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Commission assessment of the budgetary situation in Italy in relation to the Commission recommendation for a Council Recommendation with a view to giving early warning to Italy in order to prevent the occurrence of an excessive deficit

Background

Council Regulation (EC) No 1466/97, on the strengthening of the surveillance of budgetary positions and the surveillance and co-ordination of economic policies,[1] includes an early warning system under which the Council will alert a Member State at an early stage to the need to take corrective budgetary action in order to prevent a government deficit becoming excessive. Article 6(2) of the Regulation sets out for Member States participating in the single currency how the early warning system is applied. Regular monitoring of the implementation of stability programmes by the Council is carried out, in particular with a view to identifying an actual or expected significant divergence of the budgetary position from the medium-term objective for the government balance, or the adjustment path towards it, as set in the programme. In the event that the Council identifies a significant divergence, with a view to giving early warning in order to prevent the occurrence of an excessive deficit, it addresses a recommendation to the Member State concerned to take the necessary adjustment measures. This early warning is made in accordance with the procedure of Article 99(4) of the Treaty and is based on a recommendation from the Commission.

In deciding whether to activate the early warning mechanism, the Commission[2] considers the following elements: the size of the budgetary slippage, that is the extent to which the budgetary position of a Member State diverges from the targets set down in stability or convergence programmes; the reason for the budgetary slippage, that is, whether or not the divergence of the actual balance from the target can be explained by purely cyclical factors; and the risk of an excessive deficit position, that is, whether there is a risk of breaching the 3% of GDP reference value.

[1] OJ L 209, 2.8.1997.

[2] Communication from the Commission to the Council and the European Parliament of 27 November 2002 on strengthening the co-ordination of budgetary policies, COM(2002) 668 final.

Commission assessment

Deficit targets and outturns

The 2002 update of the stability programme of Italy, submitted to the Commission on 20 November 2002, covered the period from 2002 to 2006. It projected a general government deficit of 1.5% of GDP in 2003, under the assumption of an increase in real GDP of 2.3%, and a general government deficit of 0.6% of GDP in 2004, assuming an increase in real GDP of 2.9%. A series of revisions followed (outlined in the table below), ensuing from the worse than expected budgetary outturn in 2002, updated projections for economic growth and a reconsideration of budgetary targets. In the official forecast presented in September 2003 together with the budget, the deficit projection for 2003 was set at 2.5% of GDP, with real GDP growth of 0.5%. The 2004 deficit was targeted at 2.2% of GDP, assuming real GDP growth of 1.9%. These figures for both 2003 and 2004 were confirmed in the stability programme update submitted on 1 December 2003.

Successive revisions of general government deficit targets and real GDP growth for 2003 and 2004

		2003		2004	
		real GDP growth (%)	deficit in % of GDP	real GDP growth (%)	deficit in % of GDP
November 2002	2002 updated stability programme	2.3	1.5	2.9	0.6
April 2003	Update of the forecasting and planning report (RPP)	1.1	2.3		
July 2003	Economic and financial planning document (DPEF)	0.8	2.3	2.0	1.8
September 2003	Update to the economic and financial planning document	0.5	2.5	1.9	2.2
December 2003	2003 updated stability programme	0.5	2.5	1.9	2.2
March 2004	EDP notification	0.3	2.4	1.9	2.2
April 2004	Commission Spring 2004 forecast	0.3	2.4	1.2	3.2

The successive downward revisions of economic growth and the upward revisions of the budget deficit reflect a pattern highlighted in the Commission services' technical assessments of the updated stability programmes[3] and in the Council opinions on the same programmes.[4] Budgetary plans were recurrently based on overoptimistic growth assumptions, especially as regards the medium term growth outlook. As a result, the

[3] The assessments of the 2002 update and the 2003 update of the stability programme can be consulted on http://europa.eu.int/comm/economy_finance/about/activities/sgp/cswd_en.htm.

[4] OJ C 026 , 4.2.2003; OJ C 051, 26.2.2002; OJ C 077, 9.3.2001.

budgetary outturns in percent of GDP were worse than targeted both in nominal and cyclically-adjusted terms, even without additional expansionary discretionary measures within the fiscal year. The successive revisions of real GDP dragged down the level of potential output.[5] What would have been, based on the official projection, a cyclical budgetary deterioration was revealed to be of a structural nature. While any growth forecast is intrinsically subject to errors, and the duration of the present cyclical slowdown was not anticipated by most forecasters, the degree and the persistency of optimism in Italy's official growth forecasts is not consistent with a prudent fiscal strategy.

The divergence from the budgetary target in 2003

In 2003, according to the 1 March 2004 reporting of government deficit and debt levels (EDP notification), real GDP growth was 0.3%, and the deficit was 2.4% of GDP, 0.9 percentage point higher than the original deficit target, in spite of one-off measures the impact of which is estimated at over 2 percentage points of GDP. Without one-off measures, the deficit would have been over 4½ % of GDP.[6]

The slippage in 2003 compared to the 2002 updated stability programme is due to a higher than planned primary expenditure to GDP ratio in the order of 1.7 percentage points, including a shortfall in receipts from sales of real assets by around 0.4 percentage point of GDP.[7] An additional shortfall from plans, ensuing from an overoptimistic assessment of the tax content of economic growth, was fully compensated by windfall receipts from a tax amnesty. On the whole, the slippage compared to the 2002 updated stability programme in the primary budget balance amounted to 1.6% of GDP, confirming the declining trend in the primary balance after the high surpluses recorded in the late 1990s. Thanks to lower than officially projected interest payments in the order of 0.7% of GDP, the total budgetary overrun was, as indicated above, 0.9% of GDP.

Based on the commonly-agreed method for calculating potential output and the output gap, the Commission Spring 2004 forecast estimates the cyclically-adjusted deficit in 2003 at 1.9% of GDP, an improvement of 0.3 percentage point compared to the previous year. This result was achieved on the back of one-off measures, as recalled above, estimated at slightly above 2 percentage points of GDP, up from around 1.5 percentage points in 2002.

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5 Based on the method for calculating potential output and the output gap adopted by the Council on 12 July 2002.

6 "One-off measures", are measures that lead to temporary (and hence fully reversible) deteriorations or improvements in the budget balance. The critical feature is a significant, transitory and identifiable impact on the public accounts, outweighing any possible lasting effect ensuing from the measure. In particular, although it cannot be excluded that tax amnesties may lead to a permanently broader tax base and hence would not be purely one-off, the impact effect in the year in which the tax amnesty receipts accrue can be certainly qualified as temporary.

7 According to the European System of National Accounts (ESA95), sales of real assets are recorded as reducing gross fixed capital formation.

The divergence from the budgetary target in 2004

In 2004, according to the Commission Spring 2004 forecast, real GDP growth is expected to be 1.2% and in the absence of additional measures the general government deficit is projected at 3.2% of GDP, hence above the reference value established in the Treaty. Although decreasing compared to 2003, one-off measures, estimated at around one percentage point of GDP, are still substantial. Thus, net of one-off measures, the estimated deficit would stand at around 4¼ % of GDP.

Based on the Commission Spring 2004 forecast, the slippage in 2004 is of 1.0 percentage point relative to the 2.2% of GDP revised objective set out in the 2003 updated stability programme and of 2.6 percentage points relative to the 0.6% deficit objective in the 2002 updated stability programme. The Commission Spring 2004 forecast estimates the cyclically-adjusted budget deficit to rise by 0.7 percentage points compared to 2003 to 2.6% of GDP, well above the level ensuring a safety margin against breaching the 3% of GDP reference value.

The difference between the Commission Spring 2004 deficit forecast of 3.2% of GDP and the revised official target of 2.2% set out in the 2003 updated stability programme is due to the following elements taken into account in the former: (i) a worse 2003 outturn - excluding the contribution of one-off measures; (ii) lower economic growth in 2004; (iii) higher increases in compensation per employee in the public sector, based on recent contractual developments; (iv) a more cautious, but still optimistic, assessment of the sale of publicly owned real assets; and (v) ANAS, the agency charged with investment in and maintenance of the state road network, is prudentially considered to remain within the general government sector, unlike the official forecast.[8] The Commission Spring 2004 forecast nevertheless incorporates official estimates of the budgetary impact of a number of measures (extension of the terms of the tax amnesty for underdeclaration of past tax liabilities, amnesty for zoning code violations and tax settlement scheme) which, however, may not materialise as planned.

The slow reduction in the government debt-to-GDP ratio

The still high level of the general government debt-to-GDP ratio remains of great concern. In the 2002 updated stability programme, the ratio was planned to decrease by 9.5 percentage points over the period between the end of 2001 and the end of 2004, to reach 100.4% of GDP. In the 2003 updated stability programme, the official target for the debt-to-GDP ratio at the end of 2004 was revised to 105% of GDP. In March 2004 the debt at the end of 2003 was notified at 106.2% of GDP.[9] Without extraordinary operations such as a conversion of debt held by the Banca d'Italia in 2002 and the sale of government-owned stakes in ENEL, ENI and Poste SpA carried out in conjunction with the transformation of the *Cassa Depositi e Prestiti* (the formerly public bank for deposits and loans) into a joint-stock company in 2003, the debt ratio would have barely

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8 ANAS was transformed into a joint-stock company in 2002. In 2002 and 2003 Istat and Eurostat considered that it did not satisfy the requirements for being classified outside the general government, notably that sales cover at least 50% of production costs (including depreciation of the existing assets), as can be drawn from the European system of national accounts (ESA95).

9 Beyond routine debt and GDP data revisions, with the EDP notification of 1 March 2004 the series of general government debt figures from 1999 was revised to incorporate data on postal deposits (current accounts) which had not been included. The figures were further revised to adjust consolidation items.

decreased since 2001. In 2004, the Commission Spring 2004 forecast is 106% of GDP, virtually unchanged compared to the previous year despite privatisation receipts in the order of 1% of GDP (as set out in the 2003 updated stability programme).

The pace of debt reduction was slowed by: (i) the successive slippages in the budget balance, (ii) lower than projected nominal GDP growth in the order of 0.5% in 2002-2003, resulting from optimistic assumptions for real GDP growth, partly counterbalanced by higher than projected increases in the GDP deflator; and (iii) as regards the stock-flow adjustment, a continued excess of the cash borrowing (the *fabbisogno di cassa delle amministrazioni pubbliche* - a deficit measure based on cash flows and including transactions with financial assets but excluding proceeds from privatisation) over the deficit according to the Maastricht definition (on an accruals basis and excluding financial transactions).

The link between the *fabbisogno* and the Maastricht-definition deficit is not fully transparent. The discrepancy between the two aggregates results from: (i) the inexplicably persistent difference between cash and accruals accounts, which, by the nature of these aggregates, should cancel out over time, (ii) financial transactions and (iii) statistical adjustments. The cumulated excess of the *fabbisogno* over the Maastricht-definition deficit has weighed some 8 percentage points of GDP on the reduction of the debt ratio since 1999.

Looking ahead, several factors endanger the long-term sustainability of public finances. Firstly, the primary surplus has steadily declined over the past several years and in 2003 stood at 2.9% of GDP, corresponding to a cyclically-adjusted primary surplus of 3.4% in the Commission services' estimate; both are expected to deteriorate further in 2004 (Spring 2004 forecasts). As highlighted in the Commission services' technical assessment of the 2003 updated stability programme and acknowledged in the programme itself, this level would not ensure sustainability of public finances in the long run, in view of the budgetary impact of an ageing population.[10] Secondly, the benefits from a declining implicit interest rate on the debt linked to the Maastricht convergence process are coming to an end: the margins for gains from refinancing older higher-rate bonds with new issues at much lower rates are almost exhausted. In fact, there is a risk that the interest burden on the debt may again start rising, as market interest rates are likely to increase from the historical lows reached in the past years. In addition, the future path of debt reduction will also be affected by a low rate of potential output growth, which cannot be expected to recover significantly unless Italy vigorously implements structural reforms in the context of the objectives of the Lisbon agenda. Finally, the difference between cash and accruals accounts constitutes an additional obstacle to the reduction of the debt.

Policy conclusions

The Commission considers that the Commission Spring 2004 forecast signals: (1) a significant slippage in the budgetary position for 2004 in the order of one percentage point compared to the deficit target of the 2003 updated stability programme (2.2% of GDP), which in turn was increased from the 0.6% of GDP target in the 2002 updated

[10] Assessment on the 2003 update of the Stability Programme of Italy (2003-2007), ECFIN/18/04-EN (http://europa.eu.int/comm/economy_finance/about/activities/sgp/country/commwd/it/com_it20032004.pdf).

stability programme; (2) that the significant divergence from the path towards a medium-term close to balance or in surplus position can be largely explained by a deceleration in GDP which, as highlighted in successive Council opinions on the stability programme updates, was repeatedly underestimated; (3) that the divergence emerges in spite of a sizeable contribution of one-off measures in the order of one percentage point of GDP; (4) that in the absence of additional corrective measures, the expected deficit in 2004 would exceed the 3% reference value established in the Treaty; (5) that the cyclically-adjusted budget balance estimate is well above the level of 1.5% of GDP ensuring a safety margin against breaching the 3% of GDP reference value; (6) that the deviation from the path towards a medium term close to balance or in surplus position is likely to widen further in 2005 in view of the planned progressive phasing out of one-off measures – the Commission projects a deficit based on existing legislation of 4% of GDP, alongside a recovery of the economy; and (7) that the path of debt reduction is equally at risk, despite sizeable privatisation plans of 1.1% of GDP.

This calls for the activation of the early warning system in the case of Italy.

In view of the above, the Italian authorities should take additional measures to ensure that the general government deficit does not breach the 3% of GDP reference value.

A well-devised within-year adjustment, if framed as a first step of a credible multi-annual programme, could give rise to a positive confidence effect and therefore help offset short-term negative effects on demand. It should be centred on a sizeable reduction and re-composition of expenditure, creating room for the intended lowering of the tax burden, and on an acceleration in the reduction of the debt-to-GDP ratio. This would enhance potential growth in the long run.

Therefore, it would appear appropriate to implement additional measures of a permanent nature of at least € 7 billion (0.5% of GDP) in 2004 which, based on the Commission Spring 2004 forecast, would stem the deterioration of the cyclically-adjusted balance in 2004. This should provide a sufficient margin for bringing the budget below the 3% of GDP reference value, taking also into account possible risks that one-off measures may not yield the amounts projected in the Commission Spring 2004 forecast, which largely mirrors the official projections on the impact of transitory measures.

In subsequent years Italy should aim at ensuring an annual improvement of at least 0.5 percentage point of GDP in cyclically-adjusted terms, and continue to phase out one-off measures as set out in the 2003 update of the stability programme. In this context, given the Government's objective progressively to reduce the tax burden, it will prove crucial to rein in expenditure, in order to avoid the higher deficits which would result from uncompensated tax cuts. In order to maximise the medium-term benefits of fiscal consolidation the Government should also pay attention to the composition and quality of expenditure.