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COMMUNICATION FROM THE COMMISSION TO THE COUNCIL

Assessment of the action taken by Italy in response to the Council Recommendation of 28 July 2005 with a view to bringing an end to the situation of an excessive government deficit – Application of Article 104(7) of the Treaty

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1. THE EXCESSIVE DEFICIT PROCEDURE FOR ITALY

Italy undertook significant fiscal consolidation efforts during the 1990s, reducing the government deficit from almost 12% of GDP in 1990 to below 2% at the end of the decade. However, the deficit rose again to slightly above 3% of GDP in 2001, 2003 and 2004[1], in a context of low GDP growth and despite the recourse to substantial one-off measures. The primary surplus, from 5% of GDP in 1999, fell to 1.8% of GDP in 2004, and the decline in the debt-to-GDP ratio, which had peaked at 125% in 1994, slowed down considerably. At the end of 2004, the debt was 106½% of GDP.

The Council, upon the corresponding Commission recommendation, placed Italy in excessive deficit on 28 July 2005 and, in accordance with Article 104(7) of the Treaty, addressed recommendations to Italy with a view to bring the deficit below 3% of GDP in a credible and sustainable manner by 2007 at the latest[2]. The Council established a deadline of 12 January 2006 for Italy to take effective action to this end. Specifically, the Council requested Italy to: "*implement with rigour the 2005 budget*" and to "*take the necessary measures to ensure a cumulative reduction in the cyclically-adjusted deficit, net of one-off and other temporary measures, 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*". In addition, Italy was requested to "*ensure that the government gross debt ratio diminishes sufficiently and approaches the reference value at a satisfactory pace, in line with the correction of the excessive deficit, by restoring in the medium term an adequate level of the primary surplus*", and to "*pay particular attention to factors other than net borrowing, such as below-the-line operations, which contribute to the change in debt levels*". The Council also invited 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-off and other temporary measures, by at least 0.5% of GDP per year after the excessive deficit has been corrected*". Finally, the Council urged the Italian authorities to "*further improve the collection and processing of general government data*".

In accordance with Article 9(3) of Council Regulation 1467/97, as amended by Council Regulation 1056/2005[3], which states that, following the expiry of the deadline for a Member State to take measures following a 104(7) recommendation, "…*the Commission shall inform the Council if it considers that the measures taken seem sufficient to ensure adequate*

1 The budgetary impact of one-off measures amounted to 0.6% of GDP in 2001, 1.9% in 2003 and 1.4% in 2004. In 2002, the deficit was at 2.7% of GDP, with 1.3% of GDP of one-offs.

2 A political agreement on the "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" was reached on 12 July 2005.

3 Respectively, OJ L 209 of 2.8.1997 and OJ L 174 of 7.7.2005.

progress towards the correction of the excessive deficit within the time limits set by the Council, provided that they are fully implemented and that economic developments are in line with forecasts", this communication assesses the action taken by Italy in response to the Council recommendations[4].

2. ACTION TAKEN BY ITALY IN RESPONSE TO THE COUNCIL RECOMMENDATION

2.1. Government budget balances

Budget balance in 2005

The 2005 Budget Law adopted in 2004 targeted a general government deficit of 2.7% of GDP in 2005, based on a GDP growth projection of 2.1%. To achieve the target, the 2005 Budget Law envisaged a correction of 1.7% of GDP with respect to the unchanged legislation trend deficit (estimated at 4.4% of GDP)[5]. This correction, as well as tax cuts and additional expenditures worth 0.5% of GDP, were to be financed by expenditure cuts (in particular via the 2% cap on the growth of nominal spending), new revenues and one-off measures. According to the 2004 update of the stability programme, the 2005 Budget Law would have left the primary balance broadly unchanged relative to 2004, but included a reduction in the impact of one-off measures relative to 2004 by about 0.5% of GDP. The deficit target was revised twice during 2005. At the end of April, with a new GDP growth projection of 1.2%, the target was revised to a range of 2.9-3.5% of GDP. The second revision occurred in July, when the Economic and Financial Planning Document (DPEF) set a new deficit target for 2005 at 4.3% of GDP, while the forecast for the GDP growth rate was revised down to zero. To guarantee the attainment of the 4.3% of GDP deficit target, in October the government introduced new spending cuts and revenue increases amounting to some 0.1% of GDP[6]. The 2005 update of the stability programme confirmed the 4.3% deficit target.

Budget balance in 2006

Starting from a trend deficit at unchanged legislation officially estimated at about 5% of GDP, the 2006 Budget Law, approved by the Italian parliament on 22 December 2005, contains 0.5% of GDP of deficit-increasing discretionary measures aiming at supporting growth and about 2% of GDP of deficit-reducing measures. The full effect of the budget would thus deliver the official 2006 deficit target of 3.5% of GDP (see Table 1).

The growth-supporting measures include a general reduction in social contributions, prolongation of some tax breaks in the agricultural and construction sectors, a new fund to support households, measures to support investment, funds for the renewal of public sector contracts in 2006-2007, and other measures. The main corrective measures are: cuts to the

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4 The Commission is at the same time assessing Italy's December 2005 update of the stability programme. The Commission's assessment, as well as the Council opinion on the programme, can be found at: http://europa.eu.int/comm/economy_finance/about/activities/sgp/country/italy_en.htm

5 In the Italian budgetary process, all measures adopted and planned for future years are defined with respect to the trend deficit at unchanged legislation (so-called "tendenziale"). This means that future expenditure and revenue enter the trend deficit only to the extent that they reflect legislation already approved by Parliament. More details on the trend deficit and the Italian budgetary process more generally can be found in the technical assessment of the 2005 update of the stability programme.

6 These measures, introduced by the Law Decree 211/2005 of 17 October 2005, have then been incorporated in the 2006 Budget Law.

intermediate consumption of central government and local administrations (0.4% of GDP)[7]; cuts to capital expenditure and other expenditure (0.6% of GDP); savings from the health care sector, under the regions' responsibility (0.2% of GDP)[8]; additional revenues (0.75% of GDP, of which slightly more than 0.1% of GDP of new one-offs). Overall, primary expenditure is cut by 0.8% of GDP relative to the trend, and revenues are increased by 0.6% of GDP.

In order to realise the expenditure cuts, the budget strengthens expenditure control mechanisms, for instance by introducing limits to the monthly appropriation of central government expenditure and enhancing the role of the Court of Auditors in the monitoring of the domestic stability pact. The budget also includes provisions aimed at addressing the recurring overshooting of ceilings on health care expenditure[9,10].

Budget balance in 2007 and beyond

According to the December 2005 update of the stability programme, Italy aims at reducing the deficit below 3% of GDP by 2007, and at pursuing further fiscal consolidation in subsequent years towards a medium-term objective (MTO) for the budgetary position as meant in the Stability and Growth Pact of a balanced budget in structural terms. For the years 2007-2009, the update does not provide information on the measures necessary to achieve the budgetary targets; only the intention to phase out one-off measures as of 2007 is mentioned.

2.2. Government debt

After last year's increase, the 2005 update of the stability programme envisages to return the debt-to-GDP ratio on a declining path as of 2006. The debt ratio is projected to fall from 108½% in 2005 to just below 102% in 2009, mainly driven by rising primary surpluses and by privatisation proceeds in 2006 and 2007 amounting to 0.7% of GDP in each year. The debt-increasing contribution from the accumulation of financial assets (excluding privatisation proceeds) in 2005-2006 is planned to be 0.25% of GDP, down from more than 1% of GDP in 2004[11]. Although the programme does not provide details on the composition of the stock-flow adjustment in 2007-2009 (apart from the privatisations in 2007), the projected total stock-flow adjustment suggests that debt-increasing financial operations are expected to cease as from 2007.

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7 Savings on regional and local government expenditure take the form of a further extensive revision of the "domestic stability pact" introduced in 1999. Ceilings differ by type of local authority (regions or provinces and municipalities) and by type of expenditure (current or capital).

8 The savings are on net health expenditures. The expected breakdown is €1.5 billion of higher revenues and €1 billion of lower expenditure (see Table 1).

9 These provisions aim, in particular, at forcing regions with a structural health care deficit to cover part of it through additional revenues and to implement the required savings. Moreover, accountability of doctors and pharmacists will be increased, *inter alia* by the electronic recording of medicament and analysis prescriptions.

10 An amnesty on unpaid social contributions of the agricultural sector currently debated in the Italian Parliament, if eventually approved and subject to statistical verification, might produce a limited upward revision for the deficit and/or the debt ratio.

11 The update projects a cash/accruals difference of 0.5% of GDP in 2006. This difference is also related to the payment of interest on postal bonds, which accrued (and were properly recorded as expenditure) in the past but are paid only when the bonds are redeemed. Excluding this factor, the cash/accruals difference would be minor.

2.3. *Statistics*

Italy has taken measures concerning the collection and processing of general government data. The cooperation amongst the national statistical institute (ISTAT), the Bank of Italy and the Economy and Finance ministry has been stepped up, with the aim of reducing statistical discrepancies between the data from the three sources. A new Information System on the Operations of Government Bodies (SIOPE) to collect online information on budgetary transaction made by public administrations has been established.

3. ASSESSMENT OF THE ACTION TAKEN BY ITALY IN RESPONSE TO THE COUNCIL RECOMMENDATION

The assessment of compliance of the above measures with the Council recommendation under Article 104(7) is carried out on the basis of the Commission services' autumn 2005 forecasts, complemented by the information made available after the forecasts' cut-off date (7 November 2005). In particular, the 2006 Budget Law was adopted by the Italian parliament on 22 December 2005 and the government submitted the update of the stability programme on 23 December.

The macroeconomic scenario underlying the update of the stability programme projects GDP growth to accelerate from zero in 2005 to 1.5% in 2006 and 2007, and then to 1¾% in 2008-2009. This scenario, which is the same as in the DPEF and as the one underlying the Council recommendations in accordance with Article 104(7), is broadly in line with the Commission services' autumn 2005 forecasts, which project GDP growth rates of 0.2%, 1.5% and 1.4% for the years 2005 to 2007.

3.1. *Government budget balances*

Budget balance in 2005

The Council recommendation under Article 104(7) considered as compatible with the rigorous implementation of the 2005 budget a deficit of maximum 4.3% of GDP, under the assumption of zero GDP growth in 2005. The autumn forecasts projected a deficit-to-GDP ratio at 4.3% in 2005 - i.e. in line with the official target, although with slightly higher GDP growth. Recent cash data on the 2005 State sector borrowing requirement suggests that the 2005 deficit target is likely to be achieved.

Table 1: Italy's 2006 budget

In % of GDP	**Draft budget as of 28.10.2005[1]**	**Autumn 2005 forecast[2]**	**Final budget**
Unchanged legislation budget balance (*'tendenziale'*)	**-4.9**	**-5.0**	**-4.9**
Lower primary expenditure	0.8	0.5	0.8
of which: Health care sector	*0.1*	-	*0.1*
Real estate sales	0.2	0.2	-
Lisbon related expenditure	-0.2	-0.2	-
Higher revenue	0.4	0.2	0.6
of which: Health care sector	*0.1*	-	*0.1*
Budget balance	**-3.8**	**-4.2**	**-3.5**
Cyclically-adjusted balance (CAB)	-3.2	-3.6	-2.9
One-offs[3]	**0.5**	**0.4**	**0.3**
of which: - Real estate sales	*0.3*	*0.2*	*0.1*
- Tax amnesties	-	-	*0.1*
- Substitute taxes	*0.2*	*0.1*	*0.2*
Structural balance[4]	-3.7	-4.0	-3.2
Change in structural balance	**0.4**	**0.0**	**0.9**

Notes:
[1] After so called 'Terza fase' amendment of 28 October 2005.
[3] The Commission services' autumn 2005 forecast were based on the draft budget as of 28 October 2005.
[3] One-off and other temporary measures as calculated by the Commission services.
[4] Structural balance = Cyclically-adjusted balance excluding one-off and other temporary measures.

Source:
Draft and final 2006 Budget Law; Commission services' autumn 2005 economic forecasts; Commission services' calculations.

Budget balance in 2006

Based on a cautious assessment of some of the measures in the 2006 draft budget as of 28 October 2005, the Commission services' 2005 autumn forecasts projected a deficit of 4.2% of GDP in 2006, higher than the then official target of 3.8% of GDP (see Table 1). According to Commission services' calculations, the structural adjustment (i.e. the change in the cyclically-adjusted balance net of one-off and temporary measures) between 2005 and 2006 implied by the autumn forecasts would have been clearly lower than the "at least" 0.8% of GDP recommended by the Council.

The changes introduced in the final version of the budget adopted by the Italian parliament call for a reassessment of the structural adjustment. A full implementation of the 2006 Budget Law would be consistent with the minimum 0.8% of GDP improvement in the structural budget deficit in 2006 required by the Council, assuming that real GDP growth is 1.5% in 2006 and that the implemented measures are effective. The larger structural effort compared to the draft budget of 28 October is essentially explained by the additional corrective measures that support the lowering of the deficit target (to 3.5% of GDP) and by the lower amount of planned one-off measures.

The Commission considers that the likelihood of an effective implementation of the measures in the budget, and therefore of achieving the required fiscal effort in 2006, has increased following the strengthening of the mechanisms to enforce expenditure control. At the same time, the Commission believes that there are still significant uncertainties to the 2006 budgetary target, emanating from the combination of ambitious expenditure cuts and untested expenditure control mechanisms. These uncertainties concern in particular the achievement of all the planned savings on local government expenditure, health care and (to a lesser extent) central government expenditure, as well as some other minor measures. Slippages in these areas could lead to a deficit closer to 4% of GDP than to the 3.5% of GDP official target[12].

Budget balance in 2007 and beyond

Assuming that growth unfolds as expected and taking into account Italy's commitment to phase out one-off and temporary measures as of 2007, the achievement of the 2007 deficit target at 2.8% of GDP would imply a structural adjustment of 0.9% of GDP (see Table 2). However, Italy has provided no information on the broad measures envisaged to achieve the 2007 target. This makes it impossible to asses the quality and composition of the adjustment. Moreover, the programme might underestimate the trend deficit and hence the size of the budgetary correction (with respect to trend) required to achieve the 2007 target. In particular, as the unchanged legislation projections do not fully take into account future wage increases in the public sector, the programme projects an improbable 0.6% of GDP fall in compensation of employees between 2006 and 2007. This item largely explains why the 2007 trend deficit in the programme is only 3.3% of GDP, i.e. even lower than the 2006 deficit target. In the years beyond 2007, the pace of the adjustment towards the MTO implied by the programme is broadly in line with the minimum annual improvement in the structural balance of 0.5% of GDP requested by the Council.

3.2. Government debt

The reduction in the debt-to-GDP ratio planned for 2006 and 2007, if achieved, would be consistent with the Council recommendations. There are significant uncertainties concerning the debt reduction path as it is conditional on the combined effect of rising primary surpluses in line with the budgetary targets, the realisation of the privatisation plans and the effective scaling back of debt-increasing below-the-line operations, which would represent a clear discontinuity vis-à-vis the recent past[13]. In the years beyond 2007, a further strengthening of the budgetary targets seems necessary to achieve a sufficiently diminishing debt ratio towards the reference value, which is essential to contain sustainability risks over the long term.

3.3. Statistics

The efforts undertaken to improve the quality of general government data have resulted in a reduction of statistical discrepancies. Following the 1 September 2005 EDP notification, Eurostat published Italy's data with no reference to pending issues[14]. There are still, however, shortcomings in the timely availability of data relating to local authorities and the health sector. The establishment of SIOPE is expected to improve the collection of information on local finance.

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12 See footnote 10.

13 See footnote 10.

14 Apart from pointing to the need to clarify cases of reported capital injections between 2001 and 2004 in a number of countries, including Italy.

Table 2: Budget balances and debt

In % of GDP	2004		2005		2006		2007	
	COM	SP[1]	COM	SP[1]	COM[1]	SP[2]	COM[1]	SP[2]
General government balance	-3.2	-3.2	-4.3	-4.3	-4.2	-3.5	-4.6	-2.8
Primary balance	1.8	1.8	0.6	0.6	0.6	1.3	0.3	1.9
One-offs[3]	1.4	1.4	0.5	0.6	0.4	0.3	-	-
Structural balance[4]	-4.4	-4.4	-4.0	-4.1	-4.0	-3.2	-4.0	-2.3
Change in structural balance	*0.5*	*0.5*	*0.4*	*0.3*	*0.0*	*0.9*	*0.0*	*0.9*
Structural primary balance[5]	0.7	0.7	0.9	0.8	0.8	1.5	0.9	2.4
Debt	106.5	106.5	108.6	108.5	108.3	108.0	107.9	106.1
p.m. Real GDP (annual % change)	*1.2*	*1.2*	*0.2*	*0.0*	*1.5*	*1.5*	*1.4*	*1.5*
p.m. Output gap[6]	*-0.5*	*-0.4*	*-1.5*	*-1.5*	*-1.2*	*-1.2*	*-1.2*	*-1.0*

Notes:
[1] The Commission services' autumn 2005 forecast were based on the draft budget as of 28 October 2005.
[2] Output gaps and cyclical adjustment according to the December 2005 update of the stability programme (SP) as recalculated by the Commission services on the basis of the information in the programme.
[3] One-off and other temporary measures as calculated by the Commission services.
[4] Cyclically-adjusted balance (CAB) excluding one-off and other temporary measures.
[5] Cyclically-adjusted primary balance (CAPB) excluding one-off and other temporary measures.
[6] In percent of potential GDP.

Source:
Stability programme (SP); Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations.

4. CONCLUSIONS

On current information, Italy seems to have taken action consistent with the Council recommendations in accordance with Article 104(7). In particular, Italy:

– appears to have achieved the 4.3% of GDP deficit target for 2005;

– has adopted corrective measures in the 2006 Budget Law that, assuming that they are fully implemented and that economic developments are in line with the scenario underlying the Council recommendations, would ensure adequate progress towards the correction of the excessive deficit within the time limits set by the Council. In particular, subject to the above conditions, the 2006 Budget Law would deliver a structural adjustment in 2006 in line with the Council decision;

– has set a nominal deficit target below 3% for 2007, and plans a structural adjustment in line with the Council recommendations for 2007 and following years;

– plans to return the debt on a declining path thanks to the combined effect of rising primary surpluses in line with the budgetary targets, the realisation of large privatisation plans, and the scaling back of debt-increasing below-the-line operations;

– has taken initiatives which have improved the quality of general government statistics.

However, the correction of the excessive deficit by the 2007 deadline and the reduction in the debt ratio are subject to significant uncertainties as they crucially rely upon:

– an effective implementation of the 2006 budget. In case measures are not fully implemented or prove ineffective, further corrective measures would be needed;

– the specification and implementation of substantial additional corrective measures for 2007.

In view of the above assessment, the Commission considers that no further steps in the excessive deficit procedure of Italy are needed at present. The Commission will continue to closely monitor budgetary developments in Italy in accordance with the Treaty and the SGP, in particular in the light of the fragile situation of public finances.