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Fact-finding preliminary to the examination of the budget documents for the period 2006-08

Statement by the Governor of the Bank of Italy
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Contents

1. The international economy

In the first half of 2005 world economic activity continued to expand at a rapid pace. The maintenance of accommodating financial conditions helped to limit the repercussions of the large and unexpected rise in the price of oil.

In the United States GDP grew in the first half by 3.6 per cent on an annual basis, at the same rate as in the previous period. The negative impact that the sharp rise in energy prices had on consumption was countered by the favourable effect of the increase in employment and wages; investment expanded rapidly, notably in the high-tech goods sector.

In July and August economic activity continued on a favourable path. The hurricanes in the Gulf of Mexico should have limited and transitory repercussions on growth. According to recent estimates by the Congressional Budget Office, the effect will be to reduce output in the third quarter by between 1 and 1.5 percentage points on an annual basis. Congress has already allocated around $60 billion for reconstruction. The loss in output should in any case be recovered in the first half of 2006.

The rise in oil prices led to a substantial increase in consumer price inflation; so far it has not altered core inflation or inflation expectations. The Federal Reserve continued to enact a gradual tightening of monetary conditions.

An unexpected, positive outcome is the substantial decrease in the federal deficit for the fiscal year just ended. According to the latest Congressional estimates, the deficit decreased from 3.6 per cent of GDP in 2004 to 2.6 per cent, benefiting from a larger-than-expected increase in revenue from corporation tax. According to the forecasts prepared in July by the Administration, the deficit in 2006 will be unchanged as a percentage of GDP;

taking into account the rise in expenditure due to reconstruction, it could turn out to be slightly larger.

Recent estimates by the International Monetary Fund set GDP growth in the United States at 3.5 per cent in 2005, compared with 4.2 per cent in 2004; in 2006 it should be virtually the same.

In Japan, GDP grew in the first half of 2005 by 3.8 per cent on an annual basis. The increase in employment boosted household consumption; investment growth resumed at a rapid pace, fostered by the reorganization of manufacturing and the progress made in restructuring the banking sector. According to IMF forecasts, output will expand by 2 per cent in 2005 and again in 2006.

In China, GDP is expected to grow by 9 per cent this year and 8.2 per cent in 2006. Growth in the other emerging economies of Asia is expected to continue at a fairly rapid pace, 5.8 per cent in both years. In Latin America, output is expected to expand by around 4 per cent in both 2005 and 2006.

Tensions in the oil market heightened during the summer. In September the price of crude oil rose to an average of more than $61 a barrel, compared with around $40 at the end of 2004. The trend and distribution of prices of futures contracts suggest there may be further increases in the short term, with possible repercussions on economic activity.

In the euro area output grew at a modest pace in the first six months of the year, expanding by just over 1 per cent on an annual basis. Among the major countries, France and Germany recorded the strongest growth; in Italy, there was a slight decline in economic activity in the first half of the year compared with the previous period.

The growth in euro-area GDP was driven mainly by consumption, with the exception of Germany, where consumption declined. Despite the continued strong expansion of world trade, exports slowed sharply.

The harmonized index of consumer prices rose by 2 per cent in the first half of 2005 compared with the same period of 2004. In Italy the increase was of a similar order of magnitude. Core inflation, calculated by excluding the most erratic components, was 1.6 per cent in the euro area and 2.1 per cent in Italy.

In recent months, information for the euro area has indicated an improvement in the economic situation. In the main economies the index of business confidence rose and in September was close to the levels recorded at the beginning of the year.

2. Cyclical developments in Italy

In Italy, GDP declined in the first half of the year by just under 1 percentage point on an annual basis. Economic activity was mainly driven by household consumption; gross fixed investment continued the decline under way since the second half of 2004.

Performances diverged in the two quarters. In the first, economic activity slowed considerably as a result of the marked decrease in exports. In the second quarter, this downward trend reversed, causing output to resume growth at a rate of almost 3 per cent on an annual basis; household consumption rose by 2.6 per cent, thanks in particular to the sharp rise in purchases of durable goods; gross fixed investment also returned to growth, mainly owing to the rise in residential building.

In the second quarter the decline in inventories, caused by production failing to keep pace with demand, reflected the cautious response of firms to the large fluctuations in orders during the course of the year.

Employment began to increase again in the spring. The rate of unemployment, calculated on the basis of the new labour force survey, continued to decline, falling in the second quarter to 7.8 per cent on a seasonally adjusted basis. The drop in the labour market participation rate, particularly of women in southern Italy, contributed.

In the other euro-area countries the rate of unemployment remained virtually unchanged; in July it was 9.7 per cent in France, 9.3 per cent in Germany and 9.5 per cent in Spain.

In Italy GDP growth has remained slack, although the increase in industrial production in the summer and the improvement in qualitative indicators point to the consolidation of the recovery in production.

In 2005 output growth is expected to be slightly positive. The Forecasting and Planning Report published in September indicates economic activity will expand by 1.5 per cent in 2006.

For the euro area the IMF forecasts growth of 1.8 per cent. According to Consensus Forecasts, average inflation in 2006 will be just under 2 per cent both in Italy and in the euro area.

3. The public finances in Italy

3.1 Fiscal balances

In an attempt to limit the budget's restrictive impact on the economy, in the last three years extensive recourse was made to temporary measures. Their effects averaged around 1.5 percentage points of GDP each year.

The increase in public spending and the reduction in the fiscal burden sustained economic activity, which had been slowing owing to the international economic situation and internal factors of a structural nature. The result was a progressive deterioration in the public finances.

General government net borrowing overshot the 3 per cent threshold fixed in the Treaty of Maastricht every year from 2001 on, except 2002. The primary surplus began to decline in 1997, falling from 6.7 per cent of GDP in that year to 3.4 per cent in 2001 and 1.8 per cent in 2004.

The deterioration in the public finances appears more marked if the effects of temporary measures are excluded.

In July this year the EU Council initiated the excessive deficit procedure in respect of Italy and called on the Government to take the necessary steps to bring the deficit gradually back below the 3 per cent threshold. The effectiveness of the measures will be assessed in January 2006.

In 2001-04 the general government borrowing requirement, net of privatization receipts, averaged about 4 per cent of GDP. Progress in reducing the debt-to-GDP ratio slowed considerably. In recent years the decline was mainly the result of extraordinary revenues, financial operations and asset disposals.

In the early months of 2004 the evolution of the borrowing requirement was such that there was a risk net borrowing would overshoot the estimate for the year.

In April the European Commission, expecting Italy's net borrowing to reach 3.2 per cent of GDP in 2004, recommended that the EU Council should serve an early warning on Italy. The Government undertook to introduce the necessary measures to keep the deficit within the 3 per cent threshold. The Quarterly Report on the Borrowing Requirement published at the beginning of May estimated net borrowing would amount to 2.9 per cent of GDP in 2004.

In view of the difficulty of controlling the public finances, at the presentation of the Economic and Financial Planning Document in July 2004 the baseline projection for the deficit in 2005 was raised to 4.4 per cent of GDP; economic growth was adjusted downwards to 1.9 per cent. At the end of the year a set of deficit-reduction measures was enacted, officially estimated at €24 billion or 1.7 per cent of GDP. The correction consisted mainly in the introduction of a 2 per cent limit on the nominal increase in general government spending, "revenue maintenance" measures – reviews of sector studies, enlargement and recovery of tax bases – and massive asset disposals.

According to the Economic and Financial Planning Document of July 2005 and the Forecasting and Planning Report of September 2005, the deficit this year will be 4.3 per cent of GDP, reflecting a significantly smaller-than-expected impact of the budgetary measures and a basically stagnant economy. The primary surplus is estimated at 0.6 per cent of GDP. Excluding the effects of one-off-measures amounting to about half a percentage point of GDP, net borrowing would remain at approximately 5 per cent of GDP and the primary surplus be basically nil.

Only a fraction of the €7.1 billion of property disposals envisaged by the Finance Law for 2005 has been completed.

The deficit could be reduced by the deferment of part of the costs connected with the renewal of public employment contracts, which are still being negotiated in many sectors, given the time needed for their implementation; in such case the deficit for 2006 would be aggravated.

To ensure that the objective of 4.3 per cent of GDP for net borrowing this year is achieved, additional budgetary measures were recently introduced that according to the official estimates will reduce the deficit by €1.9 billion, with €0.8 billion coming from revenue increases and €1.1 billion from spending cuts.

The data available on the performance of the public finances during the current year confirm the trend towards a sharp deterioration in the balances. The general government quarterly accounts, prepared by Istat on the basis of information that is still incomplete, show that net borrowing rose from 3.6 per cent of GDP in the first half of 2004 to 5.1 per cent in the first half of this year; the increase reflects the larger one-off revenues recorded in the first half of 2004. In the first eight months of 2005 the general government borrowing requirement amounted to €56.1 billion, €4.3 billion more than in the same period of 2004. In the first nine months of 2005 the state sector borrowing requirement amounted to €59.9 billion, up by €5.6 billion compared with the same period *of 2004. In the last two months of 2004 about €6.5 billion of receipts from extraordinary transactions were recorded (€3.5 billion from the securitization of INPS credits and €3 billion from sales of public property).*

Even assuming privatizations totaling €15 billion, of which €4 billion have been completed to date, the Planning Document estimates that the ratio of debt to GDP will turn upwards after ten years of steady decline, rising from 106.5 per cent in 2004 to 108.2 per cent.

3.2 Public expenditure

In the five years 1993-97 primary current expenditure grew by 0.7 per cent per year in real terms, compared with average annual GDP growth of 1.5 per cent. In the four years 1998-2001 expenditure grew at an average annual rate of 2.1 per cent in real terms, the same as GDP; in the three years 2002-04 the rate of increase in expenditure remained virtually unchanged at 2.2 per cent, while GDP grew by just over 0.5 per cent per year.

In the second half of the 1990s the ratio of primary current expenditure to GDP fluctuated around 37.5 per cent. In 2002-04 it rose by 1.4 percentage points, reflecting the slowdown in economic activity. The Planning Document, taking account of the stagnation of the economy and the substantial outlays connected with the renewal of public employment contracts, including arrears, estimates that the ratio will increase by a further 0.9 points this year, to 40.2 per cent.

Limiting the growth in spending will involve considerable difficulties.

The methods must necessarily be differentiated in relation to the degree to which expenditure is discretionary. For the more flexible components, they can include measures that set limits on the financial resources available to individual administrations or establish planning ceilings.

A very substantial share of Italian public spending depends on the legislative and institutional framework regulating individuals' eligibility to receive some benefits and the level of services provided to the population. Outlays for pensions are equal to more than 35 per cent of primary current expenditure, those for healthcare to more than 15 per cent. On these items, the action to reduce expenditure must be carried out through a revision of the structure and functions of the public sector.

The difficulty of limiting expenditure is confirmed by the results produced by the 2 per cent cap on the nominal increase in a part of general government outlays, introduced by the budget for 2005. For the current year, the situation of the accounts given by the Planning Document published in July indicates that the measure is not sufficiently effective: intermediate consumption is estimated to be growing by 3.8 per cent, primary current expenditure by 4.7 per cent.

The 2 per cent cap introduced by last year's Finance Law applied to the nominal increases in general government primary expenditure compared with the provisional figures for 2004 published in the Forecasting and Planning Report for 2005. Social benefits in cash, Italy's contributions to the EU budget and expenditure for the Constitutional bodies were excluded. For local authorities as a whole, the introduction of the spending cap revised the rules of the Domestic Stability Pact: for municipal and provincial governments, the constraint on the deficit was replaced by a ceiling on spending growth, in the same way as for regional governments. The ceiling referred to expenditure on a cash basis and was equal to 4.8 per cent with respect to the outturn in 2003; staff costs, transfers to other public authorities, expenses deriving from financial transactions and, for the regions, health care expenditure were excluded. The last-mentioned item was subject to specific restrictions that reduced its nominal amount with respect to the provisional outturn for 2004.

3.3 Revenue policies

In the last few years the aim of budgetary policy has been to reduce the burden of tax and social security contributions in order to foster growth. This action has encountered limits in the general conditions of the public finances. Net of capital taxes, the ratio of tax and social security receipts to GDP declined from just over 42 per cent in the two years 2000-01 to 41 per cent in 2004; over the same period the tax component fell from around 29.5 to 28 per cent of GDP.

Substantial receipts have been generated by one-off measures, in particular tax amnesties and property sales; the latter are deducted from investment expenditure in the general government consolidated accounts. Amnesties, especially if they are reiterated, are likely to have a negative effect on compliance with the rules and thus on potential future receipts.

The planned further reduction in the tax burden makes it possible to strengthen the fight against evasion, limiting the impact of taxation on productive activity. The receipts recovered will make resources available for a substantial lowering of tax rates.

An excessively heavy burden of taxes and social security contributions increases the incentives for evasion and enlarges the underground economy. These phenomena have attained major dimensions in Italy. They give rise to inequity and to serious distortions in the allocation of resources. It is urgent, as all agree, to launch a virtuous process of reducing the fiscal burden and recouping tax bases.

The budget for 2005 established measures strengthening so-called sector studies. There is no evidence of their having had a significant impact on developments on the revenue side, partly owing to amendments introduced during the budget's passage through Parliament.

The Finance Bill for 2005 indicated that €3.8 billion of additional revenue would come from rules modifying sector studies and strengthening their use for tax assessment (€1.4 billion). The introduction of a mechanism for automatic annual updates on the basis of national account indicators and the implementation of periodic revisions, already envisaged by the rules establishing sector studies. However, in December 2004 the Senate passed an amendment eliminating the automatic updates and modifying the other rules. Overall, the expected additional revenue fell to €3.6 billion.

An initial periodic revision was carried out in March 2005 and led to an increase in the tax due on incomes produced in 2004, with respect to the previous year, for numerous categories of taxpayers. Although difficult to estimate ex post, the effects appear to be smaller than expected: up to *now self-assessed income tax payments for the year 2004 (mainly attributable to small firms and self-employed persons) are not larger than those for 2003.*

The property disposals included in the budget for 2005 that have been carried out to date total only about €600 million. The amount predicted was €7.1 billion, of which €4.1 billion was to come from property sales and €3 billion from the transfer of part of the road network to companies under State control.

4. The public finances in 2006

The *projections on a current programmes basis* presented in July in the Planning Document indicate net borrowing amounting to 4.7 per cent of GDP in 2006. This estimate assumes receipts from property sales totaling €6 billion, or more than 0.4 per cent of GDP, which in the general government consolidated accounts are deducted from capital expenditure.

GDP growth is projected to be 1.5 per cent, against the flat result expected for this year.

The ratio of the primary surplus to GDP is projected to fall by 0.5 percentage points, to 0.1 per cent. This would reflect a much larger fall in revenue than in primary expenditure (1.2 and 0.6 points of GDP respectively). Developments on the revenue side are influenced by the full effects of the tax reliefs granted in the previous years and by the lapsing of revenue from one-off measures.

The state sector borrowing requirement, net of settlements of past debts and privatization receipts, is forecast to be 4.7 per cent of GDP, the same as is expected for 2005 and well above the 3.7 per cent recorded in 2004.

The planning scenario outlined in the Planning Document and agreed at European level indicates that net borrowing will fall to 3.8 per cent of GDP in 2006. The correction with respect to the current programmes balance amounts to 0.8 percentage points.

After the expected increase this year, the ratio of general government debt to GDP is forecast to come down again in 2006. The decline, from 108.2 to 107.4 per cent, is entrusted to financial measures of considerable size.

In these circumstances it is essential to limit the growth in the debt structurally and to prevent the deterioration in the public finances from affecting its average cost.

The average cost of the debt – the ratio of interest payments to the average stock of liabilities – diminished continuously beginning in 1992, falling from 12.5 per cent in 1991 to 4.7 per cent in 2004. Contributory factors were the sharp reduction in interest rates and, in the most recent years, the redemption of securities with relatively high coupons. The scope for further reductions through these channels is dwindling.

The gross yield on ten-year Treasury bonds fell from above 10 per cent in early 1996 to around 4 per cent at the end of 1998; it averaged 5 per cent over the following five years and now stands at 3.5 per cent.

Between 2001 and 2004 ten-year bonds worth €76 billion reached maturity. The interest rates on this paper ranged between 8.5 and 12.5 per cent. In the three years from 2005 through 2007 another €61 billion will be redeemed, with coupon ranging from 6.75 to 10.5 per cent.

If interest rates on all maturities of government paper were to rise (or fall) by one percentage point, given the maturity distribution of the debt, interest expenditure would rise (or fall) by 0.2 percentage points of GDP in the first year, another 0.3 points in the second and 0.1 points in the third.

In an economic scenario like that set out in the Planning Document, which assumes medium-term nominal GDP growth of 3.5 per cent per year and an average interest rate of 4.5 per cent on the debt, stabilizing the debt/GDP ratio requires a steady primary surplus on a cash basis of 1 percentage point. At present the structural primary borrowing requirement is practically nil.

Reducing the burden of the debt adequately will require significantly larger primary surpluses. The Planning Document takes this perspective. It envisages a progressive improvement in the primary balance to a surplus of 3 per cent of GDP in 2009. Asset disposals and other capital transactions can hasten the reduction of the debt but cannot take the place of substantial primary surpluses.

5. The budgetary correction for 2006

The budget corrections outlined on 30 September comprised spending reductions of €13.4 billion and revenue increases of €4.7 billion, for a total adjustment of €18.1 billion.

Of this amount, €11.5 billion, or 0.8 per cent of GDP, is earmarked to reduce net borrowing and €6.6 billion is divided equally between additional spending and tax cuts, directed primarily to sustaining the economy.

In addition, a fund of up to €3 billion is envisaged to finance economic measures still to be decided in pursuit of the objectives of the Lisbon Agenda. This Innovation, Growth and Employment Fund will be financed by the proceeds of asset disposals over and above those included in the estimate of net borrowing on a current programmes basis.

5.1 Expenditure

Expenditure savings estimated at €13.4 billion will be partially offset by an increase of €3.3 billion in outlays, earmarked chiefly to support household incomes. The net reduction in spending compared with the current-programmes projection thus comes to €10.1 billion.

Of the overall spending cuts, those concerning central government departments total €7.3 billion.

The reductions will involve, in particular, public employment (€0.5 billion), intermediate consumption (€1.8 billion), transfers to businesses (€2.4 billion) and to ANAS (€0.3 billion), gross fixed investment (€0.7 billion) and various minor items (€0.8 billion). In addition, the appropriations contained in the tables annexed to the budget bill are reduced by €0.8 billion.

Savings that will have to be made by local and regional governments have been put at €6.1 billion, including €2.5 billion on healthcare.

The current-programmes projection for health spending in 2006 is €96.1 billion (€95.6 billion specified in the Economic and Financial Planning Document in July plus €0.5 billion for the renewal of collective bargaining agreements). The funding of the National Health Service under current national and regional legislation comes to €92.6 billion. The Finance Bill appropriates an additional €1 billion for the central government's contribution to fund the Service starting in 2006.

Moreover, additional resources of €2 billion are appropriated to settle the debts accumulated by the health service in the three years from 2002 to 2004, by way of derogation from the terms of the August 2001 agreement between central government and the regions, under which the latter were required to fund any health deficits out of their own resources. The Finance Law for 2005, again by way of derogation from the above-mentioned agreement, had appropriated funds to make good the debts for the years 2001-03.

In the last ten years the deficits of the health system have totaled more than €30 billion, which the central government has made good in part, with appropriations amounting to €14 billion.

A contribution to the containment of local spending will come from the further modification of the Domestic Stability Pact, which is expected to bring savings of €3.1 billion. The Pact does not apply to healthcare and personnel costs, which are subject to specific measures. The new rules of the Pact provide for reductions in current expenditure and set limits on the increase in capital expenditure. Overall, the total outlay in 2006 on the items covered by the Pact should be brought back to its 2004 level. Additional measures worth €0.5 billion will bear on public employment at local level.

The spending limits differ between regional and local governments. Regions are required to reduce their current expenditure in 2006 by 3.8 per cent with respect to the 2004 budget outturn, and municipalities by 6.7 per cent. For capital expenditure, regions are allowed an increase of up to 6.9 per cent, provinces and municipalities up to 10 per cent.

The current expenditure items subject to this ceiling do not include personnel, healthcare, social programmes and transfers to other public bodies. The ceiling on capital spending exempts not only transfers to other public bodies but also financial transactions that are not relevant for the calculation of net borrowing. By comparison with the rules for 2005, the scope of the Pact is now extended to some smaller units. The provisions for monitoring and the sanctions for violations remain in effect. More generous ceilings may be allowed for the provinces and municipalities that recorded lower annual per capita spending than provided for their population class in the three years 2002-04.

The expenditure increases, worth €3.3 billion, include support for households (€1.2 billion), costs arising from the renewal of public employment contracts for 2004-05 in addition to those projected for next year on a current programmes basis (€0.6 billion), expenditure in connection with the reform of private pension plans (€0.2 billion) and a series of minor measures (totaling €1.3 billion).

Law 243/2004 reforming the pension system empowered the Government to introduce measures to sustain supplementary private pension plans, in particular by providing incentives to use employee severance pay funds for retirement benefit purposes.

The Finance Bill institutes, for the years 2006-10, a State-financed guarantee fund to ensure firms' access to bank credit in exchange for the transfer of severance pay provisions to pension funds. The endowment of the guarantee fund for 2006 is set at €154 million.

Firms will also be partly exonerated from social security contributions, with relief in 2006 amounting to 0.12 per cent of the earnings of workers who opt to transfer their severance pay entitlements to pension funds, reducing revenues by an estimated €46 million. The relief increases gradually to 0.28 per cent of earnings in 2014.

5.2 Revenue

The increase in taxes and social security contributions of €4.7 billion will be partially offset by reliefs of €3.3 billion, bringing the net increase to €1.4 billion. The reliefs consist in a permanent reduction of 1 per cent in the social contribution rate and the extension to 2006 of temporary reliefs accorded in previous years.

The permanent relief applies first of all to the contribution rate for family allowances; and if this is lower than 1 percentage point, the relief is extended to maternity and unemployment contribution rates.

The extensions of the temporary tax reliefs concern: a) the reduction of excise taxes on some energy products used for specific purposes; b) the subsidized tax regime for agriculture; and c) the direct and indirect tax reliefs for building renovation works.

Of the €4.7 billion of additional revenue, more than two thirds will be paid by firms, and nearly half of that will come from temporary measures. Taxes on the income of banks and insurance companies are increased, as are taxes on the owners of energy transmission networks. The provisions concerning the revaluation of corporate assets are renewed. And there are measures concerning the fiscal treatment of gaming, tax collection methods and the fight against tax evasion.

For credit and financial institutions, the increase in taxation stems from a reduction in the yearly deductibility for loan write-downs and allocations to loan loss provisions (from 0.6 to 0.4 per cent of the total value of loan assets entered in the balance sheet, including value adjustments); it is estimated that this change will increase revenues by €1.1 billion in 2006. For insurance companies, the fiscal treatment of allocations to reserves for claims in the casualty segment is modified (€0.2 billion). And for all firms the taxation of fixed-asset rental and financial income is revised (€0.1 billion). These rule changes are to be permanent, but a part of the expected revenue increase for 2006 will be temporary (€0.5 billion), in connection with the procedures for the payment of self-assessed taxes.

For companies owning major electricity and methane gas networks the Finance Bill introduces a surtax as of 1 January 2006 that is in addition to the charges and taxes they already pay for the use of public land. The related provisions are nonetheless currently in the process of being amended.

Lastly, firms can take advantage of the introduction of new time limits for the revaluation of some items of their 2004 balance sheets against payment of a tax. This measure is expected to generate €0.9 billion of temporary revenue.

Measures concerning the taxation of gambling are expected to raise €0.6 billion of additional revenue. Revenue recoveries amounting to about €0.3 billion should come from a reform of the system for the collection of the revenue of central government and other public entities which will transfer this activity from private-sector companies to a company limited by shares in public ownership; another €0.3 billion should come from stepping up the fight against evasion by increasing the number of staff assigned and involving the municipalities.

To conclude, the budget introduces measures of a fiscal, administrative and financial nature intended to foster the activity of industrial, service, tourist and agricultural development districts, to be identified through the enactment of suitable provisions.

6. Assessment of the budget

The difficulties Italy is facing have their roots in factors of a structural nature that hold back improvements in labour productivity and the competitiveness of the economy. A lasting adjustment of the public finances will be very hard to achieve in conditions of only limited economic growth. The rehabilitation of the public finances must be coupled with an economic policy aimed at enhancing the prospects of growth.

The size of the adjustment in net borrowing provided for in the budget for 2006, equal to €11.5 billion, takes account of the cyclical situation of the economy, in which the recovery has not yet fully taken hold.

The effort to include measures in the budget designed to support economic activity and foster growth is to be judged positively.

In order to give confidence to households, firms and financial institutions, it is important that next year's objective for net borrowing of 3.8 per cent of GDP be achieved, and that a start be made on improving the balance further in the following years, as indicated in the Economic and Financial Planning Document.

The performance of the public finances must be monitored continuously during the year in order to ensure the objectives are achieved.

In the last twenty years the cyclically-adjusted primary surplus was frequently smaller than that derived from the forecasts on a current programmes basis made the previous year and from the budget estimates included in official documents. In the three years 2002-04 the divergence averaged one percentage point of GDP and appears set to recur this year.

The budget is based prevalently on expenditure cuts. This meets the need to avoid increases in the ratio of taxes and social security contributions to GDP in a situation marked by a fall in the competitiveness of the productive system. The savings called for should encourage greater efficiency in the provision of public services.

As mentioned earlier, €6.1 billion of expenditure savings concern local authorities. These account for 43 per cent of general government wages and salaries and for 73 per cent of the sector's spending on intermediate consumption.

In recent years the growth in primary current expenditure has been especially pronounced for local government. In the five years 1993-97 the annual increase in this sector's expenditure averaged 0.5 per cent in real terms, which was less than for general government as a whole (0.7 per cent). In the period that followed, local government expenditure grew significantly faster than that of general *government: in the four years 1998-2001 the annual increase in local government primary current expenditure averaged 4.1 per cent, which was almost twice the figure for general government as a whole. In the three years 2002-04 the figures were respectively 3.3 and 2.2 per cent.*

The instruments for monitoring disbursements at local level must be strengthened in view of the less timely availability of information on this sector; implementing the General Government Transactions Information System can help to achieve this objective.

Looking ahead, the caps on the expenditure of local authorities will need to be flanked and ultimately replaced by permanent budgetary constraints that provide certainty as to the resources available and are based on the correspondence between responsibility for revenue raising and responsibility for expenditure.

A decentralized system produces tangible benefits in terms of the allocation of resources if it can combine local authorities' spending powers with a real self-financing capability. In the last few years the right to vary the rates of the regional tax on productive activities and the income surtax has been restricted by statute law, thereby further compressing local authorities' limited scope for raising revenue. The domestic stability pact, originally introduced to involve local government in achieving the public finance objectives fixed at European level, has been turned into an instrument for controlling local expenditure; the repeated amendments have eroded its credibility.

The budget does not provide for the reduction of the regional tax on productive activities announced in the Economic and Financial Planning Document or for the implementation of the third stage of the reform of personal income tax. The available resources are appropriately concentrated on labour-related reliefs, through reductions in social security contributions totaling €2 billion. In large part they are to be financed by increasing the taxation of the service sector.

One budget measure is intended to foster economic activity through the creation of a Fund for innovation, growth and employment. In the present phase of weak economic growth this choice appears appropriate. Appropriations are subject to the raising of resources through sales of property, in addition to those included in the estimation of net borrowing on a current programmes basis. In order for the planned interventions to produce their effects for a significant part of next year, the necessary formalities will have to be set in motion as soon as possible.

The measures to encourage the development of supplementary pension schemes can contribute to the growth of the funded component; the implementing provisions of the enabling law must be approved.

7. Conclusions

Italian budgetary policy must still travel a difficult road.

Half the difference between the objective of 2.7 per cent of GDP established for net borrowing when the finance bill for 2005 was presented and the result of 4.3 per cent now projected is due to the worse-than-expected performance of the economy. The rest reflects the insufficient effectiveness of the measures, albeit important, to curb expenditure and of those intended to ensure “revenue maintenance”. Most of the property sales, originally forecast at €7.1 billion, have still to be made.

The ratio of debt to GDP is set to rise, reversing the downward trend of the last ten years.

The budget for 2006 is intended to reduce net borrowing on a current programmes basis from 4.7 to 3.8 per cent of GDP, the figure agreed at European level. With the help of property sales and privatizations the debt ratio should be brought down to 107.4 per cent, from the 108.2 per cent expected this year.

The budget seeks to reconcile adjusting the public finances with relaunching the economy.

The correction of the deficit on a current programmes basis is entrusted primarily to spending cuts. It impinges on both central and local government.

Primary current expenditure, excluding the effects of the expansionary measures, is expected to remain basically unchanged in nominal terms compared with 2005; excluding the pensions component, expenditure must be reduced by more than 1.5 per cent in nominal terms to achieve the objectives.

The intention for central government is to make cuts primarily in intermediate consumption and transfers to firms.

For local government, in the first place there is a decrease in the resources allocated to health services; for the other main expenditure items a significant reduction is required in nominal terms compared with 2004.

The results of expenditure measures have usually fallen short of what was planned. Achieving savings in the health sector has proved particularly difficult; expenditure overshoots have occurred regularly and led to the need for settlements of past debts.

In view of the experience of the last few years, it is essential that the performance of the accounts be monitored during the year to ensure it is in line with the objectives.

If the curbs on expenditure are to be fully effective, at both central and local level, all the administrations involved will have to collaborate in order to achieve the planned savings.

While safeguarding the level of public services, *inter alia* by establishing a scale of priorities, there exist margins for increasing the efficiency and cost-effectiveness with which resources are used.

The reduction in expenditure should be of a structural nature.

In line with the agreements concluded at European level, the budget provides for a significant reduction in the recourse to measures of a temporary nature. It is necessary to ensure that one-off measures that reduce the deficit do not exceed those that increase it.

The lowering of the cost of labour, an important aspect of the budget, provides immediate support to industry. Implementing the fund for the revival of the Lisbon Agenda and the measures in support of development districts, which are also innovative from the legal standpoint, can contribute to improving the economy’s competitiveness.

In a medium-term perspective only a higher rate of GDP growth and the return to a sizable primary surplus can make it possible to bring down the debt and cope with the impact on the public finances of the unfavourable demographic outlook.

It is necessary to continue the structural reforms of the main expenditure items in order to reinforce the intervention strategies indicated in the budget.

Public finances that have been restored to a sound footing will allow the budget to be used for stabilization purposes and for policies to overcome regional disparities.

The implementation of territorial decentralization, on the basis of a clear division of tasks between the various levels of government and a closer link between spending and revenue-raising responsibilities, can contribute to the indispensable recovery of efficiency in the public sector.

The size and impact of the budget require that the firm political will of the Government and Parliament be matched by a corresponding commitment on the part of central and local administrations.

The fundamental objectives for the public finances in a medium-term perspective, in which the budget for 2006 must be set, remain to reduce the fiscal burden on the productive sector, increase investment in human capital and infrastructure, strengthen research and reform the apparatus of government.

Tables and Figures

UNCONSOLIDATED CENTRAL GOVERNMENT BORROWING REQUIREMENT

(millions of euros)

	Year			*First 8 months*		
	2002	2003	2004	2003	2004	2005 (1)
Net borrowing requirement net of debt settlements and privatization receipts	**32,341**	**22,183**	**50,638**	**35,789**	**47,542**	**55,802**
Debt settlements	5,328	8,537	533	4,437	211	148
- in securities	*1*	*575*	*2*	*573*	*2*	*11*
- in cash	*5,326*	*7,961*	*531*	*3,865*	*209*	*138*
Privatization receipts	(1,929)	(16,855)	(7,673)	(1)	(15)	(4,025)
Total borrowing requirement	**35,740**	**13,865**	**43,498**	**40,226**	**47,738**	**51,925**
FINANCING						
Currency and deposits (2)	14,548	-38,593	17,112	11,166	16,082	16,129
- of which: PO funds	11,496	-64,806	-1,688	7,717	-545	-1,257
Short-term securities	-430	6,083	-924	25,641	26,700	20,548
Medium and long-term securities	26,271	19,215	36,196	27,072	45,562	47,952
MFI loans	-2,890	-4,825	-2,350	-3,147	-2,896	59
Other transactions (3)	-1,759	31,984	-6,536	-20,507	-37,709	-32,763
- of which: deposits with the Bank of Italy	284	8,022	-2,578	-19,257	-34,545	-30,467
Memorandum item : Foreign borrowings	3,448	4,135	2,314	9,724	5,647	3,770

Memorandum item: Net borrowing requirement of the state sector (4)	31,009	46,419	50,119	33,701	45,451	49,108

(1) Provisional data.

(2) Post Office funds, currency in circulation and deposits with the Treasury of entities not included in general government.

(3) Deposits with the Bank of Italy, securitizations and loans from Cassa Depositi e Prestiti S.p.A. to central government.

(4) Sources: *Relazione Trimestrale di Cassa* and Ministry for the Economy and Finance press releases.

Table 2

GENERAL GOVERNMENT BORROWING REQUIREMENT

(millions of euros)

	Year			First 8 months		
	2002	2003	2004	2003	2004	2005 (1)
Net borrowing requirement net of debt settlements and privatization receipts	**38,189**	**47,602**	**56,424**	**37,085**	**51,570**	**59,984**
Debt settlements	5,328	8,537	533	4,437	211	148
- in securities	*1*	*575*	*2*	*573*	*2*	*11*
- in cash	*5,326*	*7,961*	*531*	*3,865*	*209*	*138*
Privatization receipts	(1,929)	(16,855)	(7,673)	(1)	(15)	(4,025)
Total borrowing requirement	**41,588**	**39,283**	**49,284**	**41,522**	**51,766**	**56,107**
FINANCING						
Currency and deposits (2)	14,548	-38,593	17,112	11,166	16,082	16,129
- of which: PO funds	11,496	-64,806	-1,688	7,717	-545	-1,257
Short-term securities	-372	6,057	-998	25,687	26,623	20,501
Medium and long-term securities	31,705	23,065	41,513	27,139	46,294	49,294
MFI loans	-2,747	-5,660	-1,670	-3,868	-911	717
Other transactions (3)	-1,545	54,414	-6,673	-18,602	-36,322	-30,534
- of which: deposits with the Bank of Italy	284	8,022	-2,578	-19,257	-34,545	-30,467
Memorandum item: Foreign borrowings	7,615	6,807	4,798	10,532	5,642	5,147

(1) Provisional data.
(2) Post Office funds, currency in circulation and deposits with the Treasury of entities not included in general government.
(3) Deposits with the Bank of Italy, securitizations and loans from Cassa Depositi e Prestiti S.p.A. to central government.

ESTIMATED EFFECTS OF THE BUDGET ON THE GENERAL GOVERNMENT CONSOLIDATED ACCOUNTS (1)

Table 3

(millions of euros)

REVENUE	
Increase in revenue	**4,670**
Measures concerning tax bases [2]	1,480
Changes to the rules on financial capital gains and losses	*40*
Changes to the Ires and Irap tax bases for banks and insurance companies	*1,340*
Taxation of corporate rental income from property	*100*
Taxation of the main energy transmission networks	800
Reintroduction of rules for the revaluation of corporate fixed assets	910
Tax regime for gaming	600
Reform and strengthening of tax collection activity	320
Fight against tax evasion [2]	300
Updating of sanctions	100
Other [2]	160
Decrease in revenue	**-3,310**
Social security contributions relief [2]	-2,000
Extension of partial VAT deductibility for company cars	-220
Extension to 2006 of excise duty and agricultural tax reliefs	-750
Extension of tax relief for building renovation works	-250
Other	-90
NET CHANGE IN REVENUE	**1,360**
EXPENDITURE	
Reduction in expenditure	**-12,630**
Domestic stability pact	-3,120
Health services	-2,500
Public employment	-980
Intermediate consumption	-1,830
Transfers to firms	-2,390
Current transfers	*-1,190*
Capital transfers	*-1,200*
Gross fixed investment	-700
Restrictions on ANAS expenditure	-300
Other [2]	-810
Increase in expenditure	**3,280**
Support for families	1,170
Public employment [2]	600
Social security [2]	310
Increase in outlays under existing legislation	590
Capital expenditure	200
Other	410
Other net effects [3]	**-790**
NET CHANGE IN EXPENDITURE	**-10,140**
TOTAL REDUCTION IN THE PRIMARY BALANCE	**11,500**
Privatization receipts	**3,000**
Measures to boost the economy	**-3,000**
TOTAL REDUCTION IN NET BORROWING [1]	**11,500**

(1) Based on official estimates.
(2) Includes the measures contained in Legislative Decree no. 203 of 30 September.
(3) Includes the effects of the changes introduced in the tables attached to the Finance Bill.

Table 4

BUDGET FORECASTS IN THE ECONOMIC AND FINANCIAL PLANNING DOCUMENTS FOR 2006-09 AND 2005-08

(as a percentage of GDP)

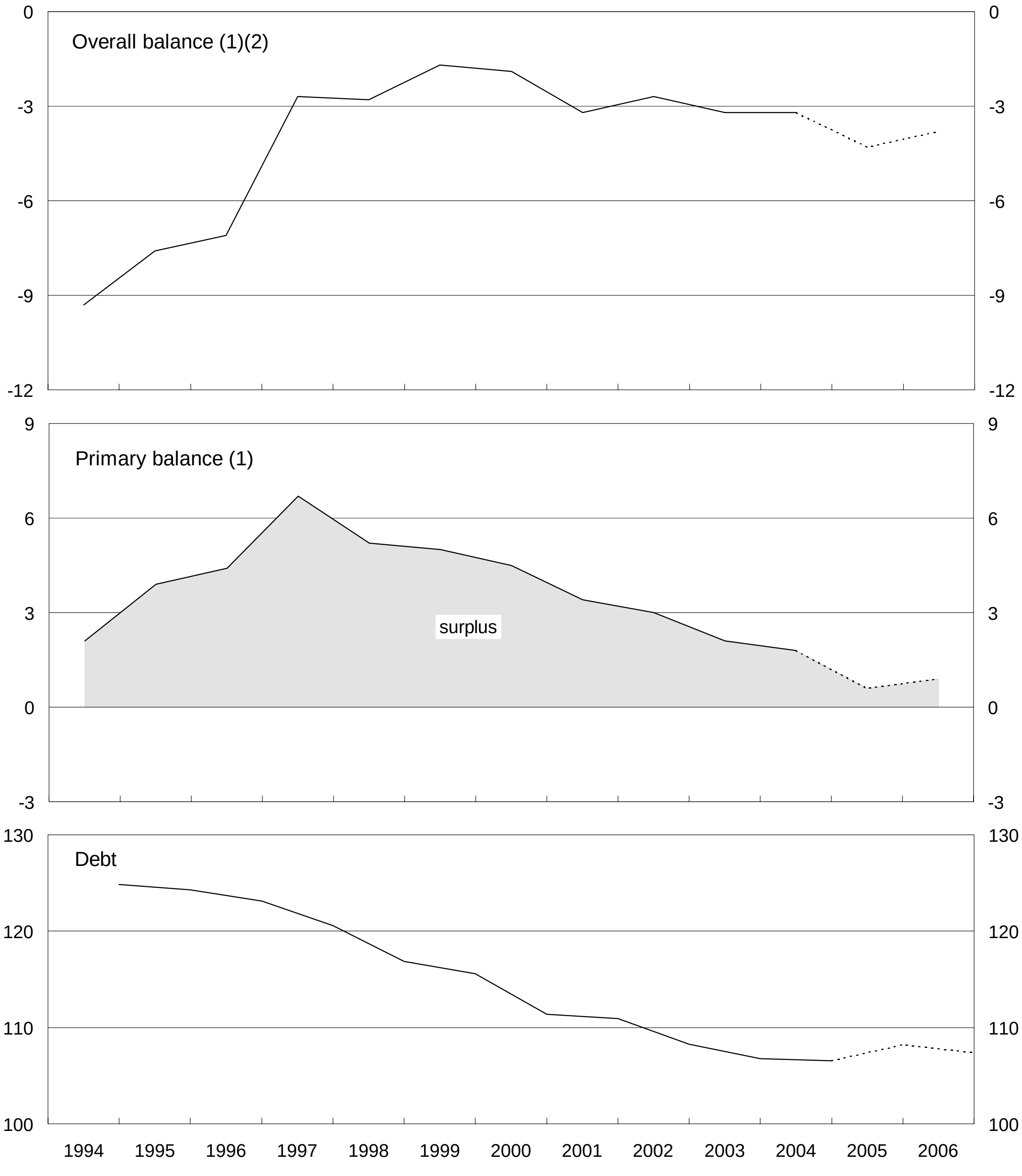
	2004	2005			2006			2007			2008			2009
	Outturn	EFPD 2005-2008		EFPD 2006-2009	EFPD 2005-2008		EFPD 2006-2009	EFPD 2005-2008		EFPD 2006-2009	EFPD 2005-2008		EFPD 2006-2009	EFPD 2006-2009
		July	Sept.(1)		July	Sept.(1)		July	Sept.(1)		July	Sept.(1)		
Net borrowing	3.2	2.7	2.7	4.3	2.2	2.0	3.8	1.7	1.4	2.8	1.2	0.9	2.1	1.5
Primary surplus	1.8	2.6	2.4	0.6	3.3	3.3	0.9	4.0	4.0	1.8	4.8	4.7	2.5	3.0
Interest payments	5.1	5.3	5.1	4.9	5.5	5.3	4.7	5.7	5.4	4.6	6.0	5.6	4.6	4.5
Debt	106.5	104.1	104.1	108.2	101.9	101.9	107.4	99.3	99.2	105.2	98.1	98.0	103.6	100.9

(1) Update of the Economic and Forecasting Planning Document for 2005-2008, presented by the Prime Minister and the Minister for the Economy and Finance on 29 September 2004.

Figure 1

GENERAL GOVERNMENT OVERALL BALANCE, PRIMARY BALANCE AND DEBT

(as a percentage of GDP)



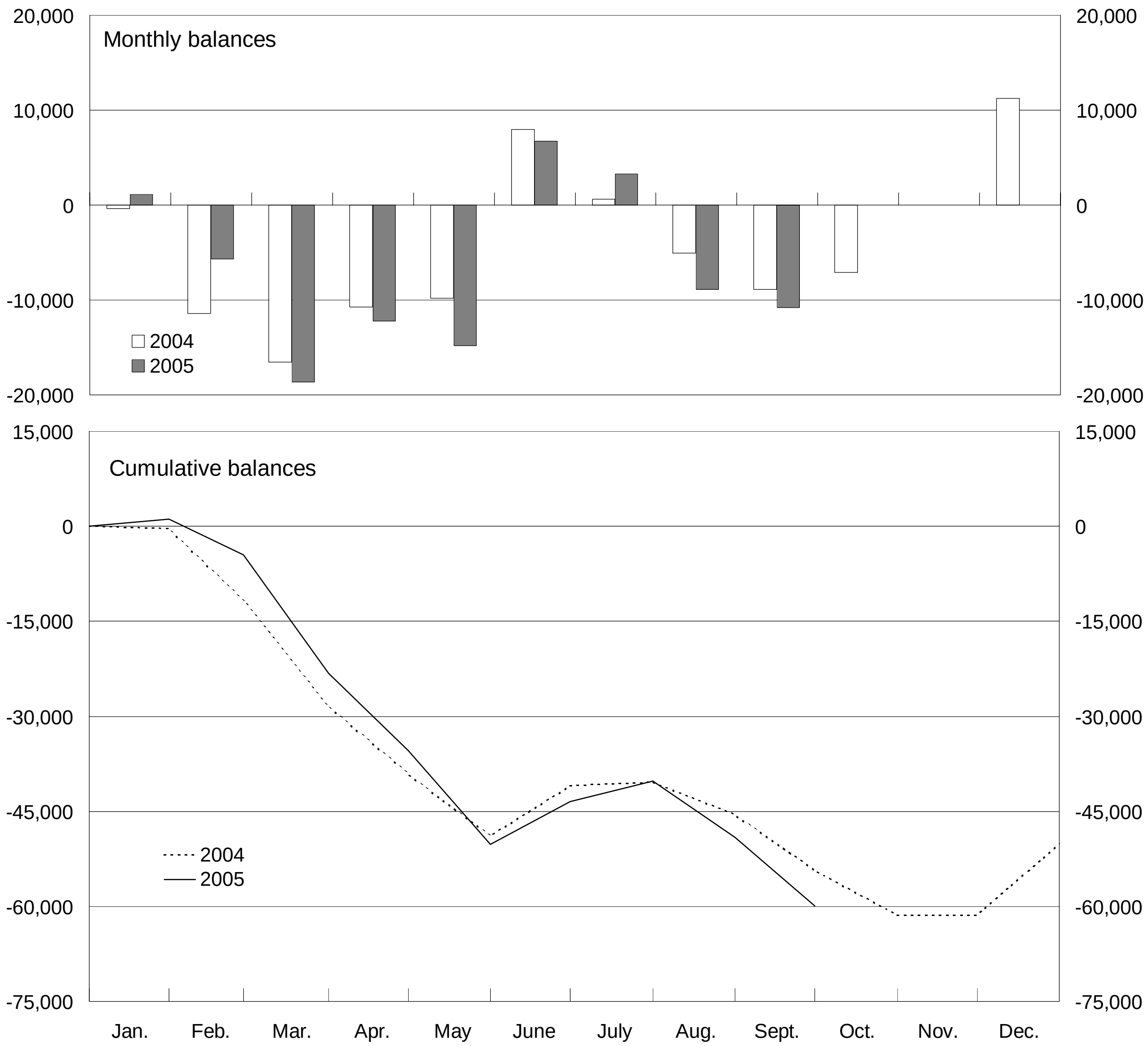
Sources: Based on Istat data and Bank of Italy data for the debt. For the years 2005 and 2006, Economic and Financial Planning Document for 2006-09.

(1) Excludes the proceeds of the sale of UMTS licences.
(2) Includes the effects of swaps and forward rate agreements.

Figure 2

MONTHLY PROFILE OF THE STATE SECTOR BORROWING REQUIREMENT IN 2004 AND 2005 (1)

(millions of euros)



Sources: *Relazione Trimestrale di Cassa* and Ministry for the Economy and Finance press releases.

(1) Excludes privatization receipts and settlements of past debts. A plus sign indicates a surplus, a minus sign a deficit.

Figure 3

GENERAL GOVERNMENT REVENUE, SOCIAL SERVICES EXPENDITURE AND GROSS INVESTMENT

(as a percentage of GDP)

Source: Based on Istat data.

(1) Includes social services in money and in kind.
(2) This item includes the proceeds of sales of public property with a negative sign.