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Italy's economic and fiscal outlook amid Europe's sovereign debt crisis

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London, September 26-27, 2011

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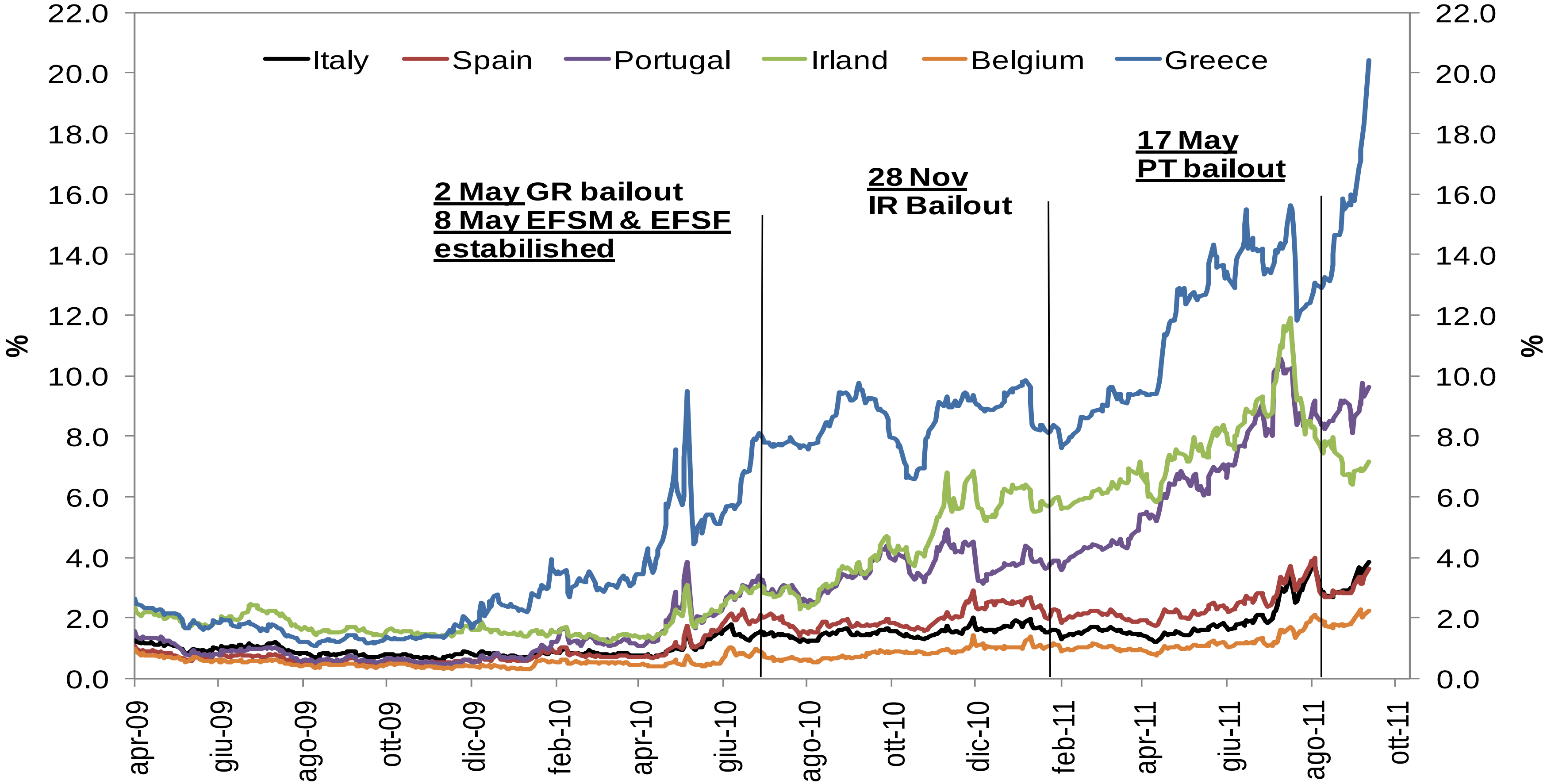
Can spread widening be reversed?

10-year sovereign bond spreads vs Germany (percentage points)

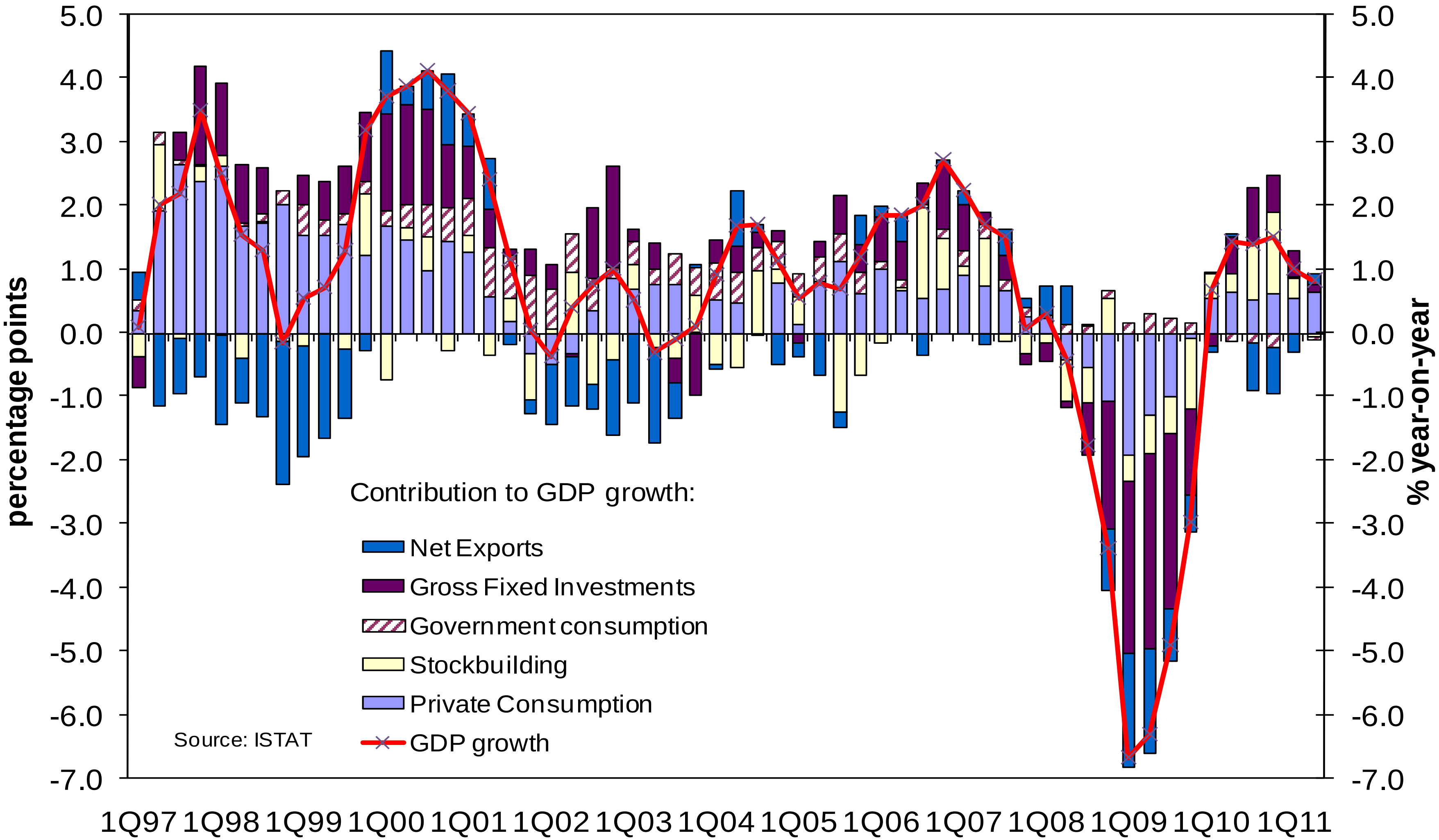


source: Thomson Reuters Datastream

The international crisis and Italy's economy

- **Effects mainly through international trade**
- **No major macroeconomic imbalances apart from high public debt**: no major bubbles in the housing market, low household debt and solid banking system
- The Government **softened the negative impact** of the crisis on the real economy by strengthening social safety nets and supporting most vulnerable social groups, while maintaining strong attention on the sustainability of public finances
- **No increase in discretionary spending** during the crisis; automatic stabilisers allowed to work.

Italy's GDP: moderate growth in 1H11, softening ahead



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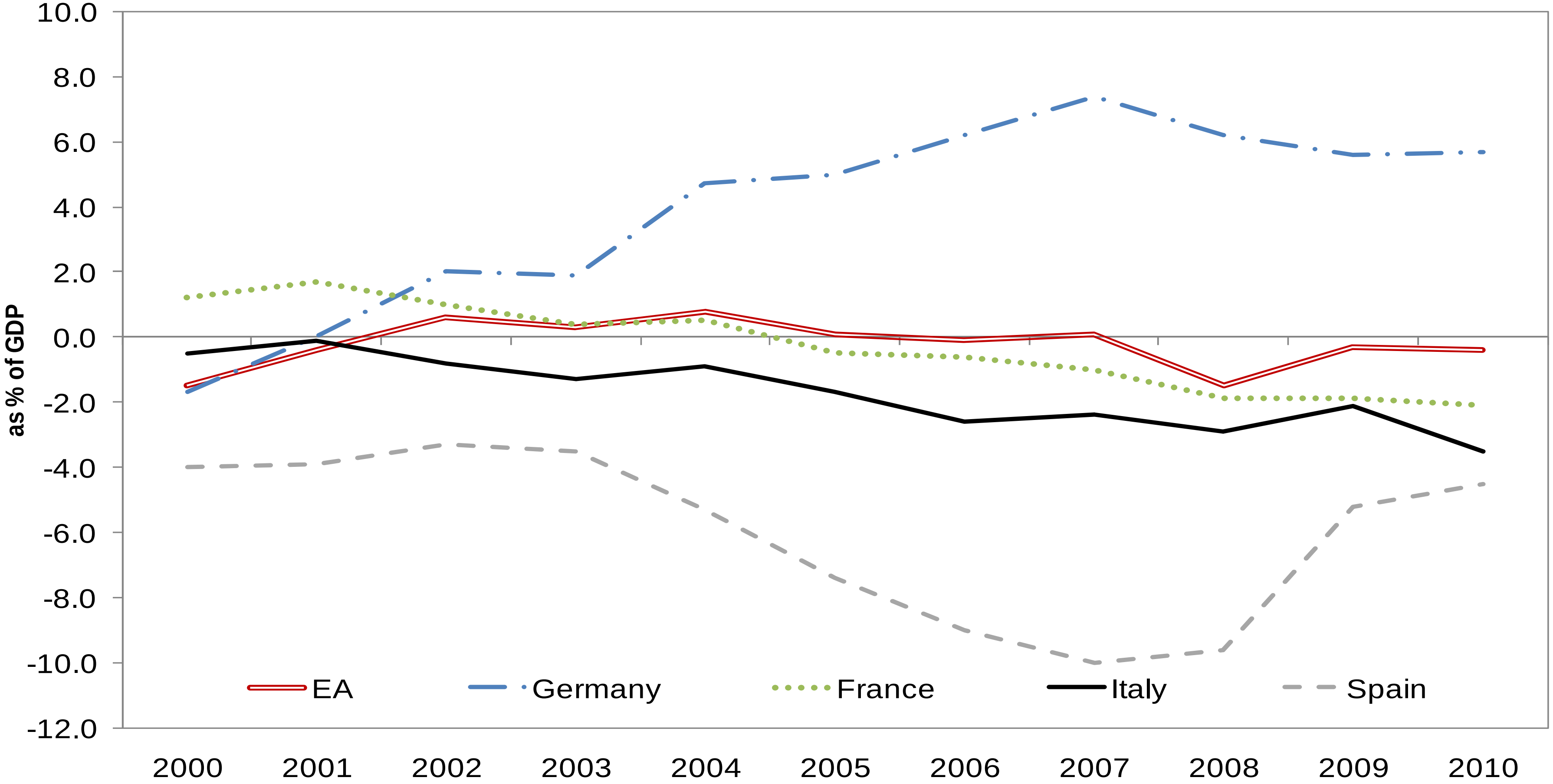
Italy’s current account balance: mild deterioration



Source: Eurostat - provisional data.
Note: For Italy, in 2010 Bank of Italy data.

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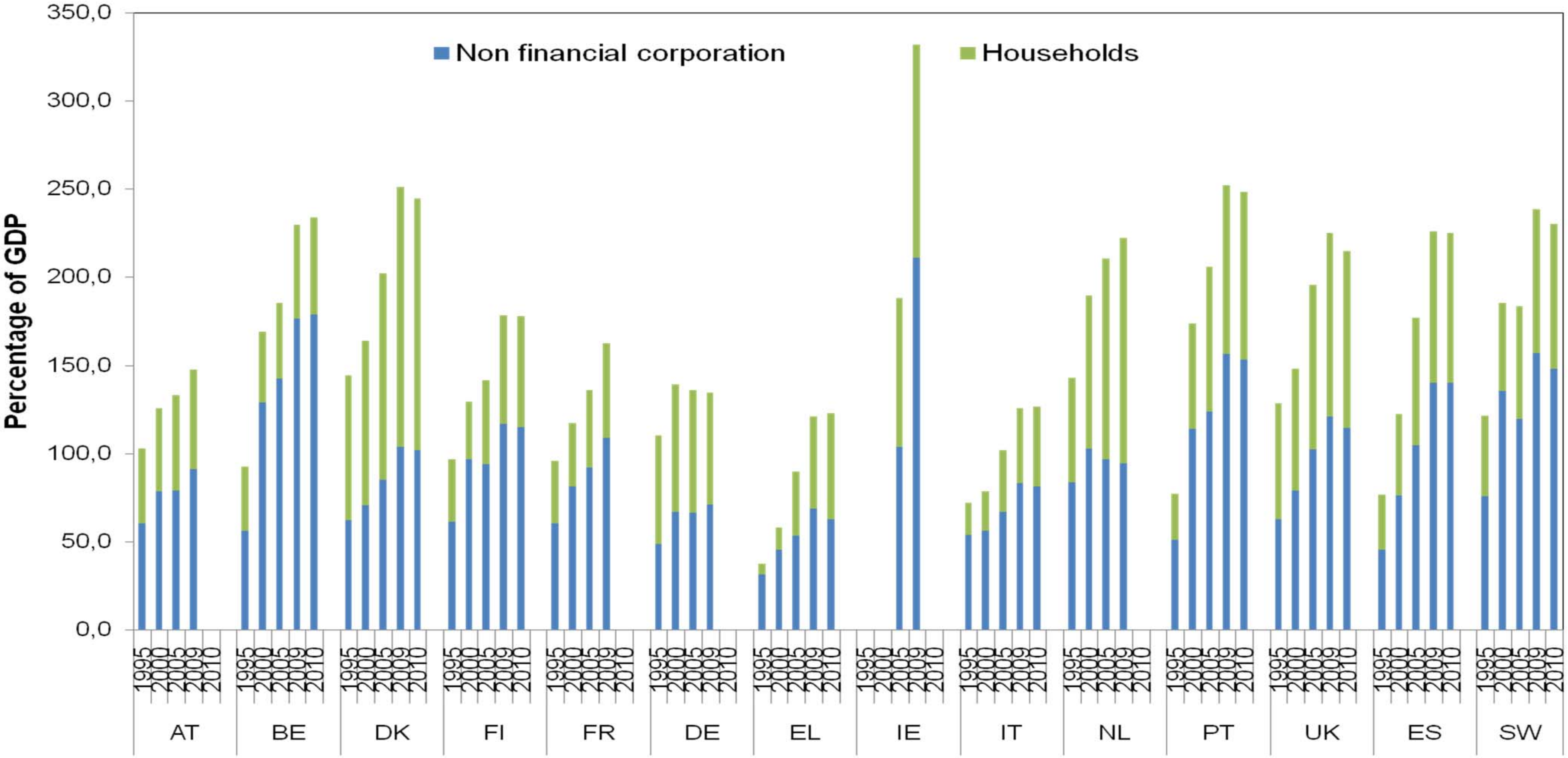
Italy’s private debt: not much leverage



Source: Our calculations on Eurostat data

Note: In 1995 and 2000, data for Ireland are not available. In 2010, data for AT, FR, DE, IE,NL are not available. For Italy, in 2010, Bank of Italy’s data.

Key macroeconomic projections

(% change yoy)	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**
Real GDP	**-5.2**	**1.3**	**0.7**	**0.6**	**0.9**	**1.2**
Domestic demand net of inventories	*-3.3*	*0.9*	*0.8*	*0.5*	*0.8*	*1.0*
Inventories	*-0.6*	*0.7*	*-0.2*	*0.0*	*0.0*	*0.*
Net export	*-1.3*	*-0.4*	*0.3*	*0.1*	*0.1*	*0.1*
Nominal GDP	**-3.1**	**1.9**	**2.2**	**2.5**	**2.6**	**2.9**
GDP deflator	**2.3**	**0.6**	**1.4**	**1.9**	**1.8**	**1.8**
Labour cost	**1.7**	**2.0**	**1.8**	**1.2**	**1.5**	**1.6**
Productivity (on GDP)	**-2.4**	**2.0**	**0.0**	**0.5**	**0.5**	**0.8**
Unit labour cost (on GDP)	**4.2**	**0.0**	**1.8**	**0.7**	**1.0**	**0.8**
Employment	**-2.9**	**-0.7**	**0.7**	**0.1**	**0.3**	**0.4**
Unemployment rate	**7.8**	**8.4**	**8.2**	**8.1**	**8.1**	**8.0**
Current account balance	**-2.0**	**-3.5**	**-3.8**	**-3.6**	**-3.3**	**-3.1**

Italian government's fiscal strategy: a summary

- Strong commitment to **fiscal consolidation**
- Most budget measures already approved **before summer**
- August's extraordinary budget to **bring forward balance-budget already in 2013**
- **Three-year plan**: cumulative **€59.8 bn** adjustment in 2011-14, i.e. 3.5% of GDP
- New rules linked to the **European Semester**: new legislation on budget procedures, with significant improvement in the quality of public finance; balanced-budget into the Constitution

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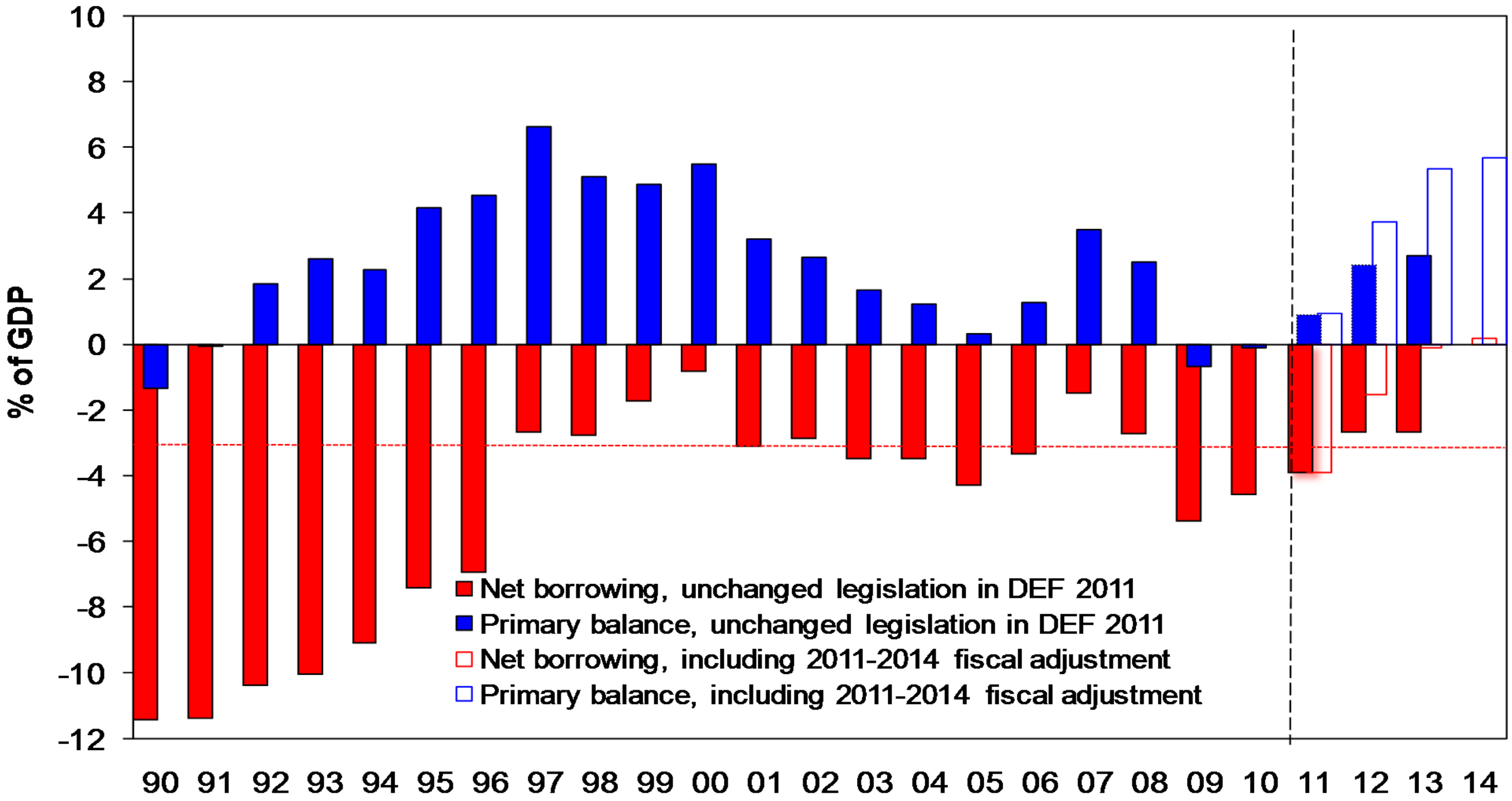
Primary balance: 0.9% in 2011 and 5.7% in 2014



Source: 2011 Stability Programme for unchanged legislation estimates and estimates for net borrowing and primary balance including the fiscal adjustment.

Budget measures in a nutshell

(€ bn if not otherwise indicated)	**2011**	**2012**	**2013**	**2014**
Net Increase in Revenues	**2.6**	**16.7**	**19.4**	**18.8**
of which increase in VAT	*0.7*	*4.2*	*4.2*	*4.2*
taxation on financial assets	*0.0*	*1.4*	*1.5*	*1.9*
excise, lotteries, stamp duties etc.	*1.2*	*5.4*	*7.8*	*6.6*
local tax on energy sector	*0.0*	*1.8*	*0.9*	*0.9*
Net Decrease in Expenditure	**0.2**	**7.6**	**18.9**	**21.0**
of which cuts in ministries expenditure	*1.7*	*7.4*	*6.3*	*5.0*
transfer to local governments	*0.0*	*4.2*	*6.4*	*6.4*
pensions	*0.0*	*1.0*	*3.5*	*3.4*
Cuts in tax expenditure (safeguard)	**0.0**	**4.0**	**16.0**	**20.0**
Impact on Primary Balance	**2.8**	**28.3**	**54.3**	**59.8**
% of GDP	***0.2***	***1.7***	***3.3***	***3.5***

Expenditure cuts

- Sizeable **central government** spending cuts
- Rationalisation in **health care spending**
- Cuts in transfers to **regions and local governments**, with the exception of 'virtuous' ones based on the Internal Stability Pact
- Cuts in **social security spending**
- Additional measures for **public sector employment**
- Constitutional amendment for the **elimination of Provinces** (budget effects not in the projections)

Pension spending: new measures

- Gradual **increase in the statutory retirement of woman** working in the private sector to 65
- Automatic mechanism linking **retirement age** to developments in life expectancy brought forwards to 2013
- Extending the '**window mechanism**' by 3 months for people retiring with 40 years of contributions
- Change in **severance pay** to public sector employees
- **Reduced indexation** of pension benefits to price inflation

Pension spending: permanent savings

- Overall, the measures adopted in July and August on pension will produce incremental savings up to 0.6 pp of GDP by 2030
- In the years 2030-2045, savings are expected to hover around 0.3 pp of GDP.
- A cumulative reduction in pension expenditure of 12 pp of GDP is expected by 2050.

Revenue increases

- A 1pp increase in the ordinary **VAT tax** rate from 20 to 21%
- Increase (0.75pp) **in the regional company tax** (IRAP) for financial institutions
- Revision of the legislation on **amortisation schedules** and the carry over of **operating losses**
- Revision of **estimated tax rates** of sectors ('studi di settore')
- Stricter rules and enforcement in the **gambling sector**
- Increase in taxes on **petrol**

Revenue increases (cont'd)

- Increase in taxes on **financial asset** deposits at banks
- The withholding tax on **financial income** has been levelled to a uniform 20% (with the exception of public debt instruments)
- Measures to **fight tax evasion**, including limiting cash transactions to amounts below €2,500 and harsher penalties
- Higher revenues are expected from **lottery** and **excise taxes** as well as from higher taxes on **energy and financial companies**
- A 3% surcharge on **personal income tax** above €300,000

Fiscal Reform (Enabling Act)

- A comprehensive reform of the tax system based on **simplicity and transparency**
- **Three income tax brackets** (20%, 30%, 40%) and reduction in tax exemptions and favourable tax treatments; gradual revision of VAT rates
- The so-called **'service tax'** due to replace a large number of current taxes; gradual elimination of the tax on productive activities (IRAP); introduction of the 'taxation for economic growth' (ACE) with tax breaks on risk capital returns

Welfare reform (Enabling Act)

- Reshuffling in **social expenditure**, with changes in access to social services and citizen’s enhanced freedom to choose social service providers
- More funding for **favourable tax treatments** on the portion of wages linked to **productivity gains**
- Liberalisation of employment **placement services**

Reduction in Public Administration costs

- Reduction in the **cost of doing politics** (MPs wages set in line with the European average; reduction in benefits, close control on political party funding)
- Implementation of the **spending review**
- **Saving targets** for central government, with the exception of universities, R&D, education, private research and infrastructure funds
- An investment fund for the **sale of real estate assets** of regions, provinces and municipalities

Reduction of Public Administration costs (cont'd)

- Rationalisation of **public administration procurement**
- Rationalisation of expenditure on **education**: merge of schools and workforce reduction by 2012
- **Elimination of ICE** (Italian institute for external trade): responsibilities moved to relevant Ministries; restructuring of other state-owned entities
- **Reorganisation of Justice**: reduction of arrears in judicial cases, introduction of economic incentives to make courts more efficient; reform of 'Tax Commissions'; reorganisation of the whole structure of judicial offices

Liberalisation measures/growth enhancing policies

- **Retail trade**: liberalisation of opening hours in tourist towns and cities
- **Petrol stations**: liberalisation in non-oil product trade in petrol stations
- **Rail and road infrastructure:** fresh funds available for investment; new agency for **road and motorway infrastructure** with the objective of better planning network developments and surveillance on road licensing
- Incentives for **venture capital** to support financing of start-ups

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Fiscal framework

- At **central level**, strengthening of budget discipline, with introduction of 3 and 5 year budget planning
- At **local level**, higher accountability of different levels of government and strengthening of enforcement mechanisms
- The recent reform improved medium-term budgetary planning by changing the **timing**, the **principles** and the **time horizon** of the annual Budget

Fiscal framework (cont'd)

- Budget cycle aligned to the **European Semester**

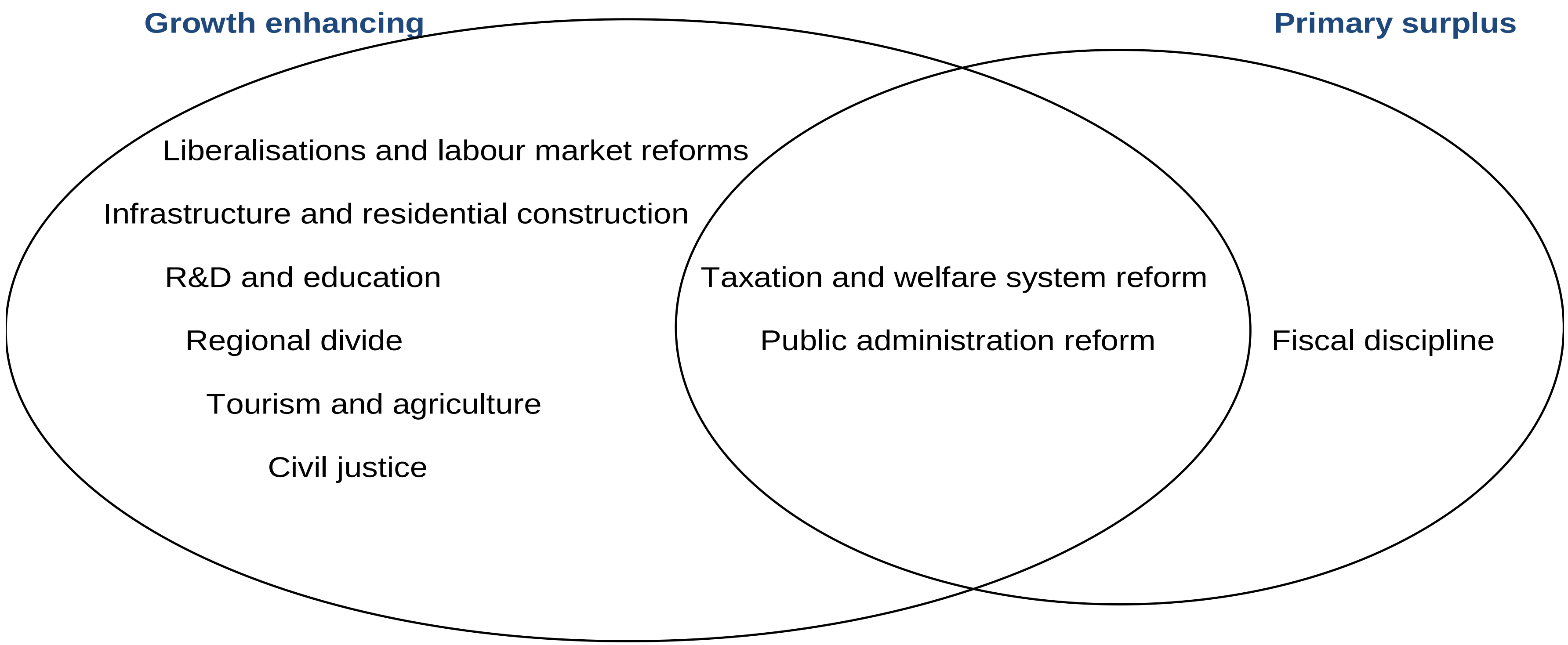
- In April: release of the Economic and Financial Document (DEF) consisting in three parts: i) the Stability Programme, ii) Public Finance Analysis and Trends; iii) the National Reform Programme

- The **Stability Programme**, to be sent to the Commission by the end of April, now plays a primary role in the early stages of the domestic economic and financial planning process

Numerical fiscal rules

- The medium-term budgetary framework is based on the following fiscal rules:
  - The Domestic Stability Pact
  - The Health Care Pact
  - The pharmaceutical spending ceilings
  - The ceilings on State Budget spending and the ex ante destination rule on extra revenues
- The Stability Law provides for an annual update of targets of fiscal rules, in line with the strategy negotiated between the central government and local authorities

A strategy for growth and fiscal consolidation: priorities



See National Reform Programme:
http://www.dt.tesoro.it/export/sites/sitodt/modules/documenti_en/analisi_progammazione/documenti_programmatici/DEF_3_xengxissn_on-linex_PROTETTO.pdf