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**Fact-finding preliminary to the
examination of the Economic and Financial Planning Document
for the years 2010-13**

Testimony of the Governor of the Bank of Italy
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Economic policy is contending with the most severe recession since the Second World War. In 2009 Italy's GDP will contract by more than 5 per cent. According to the macroeconomic scenario presented in the Economic and Financial Planning Document only in 2013 will economic activity return to its 2007 level.

The Government has taken steps to attenuate the effects of the recession on firms and workers. New measures are in the process of being approved. In Italy fiscal action is constrained as far as the deficit is concerned, but not in terms of the composition of the budget, by the high and rising level of the public debt.

In view of the sharp drop in revenue, this year's deficit will exceed 5 per cent of GDP. Public expenditure will reach very high levels.

The Planning Document sets the dual objective of strengthening the capacity of the economy to grow and consolidating the public finances. It is important to lay the basis immediately for achieving these results. This would also increase the scope for a more vigorous economic policy.

The measures announced for pensions and the plans for reform of general government go in this direction. The manner of implementing fiscal federalism will be crucial for a more effective management of resources. A comprehensive set of reforms must be drawn up with the aim of strengthening the country's physical and human capital.

Tax and social security receipts are still high in relation to GDP, close to the peak values of recent decades. Progress in curbing current expenditure and fighting tax evasion is of fundamental importance to allow labour and corporate tax rates to be reduced in the medium term.

1. The state of the public finances

After two favourable years for the public finances, the situation worsened in 2008

After two years of gradual improvement, the situation of the public finances worsened markedly in 2008. Net borrowing began to grow again, rising from 1.5 to 2.7 per cent of GDP. The ratio of the debt to GDP increased by more than 2 points, to 105.7 per cent.

The deterioration in the balance was due mainly to tax reliefs, the lapsing of some factors that had sustained tax receipts in the two previous years, and the high rate of growth (4.5 per cent) in primary current expenditure, which accelerated with respect to 2007 and outpaced nominal GDP by a considerable margin.

The impact of the business cycle on the accounts was curbed in 2008 by the relatively favourable performance of employment and earnings. The effects of the crisis are expected to be more pronounced this year and in 2010.

A further sharp deterioration in the public finances is expected in 2009

According to the estimates in the Economic and Financial Planning Document for 2010-13, this year net borrowing will rise by 2.6 percentage points, to 5.3 per cent of GDP. The public debt is projected to grow by nearly 10 percentage points, to 115.3 per cent. The Planning Document indicates that GDP will decline by 5.2 per cent. These estimates are in line with those included in the forecasts recently presented in the Bank of Italy's *Economic Bulletin*.

The new estimate of the deficit is 0.7 percentage points higher than the one given in the Combined Report on the Economy and Public Finances in April. The worsening mainly reflects the expectation of a larger contraction in GDP, which was forecast at 4.2 per cent in April, and the increase in the appropriations made with the mid-year budget revision.

Structural net borrowing is estimated at 3.1 per cent of GDP.

For the first time in 18 years, a primary deficit is projected, equal to 0.4 per cent of GDP.

Primary current expenditure is up sharply in relation to GDP

Primary current expenditure is expected to increase from 40.4 to 43.4 per cent of GDP, a historic peak around six percentage points higher than the figures recorded at the end of the 1990s. Less than a quarter of the forecast increase this year is due to the expansion of expenditure for income stabilizers and to the effects of the measures to support the economy, which will tend to be reabsorbed in the coming years.

Capital expenditure is forecast to show a steep increase in nominal terms of more than 15 per cent (equal to 6.3 per cent for the investment component alone, excluding the increment connected with the repurchase of the properties securitized in 2002). Between 2005 and 2008 capital expenditure had remained broadly stable, while the investment component had fallen by nearly 2 per cent (net of real-estate disposals). The forecast therefore assumes that the pronounced acceleration in outlays estimated by Istat for the first quarter will continue for the rest of the year.

The unfavourable cyclical situation is expected to lead to a contraction of 1.2 per cent in revenue, with a more marked drop in tax receipts. Indirect tax receipts are expected to fall by 3.8 per cent and direct tax receipts by 1.5 per cent. Tax and social security receipts are projected to rise by 0.6 percentage points, to 43.4 per cent of GDP.

The expected worsening of the public finances is borne out by the interim data currently available.

In the first few months of 2009 the borrowing requirement was far larger than in the same period of 2008

Net borrowing amounted to 9.3 per cent of GDP in the first quarter of 2009, compared with 5.7 per cent in the corresponding period of 2008. In the first five months of this year the general government borrowing requirement came to €57.4 billion, more than €19 billion higher than in the same period of 2008.

The worsening of the borrowing requirement reflected the contraction in tax and social security receipts and the significant growth in primary expenditure, which was affected by the Government's decision to speed up tax refunds in order to assist firms and by the repurchasing of properties that had been disposed of with securitizations in 2002 (€7 billion in total).

Tax revenue recorded on a cash basis in the state budget fell by 3.3 per cent in the first six months of the year compared with the same period of 2008, mainly owing to the steep decline in receipts from VAT (-11.3 per cent) and other business taxes (-9.2 per cent).

In 2008 VAT receipts had already diminished by 1.5 per cent, against an increase of 2.3 per cent in household consumption, the macroeconomic variable that best approximates the VAT tax base. VAT receipts have continued to fall this year: they were down by 10.2 per cent in the first quarter from a year earlier (and by 12.1 per cent in the second quarter), while consumption fell by 2.6 per cent. Only part of this gap appears to have been due to a shift in the composition of consumption towards essential goods, which are taxed at lower rates.

In the first half of 2009 receipts of personal income tax on payroll employment decreased by only 0.7 per cent, benefiting from the relatively favourable performance of per capita earnings.

Including receipts recorded in the first half of July, self-assessed taxes can be estimated to have grown by approximately €2 billion with respect to the corresponding period of 2008. The increase reflects the higher-than-expected receipts from the one-off substitute taxes introduced with the Finance Law for 2008 and the anti-crisis decree of last November (more than €6 billion in total). Net of these items, there was a significant fall in corporate income tax. It should be noted that whereas the receipts from the one-off taxes have basically run their course, the contraction in corporate income tax points to a fall in receipts from the second payment on account at the end of the year.

2. Fiscal policy's response to the crisis

Countries have responded to the severity of the crisis with discretionary policies to sustain the economy

The severity of the crisis has created a vast consensus at international level on the need to accompany automatic stabilizers and monetary policy with discretionary countercyclical budgetary policy interventions.

In Italy, however, the high level of the public debt limits the scope for increasing the deficit. It remains possible to act through changes in the composition of the budget.

It needs to be stressed that the sensitivity of the yields on public debt securities to the conditions of the public finances (deficit and debt) tends to increase in periods of turbulence on the financial markets: the yield differential between ten-year Italian and German government securities widened in the second half of 2008 to more than 150 basis points and is still very considerable, of the order of 100 basis points.

In the future, various factors will tend to increase the average cost of the public debt: the substantial recourse to the market by governments to fund measures for supporting the economy, the recovery of economic activity, and fears of a rise in inflation.

In Italy, the use of the budget for anti-cyclical purposes has aimed above all, including via administrative channels, to speed up the employment of resources already allocated and direct them in order to support aggregate demand and mitigate the social costs of the recession.

The interventions

The response to the crisis has consisted primarily in three decree laws, which together appropriated €25 billion of resources for the three years 2009-11 (of which €17 billion

funded by increasing revenue), and in the draft mid-year budget revision. Budgetary action came on top of measures aimed at guaranteeing the stability of the financial system and alleviating firms' liquidity problems.

In November 2008 a first package was approved. In addition to several tax reliefs for firms, the package introduced transfer payments to low-income households (known as the family bonus, which supplemented the social card scheme launched during the previous summer); automatic income stabilizers were strengthened for the two years 2009-10 (a measure funded with national and EU funds on the basis of a State-Regions agreement); there were increases in the allocations for investment in public works and in investment grants to the State Railways group (in part to offset previous cutbacks), in conjunction with the adoption of new procedures to speed up the realization of projects included within the National Strategic Reference Framework.

A second measure issued last February dealt mainly with incentives for the purchase of cars.

At the beginning of July a third decree law introduced tax incentives for investment in machinery between July 2009 and June 2010, through the exclusion from firms' income of half the expenditure.

Tax benefits for new investment had already been introduced in 1994 and 2001. Unlike the more recent measure, these envisaged the exclusion from firms' income of half the investment in equipment and capital goods made over and above the average for the previous five years (in 2001 it was possible to exclude the year in which most investment was made from the calculation of the average). Only investment in machinery included in division 28 of the ATECO classification qualifies for the new incentive, while previously property and cars were also included.

July's measure also raised the limits set on the deductibility of credit writedowns and allocations to risk provisions for banks. Firms benefited from the introduction of accelerated depreciation for technologically advanced goods; the details of the intervention will be defined in a decree to be issued before the end of the year. The decree law also introduced a series of measures designed to curb the cost of bank commissions, reduce the cost of energy for firms and households, and ensure greater timeliness in the general government payments system.

Moreover, the decree law further expanded automatic income stabilizers for the two years 2009-10.

In the first quarter of this year, the number of hours worked fell by 3.8 per cent compared with the previous year, a more pronounced decline than that in employment (1 per cent), partly the effect of the slowdown in productive activity and widespread recourse to the Wage Supplementation Fund, which more than tripled overall compared with the first three months of 2008. The number of hours of wage supplementation authorized increased further in the second quarter, by 60 per cent on the previous

period. Among those worst hit by the crisis were temporary workers, whose fixed-term or collaboration contracts were not renewed. According to Istat's survey of the labour force, in the first quarter of 2009 the number of fixed-term, collaboration or project workers was about 260,000 lower than a year earlier, against a slight rise in the number of permanent employees.

Finally, the draft mid-year budget revision increases the resources available for general government with the objective of reducing delays in payments to firms.

Compared with the budget presented last September allocations on a cash basis increased by €18 billion; those on an accrual basis by about €5 billion.

The funding of the anti-crisis measures

The expansionary measures contained in the three anti-crisis decrees are all funded within the respective provisions.

The costs associated with the November decree are covered by increases in revenue, half of which derive from the introduction of several substitute taxes on voluntary asset revaluations and, to a lesser degree, from a reduction in expenditure; those relating to the measures in the February decree are covered by the revocation of a number of tax reliefs and with increased revenue as a consequence of the growth in demand for durable goods, which the purchasing incentives are expected to deliver. Finally, the costs of the July decree are covered by new legislation to combat tax evasion, the intensification of tax collection activities, the tightening of the requirements for offsetting tax credits, and specific laws on the gaming sector and savings in the pharmaceutical sector.

A decree law in favour of the population hit by the earthquake in Abruzzo was ratified in June.

The immediate aim of the legislation is to tackle the emergency and in the longer term the objective is to finance reconstruction activity through 2032, by means of grants and state guarantees; compensation for firms is also envisaged. For the part of the plan that is explicitly quantified, the impact on net borrowing in the three years 2009-11 is virtually nil. The funding of the interventions is assured by the increase in revenue deriving from a broadening of the range of gaming activities offered to the public and a tightening of controls in the sector, from further savings in pharmaceutical expenditure and a decrease in the use of the fund for family bonuses. In the two years 2010-11 the interventions will draw mainly on funds set up for other purposes.

A rough indication of the level of support to aggregate demand expected from government interventions can be made by comparing the current estimates on expenditure in 2009 and those in last September's Government Forecasting and Planning Report. In particular, investment expenditure is now expected to increase by 6.3 per cent compared with 2008 (excluding, for uniformity of comparison, repurchases of real estate securitized in the SCIP2 operation in 2002), while in September's Report it remained unvaried; this revision corresponds to 0.1 percentage points of GDP. For expenditure on intermediate goods the upward revision is around 0.3 percentage points of GDP.

The housing plan defined in the agreement reached on 31 March 2008 between the Government, Regions, and local authorities will mobilize private savings and contribute to the recovery of investment. The agreement will be enacted fully in each of the Regions; in several cases draft laws are already in the process of being approved.

Amongst other things, the plan allows owners to increase the size of one- and two-family residential buildings by up to 20 per cent, provided these do not already exceed 1,000 cubic metres and excluding unauthorized buildings or those situated in historic centres or in areas subject to a general building ban. The derogations will remain in place for a limited time and in any event not exceed 18 months.

Other interventions concerned the Cassa Depositi e Prestiti and SACE, the export credit insurance agency. Although they have no impact on the public finances, these measures increase the liquidity available to firms, especially to small- and medium-sized enterprises. The guarantee fund for these firms was also increased.

In particular, the Cassa Depositi e Prestiti will be able to employ up to a maximum of €8 billion in resources derived from postal savings to provide credit to small- and medium-sized enterprises; SACE will be able to provide guarantees to businesses on general government receivables.

Last autumn and at the beginning of 2009 steps were also taken to guarantee the stability of the financial system. These made available to the Government a series of instruments aimed at protecting investors and maintaining adequate levels of capitalization and liquidity for banks. There is also a provision for the State to subscribe financial instruments issued by listed banks that are fundamentally sound; these instruments count as regulatory capital; in April 2009 the Combined Report on the Economy and the Public Finances assumed that the resources employed would amount to around €10 billion; to date issues of about €2 billion are nearing completion.

A description of the steps taken to support the financial sector is contained in the 2008 Annual Report published on 29 May (see Chapter 19: Supervision).

Other measures to guarantee the necessary liquidity to small -and medium-sized enterprises

3. The projections based on current legislation and the objectives set in the Planning Document for 2010-13

The deficit on a current legislation basis is expected to improve in the years 2010-13

In 2010 net borrowing on a current legislation basis is estimated to reach 5 per cent of GDP, slightly lower than in 2009. In 2011 the deficit is forecast to fall to 4.4 per cent and to decline in the following two years, reaching 3.7 per cent in 2013.

The outlook for net borrowing takes account of the marked improvement expected in the primary surplus, equal to an annual average of 0.7 percentage points in the four years from 2010-13, only partially offset by the progressive increase in interest payments as a share of GDP (from 5.1 per cent in 2010 to 6 per cent in 2013).

The expected improvement in the primary surplus is ascribable to the absence of several costs related to the recession, the effects of the three-year adjustment plan launched in the summer of 2008 and the adoption of the current legislation criterion. This criterion excludes a series of disbursements which, even if foreseeable or necessary, have not yet been the object of formal legislation, such as future public employment contracts, the renewal of service contracts and the execution of public works.

Compared with the estimates in the Combined Report, net borrowing on a current legislation basis is revised upwards by 0.4 percentage points in 2010, and by 0.1 per cent in 2011.

For 2010, the deterioration in the budget balance with respect to the estimates made in April is mainly due to the decline in revenues, particularly from social security contributions (-0.2 percentage points of GDP or €2.5 billion) and direct taxes (-0.1 points or €1.7 billion), resulting from the reduction of 0.4 percentage points in the expected level of nominal GDP in 2010. The adjustment of interest expense (-0.1 percentage points, equal to about €1 billion) will offset part of the increase in capital expenditure (0.2 percentage points or €2.4 billion).

The planning scenario

As far as the planning scenario is concerned, the EFPD sets the target for net borrowing in 2010 at the value on a current legislation basis. As explained above, in order to achieve this result it will be necessary to cover the additional expenditure not envisaged in current legislation.

In the years that follow, the targets for the deficit are below the values on a current legislation basis, by 0.4 points in 2011 and by around 1.2 points in 2012 and 2013. At the end of the planning period, the target for net borrowing is set at 2.4 per cent of GDP. The primary balance is expected to improve by 0.6 percentage points of GDP in 2010, reaching a surplus of 0.2 points, and by 3.3 points over the following three years.

The EFPD does not give details of the planning scenario

Unlike the previous EFPD, the present planning scenario does not give information on the level or composition of revenues and expenditure. The Document states that on the revenue side the corrective action will tend to reinforce the measures to combat tax evasion and avoidance. On the expenditure side, the aim will be to ensure that the regional health service deficits are rectified and to introduce more efficient methods of disbursing public services.

The lack of information on revenue and expenditure targets makes it difficult to evaluate some critical aspects of the fiscal policy outlined in the EFPD. For example, use of the current legislation basis, among other things, means that the baseline projection indicates a sharp decrease in capital expenditure in 2010. In particular, investment expenditure – after rising by 6.3 per cent in 2009 – is expected to fall by 6.6 per cent (excluding, for 2009, outlays for the repurchase of real estate securitized in 2002), returning to its 2006 value. In a cyclical phase that is likely to remain fragile, this public-sector support of aggregate demand should be maintained.

Structural net borrowing, amounting to 3.1 per cent of GDP in 2009, is projected to improve steadily until 2012 (by around 0.3 percentage points per year) and remain virtually stationary in 2013.

In 2013 less than a third of the recession-related increase in the debt will have been absorbed

The public debt is projected to increase by a further 2.9 percentage points of GDP in 2010 (to 118.2 per cent) before it begins to decline in 2011, reaching 114.1 per cent in 2013. At the end of the planning period, less than a third of the increase in the public debt associated with the recession will have been absorbed.

In the future, in implementation of the bill on public accounting and finances now before Parliament, the EFPD will be replaced by the *Decision on the public finances* as part of a reform that will also affect the timing and content of the documents marking the progress of fiscal policy. The reform should heighten the importance of medium-term considerations in the drafting of fiscal policy.

As far as concerns timing, the bill (as approved by the Senate) provides that the Government must submit the Decision on the public finances to Parliament by 20 September of each year. By 15 October the Minister for the Economy and Finance must present a bill before Parliament, called the Stability Bill, which replaces the Finance Bill and the Budget Law. The deadline for the introduction in Parliament of the measures linked to the Stability Bill remains 15 November. The time horizons for policy planning and implementation are also brought closer together: the targets set by the Decision on the public finances must relate at least to the next three-year period; budgetary policy must cover three years.

4. Fiscal policy for the years following the recession

Two objectives for economic policy

The EFPD not only points out the need to maintain the temporary support measures in favour of households and firms, it also assigns fiscal policy two main objectives: ensuring the resumption of progress towards consolidating the public finances, in order to converge towards budgetary balance; and sustaining productivity and economic growth.

According to the framework outlined in the EFPD the next years will see large deficits. Measures to restructure the public finances are planned for 2011 and 2012, once the adverse phase of the cycle is past. No corrective action is envisaged, instead, for 2013, beyond what is needed to finance the expenses not included in current legislation. Macroeconomic conditions permitting, it could be a good year in which to press on with the consolidation measures.

The legacy of the recession for the public finances: a much larger debt

The public debt is expected to diminish in relation to GDP starting in 2011, but – as pointed out earlier – at the end of the planning period less than a third of the increase due to the recession will have been absorbed. The high debt ratio will be one of the most serious consequences of the recession.

According to the EFPD forecasts, the debt will stay below the peak recorded in the mid-1990s. However, it should be pointed out that the quantity of easily liquidated public assets will also be smaller than it was then. During the decade 1995-2004 asset sales and the restructuring of the bonds assigned to the Bank of Italy in 1994 accounted for about 11 percentage points of the reduction in the debt/GDP ratio. These transactions were not carried out in conjunction with structural measures to curb the growth in current expenditure capable of putting the debt back on a steady downward path.

Compared with the 1990s the situation is aggravated by the pressure exerted on the public finances by the ageing of the population: in the mid-1990s the number of over-65 year-olds was equal to about 25 per cent of the population aged 15 to 64, while in 2010 that proportion will reach 31 per cent, rising to 34 per cent in 2015 and 36 per cent in 2020. The public debt is building up again on the eve of the period in which the large post-war generations retire.

The consolidation measures must curb primary current expenditure

Given the magnitude of the adjustment needed to put the public debt permanently back on a downward path, it is essential to draw up programmes with medium-to-long-term structural effects as early as possible. Given the present level of taxation and social

security contributions – high by both historical and international standards – action to consolidate the public finances must rely, as the EFPD also points out, not only on a significant reduction in tax evasion, but also on the containment and reorganization of current expenditure.

The effort to contain outlays must be extremely incisive

The achievement of the target set for the deficit in 2013 (2.4 per cent of GDP) requires an average annual reduction in primary current expenditure of about 1 per cent in real terms in the period 2010-13. This estimate assumes that GDP will grow by 2 per cent per year in 2011-13, in line with the macroeconomic framework of the EFPD; that interest expense and revenue will stay at their baseline levels; and that the ratio of capital expenditure to GDP will hold steady at the value forecast for 2010.

In order to achieve the deficit target for 2013 without affecting social payments (which in this second scenario will stay at their baseline levels), the other primary current expenditure items will need to decrease on average by around 3 per cent annually in real terms.

Efforts to contain outlays in the years to come must therefore be extremely incisive: in the ten years 1999-2008 primary current expenditure recorded an average annual increase of 2.1 per cent in real terms. It should be noted that over the last decade the average growth in expenditure was 1.5 points greater than projected for the following year in the Forecasting and Planning Reports.

In the years after 2013 the rapid curtailment of the debt will continue to be a priority. Unless significant progress is made in reducing current spending, and failing a resumption of growth, there can be no doubt that both the public debt and the incidence of taxation and social security contributions will remain extremely high for a long time to come.

Given the planning scenario adopted in the EFPD up to 2013, assuming the budget deficit is adjusted by about 0.5 percentage points of GDP each year (leading to balance in 2018) and that GDP grows at an annual rate of 1 per cent in real terms (slightly more than the potential growth indicated in the EFPD for 2013) and of 3 per cent in nominal terms, in 2018 the public debt will still equal 107.6 per cent of GDP. Under this scenario, assuming capital expenditure remains stationary at the level forecast for 2010 and that the average cost of the debt and the ratio of revenue to output stay at the values forecast for 2013, in the five-year period 2014-18 primary current spending should remain virtually stationary in real terms.

Assuming that budget balance is achieved in 2015 with GDP growth still at 1 per cent, in 2018 the public debt will amount to 104.5 per cent of GDP. In 2014-15 primary current expenditure will need to decrease on average by around 2 per cent per annum in real terms; in the years after, if budget balance

is maintained, there should be scope to increase current spending in real terms or to reduce the incidence of taxation.

Finally, assuming budget balance in 2015, but assuming a more favourable rate of GDP growth (2 per cent), in 2018 the public debt should fall to just under 100 per cent of GDP. The average annual reduction in current spending in the two years 2014-15 would be about 1 per cent in real terms.

5. The structural policies for consolidation of the public finances and growth

Structural reforms are needed to render the measures efficacious

The measures to contain outlays will have to be of a structural nature and will therefore necessitate a reform of the main public services and a reorganization of general government departments. In some cases this will mean continuing on a course already begun.

The reform of the budget cycle may improve the control of expenditure

The planning and implementation of measures to curb expenditure may benefit from the reform of the budget cycle currently under discussion in Parliament, which might contribute to enhancing the transparency of the public finances and encouraging the adoption of a medium-term approach to fiscal policy.

The bill approved by the Senate specifies the information on the public finances that the key documents of the budget cycle must provide. The following are especially important for planning purposes: the information needed to construct the budget on an unchanged policies basis, the data on planned revenue and expenditure, and the economic policy objectives set for the subsectors of general government.

In the last ten years the targets for the public finances have frequently been missed and the objective of budgetary balance has been repeatedly postponed. This has entailed heavy costs in the management of the present crisis and reduced the scope for budgetary policy action. Strengthening the rules and procedures of the budget is therefore of great importance.

Fiscal federalism must contribute to curbing expenditure

The implementation of fiscal federalism offers an opportunity to make the management of public resources more efficient and to rationalize expenditure, while bearing in mind the principle of solidarity.

The increase in the proportion of local taxes in the financing of local government expenditure in place of central government transfers and the strengthening of fiscal autonomy by allowing changes to tax rates and bases create a closer link between expenditure and revenue decisions and can lead to greater efficiency.

A crucial element of the enabling law passed by Parliament in April is the replacement of the historical cost criterion by that of standard costs and funding requirements for the allocation of resources to local authorities. The calculation of these indicators is subject to technical difficulties that are accentuated by the lack of harmonized budgets at the different levels of government and the large territorial disparities between the levels and quality of public expenditure.

The prompt approval of the so-called Local Government Code is also of crucial importance for the implementation of the enabling law on fiscal federalism. The plan for achieving expenditure savings by rationalizing and simplifying the different levels of government, so as to exploit economies of scale and avoid useless overlapping, appears highly commendable.

The Local Government Code will specify the division of the functions performed by municipalities and provinces, including the identification of those to be considered fundamental for ensuring fiscal equality, reorganize the network of intermediate local authorities (e.g. mountain communities and consortia of municipalities), rationalize the provinces, reorganize the peripheral offices of the ministries, streamline municipal and provincial councils, and rewrite the Domestic Stability Pact.

A significant increase in the average effective retirement age is desirable

In the medium term a significant increase in the average effective retirement age is required. Given the sharp rise in life expectancy, a lengthening of working lives is important in order to match the need to curb public expenditure with the need to ensure an adequate income in old age. If accompanied by measures to make older workers' working hours and earnings more flexible, such a lengthening would also help to increase the labour force participation rate and the economy's potential growth rate. It would allow more resources to be allocated to other forms of social expenditure.

Setting the same retirement age for male and female public-sector workers, which is necessary in order to comply with the judgment of the European Court of Justice, is a step in this direction. Thought will have to be given to completing the reform of the pension system.

The Planning Document raises the forecast for the ratio of pension expenditure to GDP in the period 2010-50, basically to take account of the lower estimates of GDP growth. The increase in the relative importance of the liabilities associated with the pension system is another adverse consequence of the recession.

According to the Planning Document, in 2010 pension expenditure is likely to be 15.5 per cent of GDP, 1.4 percentage points higher than the official estimates released at the beginning of 2008. In the following years the gap between the two sets of forecasts tends to narrow; in 2050 it is 0.7 percentage points of GDP. The sum of the revisions in the next forty years is about 35 percentage points of GDP.

Reduce tax evasion

In the budget on a current legislation basis tax and social security receipts exceed 43 per cent of GDP in 2009 and remain close to 43 per cent over the rest of the forecasting horizon. These values put Italy well above the average of the other euro-area countries and are high compared with the past, 43 per cent having been exceeded on only two occasions, in 1997 and 2007.

The Planning Document gives great importance to the fight against tax evasion. The large scale of the underground economy increases the burden on law-abiding taxpayers, causes distortions and reduces the competitiveness of the majority of firms. These effects may well be more pronounced in the present phase of economic crisis.

As mentioned earlier, a gap has emerged between the rate of growth in VAT receipts and the VAT base. This development needs to be examined with care, not least in view of the reliance some of the measures adopted in the last twelve months have placed on the reduction of tax evasion in order to cover expenditure.

In addition to stepping up audits and sanctions, it is necessary to reduce the areas of evasion by lowering – in the medium term – statutory tax rates, which is to be made possible by curbing expenditure. Stabilizing the legislation on assessments and fostering public intolerance of tax evasion would also help.

Reforms for reviving growth

It is not sufficient to return to the growth rates of recent years, which were extremely low by international standards. There is a need for structural reforms that will put Italian industry in the best possible position to grasp the opportunities that will be offered by the recovery of the world economy. Once the crisis has been overcome, Italy will find itself with its stock of physical and human capital eroded by the fall in investment and the rise in unemployment. The decline in potential GDP growth that could follow is one of the most worrying consequences of the crisis, as the Planning Document also notes.

Increase the efficiency of government departments

In Italy the administrative and bureaucratic costs incurred by businesses are high by international standards. The recent measures adopted in relation to setting up businesses are a move in the right direction, but they need to be strengthened and accompanied by further action to improve the efficiency of public offices. The wide gaps between the performances of different public structures are evidence of the scope for large efficiency gains for firms if every office adopted the best practices.

The bureaucratic formalities the productive sector must comply with affect many aspects of firms' competitiveness: their birth, size and productivity. The time consumed and the costs incurred in complying with these formalities show wide territorial variations. According to a survey conducted by the Bank of Italy (on the basis of an international comparison carried out by the World Bank), it takes 12 days on average to set up a company in the "fastest" area and more than 27 in the "slowest" area; the costs range from 13 per cent of per capita income to nearly 30 per cent. The recent reforms have significantly reduced these times, with the greatest improvements taking place in the slowest areas. Large territorial differences were also found in the case of the procedures for obtaining building permits and the transfer of real estate.

Improve the quality and effectiveness of government action

The recent reform of general government is marked by the scale of the intervention and the importance of the principles upon which it is based: transparency, linking earnings and performance, and benchmarking for the control of results. The effect on the quality of government action will depend, however, on how these principles are applied in practice.

Important factors will include the autonomy, organizational and otherwise, of the Assessment Committee and the actual independence of the assessment bodies from the departments they belong to. The major difficulties encountered in measuring the output of the public sector will have to be overcome.

Modernize schools and universities

It is necessary to continue with the renovation of the school and university systems. Independence and assessment are the key principles. As is also stressed in the annexes to the Planning Document, the strategy for intervention in this field must aim at enhancing the value of human resources, recognizing merit and excellence, and curbing expenditure.

Last year saw the inclusion in the Italian middle school final exam of a written exam that is the same across the whole country; it supplements the other tests and teacher assessments. The curricula of high schools have been revised. The reform of the technical institutes – which will come fully into force in 2010 – will permit a closer interaction between schools and the productive sector, as a result of the increased importance assigned to scientific and technological subjects and English, and the introduction of organizational models that facilitate training carried out in collaboration with firms. At university level, the allocation of resources is made more efficient by implementing the criteria previously announced, which reward the quality of research and teaching.

Eliminate the fragmentation of worker protection

The Government's anti-crisis measures have appropriately aimed at preventing the interruption of employment relationships and introduced experimental income-support solutions for some less protected workers. There nonetheless remains a need for a comprehensive reform of Italy's system of automatic stabilizers.

The ISAE survey of manufacturing firms shows some initial signs of a halt in the deterioration of the outlook for employment in the second half of the year. However, without a reversal of the trend of industrial production, which, despite remaining stable in the last three months, is about 25 per cent below the peak reached in April 2008, it is possible that not even recourse to the Wage Supplementation Fund, which has so far been extremely effective, will be able to fend off a fall in employment.

A reform of the system of automatic stabilizers for job-seekers that eliminated the present fragmentation of protection – provided it is accompanied by a strengthening of the eligibility checks – would improve the working of the labour market by fostering the reallocation of workers between sectors and firms. Household consumption would also benefit, not only through direct economic support in the event of the loss of a job but also by reducing the need to save in order to cope with unforeseen events.

The Italian economy is grappling with a very severe recession, which follows years of modest growth. The period during which economic conditions grew progressively worse appears to have ended; there are some positive signs. Benefiting from the recovery of the world economy, economic activity should start to expand again during 2010.

Giving support to industry nonetheless remains a priority objective; a structural weakening of the productive system must be avoided. The exit from the market of a large number of firms would reduce the country's potential output and would also impose heavy costs in terms of human capital.

Budgetary policy must continue in the effort to reallocate resources in favour of labour and firms. The immediate definition of structural measures, capable of curbing expenditure and the public debt in the medium term, would increase the scope for more vigorous action to counter the crisis.

A comprehensive strategy of structural reforms, some of which are being implemented and others prepared, can enhance the effectiveness of the action to be taken in the short term, provide certainty to households and firms, and create the conditions for the economy to move to a higher growth path.

Tables and Figures

- Table 1. Main public finance indicators for general government*
- Table 2. General government revenue*
- Table 3. General government expenditure*
- Table 4. General government borrowing requirement*
- Table 5. Current legislation forecasts and Government targets in the Combined Report on the Economy and Public Finances (CREPF) for 2009 and the Economic and Financial Planning Document (EFPD) for 2009-13 and 2010-13*
- Table 6. Effects on the general government consolidated accounts of the anti-crisis measures and the earthquake decree*
- Figure 1. Primary surplus and temporary effects*
- Figure 2. Net borrowing in Italy and the euro area*
- Figure 3. Debt in Italy and the euro area*
- Figure 4. Tax revenue and social security contributions and primary expenditure in Italy and the euro area*
- Figure 5. Average cost of the debt, average gross interest rate on BOTs, and gross yield of 10-year BTPs*
- Figure 6. 10-year yield differentials with respect to Germany*
- Figure 7. Primary surplus: objectives and outturns*
- Figure 8. Twelve-month cumulative borrowing requirement*
- Figure 9. Tax revenue*

Table 1

Main public finance indicators for general government (1) (as a percentage of GDP)										
	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Revenue	46.4	45.4	45.0	44.5	45.1	44.5	44.2	45.8	46.9	46.6
Expenditure (2)	48.1	47.4	48.1	47.4	48.6	48.0	48.5	49.2	48.4	49.3
<i>of which: interest payments</i>	6.6	6.3	6.3	5.5	5.1	4.7	4.6	4.6	5.0	5.1
Primary surplus	4.9	4.3	3.2	2.7	1.6	1.2	0.3	1.3	3.5	2.4
Net borrowing	1.7	2.0	3.1	2.9	3.5	3.5	4.3	3.3	1.5	2.7
Borrowing requirement	1.4	2.2	4.6	2.9	3.0	3.6	4.9	4.0	1.7	3.1
Borrowing requirement net of privatization receipts	3.4	3.5	5.0	3.1	4.2	4.2	5.3	4.0	1.9	3.1
Debt	113.7	109.2	108.8	105.7	104.4	103.8	105.8	106.5	103.5	105.7

Source: For the general government consolidated accounts, based on Istat data.

(1) Rounding may cause discrepancies in totals. – (2) This item includes the proceeds of sales of public real estate with a negative sign. The figure for 2000 does not include the proceeds of the sale of UMTS licences, (1.2 per cent of GDP in 2000). In the national accounts these receipts are deducted from the item "Other capital expenditure".

Table 2

General government revenue (1) (as a percentage of GDP)										
	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Direct taxes	14.9	14.4	14.7	13.9	13.4	13.3	13.3	14.4	15.1	15.4
Indirect taxes	14.9	14.7	14.2	14.3	14.0	14.0	14.2	14.8	14.7	13.7
Capital taxes	0.1	0.1	0.1	0.2	1.3	0.6	0.1	0.0	0.0	0.0
Tax revenue	29.9	29.2	29.0	28.4	28.7	28.0	27.6	29.2	29.8	29.1
Social security contributions	12.5	12.4	12.3	12.5	12.6	12.6	12.8	12.8	13.3	13.7
Tax revenue and social security contributions	42.4	41.6	41.3	40.8	41.4	40.6	40.4	42.0	43.1	42.8
Other current revenue	3.6	3.4	3.5	3.5	3.4	3.6	3.5	3.6	3.5	3.6
Other capital revenue	0.4	0.3	0.2	0.2	0.3	0.3	0.3	0.3	0.3	0.2
Total revenue	46.4	45.4	45.0	44.5	45.1	44.5	44.2	45.8	46.9	46.6

Source: Based on Istat data.

(1) Rounding may cause discrepancies in totals.

Table 3

General government expenditure (1)
(as a percentage of GDP)

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Compensation of employees	10.6	10.4	10.5	10.6	10.8	10.8	11.0	11.0	10.6	10.9
Intermediate consumption	5.0	5.0	5.1	5.2	5.3	5.4	5.5	5.2	5.2	5.4
Social benefits in kind	2.1	2.3	2.5	2.6	2.6	2.7	2.8	2.8	2.7	2.7
Social benefits in cash	16.9	16.4	16.2	16.5	16.8	16.9	17.0	17.0	17.1	17.7
Interest payments	6.6	6.3	6.3	5.5	5.1	4.7	4.6	4.6	5.0	5.1
Other current expenditure	3.1	3.1	3.2	3.3	3.6	3.6	3.6	3.6	3.6	3.7
Total current expenditure	44.2	43.6	43.9	43.8	44.2	44.0	44.4	44.1	44.3	45.5
of which: <i>excluding interest payments</i>	37.6	37.3	37.6	38.3	39.1	39.3	39.8	39.5	39.3	40.4
Gross fixed investment	2.4	2.3	2.4	1.7	2.5	2.4	2.4	2.3	2.3	2.2
Other capital expenditure (2)	1.5	1.4	1.8	1.9	1.9	1.5	1.7	2.7	1.7	1.5
Total capital expenditure (2)	3.9	3.7	4.2	3.6	4.3	4.0	4.1	5.0	4.1	3.8
Total expenditure (2)	48.1	47.4	48.1	47.4	48.6	48.0	48.5	49.2	48.4	49.3
of which: <i>excluding interest payments (2)</i>	41.5	41.0	41.8	41.9	43.4	43.3	43.9	44.5	43.4	44.1
of which: <i>health expenditure</i>	5.4	5.7	6.0	6.1	6.1	6.6	6.7	6.8	6.6	6.9
of which: <i>pension expenditure (3)</i>	15.1	14.7	14.7	15.0	15.2	15.2	15.3	15.2	15.2	15.6

Source: Based on Istat data.

(1) Rounding may cause discrepancies in totals. – (2) The figure for 2000 does not include the proceeds of the sale of UMTS licences (1.2 per cent of GDP in 2000). In the national accounts these receipts are deducted from the item "Other capital expenditure". – (3) Includes expenditure on social security and assistance.

General government borrowing requirement
(millions of euros)

	Year			First 5 months		
	2006	2007	2008	2007	2008	2009 (1)
Borrowing requirement net of settlements of past debts and privatization receipts	58,606	26,741	46,647	45,417	37,922	57,076
Settlements of past debts	243	3,129	1,653	44	34	277
- in securities	2	0	0	0	0	0
- in cash	241	3,129	1,653	44	34	277
Privatization receipts	-38	-3,500	-19	-3,500	0	0
Borrowing requirement	58,811	26,370	48,282	41,961	37,956	57,353
FINANCING						
Cash and deposits (2)	7,476	-13,977	4,224	-8,874	-1,036	3,554
of which: <i>Post Office deposits</i>	-4,957	-28,447	-5,683	-9,654	-1,638	-1,276
Short-term securities	4,847	5,562	19,502	23,043	35,245	32,186
Medium and long-term securities	33,102	22,516	40,994	30,833	14,640	49,893
Loans from MFIs	68,075	-2,522	-1,086	-367	1,897	3,177
Other liabilities (3) (4)	-54,689	14,791	-15,353	-2,673	-12,790	-31,457
of which: <i>deposits with the Bank of Italy</i>	-8,230	13,142	-10,611	-3,269	-10,472	-31,393
<i>Memorandum item: borrowing requirement financed abroad</i>	-7,011	-6,189	-10,338	325	-2,721	2,377

(1) Provisional. – (2) Post Office funds, notes and coins in circulation, and deposits held with the Treasury by entities not included in general government. – (3) As of September 2006 Cassa Depositi e Prestiti s.p.a. has been included among MFIs; as of the same date the loans it has granted to general government entities, previously included under “Other liabilities”, have been included under “Loans from MFIs”. – (4) Includes deposits held with the Bank of Italy and securitizations.

Table 5

Current legislation forecasts and Government targets in the Combined Report on the Economy and Public Finance (CREPF) for 2009 and the Economic and Financial Planning Document (EFPD) for 2009-13 and 2010-13 (1)
(as a percentage of GDP)

	2008	2009			2010			2011			2012		2013	
	Outturn	EFPD 2009-13	CREPF 04/2009	EFPD 2010-13	EFPD 2009-13	CREPF 04/2009	EFPD 2010-13	EFPD 2009-13	CREPF 04/2009	EFPD 2010-13	EFPD 2009-13	EFPD 2010-13	EFPD 2009-13	EFPD 2010-13
CURRENT LEGISLATION FORECASTS														
Net borrowing	2.7	2.6	4.6	5.3	2.1	4.6	5.0	2.0	4.3	4.4	1.9	4.1	1.8	3.7
of which: <i>current</i>	-0.8	-1.2	0.9	1.3	-1.5	1.2	1.4	-1.6	1.2	1.3	-1.6	1.0	-1.6	0.7
<i>capital</i>	3.5	3.8	3.7	4.0	3.6	3.4	3.6	3.6	3.1	3.1	3.5	3.1	3.4	3.0
Primary surplus	2.4	2.5	0.4	-0.4	3.0	0.6	0.2	3.1	1.1	1.1	3.2	1.7	3.4	2.3
Total revenue	46.6	46.5	47.6	47.5	46.7	47.2	47.1	46.6	47.0	46.9	46.5	46.9	46.3	46.8
of which: <i>taxes and social security contributions</i>	42.8	42.6	43.5	43.4	42.8	43.2	43.0	42.8	43.0	42.8	42.7	42.9	42.6	42.9
Primary expenditure	44.1	44.0	47.2	47.9	43.6	46.6	46.9	43.5	45.9	45.7	43.3	45.1	43.0	44.5
of which: <i>current</i>	40.4	39.9	43.0	43.4	39.7	42.8	43.0	39.6	42.4	42.2	39.5	41.6	39.3	41.2
<i>capital</i>	3.8	4.1	4.2	4.5	4.0	3.7	3.9	3.9	3.5	3.5	3.8	3.5	3.7	3.3
Interest payments	5.1	5.1	5.0	5.0	5.1	5.2	5.1	5.1	5.5	5.5	5.1	5.9	5.1	6.0
<i>Nominal GDP growth</i>	1.8	3.0	-2.8	-3.2	3.2	1.7	1.9	3.1	2.9	3.6	3.3	3.8	3.3	3.9
GOVERNMENT TARGETS														
Net borrowing	2.7	2.0	....	5.3	1.0	....	5.0	0.1	....	4.0	0.0	2.9	-0.1	2.4
Primary surplus	2.4	3.1	....	-0.4	4.0	....	0.2	4.9	....	1.5	4.9	2.9	5.0	3.5
Interest payments	5.1	5.1	....	5.0	5.0	....	5.1	5.0	....	5.5	4.9	5.8	4.9	5.9
Debt	105.7	102.7	....	115.3	100.4	....	118.2	97.2	....	118.0	93.6	116.5	90.1	114.1

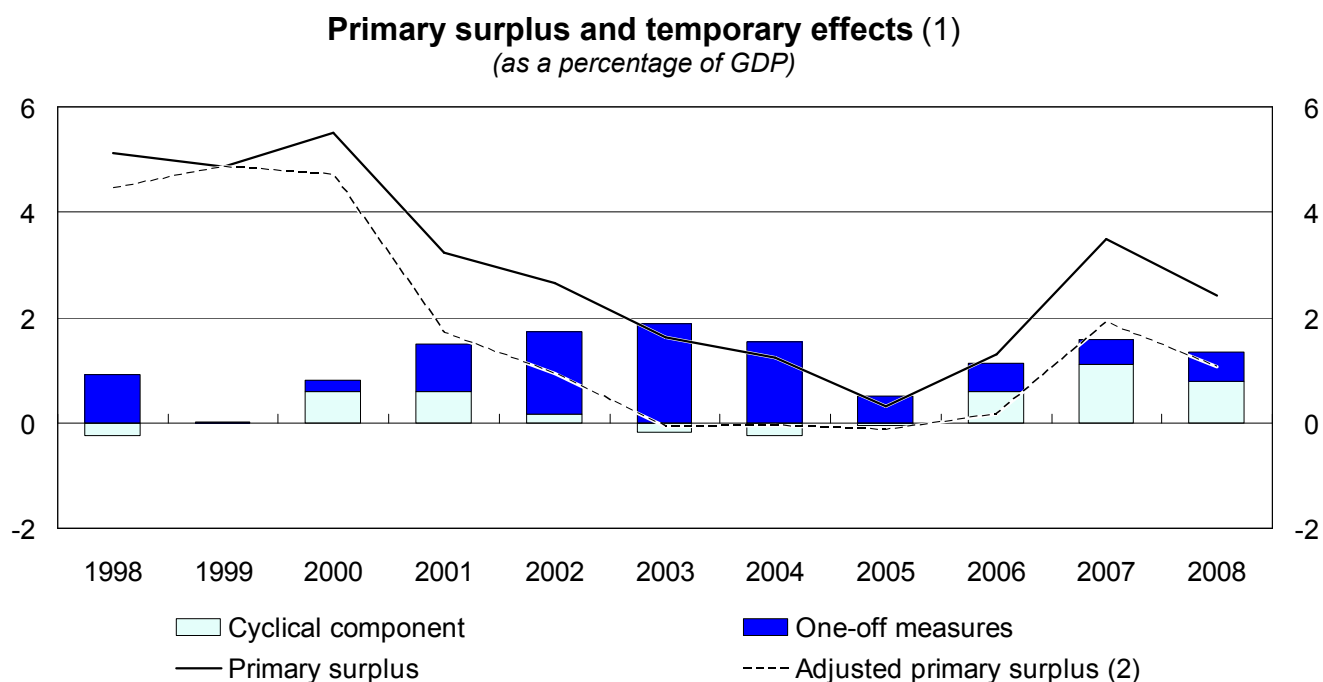
(1) The estimates contained in EFPD 2009-13 include the effects of Decree Law 93/2008; those contained in EFPD 2010-13 include the effects of Decree Law 78/2009 and the mid-year revision of the budget for 2009. Rounding may cause discrepancies in totals.

Effects on the general government consolidated accounts of the anti-crisis measures and the earthquake decree
(billions of euros)

	2009					2010					2011				
	Anti-crisis decree of November 2008	Anti-crisis decree of February 2009	Earthquake decree of April 2009	Anti-crisis decree of July 2009	Total	Anti-crisis decree of November 2008	Anti-crisis decree of February 2009	Earthquake decree of April 2009	Anti-crisis decree of July 2009	Total	Anti-crisis decree of November 2008	Anti-crisis decree of February 2009	Earthquake decree of April 2009	Anti-crisis decree of July 2009	Total
	(1)	(2)	(3)	(4)		(1)	(2)	(3)	(4)		(1)	(2)	(3)	(4)	
REVENUE															
Increases in revenue	5.2	0.7	0.5	1.1	7.5	2.5	0.1	0.7	2.7	5.9	2.5	0.2	0.5	2.5	5.7
Substitute tax on asset revaluations	2.8				2.8	0.1				0.1	0.1				0.1
Action against tax havens and international tax arbitrage					0.0				1.0	1.0				1.0	1.0
More stringent requirements for offsetting tax credits				0.2	0.2				1.0	1.0				1.0	1.0
Other revenue	2.4	0.7	0.5	0.9	4.5	2.4	0.1	0.7	0.7	3.8	2.4	0.2	0.5	0.5	3.6
Decreases in revenue	-2.2	-0.0	-0.0	-0.5	-2.7	-1.6	-0.2	-0.1	-1.9	-3.8	-2.1	-0.4	0.0	-2.5	-5.0
Tax reliefs	-1.4				-1.4	-1.0				-1.0	-1.0				-1.0
Tax incentives for new investments					0.0				-1.8	-1.8				-2.4	-2.4
Other revenue	-0.7	-0.0	-0.0	-0.5	-1.3	-0.6	-0.2	-0.1	-0.0	-1.0	-1.1	-0.4		-0.1	-1.6
NET CHANGE IN REVENUE (5)	3.0	0.7	0.5	0.6	4.8	0.9	-0.1	0.6	0.8	2.2	0.4	-0.2	0.5	0.1	0.8
EXPENDITURE															
Increases in expenditure	4.2	1.1	1.2	0.7	7.2	2.3	0.1	1.0	1.9	5.3	2.7	0.0	0.7	0.9	4.3
Current expenditure	3.7	0.0	0.8	0.6	5.1	1.2	0.1	0.1	0.9	2.3	1.1	0.0	0.0	0.9	1.9
<i>Health</i>			0.0	0.1	0.1				0.9	0.9				0.9	0.9
<i>Family bonuses</i>	2.4				2.4										0.0
<i>Other</i>	1.3		0.8	0.5	2.6	1.2	0.1	0.1	0.0	1.4	1.1		0.0	0.0	1.1
Capital expenditure	0.5	1.1	0.5	0.1	2.2	1.1	0.0	0.9	1.0	3.0	1.6	0.0	0.7	0.1	2.4
<i>Incentives for motor vehicles</i>		1.1			1.1					0.0					0.0
<i>Other</i>	0.5	0.0	0.5	0.1	1.1	1.1		0.9	1.0	3.0	1.6		0.7	0.1	2.4
Decreases in expenditure	-1.2	-0.4	-0.8	-0.2	-2.5	-1.6	-0.2	-0.4	-1.1	-3.3	-2.5	-0.2	-0.2	-0.9	-3.8
Current expenditure	-0.1	-0.4	-0.7	-0.1	-1.3	-0.1	-0.2	-0.2	-0.9	-1.4	-0.1	-0.2	-0.2	-0.9	-1.5
<i>Health</i>			-0.4	-0.1	-0.5				-0.9	-0.9				-0.9	-0.9
<i>Other</i>	-0.1	-0.4	-0.3		-0.9	-0.1	-0.2	-0.2		-0.5	-0.1	-0.2	-0.2	-0.0	-0.6
Capital expenditure	-1.1	0.0	-0.0	-0.1	-1.2	-1.5	0.0	-0.2	-0.2	-1.9	-2.3	0.0	0.0	0.0	-2.3
NET CHANGE IN EXPENDITURE (5)	3.0	0.7	0.5	0.6	4.7	0.7	-0.1	0.6	0.8	2.0	0.2	-0.2	0.5	0.1	0.5
CHANGE IN NET BORROWING (5)	-0.0	-0.0	-0.0	0.0	-0.0	-0.2	-0.0	-0.0	-0.0	-0.2	-0.2	-0.0	-0.0	0.0	-0.2

(1) Decree Law 185/2008, ratified by Law 2/2009. Based on official estimates contained in *La manovra di bilancio per il triennio 2009-2011*, Ministry for the Economy and Finance, State Accounting Office, February 2009. — (2) Decree Law 5/2009, ratified by Law 33/2009. Based on official estimates contained in *La manovra di bilancio per il triennio 2009-2011*, Ministry for the Economy and Finance, State Accounting Office, February 2009. — (3) Decree Law 39/2009, ratified by Law 77/2009. Based on official estimates contained in the decree ratification bill (Parliamentary Act of the Chamber of Deputies, 16th legislature, no. 2468). — (4) Decree Law 78/2009. Based on official estimates contained in *Documento di programmazione economico-finanziaria* for the years 2010-2013. — (5) A positive sign indicates an increase, a negative sign a decrease. Rounding may cause discrepancies in totals.

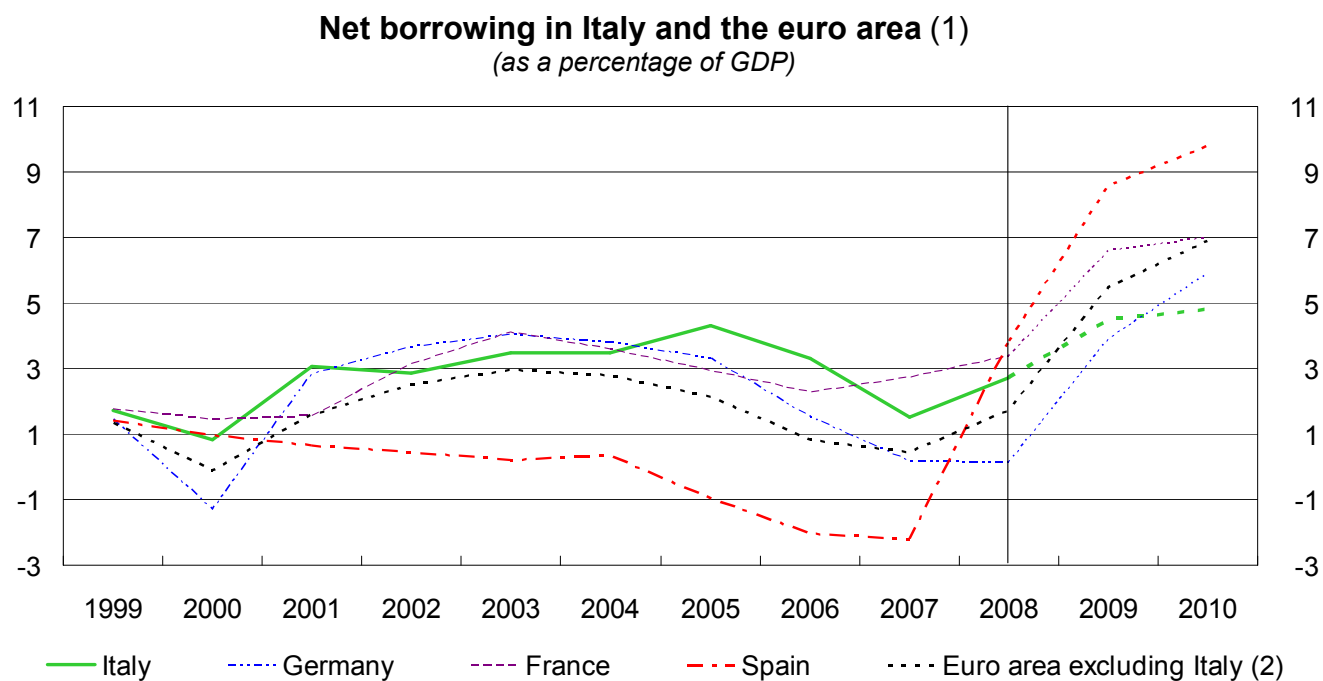
Figure 1



Source: Based on Istat data.

(1) The estimates of temporary effects are based on the methods used by the Bank of Italy (see the Annual Report for 2006). – (2) Adjusted for the effects of the economic cycle and one-off measures, as a percentage of trend GDP.

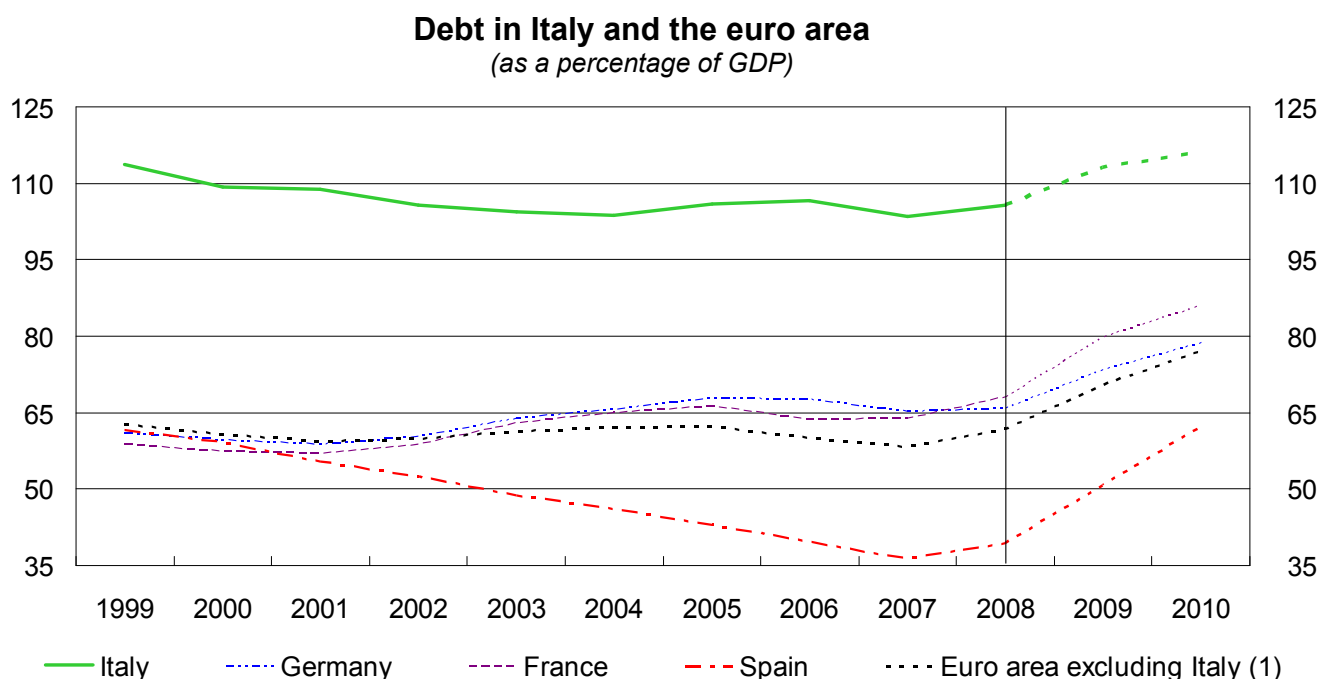
Figure 2



Sources: Based on Istat and European Commission data. For the sake of comparison the forecasts are based on European Commission data (*Spring Forecasts*, May 2009).

(1) The data include the effects of swaps and forward rate agreements. – (2) For the sake of comparison, the euro area includes Greece, Slovenia, Slovakia, Cyprus and Malta for the entire period considered.

Figure 3

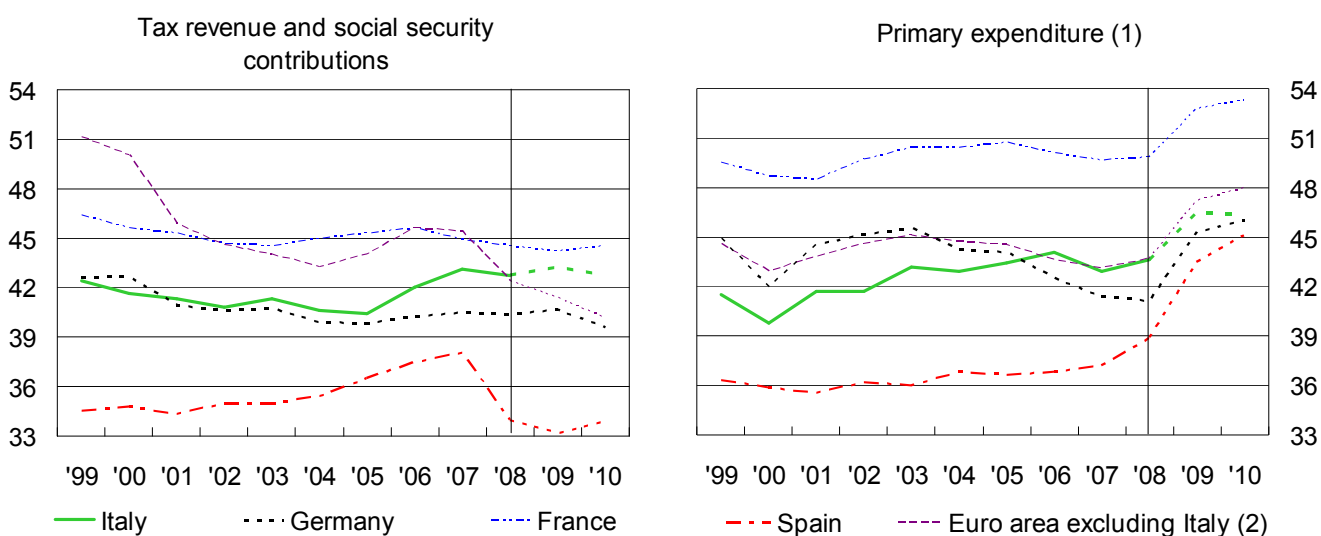


Sources: Based on Istat and European Commission data. For the sake of comparison the forecasts are based on European Commission data (*Spring Forecasts*, May 2009).

(1) For the sake of comparison, the euro area includes Greece, Slovenia, Slovakia, Cyprus and Malta for the entire period considered.

Figure 4

**Tax revenue and social security contributions
and primary expenditure in Italy and the euro area**
(as a percentage of GDP)



Sources: Based on Istat and European Commission data. For the sake of comparison the forecasts are based on European Commission data (*Spring Forecasts*, May 2009).

(1) For the sake of comparison among the euro-area countries, the figures are calculated in accordance with Regulation EC 1500/2000. – (2) For the sake of comparison, the euro area includes Greece, Slovenia, Slovakia, Cyprus and Malta for the entire period considered.

Figure 5

Average cost of the debt, average gross interest rate on BOTs, and gross yield of 10-year BTPs
(percentages)

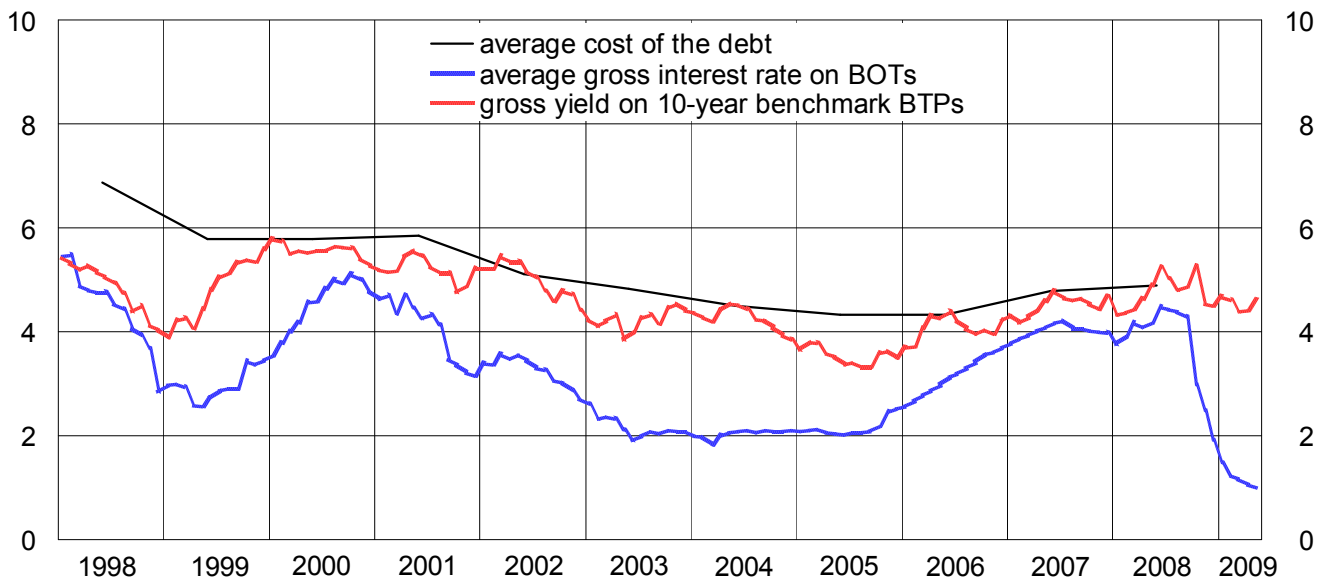
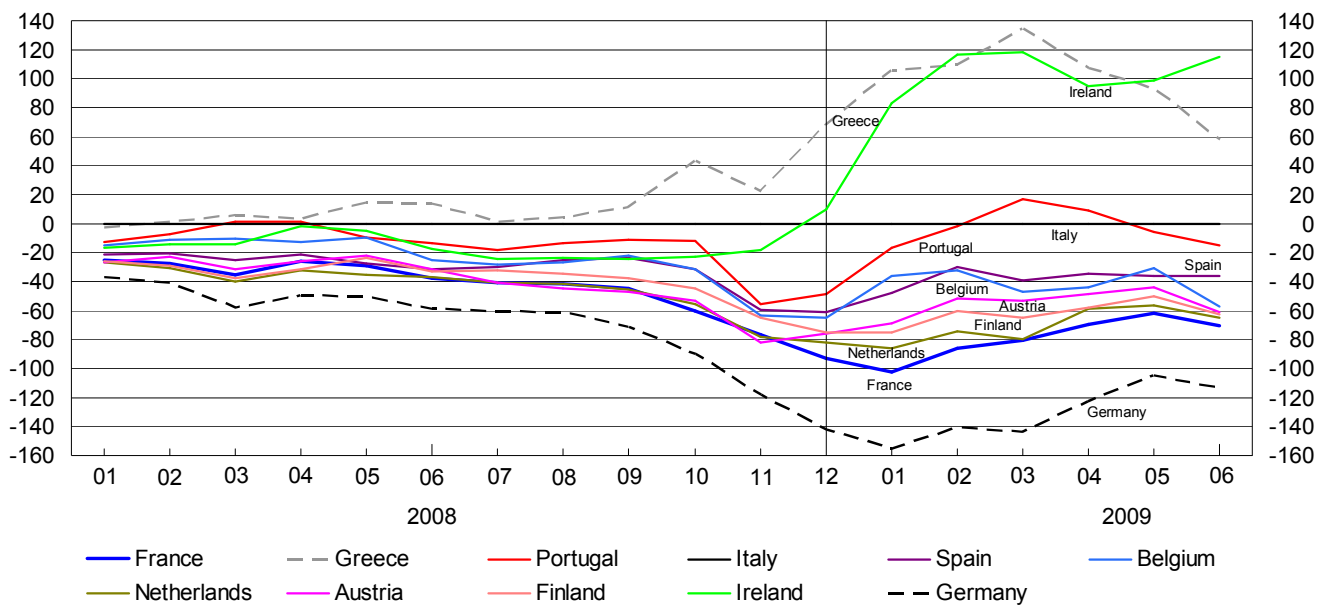
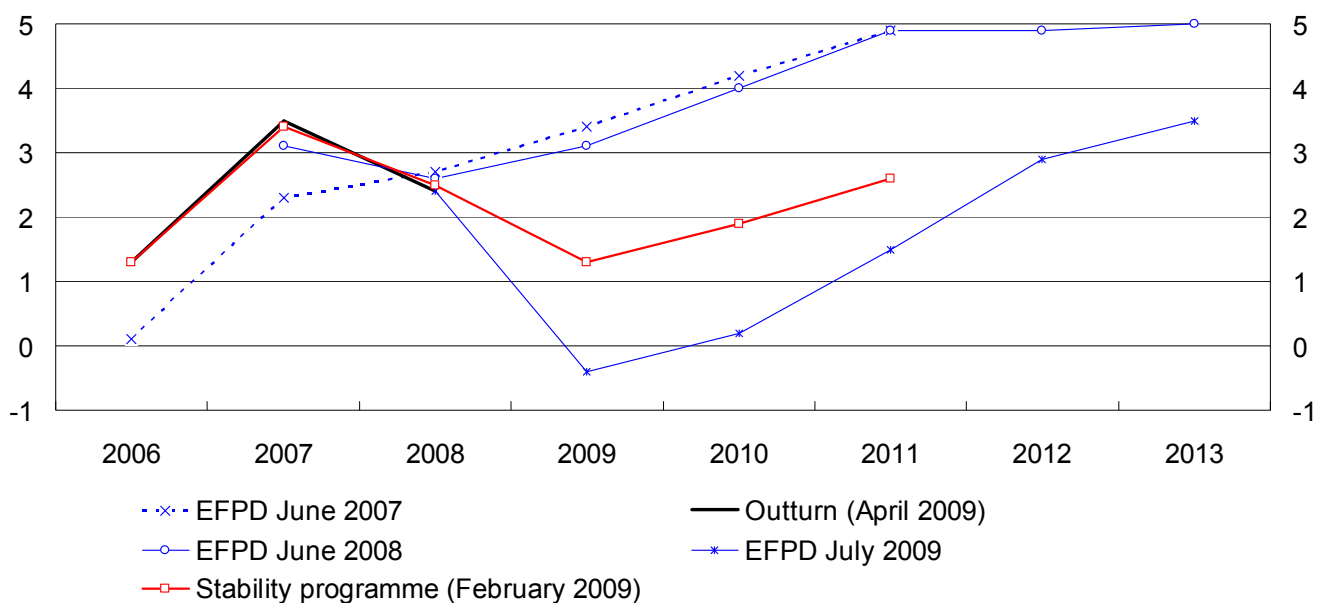


Figure 6

10-year yield differentials with respect to Germany
(basis points)

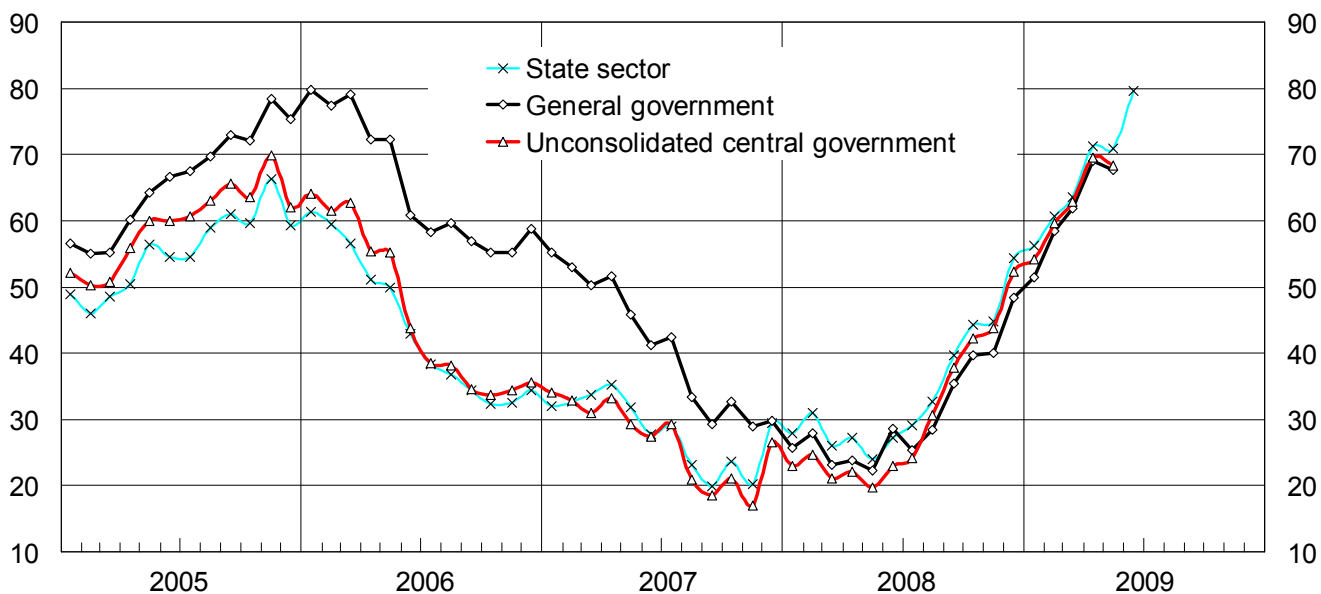


Primary surplus: objectives and outturns
(as a percentage of GDP)



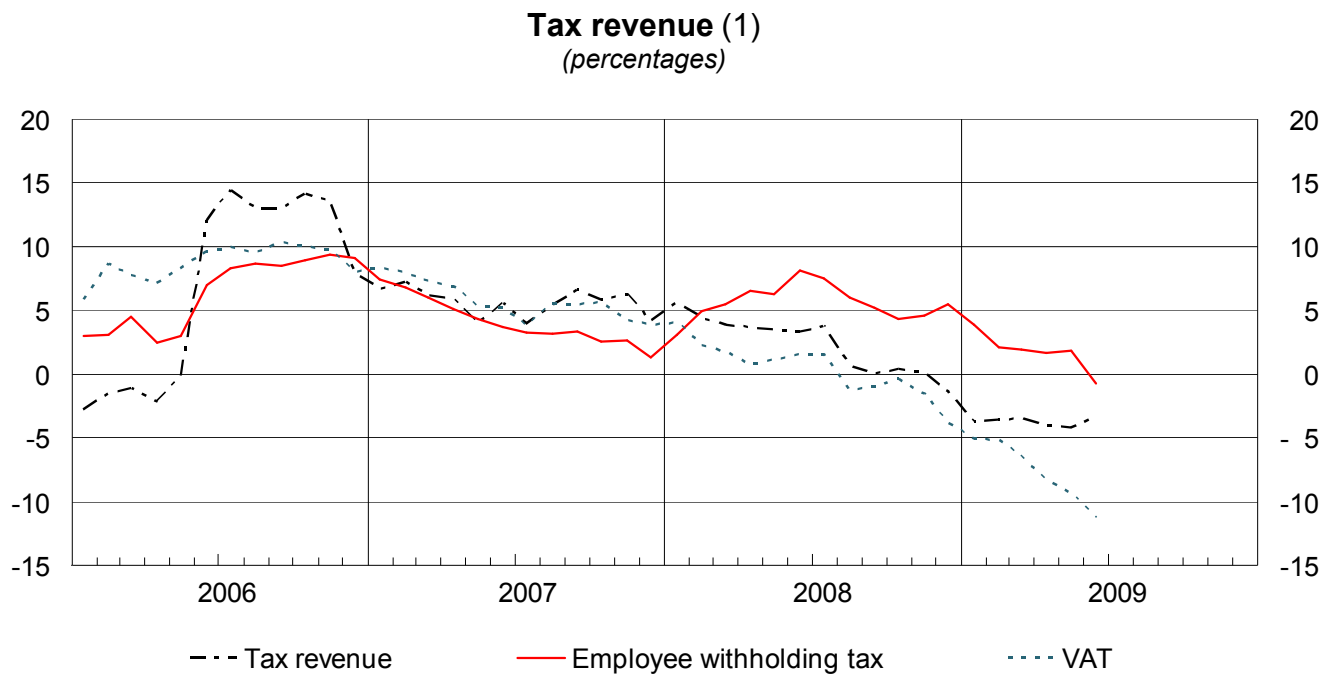
Legend:
EFPD – Economic and Financial Planning Document

Twelve-month cumulative borrowing requirement (1)
(billions of euros)



Source: For the state sector borrowing requirement, the Ministry for the Economy and Finance.

(1) Excluding privatization receipts.



Source: State budget.

(1) Percentage change of the six-month moving sum with respect to the twelve-month earlier period.