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Recommendation for a

COUNCIL RECOMMENDATION TO ITALY

with a view to bringing an end to the situation of an excessive government deficit

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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 shall 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 2005 reform of the Stability and Growth Pact sought to strengthen its effectiveness and economic underpinnings as well as to safeguard the sustainability of the public finances in the long run. It aimed at ensuring that in particular the economic and budgetary background was taken into account fully in all steps in the EDP. In this way, the Stability and Growth Pact provides the framework supporting government policies for a prompt return to sound budgetary positions taking account of the economic situation.

(4) The Council has decided on [2 December 2009], in accordance with Article 104(6), that an excessive deficit exists in Italy.

(5) In accordance with Article 104(7) of the Treaty and Article 3 of Council Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure[1] (which is part of the Stability and Growth Pact), the Council is also required to make recommendations to the Member State concerned with a view to bringing the situation of excessive deficit to an end within a given period. The recommendation has to establish a deadline of six months at the most for effective action to be taken by the Member State concerned 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. In deciding whether special circumstances exist, "relevant factors" as clarified in Article 2(3) of Regulation (EC) No 1467/97 should be taken into account. Furthermore, in a recommendation to correct an excessive deficit the Council should

[1] OJ L 209, 2.8.1997, p. 6.

request the achievement of a minimum annual improvement in the structural balance, i.e. the cyclically-adjusted balance excluding one-off and other temporary measures, of at least 0.5% of GDP as a benchmark.

(6) Special circumstances, which are relevant for the greater flexibility in the application of the EDP introduced with the 2005 reform of the Stability and Growth Pact, are deemed to exist in the case of Italy. In particular, the global financial and economic crisis has had a strong adverse impact on the Italian economy. According to the Commission services' autumn 2009 forecast, real GDP is set to contract by 4.7% in 2009, before turning positive in 2010 and 2011. The general government deficit is projected to reach 5.3% of GDP in 2009 and to remain at around that level in 2010 and only slightly decrease in 2011, on a no-policy change basis. The existence of special circumstances authorises the Council to allow the correction of the excessive deficit in a medium-term framework.

(7) The widening deficit in 2009 is mainly the result of the working of the automatic stabilisers, as the government's response to the crisis was appropriately mindful of the need to avoid a further deterioration of public finances, given the very high gross debt. Discretionary measures, taken in line with the European Economic Recovery Plan, have been financed mainly by reallocating funds or by other compensating measures. The deep economic downturn has so far derailed the implementation of the expenditure-based consolidation plan enshrined in the three-year fiscal package approved in summer 2008, which spelled out detailed expenditure targets and the measures for their achievement in the period 2008-2011. Without providing any such detailed plan, the Economic and Financial Planning Document (DPEF) for 2010-2013 updated in September 2009 confirmed the commitment to an expenditure-based adjustment. Accordingly, the Commission services' autumn 2009 forecast projects a marked slowdown in expenditure dynamics in 2010 and 2011, based on the customary no-policy change assumption. Still, the deficit is set to remain well above the 3% of GDP threshold in those years. Also thanks to a more favourable macroeconomic scenario, with real GDP growth projected at 2% in both years, the DPEF plans to bring the deficit below the reference value in 2012. To achieve this objective, an additional consolidation effort at 0.4% of GDP in 2011 and a further 0.8% 2012 is planned, but is not translated into specific corrective measures.

(8) Considering the special circumstances and the EERP framework, an average annual structural budgetary adjustment is recommended. The required adjustment should take into account the fiscal room for manoeuvre which is assessed on the basis of all factors relevant for achieving the fiscal policy objectives, starting with the level of the general government deficit and gross debt as well as other indicators, such as the current account position, the level of contingent liabilities of the financial sector, interest payments, risk premia and the expected change in age-related expenditure in the medium term. In calculating the average annual adjustment, the 2011 deficit in the Commission services' autumn 2009 forecast is taken as the starting point. The total structural adjustment needed to reach the nominal deficit target of 3% by the deadline is then calculated by assuming a gradual closure of the output gap by 2015.

(9) Against this background, it is appropriate to consider the correction of the excessive deficit in a medium-term framework with a deadline for the correction of 2012. In particular, in view of the very high debt ratio and the related interest payments, a credible and sustainable adjustment path would require the Italian authorities to

implement the budgetary measures in 2010 as planned in the three-year fiscal package for 2009-2011 approved in summer 2008 and confirmed in the DPEF 2010-2013 and ensure an average annual structural budgetary adjustment of ½pp. of GDP over the period 2010-2012; specify the measures to achieve the correction of the excessive deficit by 2012 cyclical conditions permitting; and accelerate the reduction of the deficit if economic or budgetary conditions turn out better than currently expected. The budgetary consolidation should also contribute to bringing the government gross debt ratio back on a declining path that approaches the 60% of GDP reference value at a satisfactory pace by restoring an adequate level of the primary surplus.

(10) According to the Commission services' autumn 2009 forecast, the debt ratio is expected, on a no-policy change basis, to grow steadily over the forecast period to 117.8% of GDP in 2011, moving further away from the reference value and continuing to be among the highest in the EU. Pursuing the recommended budgetary consolidation so as to bring the deficit ratio below the 3% reference value by 2012 would contribute to bringing the gross government debt ratio back on a declining path in the medium term. In addition, the Italian authorities should seize any opportunity beyond the structural adjustment to accelerate the reduction of the gross debt ratio towards the 60% of GDP reference value.

(11) The long-term budgetary impact of ageing in Italy is lower than the EU average. However pension expenditure as a share of GDP remains among the highest in the EU and the projections hinge upon the assumption that the adopted reforms are fully implemented. Moreover, the current level of gross debt, which is well above the Treaty reference value, adds to the sustainability risk. Achieving high primary surpluses would therefore contribute to limiting the risk to the long-term sustainability of public finances as defined by the Commission Communication[2] on 'Long-term sustainability of public finances for a recovering economy' and endorsed by the ECOFIN Council[3] on 10 November 2009.

(12) Enhanced surveillance under the EDP, which seems necessary also in view of the deadline for the correction of the excessive deficit, will require regular and timely monitoring of the progress made in the implementation of the fiscal consolidation strategy. In this context, a separate chapter in the updates of Italy's stability programme which will be prepared between 2009 and 2012 could usefully be devoted to this issue.

(13) In general, 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. The adoption, for the first time in July 2008, of a multi-annual budgetary consolidation package has considerably improved Italy's medium-term budgetary consolidation framework, by enshrining the budgetary targets in legislation and spelling out the measures to enable their achievement. However, it was not followed up this year by a comparable document. A reform of the budgetary process, currently under parliamentary discussion, will imply a change in the budgetary cycle and planning instruments so as to allow a greater involvement of the sub-national administrations in setting the budgetary targets and the medium-term strategy for fiscal consolidation. Such

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[2] Available at: http://ec.europa.eu/economy_finance/publications/publication15996_en.pdf

[3] Available at: http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/111025.pdf

improvements in fiscal governance are set to strengthen the enforceable nature of the medium-term budgetary framework and enhance expenditure control, which are key to achieving the planned expenditure-based adjustment. In order to safeguard an adequate level of public services, this will also require improving efficiency and effectiveness of spending. In this context, the challenge for fiscal governance is to design a new framework for fiscal federalism that supports these objectives. In addition, improving the composition of social spending to make it more supportive of adjustment in the labour market would help reinforce the growth potential of the economy, together with the following reforms: strengthening competition in product and services markets, simplifying legislation, reducing the administrative burden at all levels of government and, within a "flexicurity" approach and with a view to reducing regional disparities, improving the functioning of the labour market and the efficiency, outcomes and standards of the education system.

(14) In addition, in view of the importance of achieving its medium-term objective (MTO) to provide an adequate safety margin against cyclical downturns and to ensure convergence of the debt ratio towards a prudent level, also taking into account implicit liabilities related to ageing, Italy should also ensure that budgetary consolidation towards the MTO is sustained after the excessive deficit will have been corrected.

HEREBY RECOMMENDS:

(1) Recognising that Italy's budgetary position in 2009 resulted from an appropriate response to the European Economic Recovery Plan and the free play of automatic stabilisers, the Italian authorities should put an end to the present excessive deficit situation by 2012.

(2) The Italian authorities should bring the general government deficit below 3% of GDP in a credible and sustainable manner by taking action in a medium-term framework. Specifically, to this end, the Italian authorities should:

(a) implement the budgetary measures in 2010 as planned in the three-year fiscal package for 2009-2011 approved in summer 2008 and confirmed in the DPEF 2010-2013;

(b) ensure an average annual structural budgetary adjustment of ½pp. of GDP over the period 2010-2012, which should also contribute to bringing the government gross debt ratio back on a declining path that approaches the 60% of GDP reference value at a satisfactory pace by restoring an adequate level of the primary surplus;

(c) specify the measures that are necessary to achieve the correction of the excessive deficit by 2012 cyclical conditions permitting and accelerate the reduction of the deficit if economic or budgetary conditions turn out better than currently expected.

(3) In addition, the Italian authorities should seize any opportunity beyond the structural adjustment to accelerate the reduction of the gross debt ratio towards the 60% of GDP reference value.

(4) The Council establishes the deadline of [2 June 2010] for the Italian government to take effective action to implement the fiscal measures in 2010 as planned and to

outline the measures that will be necessary to progress towards the correction of the excessive deficit. The assessment of effective action will take into account economic developments compared to the economic outlook in the Commission services' autumn 2009 forecast.

The Italian authorities should report on progress made in the implementation of these recommendations in a separate chapter in the updates of the stability programmes which will be prepared between 2009 and 2012.

In addition, the Council invites the Italian authorities to implement reforms with a view to raising potential GDP growth. This includes reforms conducive to enhancing the quality of public finances, in particular to strengthen further the enforceable nature of the medium-term budgetary framework, effectively implement mechanisms to monitor and control expenditure, improve the composition, efficiency and effectiveness of spending and develop the framework for the forthcoming fiscal federalism in such a way that it fully supports these objectives. The Italian authorities are also invited to step up efforts to strengthen competition in product and services markets, simplify legislation, reduce the administrative burden at all levels of government and, within a "flexicurity" approach and with a view to reducing regional disparities, improve the functioning of the labour market and the efficiency, outcomes and standards of the education system.

This recommendation is addressed to the Italian Republic.

Done at Brussels,

For the Council
The President