THE ITALIAN BUDGET IN BRIEF

Rome, March 2007

The frame of reference: 2006

Last year the euro area benefited from the good performance of the world economy to record one of the highest growth rates in the last five years. The components making the most notable contributions were the strong gain in investment and the substantial expansion of exports. The European labour market also did well in 2006, the unemployment rate falling to 7.8 per cent by July.

In Italy the cyclical expansion of GDP last year reflected the strengthening economic upturn. GDP at current market prices in 2006 came to €1.475 trillion. This represented real GDP growth of 1.9 percent, a sharp acceleration with respect to 2005. Real growth was sustained mainly by industry excluding construction (growth of 2.5 percent), construction (1.8 percent) and services (1.9 percent).

The growth of output was accompanied by a 4.3 percent increase in imports of goods and services, resulting in a 2.4 percent increase in available resources. Exports grew 5.3 percent overall, with both goods and services contributing (rises of 4.4 and 8.8 percent respectively).

Turning to the balance of trade, the nominal growth of imports outpaced that of exports, especially in the first seven months of the year (14.8 and 9.5 percent respectively). This widened the trade deficit, which tripled by comparison with the same period of 2005.

In the fourth quarter the labour force showed an increase of 0.2 percent (61,000) over the fourth quarter of 2005. The number of persons in work during the year came to 23,018,000, an increase of 1.5 percent (333,000) on an annual basis.

The employment rate for the working-age population (aged 15-64) rose by 0.7 percentage points in the fourth quarter over the same period of 2005 to 58.5 percent, while the number of persons unemployed fell by 272,000 to 1,709,000 (a decline of 13.7 percent). Meanwhile, the unemployment rate fell from 7.7 to 6.8 percent.

The year-on-year inflation rate was broadly stable at just over 2 percent.

The state sector borrowing requirement worked out at €34.6 billion for the year, €25.4 billion less than in 2005. The improvement can be credited to the performance of tax revenues (which were much higher than had been estimated initially) and to spending in line with the Economic and Financial Planning Document released in July.

General government net borrowing came to 4.4 percent of GDP in 2006 (up from 4.1 percent in 2005), representing an increase of some €6 billion in absolute terms. About 2 percentage points of the increase was due to extraordinary expenditures equal to €29.67 billion for reimbursement of firms' VAT payments on company cars under the sentence of the European Court of Justice of 14 September 2006 (€15,982 million), the cancellation of State credits vis-à-vis the high-speed rail corporation TAV (€12,950 million) and the retrocession to the securitisation vehicle of social contribution credits owed by farm workers whose collection had been temporarily suspended by law (€734 million). Net of these extraordinary expenditures, therefore, the ratio of net borrowing to GDP would have been 2.4 percent.

The primary balance (net borrowing excluding interest payments), though still positive, also worsened in 2006, to a surplus of 0.2 percent of GDP compared with 1.3 percent in 2004 and 0.4 percent in 2005. Net of the extraordinary expenditures mentioned, the primary surplus would have come to 2.2 percent.

Developments on the revenue side were highly positive. The growth of tax revenue on an annual basis was substantial, with significant increases in direct taxes (12.4 percent) and indirect taxes (7.8 percent). Thanks to this gain, the net saving of general government, equal to the current account balance, swung back positive after three years and came to €19 billion, over 1.3 percent of GDP.

The public finance objectives for 2007-2009

The public finance objectives for the years from 2007 through 2009 set in Italy's new Stability Programme are given in the chart below:

General government accounts planning framework
(as a percentage of GDP)

	2007	2008	2009
Primary balance	2.6	2.4	2.6
Interest payments	4.8	4.8	4.7
Net borrowing	-2.3	-2.3	-2.1
Public debt	106.9	105.4	103.5

Source: *Italy's Stability Programme (Update December 2006)* and *Relazione unificata sull'Economia e la Finanza Pubblica, March 2007)*

The budget strategy set out in the Economic and Financial Planning Document released in July and confirmed in the autumn "Update" to the Document is designed to combine the structural adjustment of the public finances with support for economic growth in a framework of greater social equity.

The budget for 2007 aimed not only to fulfil Italy's budget commitment with the European Union but more particularly to bring public finance trends, above all current spending, back onto a path of adjustment and long-term sustainability. To this end it also introduced significant elements towards future reform in the major areas of expenditure.

Net of the offsetting of the Court of Justice decision on VAT, the Finance Law procures a total of €36.3 billion in additional resources, allocating €15.2 billion to reducing the budget deficit on a current programmes basis and €21.1 billion to economic development.

The new targets outline the steady decrease in net borrowing to 0.7 percent of GDP in 2010, an increase in the primary surplus from 2.2 percent in 2007 to 4.2 percent in 2010, and a lowering of the debt ratio from 106.8 percent of GDP in 2006 to 100.7 percent in 2010. On a cyclically adjusted basis, net borrowing is set to decline from 2.1 percent of GDP in 2007 to 0.1 percent in 2010, while the primary surplus should rise from 3.0 to 4.8 percent.

The public finance package for 2007

The public finance measures for 2007 consisted of the Finance Law and its accompanying Decree Law 262, approved with amendments as Law 248/2006 enacting measures against tax evasion and avoidance and other urgent tax measures.

The net budget correction comes to €15.2 billion. The total amount of resources procured is €36.3 billion, raised in the major areas of expenditure specified in the Economic and Financial Planning Document for 2007-2011:

- on the revenue side, action comprises both changes to tax and contribution rates and measures to counter tax evasion and avoidance;
- on the expenditure side, the adjustment measures bear on health care, pensions, public employees, the fundamental functions of the State and local government.

The *measures to procure resources* (€36.3 billion) involve:

- Central government (€14.3 billion):
  - a) measures to contain spending on public employment (€400 million)
  - b) reorganisation and rationalisation of general government (€4.3 billion)
  - c) enhanced revenue-raising efficiency (€9.1 billion)
  - d) exploitation of public assets (€500 million);
- Local government (€4.4 billion)
- Health care system (€3.1 billion)
- Pensions (€10.5 billion)
  - a) severance pay funds (€6 billion)
  - b) contribution increases (€4.5 billion)
- Additional tax revenue (€4.1 billion)

The *utilisation of the resources* consisted in measures for growth and equity (€21.1 billion), including:

- Reduction of the tax wedge on labour (€5.5 billion);
- Fundamental functions of the State (€4.272 billion):
  - a) international peace missions (€1 billion)
  - b) public employment (€1.272 billion)
  - c) school system (€360 million)
  - d) public enterprises (€1.065 billion)
  - e) transport (€310 million)
  - f) other (€265 million)
- Development measures (€8.5 billion):
  - a) extension of tax subsidies (€1.1 billion)
  - b) rail and road infrastructure (€2.9 billion)
  - c) public works (€520 million)
  - d) EU cofinancing (€550 million)
  - e) business incentives (€950 million)
  - f) transport, agriculture and environment (€1.1 billion)
  - g) other (€1.38 billion)
- Social measures (€2.2 billion).

The central government budget

The following table summarises the Italian central government budget on an accrual basis for major items as voted by Parliament. Like the successive tables drawn up on economic accounting principles, it is net of the allocations provided for by Paragraph 507 of the Finance Law for 2007.

State budget on an accrual basis (1)

(millions of euros)

	2006 forecast	2007 forecast
REVENUES		
Tax revenues	**363,708**	**404,669**
- Ordinary management	345,964	380,887
- Tax assessment and control	17,744	23,782
Non-tax revenues	**28,730**	**25,497**
Sale and amortisation of assets and collection of debts	**1,874**	**2,139**
FINAL REVENUES	**394,311**	**432,304**
EXPENDITURES		
Current expenditure	**398,814**	**411,336**
Operating expenses	**78,159**	**80,488**
of which: - Personnel	72,514	73,285
Programmes	**218,703**	**225,469**
of which: - Support to Social Security Fund	47,137	48,170
- National Health Fund	6,574	9,321
- Local authorities	12,088	11,638
- Special-status Regions	12,799	13,056
- E.U. budget	15,850	17,400
- Lottery services	7,400	6,000
- Contribution reliefs	11,706	13,205
- Universities	6,924	7,084
- Fund for tax federalism	43,268	45,669
Common expenses	**28,834**	**29,715**
of which: - Additional grant to Soc. Sec. Inst. for Civil Servants	8,622	8,567
- Special fund	160	92
- Payment fund for the costs of staff	5,956	5,569
- Constitutional bodies	1,711	1,741
Retirement pensions	**1,090**	**1,100**
Burden of national debt	**72,028**	**74,564**
of which: - Interest payments	71,400	74,050
Capital expenditure	**32,161**	**39,369**
Investment	**28,743**	**35,417**
of which: - Underdeveloped areas	8,333	4,510
- Railways	530	2,539
- Local authorities	2,174	1,979
- National Road Board	101	1,121
- Revolving fund for Community policies	2,050	4,254
Other	**122**	**122**
Common expenses	**3,296**	**3,830**
FINAL EXPENDITURE	**430,975**	**450,705**
REDEMPTION OF NATIONAL DEBT	**188,925**	**189,099**
TOTAL EXPENDITURE	**619,900**	**639,804**
NET BALANCE TO FINANCE	**36,664**	**18,401**

(1) net of settlements of past debts and Value Added Tax refund

The following table reflects the classification of spending by objective-functions, the product of combining the structure proposed by the European Union (COFOG, ESA95) with that of Italy's administrative services.

State budget on an accrual basis (1)

(millions of euros)

COFOG Divisions	2006 forecast	2007 forecast
General public services	135,867	138,568
Defence	16,626	17,791
Public order and safety	21,608	21,112
Economic affairs	44,197	54,199
Environment protection	1,170	1,570
Housing and community amenities	1,131	1,138
Health	8,811	11,661
Recreation, culture and religion	12,351	11,450
Education	48,359	50,066
Social protection	69,456	69,100
Total expenditure excluding interest	**359,576**	**376,655**
Interest	71,400	74,050
TOTAL EXPENDITURE	**430,975**	**450,705**

(1) net of settlements of past debts and Value Added Tax refund

Along with the budget for the year on an accrual basis, the administration also prepares and presents to Parliament the central government budget based on the accounting principles introduced with the budget reform of 1997. This exercise is summarised in the following table:

Economic budget
Cost analysis by nature

(millions of euros)

	2006	2007	% change	2007 incidence
PERSONNEL COSTS	**75,475**	**74,360**	**-1.5**	***89.5%***
Wages	73,846	73,000	-1.1	87.9%
Missions	437	353	-19.3	*0.4%*
Other personnel costs	1,192	1,008	-15.4	*1.2%*
OPERATING COSTS	**6,793**	**6,231**	**-8.3**	***7.5%***
Supplies	1,022	867	-15.2	*1.0%*
Purchase of services and use of third parties goods	5,475	5,072	-7.4	*6.1%*
Other operating costs	296	292	-1.2	*0.4%*
EXTRAORDINARY AND SPECIAL COSTS	**102**	**105**	**2.5**	***0.1%***
Expense for litigation	92	97	5.0	*0.1%*
Other extraordinary costs	4	3	-21.4	*0.0%*
Financial services	6	5	-19.8	*0.0%*
AMORTISATION	**2,270**	**2,378**	**4.8**	***2.9%***
CENTRAL GOVERNMENT COST TOTAL	**84,640**	**83,074**	**-1.8**	***100%***
DISPLACED COSTS	**236,079**	**247,787**	**5.0**	
Current transfers	206,506	215,629	4.4	
Contribution to investments	18,661	24,170	29.5	
Other capital account transfers	10,912	7,988	-26.8	
OVERALL COST TOTAL	**320,719**	**330,861**	**3.2**	
FINANCIAL COSTS	**68,643**	**74,050**	**7.9**	
FUNDS TO BE ALLOCATED	**20,070**	**26,818**	**33.6**	
GRAND TOTAL	**409,432**	**431,729**	**5.4**	

The rationalisation of general government expenditure has also involved a breakdown according to use of funds. In the next table, the budget charges for 2007 are set out according to the central government sector policy of which they form part. They are aggregated into the ten "divisions" that make up the first level of the international Classification Of the Functions Of Government (COFOG).

For each division, the Budget distinguishes between "own costs of central government departments" (the expenditure on the human and material resources employed directly by the departments in performing their institutional functions) and "displaced costs" (financial resources transferred to public bodies).

The public finances in Italy and the euro area

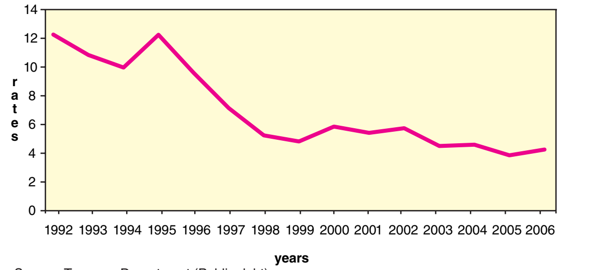
Since the 1990s the Treasury has benefited from the decline in interest rates. The following graph traces the average rates on ten-year Treasury bonds, one of the key indicators of financial market developments:

Economic budget
Summary of costs by use

(millions of euros)

COFOG Divisions	Own costs	Displaced costs	TOTAL Amount	TOTAL % of cost total
General public services	3,201	104,169	107,370	*31.7%*
Defence	14,758	1,812	16,570	*5.1%*
Public order and safety	18,943	564	19,507	*6.1%*
Economic affairs	1,358	51,011	52,369	*14.9%*
Environment protection	362	702	1,064	*0.3%*
Housing and community amenities	31	1,061	1,092	*0.5%*
Health	233	12,028	12,261	*3.4%*
Recreation, culture and religion	694	2,588	3,282	*1.0%*
Education	43,357	7,867	51,224	*16.1%*
Social protection	137	65,985	66,122	*20.9%*
Overall Cost Total	**83,074**	**247,787**	**330,861**	***100%***

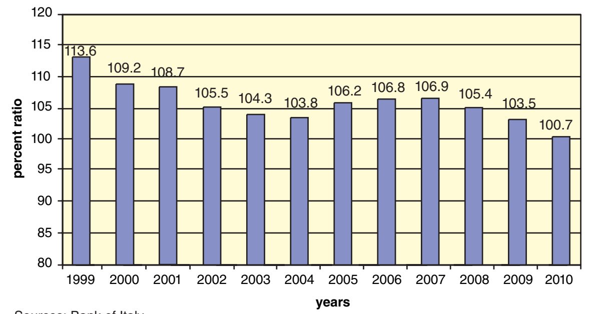
Average gross interest on 10-year Treasury bonds



Source: Treasury Department (Public debt)

The decline in the incidence of public debt on GDP was interrupted between 2004 and 2006, when the debt ratio rose from 103.8 to 106.8. The downtrend will resume in 2007 bringing the ratio to 100.7 percent in 2010.

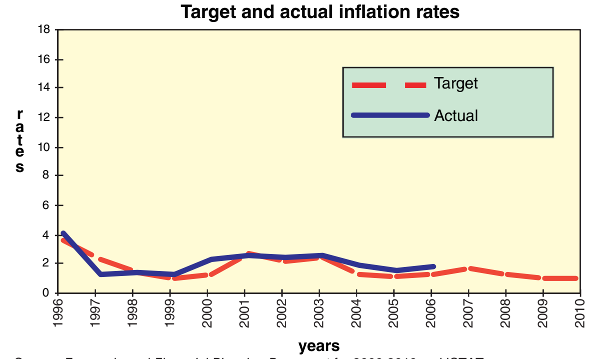
Public debt (as a percentage of GDP)



Sources: Bank of Italy
Treasury Department (Public debt)
Relazione Unificata sull'Economia e la Finanza Pubblica (March 2007)
Italy's Stability Programme (Update December 2006)

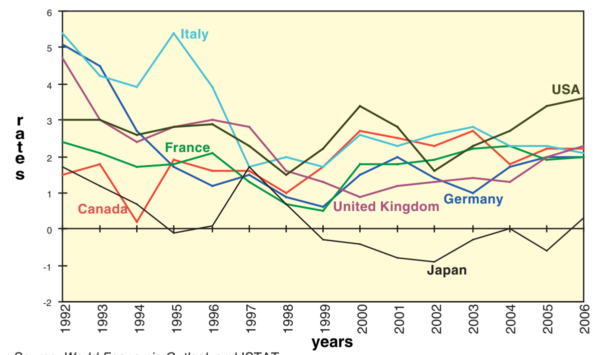
Target and actual inflation rates as compared with developments in the other G7 countries are given in the next two graphs.

Target and actual inflation rates



Source: *Economic and Financial Planning Document for 2006-2010* and ISTAT

Inflation rates in G7 countries



Source: *World Economic Outlook* and ISTAT

The public finance objectives set out above are based on the following macroeconomic scenario:

Medium-term macroeconomic framework
(percentage changes)

	2007	2008	2009
Macroeconomic Projection (in real terms)			
GDP	2.0	1.7	1.6
Imports	4.8	3.9	4.0
Household consumption	1.8	1.6	1.5
Gross fixed investment	3.2	2.7	3.0
Exports	5.1	4.5	4.3
Contribution to Growth (Pct. Pts.)			
Net exports	0.1	0.1	0.1
Inventories	0.1	0.0	0.0
National demand	1.9	1.6	1.6
Prices			
Import deflator	2.2	2.2	1.8
GDP deflator	1.9	1.9	1.9
Consumption deflator	2.0	1.9	1.8
Labour			
Cost of labour	2.3	2.2	2.2
Productivity (measured on GDP)	1.1	0.9	0.8
Employment (std. Labour units)	1.0	0.8	0.8
Unemployment rate	6.3	6.0	5.7

Source: *Relazione Unificata sull'Economia e la Finanza Pubblica (March 2007)*

Especially given the present state of the world economy, these projections are subject to a good deal of uncertainty, bearing not only on the implementation of the national economic policy guidelines but on developments and policies in other countries (not only those of the euro area).

The public financial impact of alternative economic scenarios also needs to be evaluated. The underestimation or overestimation of GDP growth, in fact, would have an impact on the effective realisation of the macroeconomic scenario for the years 2007-2010.

This effect has been estimated assuming different rates of economic growth – 0.5 percentage points higher and lower, respectively, than the baseline scenario – for each year from 2007 to 2010. Favourable trends in key world economic variables (e.g., oil prices lower than $60/barrel) would result in faster Italian growth. Unfavourable trends (oil over $80/barrel, say) would correspond to slower expansion of economic activity in Italy. Obviously, different economic growth rates would have a different impact on net borrowing.

Sensitivity to economic growth
(percentage values)

	Average GDP growth rate 2007-2010	Net borrowing/GDP 2010
Baseline scenario	1.525	- 0.7
Low-growth scenario	1.025	- 1.7
High-growth scenario	2.025	0.3

Source: *Italy's stability programme (Update December 2006)*

The low-growth scenario would produce a slower reduction in general government net borrowing than the baseline scenario; it would only come down to 1.7 percent of GDP in 2010, compared with the baseline projection of 0.7 percent. The high-growth scenario, naturally, would bring net borrowing down faster, from 2.6 percent of GDP in 2007 to 0.3 percent in 2010. It is worth emphasizing that in any event, under both the slower and the faster growth scenario, the ratio of public debt to GDP declines. Obviously the reduction is smaller and slower in the pessimistic scenario (104.2 percent in 2010), larger and faster in the optimistic one (97.5 percent).