the 1995 Reform, whose important impact on pension expenditure is highlighted in Figure 6.

6.2 Sustainability of public finances

Sustainability of public finances is assessed by simulating developments in the debt-to-GDP ratio over the period 2011-2050 and taking into consideration some indicators agreed at European level.[25]

The simulations presented in this Chapter were carried out under the assumption that the 2011 debt and primary surplus targets presented in this Update (ref. 3.2) will be met. Furthermore, it is assumed that higher revenues or lower expenditures will not offset the expenditures arising from the ageing population but, instead, they will entirely be reflected in primary surplus changes.

The simulation shows that the debt-to-GDP ratio declines steadily over the whole period (from circa 97.8 per cent in 2011) to eventually turn negative towards the end of the projection period (solid line in Figure 7). In particular, the debt-to-GDP ratio is expected to drop below the 60-per cent threshold already in 2020 – four years earlier than envisaged in the 2005 Update. The improvement results from an increase in the primary balance at the beginning of the projection period 2011-2050 versus the previous Update's estimates. As above, it is important that the adjustment of the cyclically-adjusted balance

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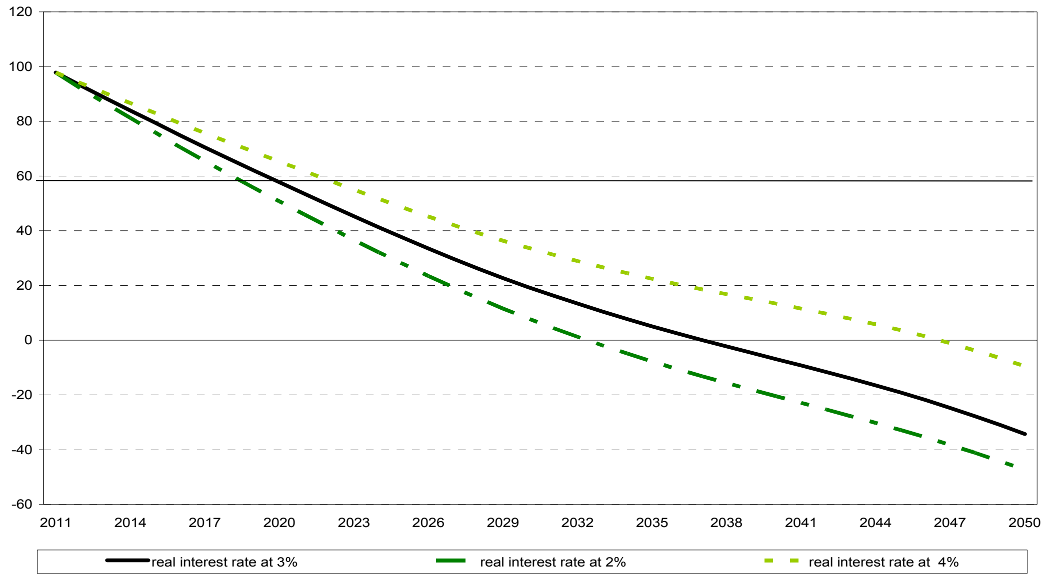
methodologies adopted within the EPC-AWG. For more details see: -*EPC and European Commission*, "*The impact of ageing on public expenditure: projections for the EU 25 Member States on pensions, health care, long-term care, education and unemployment transfers (2004-2050)", Special Report n. 1/ 2006.*

25 The assumptions underlying the simulation correspond to the demographic and macroeconomic scenario agreed within the EPC-AWG and described above (Table 8). A constant annual 3 per cent real interest rate is assumed for the entire projection period.

net of one-off measures be significantly in place already as of 2007, thereby avoiding having to rely on measures not covered by the Budget Law.

Figure 7. PUBLIC DEBT SENSITIVITY TO REAL INTEREST RATES (percentage of GDP)



In order to highlight the robustness of projections, different scenarios are analysed.

Instead of assuming a yearly real interest rate of 3 per cent[26] as in the baseline scenario, the sensitivity analysis considers firstly an optimistic scenario in which the real interest rate is 2 per cent and, secondly, a pessimistic scenario whereby the real interest rate is 4 per cent.

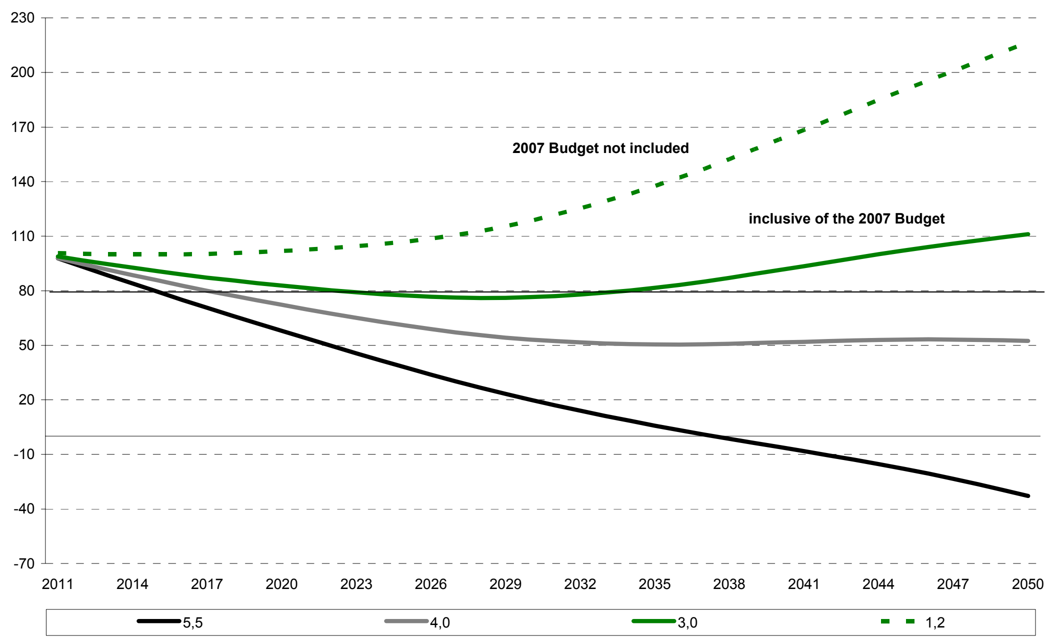
With an interest rate of one-percentage point lower than in the baseline scenario, the debt-to-GDP ratio would decline at an even faster rate and would eventually drop below 60 per cent in 2019 – one year earlier than in the baseline (dotted lines in Figure 7). With an interest rate of 4 per cent, on the contrary, the ratio would still decline albeit at a somewhat slower pace. Therefore, substainability would be preserved even in case of a permanent increase in interest rates.

[26] As agreed at EU level, a constant 2 per cent yearly inflation rate is also assumed.

The results of the simulation show that with values of the primary balance between 5.5 and slightly above 4 per cent, the debt-to-GDP ratio decreases and stays below 60 per cent from 2025 onwards. Instead, if the cyclically-adjusted primary surplus were around 3 per cent of GDP in 2011, the debt ratio would initially decline till 2032 and then begin to increase without ever decreasing below the 60-per-cent threshold. Finally, with a primary balance of 1.2 per cent – namely without the correction of public finances detailed in this Update – debt-to-GDP developments would become explosive.

Figure 8 shows the noteworthy improvement the 2007 Budget Law brings about. At the same time, the budget consolidation that ensures sustainability implies further corrections over the coming years through further improvement in the primary balance.

Figure 8. PUBLIC DEBT DEVELOPMENTS AS A RESULT OF DIFFERENT 2011 PRIMARY BALANCE ASSUMPTIONS (Percentage of GDP)



Nevertheless the measures included in the 2007 Budget Law are of permanent nature and represent an important step forward in ensuring debt sustainability. The long-term sustainability of public finances can also be assessed by employing the sustainability gap indicators currently used at European level in two different versions: the first (thereinafter referred to as S_{60}) assumes as a target a debt-to-GDP ratio of 60 per cent in 2050, whilst the second (thereinafter referred to as S_∞) assumes that the government intertemporal budget constraint is respected on an infinite horizon.

A third indicator has recently been added. It is the so-called Required Primary Balance (hereinafter referred to as RPB), which indicates the average primary surplus required in the first 5 years of the projection period (2012-2017) so as to respect the government intertemporal budget constraint on an infinite horizon.

Table 12 shows the value of the above indicators. Sustainability gaps have a negative sign in both scenarios considered, thus confirming that meeting the fiscal targets presented in this Update would enable achieving sustainability in the long run. Furthermore the RPB is lower than the primary surplus indicated in the present Update for 2011, thus highlighting how the government intertemporal budget constraint could be respected even with medium-term primary surplus levels lower than those projected for 2011 by the present Update.

Table 12. LONG-TERM SUSTAINABILITY INDICATORS

Sustaibility gap Indicators		
S_{60}	S_∞	RPB
-1.8	-1.7	3.6

ANNEX 1. THE WORLD ECONOMY

Over the first part of 2006, notwithstanding high oil prices and a moderate tightening of monetary policy, the performance of the world economy exceeded expectations. World GDP growth should settle at around 5 per cent for the full year in spite of the ongoing slight slowdown in the second half. Growth is expected to marginally moderate to 4.8 per cent in 2007, and international trade should continue to expand at a very brisk pace in 2006 (8.9 per cent), expected however to slightly moderate to 7.6 per cent in 2007.

In the United States, economic activity is expected to markedly slow down, with GDP growth rate expected to contract from 3.4 per cent in 2006 to 2.9 per cent in 2007. The main international forecasters are currently revising their estimates further downwards.

The ongoing deceleration is mainly tied to the abrupt trend inversion in the residential construction sector and, partly, to the expected households' saving rate adjustment–- the latter variable turned negative in the most recent quarterly surveys. Spillover effects from the residential sector to the rest of the economy should only be limited and fundamental macroeconomic conditions remain sound. In the second part of 2007 the US economy should resume growing at a pace closer to its potential, also thanks to a change in direction by monetary policy and the recent partial retrenchment in oil prices. The current account deficit is expected to stabilize at around 6.5 per cent of GDP, as a result of the expected slowdown in domestic demand and the persisting expansion of world growth.

The Japanese economy's performance in 2006 has exceeded expectations with year on year growth forecast to reach 2.7 per cent at year-end, assumingly resulting from broad-based growth in all expenditure components. Export growth is still supported by the persisting rise in trade with the rest of Asia and, at the same time, recovery in domestic demand seems to have become self-sustaining. Some factors are nevertheless likely to become slightly less favourable in 2007, such as the phasing out of the 2006 temporary tax rebate and the expected international trade deceleration. As a result GDP growth should slide back to approximately 2 per cent in 2007.

The Chinese economy continues to expand at a pace close to 10 per cent per year. The policy measures devised to slow down investment activity should ultimately prove – although perhaps only partially – effective. Nevertheless, underlying conditions continue to support the Chinese economy's competitiveness, hence strong export performance. Whilst a slight deceleration is expected for the Indian economy due to a tighter monetary policy, the Brazilian economy should resume growing robustly. As a whole, emerging countries' economies will significantly contribute to international trade expansion, their growth rate continuing to exceed 7 per cent both in 2006 and 2007.

As for the Euro Area, the long-awaited recovery in domestic demand seems to have eventually set in. Consumption growth in particular has strengthened and consumer confidence indicators show a gradual-but-steady increase. Business confidence indicators remain at high levels. Euro-Area GDP growth should exceed 2 per cent both in 2006 and 2007.

The stabilisation in oil prices, the cautious conduct of monetary policy, and the US economy's slowdown are expected to reduce inflationary risks in the short term. Such

view appears to be confirmed by the reduction of long-term interest rates recorded over the past few months.
The favourable outlook for the international economy is underpinned by the recent upturn in stock markets following the drop occurred in spring. The main risks for the future are linked to possible fresh geopolitical tensions (which would likely once again push oil prices up), an always possible abrupt rebalancing in international capital flows as a result of the ongoing current account imbalances, and an even larger-than-expected correction in the US housing market. The latter could lead to a more-negative-than currently-envisaged impact on the whole US economy and thus exert adverse effects also in Europe and in Asia.

Table 13. ASSUMPTION ON INTERNATIONAL ECONOMIC VARIABLES
(Percentage change, unless otherwise specified)

	2006	2007	2008	2009	2010	2011
Short-term interest rate	2.7	3.1	3.7	3.7	3.7	3.7
Long-term interest rate	4.0	4.1	4.3	4.5	4.5	4.5
USD/EUR exchange rate	1.25	1.28	1.28	1.28	1.28	1.28
Change in nominal effective exchange rate	0.6	0.5	0.0	0.0	0.0	0.0
GDP growth, World excluding EU, GDP growth	5.6	5.4	4.7	4.6	4.6	4.6
EU-25 GDP growth	2.7	2.3	2.5	2.5	2.5	2.5
Growth in Italy's foreign markets	9.7	7.3	6.4	6.3	6.3	6.3
World import volumes, excluding EU	8.6	8.0	7.2	7.1	7.1	7.1
Oil price (Brent, USD/barrel)	70	69	69	69	69	69

ANNEX 2. CONSEQUENCES OF THE SENTENCE ON VAT DEDUCTIBILITY

The sentence of 14 September 2006[27] *declared the provisions limiting VAT deductibility*[28] *incompatible with Community Law.*

As a result, Italian taxpayers will be refunded for the unduly paid VAT on purchases, fuel, maintenance and repair of cars and motorcycles. The years 2003-2006 are considered the reference period, as under the VAT legislation the right to deduct the tax on goods and services bought or imported arises when the tax is actually liable. The right can be exercised at the latest within the income tax declaration referring to the second year following the one in which the right arose.

On the basis of the above considerations, an estimate has been made of the amount of the refund claims that taxpayers could submit to the VAT offices for the past few years' expenses not previously entitled to full deduction. Such an estimate amounts to 17.1 billion euros and is the maximum theoretical amount the State would have to bear in the case all taxpayers entitled to refunds submitted their claims. Out of the 17.1 billion euros, 3.7 billion euros relate to the period 1 January 2006 – 13 September 2006, and the remaining 13.4 billion euros to the three-year period 2003-2005.

Besides the State liabilities relative to past years, the sentence determines lower VAT revenues as of 14 September 2006, having introduced the principle of full deductibility. The consequences arising once the system has become fully operational have been estimated in accordance with the same principle defining the maximum theoretical amount: a VAT revenue shortfall of 1.5 billion euros is expected for the remaining part of 2006, whilst 5.2 billion euros for 2007 and the following years. Once the system has become fully operational, such a shortfall will be completely offset by the measures contained in Law Decree 262 of 3 October 2006.

[27] Action C-228 2005.

[28] Presidential Decree 633 of 26/10/72, Article 19-bis1, paragraph 1, letters c) and d).

ANNEX 3. FINANCING OF THE TURIN-MILAN-NAPLES HIGH-SPEED RAILWAY LINE

The current financing framework: financing through ISPA

The 2003 Budget Law introduced a financing mechanism to complete the high-speed/high-capacity rail network system (AV/AC). The scheme is based on loans granted by Infrastrutture S.p.A. (ISPA - merged and later incorporated into Cassa Depositi as of 1 January 2006), which provides financing to the rail infrastructure management company (RFI/TAV) mainly through issuance of bonds in capital markets. Reimbursement of loans granted by ISPA in favour of RFI/TAV should have been guaranteed by:

- *Cash flows generated during the economic life of the network (i.e. amounts paid by the train operators to RFI);*
- *State transfers to RFI/TAV to service the part of the debt not covered by the cash flows under the previous point.*[29]

EUROSTAT's decision 2005

In May 2005 EUROSTAT reclassified ISPA's debt into State Debt defining the operation as a "financial operation", in the form of a Government loan to RFI/TAV, and therefore having no effect on Government net borrowing except for the annual amounts actually paid by the State to the Ferrovie SpA (FS) group for interests and/or repayment of capital. The main underlying reasons were:

- *ISPA did not assume any risks in the financing of the AV/AC network system;*
- *The revenues deriving from the management of the AV/AC Project were insufficient to service the debt, and the supplementary State intervention was certain, substantial and essential. Therefore, the State had to be considered as the "true" debtor.*

The State's decision to assume the ex-ISPA debt

Over the past few weeks, within the overall scheme aiming to guarantee the financial resources required to complete the network, the Government has evaluated the possibility to consolidate the IPSA debt within the current year. This would result in a

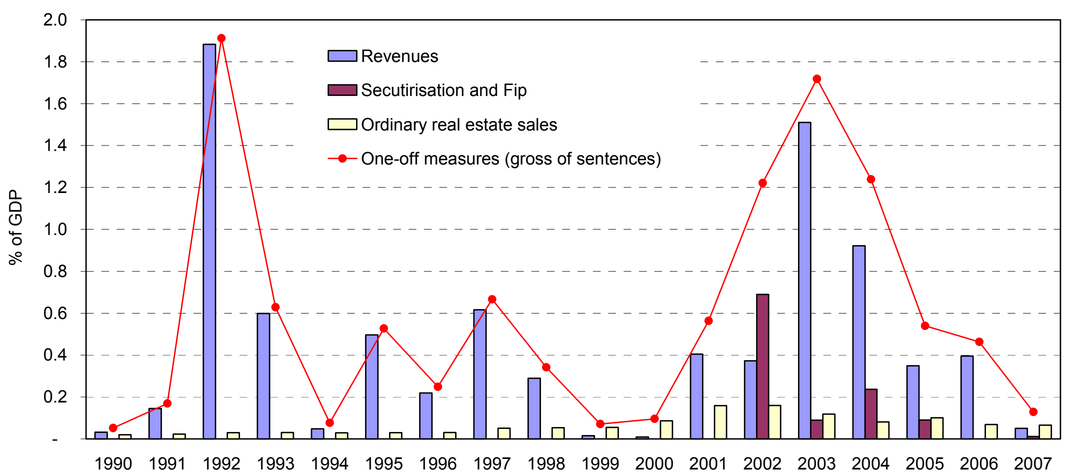
[29] The regulation envisaged that "in order to keep ISPA in economic and financial equilibrium, the State shall stand the supplementary financial burden needed to service the part of ISPA debt not adequately serviced by the estimated cash flows during the economic life of the high-speed/high-capacity system. The same regulation envisages that "the credits and revenues deriving from the utilisation of the 'high-speed/high capacity system' shall be used, in priority, to service the ISPA debt. Other creditors do not have the right to promote actions until the debt has been fully extinguished.

more coherent accounting representation of the debt that, although reclassified as 'public debt', is formally in the books of RFI/TAV (an entity external to the Public Administration).
The operation will produce an increase in the net borrowing of the Public Administration for 2006 of approximately 13 billion euros, will conclude a period of overlapping of different financing schemes since the beginning of the AV/AC Project in 1991, and will moreover allow for a change in the financing of the AV/AC network to ensure full availability of the funds required to complete the network.
Following the State's decision to consolidate the IPSA debt and the approval by ISPA board holders, track access revenues–- which under the old financing scheme should be used to repay the ISPA debt – can now be made available for other financing opportunities.
In brief, the financing cost of the Turin-Milan-Naples Project is estimated to amount to approximately 33.2 billion euros.

ANNEX 4. ONE-OFF MEASURES

In the past, one-off measures contributed to the consolidation process of public finances, notably over periods of unfavourable economic conditions.
The impact of temporary measures on public accounts is evident from the figure below, which shows the breakdown in revenue provisions and public real estate sales (both as direct sales and securitisation operations) as a percentage of GDP. The figure takes into account solely the measures that have determined a positive impact on the deficit without considering transactions that worsen the budget balance (i.e. burdens for arrears arising from court sentences).
In the nineties the use of such measures appears to progressively decrease following the 1992 peak (1.9 per cent of GDP), reached during the monetary and financial crisis.
One-off measures increased from 2001 onwards, as negative cyclical developments led to a worsening in public finances. Their use reached a peak again in 2003, when one-off measures approached 1992 values (1.7 per cent of GDP) due to the necessity to collect additional resources to meet European budget requirements without producing short-term negative impacts on economic growth.
Comparing the two decades reveals major differences. In recent years the use of one-off revenue measures has been on average higher than in the nineties and has coincided with the recorded acceleration in real estate sales through securitisation.

Figure 9. ONE-OFF MEASURES (Percentage of GDP) (1)



(1) 2000 does not include revenues from UMTS licences.

ANNEX 5. HEALTH CARE RULES

Health care rules included in the 2007 Budget Law are in line with the specific agreement subscribed by the Central Government and Regions. The level of Central Government financing has been set for 2007 and the following years in accordance with the expected GDP growth. Furthermore a temporary fund equal to 1 billion euros for 2007 has been created so as to support the consolidation plans of high deficit Regions.

Further measures have been outlined in order to:

1. *Ensure stability of the financial planning instruments through:*
    - *Extension of the automatic increase in tax rates;*
    - *Confirmation of the expenditure containment measures adopted by the Italian Pharmaceutical Agency (AIFA) that guarantee overall annual savings of 2 billion euros. The measures consist in a 10 per cent reduction of pharmaceutical prices, a further 0.6 per cent reduction in the retail price going to producers, as well as a revision of the pharmaceutical reference book;*
    - *An increase in tax rates above the limit established by current legislation for high-deficit Regions not compliant with consolidation objectives.*
2. *Make Regions more responsible as to proper use of resources through:*
    - *A 50-per cent cut in tariffs for services that make use of automatic procedures;*
    - *Transfer of services from day hospital regime to outpatient regime and modification of appropriate thresholds for services supplied in day hospital procedures;*
    - *Definition of a time path for admissions in order to overcome the problem of transitory and temporary admissions;*
    - *Establishing base auction prices for supplies to the ASL (Italy's national health service) of medical devices that account for a significant share of the overall expenditure;*
    - *Dissuading extensive use of medicines for not authorised purposes, by seeking legal protection against damages to the ASL.*
3. *Enhance citizens' level of responsibility in the use of health care by means of co-payment for specialist services and access to first aid not followed by hospitalisation.*

Finally, further measures have been introduced as to the definition of diagnostic-therapeutic paths to allow for a more appropriate use of health care resources and impose sanctions on those convicted for fraud against the ASL.
On the whole, the above measures should result in savings of approximately 3 billion euros in 2007 (circa 2 billion euros as lower expenditures and approximately 1 billion euros as higher net revenues), 3.3 billion euros in 2008 (circa 2.4 billion euros as lower expenditures and approximately 0.9 billion euros as higher net revenues), and 4.2 billion euros in 2009 (circa 3.2 billion euros as lower expenditures and approximately 1 billion euros as higher net revenues).

ANNEX 6. SEVERANCE PAYMENT FUND

The 2007 Budget Law, as modified following the agreement between the Government and social parties in October, envisages the institution at the State Treasury of a Fund managed in accordance with a pay-as-you-go (defined benefits) scheme aimed at paying out severance benefits (TFR). The administrative functions are granted to INPS (National Social Security Institute).

Starting from 1 January 2007, contributions paid by employers, amounting to the accrued TFR not allocated by employees to supplementary pension schemes, are transferred into this Fund. Only employers with at least 50 employees are due to pay contributions into it.

The pay-as-you-go scheme provides employees with the same benefits as the existing TFR legislation on the basis of contributions paid into the Fund.

Employers with at least 50 employees will, however, continue to pay directly the accrued TFR amounts until 31 December 2006.

Payment rules of severance benefits will be defined by a ministerial decree expected to be published by January 2007.

In order to offset the higher costs on employers deriving from the transfer of TFR contributions into the pension fund at the State Treasury, the 2007 Budget envisages the same contribution exemptions and tax allowances established for payments to the supplementary pension schemes. Notably:

- *Effective 2007, exemption from contribution to the guarantee fund at INPS (0.2 per cent for all employees);*
- *Effective 2008, exemption from the Law Decree 203/2005 contributions (0.19 per cent in 2008, increasing thereafter to a maximum of 0.28 per cent as of 2014);*
- *Effective 2007, income tax allowances for companies (4 per cent).*

The inflows of the severance payment fund at the Treasury, net of the withdrawals deriving from the expected increase in the number of employees joining supplementary schemes and the compensatory measures in favour of employers, will be used to finance growth-enhancing measures. Such resources – estimated at approximately 5 billion euros in 2007, 4.5 billion euros in 2008, and 3.9 billion euros in 2009 – will be used for growth-enhancing measures within the set limit through a specific procedure (Conferenza dei Servizi).

ANNEX 7. REGIONAL POLICY CONTRIBUTION

Regional policy – outlined in the Economic and Financial Planning Document (DPEF) 2007-2011 – aims to support regional cohesion between Italy's Centre-North and South, contributing to an increase in growth opportunities in the South and competitiveness and productivity levels throughout the Country, and, at the same time, being closely tied to the goals of the Lisbon strategy. In accordance with such objectives, regional policy is designed so as to foster implementation of material and immaterial infrastructures and improvement of public services, in order to ultimately increase the profitability of private investments, income and employment.

A National Strategic Framework (NSF) 2007-2013 for regional development and cohesion policy (financed through EU and Italian resources) is about to be finalised on the basis of European commitments and a formal agreement reached in February 2005 by the National Government and Regions. The Framework describes the structure of the programme, its priorities, implementation rules, requisites of additionality and conditionality of expenditure, as well as its specific objectives and a number of quantitative targets expressed in terms of services provided to citizens.

In the light of the unifying nature of national and European resource planning – stated by the same agreement under the NSF also for allocating the Fund for Under-utilised Areas (FUA) and European funds and co-financing – resources have to be spread over the same 7-year horizon of the concerned plans.

The Budget Law for 2007 has therefore earmarked 63,273 million euros for the FUA to implement regional policy for the period 2007-2013 and has identified the NSF as the planning framework for additional resources (national and European) and for ordinary capital account resources, while maintaining Regional decision-making powers.

The established policy goals (developing knowledge networks; improving quality of life and increasing security and social cohesion; strengthening production and services pipelines and competition; internationalising and modernising the economic system) take into account the need of reinforcing complementarities between additional regional policy and the Lisbon strategy.