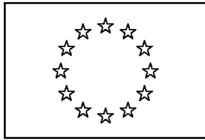

COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 29.6.2005
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# COMMISSION OPINION

## on the existence of an excessive deficit in Italy – Application of Article 104(5) of the Treaty establishing the European Community

# EXPLANATORY MEMORANDUM

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. The revision addressed some of the issues indicated in Eurostat's 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 data that, while incorporating the above Eurostat's decisions, made additional slight 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 and 106.8% in 2003, and confirmed at 106.6% in 2004. Before proceeding to validate the data, Eurostat is considering further information from the Italian authorities.

The application of the excessive deficit procedure (EDP) is governed by Article 104 of the Treaty and by 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[1]. In its assessment 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].

The Commission report according to Article 104(3) of the Treaty assessed the fulfilment of the Treaty requirements concerning the deficit and the debt criteria.

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 both years. 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 cannot be considered temporary because the deficit, after exceeding the reference value in 2003 and 2004, is projected by the Commission to exceed it by a large margin in 2005 and 2006 based on the standard assumption of unchanged policies. The Commission services spring forecast projected a deficit of 3.6% of GDP in 2005 and 4.6% of GDP in 2006. In view of the deterioration in economic activity in the first quarter of 2005, which implies lower expected growth in 2005, and taking also into account the 29 April revision of the deficit target by the Italian authorities[3], deficit projections are bound to be revised upwards. This suggests that the Treaty requirement concerning the deficit criterion is not fulfilled.

The high debt-to-GDP ratio, at around 106-107% of GDP in 2004, is clearly above the reference value of the Treaty and has not declined at a satisfactory pace over recent years. The pace of debt reduction has been affected by debt–increasing below the line operations, which, based on the government own projections, are expected to continue over the medium-term.

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[1] OJ L 209, 2.8.1997.

[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 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). In that occasion, the 2005 deficit target was revised to a range between 2.9% and 3.5% of GDP.

Moreover, the present level of the primary surplus (below 2% of GDP in 2004), does not ensure a satisfactorily declining path of the debt ratio. This suggests that the Treaty requirement concerning the debt criterion is not fulfilled.

In its report in accordance to Article 104(3), the Commission also analysed relevant factors pertaining to the medium-term economic and budgetary positions, as well as others that appeared relevant to the assessment of public finances in Italy.

With a letter dated 6 June 2005, the Italian authorities put forward additional factors, relating specifically to the nature of the statistical revisions, the negative quarterly GDP growth rates recently experienced by Italy, the budgetary impact of the net contribution to the EU budget and the contribution to fostering international solidarity.

In its report of 20 March, the Council underlined that taking into account other relevant factors in the steps leading to the decision on the existence of an excessive deficit, thus including the Economic and Financial Committee opinion in accordance with Article 104(4), the Commission opinion in accordance with Article 104(5) and the Council decision in accordance with Article 104(6), "must be fully conditional on the overarching principle that – before other relevant factors are taken into account - the excess of the reference value is temporary and the deficit remains close to the reference value". In the case of Italy, this condition is not met: the excess over the reference value cannot be considered temporary, although the deficit remained close to the reference value in 2003 and 2004. Therefore, for the purpose of the Commission opinion in accordance with Article 104(5) and the Council decision in accordance with Article 104(6), other relevant factors are not taken into account in the case of Italy.

Article 104(4) of the Treaty states that "the Committee provided for in Article 114 (i.e. the Economic and Financial Committee) shall formulate an opinion on the report of the Commission". The Committee issued its opinion on 20 June 2005, confirming the assessment made by the Commission in its report. In particular, the Committee concluded that the budgetary developments in Italy in 2004 indicated the existence of an excessive deficit under both criteria foreseen by Article 104(2) for the identification of such deficits. The Committee also considered that, based on the standard assumption of unchanged policies and taking into account the deterioration in economic activity recorded in the first quarter of 2005, the general government deficit would continue to exceed the Treaty reference value in 2005 and 2006, and the general government gross debt would continue to remain well above the Treaty reference value of 60% of GDP. The Committee considered that both the high level of government debt and its slow pace of reduction are cause for concern, especially in view of the significant debt-increasing below-the-line operations in the past. While the Committee examined all other relevant factors, it concluded that these factors would not be taken into account in its assessment.

The Commission, having taken into account its report and having regard to the opinion of the Committee, is of the opinion that an excessive deficit exists in Italy. This opinion, adopted by the Commission on 29 June 2005, is herewith addressed to the Council, according to Article 104(5) of the Treaty. The Commission is recommending that the Council shall decide accordingly, in conformity with Article 104(6). In addition, the Commission is submitting to the Council a recommendation for a Council recommendation to be addressed to Italy with a view to bringing the situation of an excessive deficit to an end, according to Article 104(7) of the Treaty.

## COMMISSION OPINION

### on the existence of an excessive deficit in Italy – Application of Article 104(5) of the Treaty establishing the European Community

GENERAL CONSIDERATIONS

According to Article 104 of the Treaty, Member States are to avoid excessive government deficits. Decisions on the existence of an excessive deficit are governed by the excessive deficit procedure (EDP) specified 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.

Article 104(2) of the Treaty requires the Commission to monitor the development of the budgetary situation and of the stock of government debt in the Member States with a view to identifying gross errors. In particular, the Commission has to examine compliance with budgetary discipline on the basis of two criteria, one for the ratio of the planned or actual government deficit to gross domestic product (GDP) and one for the ratio of government debt to GDP. The statistical data on these variables are provided by the Commission on the basis of reporting by the Member States.

Article 104(3) of the Treaty requires the Commission to prepare a report if the requirements under one or both of the criteria of Article 104(2) are not fulfilled or if, notwithstanding the fulfilment of the requirements under the criteria, the Commission is of the opinion that there is a risk of an excessive deficit in a Member State. 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 clarifies the framework within which such relevant factors should be taken into account. Based on data for the year 2003 and 2004 released by Eurostat on 23 May 2005 and also taking into account the Commission services spring 2005 forecast, the Commission has adopted such a report for Italy on 7 June 2005.

Subsequently, and in accordance with Article 104(4), the Economic and Financial Committee has formulated an opinion on the report of the Commission on 20 June 2005.

Article 104(5) of the Treaty requires the Commission to address an opinion to the Council if the Commission considers that an excessive deficit in a Member State exists or may occur. In order to reach a conclusion on whether an excessive deficit exists or may occur, the Commission considers that account should be taken of: (i) the conclusions of its own report, namely whether the requirements under one or both of the criteria of Article 104(2) of the Treaty are not fulfilled, and (ii) the opinion of the Economic and Financial Committee on the report of the Commission. On the basis of these elements, the Commission has established a number of considerations for Italy.

CONSIDERATIONS CONCERNING ITALY

1. According to the figures for 2003 and 2004 released 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 rate of economic growth over the last three years was positive but low (0.4%, 0.3% and 1.2%, in 2002, 2003 and 2004, respectively). While the output gap is estimated to have turned from 2.1% of potential GDP in 2001 to -1.3% of potential GDP in 2004, the negative output gap in 2004 was smaller than the values recorded in previous downturns. In addition, the deficit ratio has not only remained above the Treaty reference value in 2003 and 2004, but it is also projected by the Commission to exceed it by a large margin in 2005 and 2006 under the standard no-policy change assumption. Therefore, the excess over the reference value cannot be considered either exceptional or temporary. This indicates that the Treaty requirement concerning the deficit criterion is not fulfilled.

2. The debt-to-GDP ratio, at around 106-107% in 2004, is clearly above the reference value of the Treaty and has not declined at a satisfactory pace over recent years. The pace of debt reduction has been affected by 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 surplus (below 2% of GDP in 2004) does not ensure a satisfactorily declining path of the debt ratio. This indicates that the Treaty requirement concerning the debt criterion is not fulfilled.

3. In its report according to Article 104(3) if the Treaty, the Commission analysed relevant factors pertaining to the medium-term economic and budgetary positions, as well as others that appeared relevant to the assessment of public finances in Italy.

4. With a letter dated 6 June 2005, the Italian authorities put forward additional factors, relating specifically to the nature of the statistical revisions, the negative quarterly GDP growth rates recently experienced by Italy, the budgetary impact of the net contribution to the EU budget and the contribution to fostering international solidarity.

5. In its report to the European Council on ‘Improving the implementation of the Stability and Growth Pact’, of 20 March 2005, endorsed by the latter on 22 March 2005, the Ecofin Council underlined that taking into account other relevant factors in the steps leading to the decision on the existence of an excessive deficit, thus including the Commission opinion in accordance with Article 104(5) and the Council decision in accordance with Article 104(6), “must be fully conditional on the overarching principle that – before other relevant factors are taken into account - the excess of the reference value is temporary and the deficit remains close to the reference value”. This condition is not met in the case of Italy. Therefore, for the purpose of the Commission opinion in accordance with Article 104(5), other relevant factors are not taken into account in the case of Italy.

6. The opinion of the Economic and Financial Committee in accordance with Article 104(4) of the Treaty is consistent with the assessment in the Commission report under Article 104(3).

CONCLUSION

The monitoring of the budgetary situation in Italy and, in particular, the examination of compliance with the criteria laid down in Article 104(2) has led the Commission to prepare a report in accordance with Article 104(3) of the Treaty. The Commission, having taken into account its report, and having regard to the opinion of the Economic and Financial Committee, is of the opinion that an excessive deficit exists in Italy.