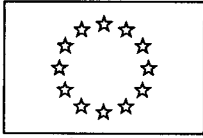

COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 30.1.2002
SEC(2002) 113 final

RESTRICTED EU

Recommendation for a

COUNCIL OPINION

in accordance with the third paragraph of Article 5 of Council Regulation (EC) No 1466/97 of 7 July 1997

on the updated stability programme of Italy, 2001-2005

(presented by the Commission)

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EXPLANATORY MEMORANDUM

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], stipulated that countries participating in the single currency were to submit stability programmes to the Council and the Commission by 1 March 1999. In accordance with Article 5 of this Regulation, the Council had to examine each stability programme based on the assessments prepared by the Commission and the Committee set up by Article 114 of the Treaty (the Economic and Financial Committee). The Commission adopted a recommendation on each programme. On the basis of this recommendation and after having consulted the Committee set up by Article 114, the Council delivered an opinion, following its examination of the programme.

Italy's first stability programme covering the period 1998-2002 was submitted on 22 December 1998 and assessed by the Council on 8 February 1999[2].

According to the Regulation, the updated stability programmes, to be presented annually, may also be examined by the Council in accordance with these same procedures. The first annual update covering the period 1999-2003 was submitted on 19 January 2000 and assessed by the Council on 28 February 2000[3]. The second update, covering the period 2000-2004, was submitted on 20 December and assessed by the Council on 12 February 2001[4].

Italy submitted its third updated stability programme, covering the period 2001-2005, on 16 November 2001. The Commission services have carried out a technical evaluation of this updated programme, which warrants the following assessment:

> The updated programme, the first to be submitted by the new government which took office in June following the general elections in May, broadly complies with the requirements of the revised "code of conduct on the content and format of stability and converge programmes"[5], although there are some inconsistencies in the aggregation of expenditures and revenues, specifically concerning the treatment of the large sales of real assets. Moreover, the programme omits medium-term projections of revenue and expenditure components, which would have permitted a fuller understanding of the budgetary adjustment path.
>
> In a context of considerably weaker output growth in 2001 and 2002 than assumed in the previous update, and with the projected deficit for 2001 slightly exceeding the original objective, the programme reconfirms the budgetary targets for 2002 and 2003 endorsed by the Council in its opinion on the previous update and specifically the balanced budget in the latter year. The achievement of a slight surplus is postponed to 2005. In contrast with the recommendations in the Council opinion on the 2000 update and the BEPG-2001, the ratio of the general government debt to GDP is no longer expected to fall below 100% by 2003, postponing by one year the commitment made by Italy in 1998.

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1 OJ L209, 2.8.1997.
2 OJ C68, 11.3.1999.
3 OJ C98, 6.4. 2000.
4 OJ C77, 9.3.2001.
5 *Revised Opinion of the Economic and Financial Committee on the content and format of stability and converge programmes*, document EFC/ECFIN/404/01 – REV 1 of 27.6.2001 endorsed by the Ecofin Council on 10.7.2001.

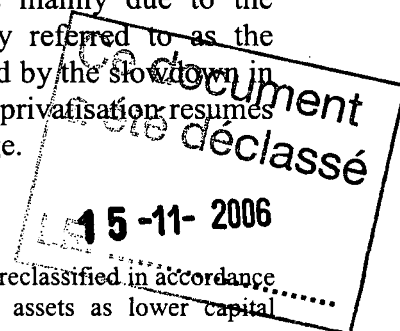
The external assumptions underpinning the programme do not sufficiently reflect the deterioration in the global economic outlook observed during 2001. In spite of a downward revision for 2001 and 2002, the domestic macroeconomic scenario still assumes an acceleration of real GDP growth starting in 2001, with a further strengthening in 2003 and beyond, when economic growth is expected to steady at around 3%. Overall, the risks to the macroeconomic scenario are concentrated on the downside, which does not seem consistent with the degree of caution that should underpin a prudent fiscal strategy.

The consolidation effort over the programme period appears to be driven by a decrease in the ratio to GDP of total expenditures, over a third of which is accounted for by lower interest payments, while the revenue ratio is projected to decrease by one percentage point of GDP.[6] However, the adjustment effort in the first two years of the programme relies heavily on the effects of the sale of real assets. Indeed, without the contribution from such one-off operations, the primary expenditure ratio actually is still increasing in 2002. The effort of reducing the primary expenditure ratio in the last two years of the programme is presumably facilitated by the projected acceleration in growth, but with no clarification as to which measures are intended to replace the one-off effects of the sales of real assets.

The targets in the programme, including their evaluation in cyclically-adjusted terms, imply that the "close-to-balance" objective of the Stability and Growth Pact would be respected by 2003. They allow sufficient margin to avoid breaching the three percent of GDP deficit threshold in normal cyclical fluctuations throughout the programme period. However, the achievement of the "close to balance" objective could be questioned if one adopts a more cautious evaluation of the fiscal policy measures and a less upbeat macroeconomic scenario than those presented in the programme. Using the Commission's Autumn forecast (which covers the period up to the year 2003) as a reference scenario, the structural improvement in the first two years of the programme becomes significantly smaller than implied in the government figures, leaving an underlying deficit of 1.0% of GDP still in place by 2003.

The extensive recourse to one-off measures reduces the quality of adjustment, apart from any considerations on uncertainties regarding their yield. The budgetary objectives remain at risk, particularly if the economy does not follow the high-growth path envisaged by the government. This conclusion is reinforced by the lack of information on the determinants of the reduction of primary expenditure after 2003 and by the absence of proven effective expenditure rules for the monitoring and control of current outlays.

As for the path for the reduction of the government debt ratio, the programme indicates a slowdown compared to previous plans. This is mainly due to the unexpectedly large debt-augmenting contribution traditionally referred to as the "stock-flow" adjustment. While in 2001 this is largely explained by the slowdown in the privatisation process, in the following years, assuming that privatisation resumes as planned, the unexplained residual becomes exceptionally large.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6 For the purpose of this assessment, expenditure and revenue projections were reclassified in accordance with ESA 95 rules (i.e. recording figures for the planned sales of real assets as lower capital expenditure).

The update emphasises the importance of the government's structural reform programme, with three priorities: the labour market, taxation and social security. The government has recently presented to Parliament "enabling acts" containing the mainstays of the three reforms, however their content is not explicitly discussed in the programme and there is still vagueness on their timing. Accordingly, their effect on public finances is not included in the programme's projections. Somewhat inconsistently, however, the reforms underpin the strong and rapid acceleration of GDP growth, which in turn could be questioned in the light of the intention to implement the reforms "in a gradual and balanced fashion".

Although the reforms of the pension system of the 1990s have averted the risk of a significant increase in pension outlays in percentage of GDP in the medium term, they have so far been implemented very gradually. The programme's analysis of the long-term sustainability of public finances suggests that the future increase in age-related expenditure will be relatively low and that the budget will be able to absorb it without imbalances. This conclusion crucially depends on Italy's ability to sustain large primary surpluses over the long run and achieve very large increases in labour force participation rates. This highlights the necessity to hasten the implementation of the pension and labour market reforms and accelerate the reduction of the high debt ratio, in order to increase participation ratios and provide in advance for competing claims on public resources.

Based on this assessment, the Commission has adopted the attached recommendation for a Council opinion on the Stability Programme update of Italy and is forwarding it to the Council.

Recommendation for a

COUNCIL OPINION

in accordance with the third paragraph of Article 5 of Council Regulation (EC) No 1466/97 of 7 July 1997

On the updated stability programme of Italy, 2001-2005

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

Having regard to Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and co-ordination of economic policies[1], and in particular Article 5 (3) thereof,

Having regard to the recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

On [12 February 2002] the Council examined Italy's updated stability programme, which covers the period 2001-2005. The new update broadly complies with the requirements of the revised "code of conduct on the content and format of stability and convergence programmes"[2], although some inconsistencies exist in the aggregation of expenditures and revenues in ESA 95 terms; the Council urges Italy to address this issue in view of the submission of the next updated programme.

The Council notes Italy's intention to continue to secure high primary surpluses throughout the programme period, while allowing for some easing in the tax burden. It further notes with satisfaction the confirmation of the previous updated programme's objectives for the general government balance in 2002 and 2003. It welcomes in particular the balanced budget in the latter year. The Council regrets, however, that the reduction of the debt ratio below 100% of GDP is now postponed to 2004, in contrast with Italy's commitments since 1998.

The programme's macroeconomic scenario assumes an acceleration of real GDP growth already in the second half of 2001, with a further strengthening in 2003 and beyond, when economic growth is expected to steady at around 3%. The macroeconomic scenario is based on external assumptions which do not sufficiently reflect the deterioration in the global economic outlook observed during 2001. The acceleration in economic growth is supported by the programme of structural reforms, the budgetary effects of which, however, are not

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1 OJ L209 of 2.8.1997.

2 *Revised Opinion of the Economic and Financial Committee on the content and format of stability and converge programmes*, document EFC/ECFIN/404/01 – REV 1 of 27.6.2001 endorsed by the Ecofin Council on 10.7.2001.

detailed in the update. The Council observes that the risks to the macroeconomic scenario are mainly on the downside, which does not seem consistent with the degree of caution that should underpin a prudent fiscal strategy.

The budgetary targets in 2002 and 2003 rely heavily on one-off measures, in particular the sale of publicly-owned real assets, while few details are provided on the planned sizeable reduction in non-interest expenditure in percentage of GDP over the programme period. The Council remarks that the extensive recourse to one-off operations, with no clarification as to which measures are intended to replace them, reduces the quality of the adjustment.

The Council observes that the budgetary targets in the programme, including their evaluation in cyclically-adjusted terms, imply that the close-to-balance objective of the Stability and Growth Pact would be respected as of 2003. The budgetary projections provide sufficient margin to avoid breaching the 3% of GDP deficit threshold in normal cyclical fluctuations throughout the programme period.

The Council considers it essential that the balanced fiscal position over the medium term is achieved as planned and that the required high levels of primary surpluses in the order of 5% of GDP are secured by measures aimed at a lasting reduction of primary current expenditures. The careful design and timely implementation of such measures is all the more important in the light of Italy's past failures to achieve a durable reduction in the primary expenditure ratio and of the challenges arising from the planned reform of taxation, which should result in a further significant reduction of the tax burden. The Council urges Italy to adopt rules allowing for an effective monitoring and control of current outlays at all levels. It further recommends that Italy stand ready to keep fiscal consolidation on course after 2003 in the event that the programme's high trend growth assumptions are not supported by actual developments.

The Council observes that Italy's capacity to absorb age-related imbalances depends crucially on maintaining high primary surplus over the long term and very large increases in labour force participation rates. Reforms of the pension system so far have been implemented very gradually but will eventually result in a significant fall in the level of pensions relative to wages. Consequently, in line with its Opinion on the previous updated programmes and the Broad Economic Policy Guidelines for 2001, the Council encourages Italy to accelerate the implementation of the pension reform to control expenditure and to promote supplementary private pension provisions, as stated in the programme. Moreover it notes the key importance of labour market reforms and of accelerating the reduction in the debt ratio, in view of the necessity to increase participation ratios and provide in advance for competing claims on public resources.

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