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REPORT FROM THE COMMISSION

Italy

Report prepared in accordance with Article 104(3) of the Treaty

{SEC(2005) aaaa}

This report, prepared by the Commission according to Article 104(3), assesses recent and current budgetary developments in Italy and reviews the short- and medium-term prospects in the light of overall economic conditions and policy action taken by the government. The analysis underpinning the conclusions of the report is provided in an accompanying technical document.[1] In preparing the report the Commission has taken due account of the 20 March 2005 Ecofin Report to the European Council on 'Improving the implementation of the Stability and Growth Pact', endorsed by the latter on 22 March 2005[2].

1. INTRODUCTION AND REASONS OF THE REPORT

On 23 May 2005, Eurostat released revised figures on Italian government data, showing a general government deficit of 3.1% of GDP in both 2003 and 2004[3]. The revision, still to be considered provisional, addressed a number of the outstanding issues indicated in its press release of 18 March on the March 2005 EDP notification. Over the same two years, the debt-to-GDP ratio is reported to have remained broadly stable at around 106-107% of GDP. On 24 May the Italian institute of statistics (ISTAT) released new public finances data that, while incorporating the above Eurostat's decisions, made additional upward revisions of deficit and debt figures over the 2000-2004 period. The deficit was reported at 3.2% of GDP in 2001, 2003 and 2004. The debt-to-GDP ratio was revised upward to 111.3% in 2000, 110.9% in 2001, 108.3 in 2002, 106.8% in 2003, and confirmed at 106.6% in 2004. Although ISTAT has provided information in order to reconcile EDP and cash deficits, the data released on 24 May are to be considered still provisional. Eurostat has requested further information from the Italian authorities.

The revised figures on both the deficit and the debt therefore provide *prima facie* evidence on the existence of an excessive deficit in Italy in 2003 and 2004, within the meaning of the definitions set out in the Treaty and the Stability and Growth Pact. In the light of this evidence the Commission has decided to initiate the excessive deficit procedure (EDP) for Italy.

The application of the EDP is governed by Article 104 of the Treaty and Council Regulation (EC) No 1467/97 "on speeding up and clarifying the implementation of the excessive deficit procedure", which is part of the Stability and Growth Pact (SGP). According to Article 104(2) of the Treaty, the Commission shall monitor compliance with budgetary discipline on the basis of two criteria: (a) whether the ratio of the planned or actual government deficit to gross domestic product exceeds the reference value of 3%, unless: either the ratio has declined substantially and continuously and reached a level that comes close to the reference value; or, alternatively, the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value; and (b) whether the ratio of government

[1] Technical document by the Commission services accompanying the report on Italy prepared in accordance with Article 104(3) of the TreatySEC(2005) 755.

[2] See Presidency conclusions of the Brussels European Council of 22 and 23 March 2005 (7619/05) and the (Ecofin) Council report to the European Council of 20 March 2005 (7423/05).

[3] On the basis of the March 2005 EDP reporting - not validated by Eurostat -, the Commission services spring 2005 forecasts, published on 4 April, projected a general government deficit of 3.0% of GDP for 2004. On 13 April 2005, Eurostat launched a consultation of the Committee on Monetary, Financial and Balance of Payment Statistics (CMFB) on two particular issues, i.e. SCIP and ISPA, and was also in direct contact with the Italian authorities. On 23 May 2005, Eurostat revised deficit and debt figures for the years 2003 and 2004, also taking into account the result of the consultation of the CMFB. These revisions, however, should be considered provisional because of the still outstanding issues.

debt to gross domestic product exceeds the reference value of 60%, unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace.

Table 1: General government balance and debt (% of GDP)

	1999	2000	2001	2002	2003	2004	Commission services 2005 spring forecasts	
							2005	2006
General government balance	-1.7	-0.6	-3.0	-2.6	-3.1	-3.1	-3.6	-4.6
General government gross debt	115.5	111.2	110.7	108.0	106.5	106.6	105.6	106.3

N.B. The figures shown in this table are provisional. In particular, data for 2001 and 2002 are based on the EDP notification of 1 March 2005, while 2003 and 2004 figures are based on Eurostat's revision of 23 May 2005. The deficit for 2000 includes UMTS receipts amounting to 1.2% of GDP. 2005 and 2006 forecasts were based on the 1 March 2005 notification. Data for the period 2000-2004 were revised by ISTAT on 24 May 2005.

Article 104(3) of the Treaty stipulates that "if a Member State does not fulfil the requirements under one or both of these criteria, the Commission shall prepare a report. The report of the Commission shall also take into account whether the government deficit exceeds government investment expenditure and take into account all other relevant factors, including the medium-term economic and budgetary position of the Member State."

2. DEFICIT CRITERION

Eurostat's revision of 23 May 2005 shows that the general government deficit reached the level of 3.1% of GDP in 2003 and posted the same outturn in 2004. The revision resulted from the clarification of a number of outstanding issues mentioned by Eurostat in its press release of 18 March 2005[4]. According to Eurostat's press release of 23 May 2005, the outcome of the examination of pending issues could lead to a further upward revision in the deficit for the period between 2001 and 2004[5].

According to the figures for 2003 and 2004 reported so far, the deficit is therefore above albeit close to the 3% of GDP reference value.

The excess over the 3% of GDP reference value is <u>not exceptional</u>. The growth performance preceding and accompanying the occurrence of an excessive deficit in Italy in 2003 and 2004 does not qualify as a severe economic downturn. First, the rate of economic growth was low yet stayed positive in 2003 and 2004. Second, the 2003-2004 cyclical slowdown compared to the rate of potential output growth was not protracted. Rather, economic growth in Italy has been slow for more than a decade due to a number of mutually reinforcing structural

[4] The main outstanding issues mentioned by Eurostat were: (i) the recording of payments to government by financial institutions which act as tax collectors (*concessionari d'imposta)*, (ii) the sectoral classification of ISPA, (iii) the treatment of securitisation operations (SCIP), (iv) the recording of transactions with the EU budget, (v) inconsistencies between data on cash and accrual bases and (vi) statistical discrepancies in government accounts. The first three issues have been clarified and the results were communicated by Eurostat in its press release of 23 of May 2005. The clarification entailed an upward revision of the deficit from the notified 2.9% of GDP in 2003 and 3.0% of GDP in 2004 to 3.1% of GDP in both years.

[5] The risks of further upward revisions were corroborated by ISTAT's press release of 24 May 2005, which increased the deficit by around 1 decimal point of GDP per year between 2000-2004. This revision represents an additional step towards a final clarification of the outstanding issues.

weaknesses. Finally, the cumulated loss of output relative to potential is comparatively small[6]. In 2004, actual output was 1.3 percentage points[7] below potential as compared to over 2 percentage points during episodes of recessions recorded in past decades.

Table 2: Macroeconomic and public finances developments

	1999	2000	2001	2002	2003	2004	Commission services 2005 spring forecasts 2005	2006
Real GDP (% change)	1.7	3.0	1.8	0.4	0.3	1.2	1.2	1.7
Potential GDP growth	1.6	1.8	1.7	1.6	1.7	1.9[b]	1.5	1.4
Output gap (% of potential GDP)	0.8	2.0	2.1	0.8	-0.6	-1.3[b]	-1.6	-1.4
General government balance [a]	-1.7	-0.6	-3.0	-2.6	-3.1	-3.1	-3.6	-4.6
Primary balance	5.0	5.8	3.6	3.2	2.2	1.9	1.3	0.4
Gross fixed capital formation of government sector	2.4	2.4	2.5	1.9	2.6	2.6	2.4	2.9
Cyclically-adjusted balance (CAB)	*-2.1*	*-2.7*[c]	*-3.9*	*-2.9*	*-2.8*	*-2.5*	*-2.9*	*-4.0*
Cyclically-adjusted primary balance (CAPB)	*4.7*	*3.7*[c]	*2.7*	*2.8*	*2.5*	*2.5*	*2.0*	*1.0*
One-off measures	-	-	*0.6*	*1.3*	*1.9*	*1.4*	¾	-
CAB excluding one-offs	*-2.1*	*-2.7*	*-4.4*	*-4.2*	*-4.7*	*-3.9*	*-3.7*	*-4.0*
CAPB excluding one-offs	*4.7*	*3.7*	*2.1*	*1.6*	*0.6*	*1.1*	*1.2*	*1.0*

[a] See comments in Table 1.
[b] The estimate of potential output growth for 2004, drawn up in accordance with the common method, is based on official though provisional demographic data showing an exceptionally strong increase in working age population which could be due to statistical factors linked to the break in the population series after the 2001 census. This may imply a bias in the output gap calculation. The 2004 update of the stability programme projected a potential growth of 1.6% in 2004.
[c] Already excluding UMTS receipts (1.2% of GDP).

The excess over the 3% of GDP reference value is not temporary. The deficit was in excess of the 3% of GDP reference value of the Treaty at least in two years, namely 2003 and 2004[8]. Moreover, the Commission services spring 2005 forecasts projected a deficit of 3.6% of GDP in 2005 and 4.6% of GDP in 2006. Furthermore, in view of the deterioration of economic activity in the first quarter of 2005, and taking also into account the recent revised 2005 deficit target (a range between 2.9% and 3.5% of GDP) released by the Italian authorities on 29 April 2005[9], deficit projections are bound to increase substantially. In particular, the government has acknowledged that its latest growth projection for 2005 of 1.2% is on the high side and that a further downward revision would affect the deficit. Consequently, the deficit would remain well above the reference value in the coming years even if economic growth returned to its potential rate. These recent budgetary developments confirm the

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6 It should be noted that actual growth has an effect on potential growth.

7 The size of the negative output gap in 2004 is likely to be inflated by a break in the population series.

8 As mentioned in the introduction, the revised figures released by ISTAT indicated that the deficit was above 3% of GDP also in 2001.

9 On 29 April, the government adopted the planning documents "*Relazione sull'andamento dell'economia nel 2004 e aggiornamento delle previsioni per il 2005*" (Report on the development of the economy in 2004 and revision of the forecasts for 2005) and "*Relazione sulla stima del fabbisogno di cassa per l'anno 2005 e situazione di cassa al 31 dicembre 2004*" (Report on the estimate of the cash borrowing requirement for 2005 and the state of the public finance in cash terms on 31 December 2004).

reiterated warnings in successive Council opinions[10] on the updates of the Italian stability programme, which stressed the risks of a budgetary stance that did not provide a sufficient safety margin against breaching the 3% of GDP deficit value with normal macroeconomic fluctuations. The Commission recommended on this ground the Council to adopt an early warning to Italy on 28 April 2004[11].

This analysis suggests that the Treaty requirement concerning the deficit criterion is not fulfilled.

3. DEBT CRITERION

The debt-to-GDP ratio at 106.6% of GDP in 2004 is clearly above the reference value of the Treaty. The ratio decreased by less than 5 percentage points of GDP between 2000 and 2004, i.e. on average by around 1.2 percentage points of GDP per year. The pace of debt reduction has slowed markedly since 2001 and since 2003 the debt-to-GDP ratio has essentially remained unchanged at a very high level of around 106-107% of GDP. Moreover, the revisions of the deficit figures for 2005 and 2006 imply a concomitant upward revision of debt projections compared to the Commission services spring 2005 forecast.

Table 3: Debt dynamics

in % of GDP	1999	2000	2001	2002	2003	2004	Commission services 2005 spring forecasts 2005	2006
Government gross debt ratio [a]	115.5	111.2	110.7	108.0	106.5	106.6	105.6	106.3
Change in debt ratio	-1.3	-4.3	-0.6	-2.6	-1.5	0.1	-0.2	0.7
Contributions:								
Primary balance	-5.0	-5.8	-3.6	-3.2	-2.2	-1.9	-1.3	-0.4
"Snow-ball" effect [b] *of which*	3.1	0.7	1.8	2.1	2.0	1.0	1.4	1.0
Interest expenditure	*6.7*	*6.5*	*6.5*	*5.8*	*5.3*	*5.0*	*4.9*	*5.0*
Stock-flow adjustment *of which*	0.7	0.9	1.2	-1.5	-1.3	1.0	-0.3	0.1
Cash/accruals primary items and statistical discrepancies [c]	*1.2*	*1.4*	*1.6*	*1.2*	*1.1*	*0.6*		
Accumulation of financial assets [c]	*-1.1*	*-0.2*	*0.1*	*0.0*	*-1.6*	*0.7*		
of which Privatisation proceeds	*-2.0*	*-0.4*	*-0.4*	*-0.1*	*-1.3*	*-0.6*	*-2.1*	*-2.0*

[a] See comments in Table 1.

[b] The snow-ball effect measures the combined effect of interest expenditure and economic growth on the debt ratio. The first has an increasing impact; the second a decreasing impact.

[c] The information provided by ISTAT after the revision of 24 May 2005 warrants a different composition with higher accumulation of financial assets (excluding privatisation proceeds and liquidities) and lower cash/accruals differences. However, there is only a marginal decrease in the debt-increasing part of the Stock flow adjustment.

10 See Council opinion of 10 February 2004 on the updated stability programme of Italy, 2003-2007 and Council opinion of 17 February 2005 on the updated stability programme of Italy, 2004-2008, respectively.

11 See "Recommendation for the Council Recommendation with a view to giving early warning to Italy in order to prevent the occurrence of an excessive deficit" SEC(2004) 485 and Press release 10888/04 concerning the Ecofin Council of 5 July 2004.

The slowdown in the pace of debt reduction in the years 2001-2004 took place despite historically low interest rates that markedly reduced the cost of servicing the debt, and can be explained by a remarkably shrinking primary surplus, the present level of which does not ensure a decline in the debt, and the existence of debt-increasing below-the-line operations that more than offset significant privatisation proceeds, as well as, albeit to a minor extent, to low real GDP growth. Over the 2001-2004 period the debt-increasing components of the Stock-Flow Adjustment (SFA) were on average close to 1½ percentage points per year. Based on the 2004 updated stability programme, this pattern is expected to continue in the future. If the debt-to-GDP ratio were to continue to decline at the annual average recorded over the 2001-2004 period, it would take more than 30 years to approach the 60% Treaty reference value. This conflicts with the condition that the "debt ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace".

This analysis suggests that the Treaty requirement concerning the debt criterion is not fulfilled.

4. OTHER RELEVANT FACTORS

Article 104(3) of the Treaty provides that the Commission report "shall also take into account whether the government deficit exceeds government investment expenditure and take into account other relevant factors". The Ecofin report of 20 March 2005 also refers to the need to consider other relevant factors in the Commission report and clarifies the framework within which such relevant factors should be taken into account. The following three subsections therefore consider in turn the medium-term economic position, the medium-term budgetary position and other factors relevant for the purpose of this report.

I. Medium-term economic position

Cyclical conditions and potential growth. According to the available evidence the economic prospects over the next two to three years remain subdued. The pace of acceleration of economic growth towards the potential rate currently estimated at around 1½% is expected to be moderate. Hence, the output gap is expected to stay negative. As to the medium-term prospects, the structural reforms implemented so far have delivered higher employment growth, without however increasing potential economic growth as many structural weaknesses hampering factor efficiency remain largely unaddressed. The low rate of potential growth calls for more ambitious fiscal targets (balance or surplus) to allow a reduction in the debt ratio.

Recent structural reforms. Labour market reforms implemented since the mid-1990s have contributed considerably to strong job creation, which may have had positive feedback effects on public finances through higher revenue. In 2004 the government also introduced a pension reform. These reforms have had no direct budgetary costs. In March 2005, the government launched an initiative intended to improve the competitiveness of the Italian economy by reducing red tape, reforming R&D subsidies and reforming the bankruptcy laws. The budgetary impact of this initiative is estimated at less than 0.1 % of GDP per year.

II. Medium-term budgetary position

Public investment. Since 2001 the general government deficit has consistently exceeded gross fixed capital formation. Moreover, the gross fixed capital formation has only marginally increased in 2003 and 2004 (table 2) compared to the previous year. The low level of public investment in 2002 is largely explained by sales of real estate which are recorded as negative gross fixed capital formation.

Structural deficit. The lack of fiscal consolidation is evidenced by the high level of the structural deficit, i.e. the deficit net of cyclical factors and one-off measures. It increased from 2.1% of GDP in 1999 and peaked at 4.7% of GDP in 2003. It declined to 3.9% of GDP in 2004 (table 2) and is predicted to remain at around this level in 2005 and 2006. The structural primary surplus deteriorated remarkably from 4.7% of GDP in 1999 to 0.6% of GDP in 2003. In 2004, it increased to 1.1% of GDP and is projected to stay at about this value in 2005 and 2006. This level does not ensure a decline in the debt ratio.

Fiscal consolidation efforts in good times. Italy significantly loosened its fiscal position net of both cyclical factors and one-off measures in 2000 and 2001 when actual economic growth was above potential growth and the output gap was significantly positive. The cyclically-adjusted deficit excluding temporary measures deteriorated by 0.6% of GDP in 2000 and by 1.7% in 2001 (table 2), when real GDP exceeded its potential level by about 2 percentage points. It can therefore be concluded that the worsening of the structural budgetary position in Italy has its roots in the implementation of a strongly pro-cyclical fiscal policy in good times and was masked by the heavy recourse to temporary revenue increasing and expenditure reducing measures.

Expenditure on education and R&D. Expenditure on education including universities has remained essentially unchanged at some 5% of GDP over recent years, in line with the EU average. It increased only marginally in 2003 (the latest year for which a functional breakdown of the budget is available). Public expenditure on R&D in Italy including outlays for research in university was broadly stable at around 0.6-0.7 % of GDP per year over the 1995-2003 period.

Temporary measures. Since 2001 the increasing gap between revenues and primary expenditure has been partially bridged by so called one-off measures, i.e. temporary revenue increasing or expenditure reducing operations. These grew from 0.6% of GDP in 2001 to almost 2% of GDP in 2003 (table 2). The reliance on temporary measures declined in 2004 and is planned to decline further in 2005 and to phase out completely in 2006. However, the ensuing decline in revenues or increase in expenditure is only partly being compensated by structural consolidation measures. This, among other things, explains the projected slippages in 2005 and 2006.

Long-term sustainability of public finances. With regard to the long-term sustainability of public finances, Italy appears to be at some risk.[12] Although the new pension reform approved in July 2004 is an important step in the right direction, it is expected to reduce expenditure only from 2011 onwards. The effectiveness of the reform remains to be seen. Moreover, as indicated above, the projected level of the primary balance for 2005 and 2006, net of cyclical factors and one-off measures (around 1% of GDP), is too low compared with the minimum level of 4% of GDP which appears required to guarantee the respect of the government's inter-temporal budget constraint. In the past years, interest rates have decreased to reach historically low levels. A reversal of this trend could have a significant negative impact on the budget and the long-term sustainability of public finances.

[12] The assessment has not changed compared to the Council opinion of 17 February 2005 on the updated stability programme of Italy.

III. Other relevant factors for a comprehensive qualitative assessment of the excess of the deficit over the reference value

A number of elements characterising public finance developments in Italy over the past several years in existing budgetary institutions and procedures deserve attention. (i) Budget plans have repeatedly been built upon overoptimistic assumptions about GDP growth, which has contributed to significant budgetary slippages in implementation, including in cyclically-adjusted terms. (ii) Over the past several years Italy has launched a series of initiatives aimed at controlling expenditure, including the recent 2% cap on the annual increase in nominal primary expenditure excluding pensions. Available evidence suggests that the effectiveness of such expenditure rules has been disappointing, in particular when it comes to their implementation at the regional and local level. (iii) The fact that the government data have not been validated by Eurostat and the statistical revisions which have taken place over the last years concerning data for 2000-2004 indicate the existence of problems in statistical governance. The recent revisions represent an additional step towards a final clarification of government data in Italy. (iv) The process leading to the adoption of the budget law appears to be not very efficient. Efforts intended to enhance this process have not yet achieved the objective.

6. CONCLUSIONS

According to the figures for 2003 and 2004 reported so far, the deficit ratio has been above but close to the 3% of GDP reference value in 2003 and 2004. The excess of the 3% reference value in 2003 and 2004 took place in a situation of slow growth, which however cannot be qualified as exceptional in the sense of the Treaty and the SGP. The excess over the reference value is projected to increase in 2005 and 2006. Therefore, the excess over the reference value cannot be considered either exceptional or temporary. Moreover, there are risks of further upward revisions of the deficit figures over the 2000-2004 period. In particular, Eurostat has requested further information on the data provided by ISTAT, which tries to reconcile EDP and cash deficit figures. This suggests that the Treaty requirement concerning the deficit criterion is not fulfilled.

The debt ratio remains very high at around 106-107% of GDP and has not declined at a satisfactory pace over recent years. The pace of debt reduction has been affected by persistent debt–increasing below the line operations, which, based on the government own projections are expected to continue over the medium-term. Moreover, the present level of the primary balance does not ensure a declining path of the debt ratio. This suggests that the Treaty requirement concerning the debt criterion is not fulfilled.

The consideration of other relevant factors reinforces the above conclusions.