COMMISSION OF THE EUROPEAN COMMUNITIES

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RESTRICTED

Recommendation for a

COUNCIL RECOMMENDATION TO ITALY

with a view to bringing an end to the situation of an excessive government deficit - Application of Article 104(7) of the Treaty establishing the European Community

(presented by the Commission)

Ce document a été déclassé

LE: 4/11/2005

EXPLANATORY MEMORANDUM

THE EXCESSIVE DEFICIT PROCEDURE FOR ITALY

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 provided evidence that the Treaty requirements concerning both the deficit and the debt criteria are not fulfilled. 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". In its opinion of 20 June 2005, the Committee concluded that the budgetary developments in Italy in 2004 were such that both criteria in Article 104(2) for the identification of an excessive deficit are not respected. In particular, although the 2004 deficit was close to 3% of GDP, its excess over the reference value cannot be considered exceptional and temporary. The Committee 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, has been addressed to the Council, according to Article 104(5) of the Treaty. The Commission has also made a recommendation for a Council

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).

decision on the existence of an excessive deficit in Italy in accordance with Article 104(6). In addition, the Commission is herewith submitting to the Council this recommendation for a Council recommendation to be addressed to Italy with a view to bringing the situation of an excessive deficit to an end, in accordance with Article 104(7) of the Treaty.

THE CORRECTION OF THE EXCESSIVE DEFICIT

Council Regulation (EC) No 1467/97 says that "The Council recommendation should (...) establish a deadline for the correction of the excessive deficit, which should be completed in the year following its identification unless there are special circumstances". On 20 March 2005, the Council agreed that the determination of the existence of special circumstances should take into account a balanced overall assessment of other relevant factors. In the case of Italy, unless there are special circumstances, the correction of the excessive deficit should therefore be completed by 2006.

The following elements need to be taken into account in deciding whether there are special circumstances.

A rapid correction of the excessive deficit in Italy appears essential given the high debt-to-GDP ratio and the high level of the structural deficit (the cyclically-adjusted deficit, excluding one-offs and other temporary measures), and considering that persistent budgetary imbalances weigh on confidence and ultimately affect output growth. The budgetary situation of Italy progressively and significantly deteriorated over the recent years. In particular, the primary balance has rapidly declined from 5.0% of GDP in 1999 to below 2% of GDP in 2004. This level, which reflects only to some extent the economic slowdown, exposes the country to considerable risks, which call for a lasting improvement in the public finances. However, in determining the adjustment path, consideration needs also to be given to the current economic situation and the size of the required budgetary correction. While in the case of Italy budgetary consolidation is essential for growth in the medium term, especially if it is of the right composition and it strengthens confidence, too large an effort in too short a period may prove economically costly, in particular considering the current cyclical weakness.

On the basis of recent economic data, according to which GDP fell for two consecutive quarters at the end of 2004 and beginning of 2005, GDP growth in 2005 is now expected to be around zero, down from 1.2% in 2004. This growth rate compares to the 1.2% foreseen in the Commission spring forecast for 2005. As a result of the significantly worsened GDP growth prospects, the upward revision to the 2004 deficit, as well as the revision of the contribution from temporary measures to about 0.4% of GDP from the originally planned ¾% of GDP, the 2005 deficit-to-GDP ratio is now expected to be above 4%, compared to 3.6% in the Commission spring forecast. Assuming no additional measures in 2005, and GDP growth recovering to 1.5% in 2006, bringing the deficit below 3% in 2006 would require an adjustment in structural terms, relative to 2005, of more than 1.5% of GDP.

All in all, in view of the current cyclical weakness in Italy and the size of the required adjustment to bring the deficit below the 3% of GDP reference value by 2006, special circumstances appear to exist and an extension of the deadline for the correction of the excessive deficit to 2007 seems warranted.

A credible adjustment path would require the Italian government to: (i) implement with rigour the 2005 budget. Assuming zero GDP growth and a reduction in temporary measures from

1.4% of GDP in 2004 to 0.4% of GDP in 2005, this would imply a nominal deficit in 2005 of at most 4.3% of GDP and a slight reduction in the structural deficit with respect to 2004; and, (ii) take the necessary measures to ensure a cumulative reduction in the structural deficit of at least 1.6% of GDP over 2006-2007 relative to its level in 2005, with at least half of this correction taking place in 2006. Assuming that GDP growth recovers to around 1.5% in 2006 and 2007 and that half of the total correction takes place in 2006, the deficit-to-GDP ratio would decrease to clearly below 4% and 3% in 2006 and 2007, respectively. The budgetary adjustment needs to be framed within a comprehensive reform strategy aiming at tackling the deep-rooted structural problems that have saddled the Italian economy in the last decade.

The high level of government debt and its slow pace of reduction are cause for concern. In a context of low potential output growth, ensuring that the government gross debt ratio diminishes sufficiently and approaches the reference value at a satisfactory pace would require restoring an adequate level of the primary surplus and addressing factors other than net borrowing that have contributed to the change in debt levels. Particular attention needs to be paid to debt-increasing below-the-line operations, which, based on the government own projections, are expected to continue over the medium term.

Finally, repeated revisions to reported budgetary data highlighted some deficiencies in the collection and processing of general government data, pointing to the need for further improvement in this area.

Recommendation for a

COUNCIL RECOMMENDATION TO ITALY

with a view to bringing an end to the situation of an excessive government deficit - Application of Article 104(7) of the Treaty establishing the European Community

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community, and in particular Article 104(7) thereof;

Having regard to the recommendation from the Commission;

Whereas:

(1) According to Article 104 of the Treaty, Member States are to avoid excessive government deficits.

(2) The Stability and Growth Pact is based on the objective of sound government finances as a means of strengthening the conditions for price stability and for strong sustainable growth conducive to employment creation.

(3) 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, confirms that the Stability and Growth Pact is an essential part of the macroeconomic framework of the Economic and Monetary Union and presents proposals for strengthening and clarifying its application.

(4) The Council has decided on (xx xx 2005), in accordance with Article 104(6), that an excessive deficit exists in Italy.

(5) Having decided on the existence of an excessive deficit in Italy, the Council, in accordance with Article 104(7) of the Treaty and Article 3 of Council Regulation (EC) No 1467/97, is required to make at the same time recommendations to the Member State concerned with a view to bringing that situation to an end within a given period. The Council recommendation has to establish a deadline of four months at the most for effective action to be taken by Italy to correct the excessive deficit as well as a deadline for the correction of the excessive deficit, which should be completed in the year following its identification unless there are special circumstances. On 20 March 2005, the Council agreed that the determination of the existence of special circumstances should take into account a balanced overall assessment of other relevant factors.

(6) In deciding on the existence of special circumstances, the following elements should be taken into account.

(7) A rapid correction of the excessive deficit in Italy appears essential given the high debt-to-GDP ratio and the high level of the structural deficit (the cyclically-adjusted deficit, excluding one-offs and other temporary measures), and considering that persistent budgetary imbalances weigh on confidence and ultimately affect output growth. The budgetary situation of Italy progressively and significantly deteriorated over the recent years. In particular, the primary balance has rapidly declined from 5.0% of GDP in 1999 to below 2% of GDP in 2004. This level, which reflects only to some extent the economic slowdown, exposes the country to considerable risks, which call for a lasting improvement in the public finances. However, in determining the adjustment path, consideration needs also to be given to the current economic situation and the size of the required budgetary correction. While in the case of Italy budgetary consolidation is essential for growth in the medium term, especially if it is of the right composition and it strengthens confidence, too large an effort in too short a period may prove economically costly, in particular considering the current cyclical weakness.

(8) On the basis of recent economic data, according to which GDP fell for two consecutive quarters at the end of 2004 and beginning of 2005, GDP growth in 2005 is now expected to be around zero, down from 1.2% in 2004. This growth rate compares to the 1.2% foreseen in the Commission spring forecast for 2005. As a result of the significantly worsened GDP growth prospects, the upward revision to the 2004 deficit, as well as the revision of the contribution from temporary measures to about 0.4% of GDP from the originally planned ¾% of GDP, the 2005 deficit-to-GDP ratio is now expected to be above 4%, compared to 3.6% in the Commission spring forecast. Assuming no additional measures in 2005, and GDP growth recovering to 1.5% in 2006, bringing the deficit below 3% in 2006 would require an adjustment in structural terms, relative to 2005, of more than 1.5% of GDP.

(9) All in all, in view of the current cyclical weakness in Italy and the size of the required adjustment to bring the deficit below the 3% of GDP reference value by 2006, the Council takes the view that special circumstances exist and an extension of the deadline for the correction of the excessive deficit to 2007 is warranted.

(10) In general, in the view of the Council, budgetary consolidation measures should secure a lasting improvement in the general government balance, while being geared towards enhancing the quality of the public finances and reinforcing the growth potential of the economy. In the case of Italy, the correction of the excessive deficit needs to be framed within a comprehensive reform strategy aiming at tackling the deep-rooted structural problems that have saddled the economy in the last decade.

(11) A credible adjustment path requires the Italian government to: (i) implement with rigour the 2005 budget. Assuming zero GDP growth and a reduction in temporary measures from 1.4% of GDP in 2004 to 0.4% of GDP in 2005, this would imply a nominal deficit in 2005 of at most 4.3% of GDP and a slight reduction in the structural deficit with respect to 2004; and, (ii) take the necessary measures to ensure a cumulative reduction in the structural deficit of at least 1.6% of GDP over 2006-2007 relative to its level in 2005, with at least half of this correction taking place in 2006. Assuming that GDP growth recovers to around 1.5% in 2006 and 2007 and that half of the correction takes place in 2006, the deficit-to-GDP ratio would decrease to clearly below 4% and 3% in 2006 and 2007, respectively.

(12) The high level of government debt and its slow pace of reduction are a cause for concern. In a context of low potential output growth, ensuring that the government gross debt ratio diminishes sufficiently and approaches the reference value at a satisfactory pace requires restoring an adequate level of the primary surplus and addressing factors other than net borrowing that have contributed to the change in debt levels, such as debt-increasing below the line operations.

(13) Repeated revisions to reported budgetary data highlighted some deficiencies in the collection and processing of general government data,

HEREBY RECOMMENDS

- The Italian authorities should put an end to the present excessive deficit situation as rapidly as possible and by 2007 at the latest in accordance with Article 3(4) of Council Regulation (EC) No 1467/97. The Council establishes the deadline of 12 November 2005 for the Italian government to take effective action to this end;

- the Italian authorities should bring the general government deficit below 3% of GDP in a credible and sustainable manner by 2007. Specifically, to this end, the Italian authorities should:

    - implement with rigour the 2005 budget;

    - take the necessary measures to ensure a cumulative reduction in the structural deficit of at least 1.6% of GDP over 2006-2007 relative to its level in 2005, with at least half of this correction taking place in 2006;

- the Italian authorities should ensure that the government gross debt ratio diminishes sufficiently and approaches the reference value at a satisfactory pace by restoring an adequate level of the primary surplus and by paying particular attention to factors other than net borrowing, such as below-the-line operations, which contribute to the change in debt levels;

- the Italian authorities should further improve the collection and processing of general government data.

In addition, the Council invites the Italian authorities to ensure that budgetary consolidation towards the medium term position of government finances close to balance or in surplus is sustained through a reduction in the cyclically-adjusted deficit, net of one-offs and other temporary measures, by at least 0.5% of GDP per year after the excessive deficit has been corrected.

This recommendation is addressed to Italy.

Done at Brussels,

For the Council
The President
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