



COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 2.2.2005
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Recommendation for a

COUNCIL OPINION

**in accordance with the third paragraph of Art. 5 of
Council Regulation (EC) No 1466/97 of 7 July 1997**

On the updated stability programme of Italy 2004-2008

(presented by the Commission)

EXPLANATORY MEMORANDUM

Council Regulation (EC) No. 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies¹ stipulates that participating Member States, that is, those which have adopted the single currency, had to submit stability programmes to the Council and the Commission by 1 March 1999. In accordance with Article 5 of this Regulation, the Council had to examine each stability programme based on assessments prepared by the Commission and the Committee set up by Article 114 of the Treaty (the Economic and Financial Committee). On the basis of a recommendation from the Commission and after having consulted the Economic and Financial Committee, the Council delivered an opinion, following its examination of the programme. According to the Regulation, Member States need to submit annual updates of their stability programmes, which may also be examined by the Council in accordance with these same procedures.

The first stability programme of Italy, covering the period 1998-2001, was submitted on 22 December 1998 and assessed by the Council on 8 February 1999. Updates were presented every following year. Italy submitted the most recent update of its stability programme on 1 December 2004. The Commission services have carried out a technical evaluation of this update, taking into account the results of the Commission services Autumn 2004 economic forecasts, and having regard to the code of conduct², the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances, the recommendations in the Broad Economic Policy Guidelines for the period 2003-2005 and the principles laid down in the Communication from the Commission to the Council and the European Parliament of 27 November 2002 on strengthening the coordination of budgetary policies³. This evaluation warrants the following assessment:

- The programme complies partly with the data requirements of the “code of conduct on the content and format of stability and convergence programmes”. For the years 2006 and beyond only the size of the future fiscal correction is indicated not its composition and the breakdown of the budget is not consistent with the budgetary targets presented in the programme.
- The macroeconomic scenario presented in the programme portrays a gradual and domestic-demand-driven acceleration of economic activity up until 2006 when real GDP growth is expected to stabilise at around 2.3% per year. The scenario incorporates the information set available at around mid-year 2004. Developments emerging after the presentation of the medium-term economic and financial framework (*Documento di programmazione economico-finanziaria – DPEF*) at the end of July 2004 are not reflected. As a result, the short-term growth assumption would appear to be somewhat favourable compared to the Commission 2004 autumn forecast. The same holds for the medium-term outlook. Based on Commission services calculations according to the commonly agreed methodology potential output growth is estimated at around 1¾ % per year as opposed to 1¼ % in the Commission 2004 autumn forecast.

1 OJ L 209, 2.8.1997. All the documents referred to in this text can be found at the following website: http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm.

2 Revised Opinion of the Economic and Financial Committee on the content and format of stability and convergence programmes, endorsed by the ECOFIN Council on 10.7.2001.

3 COM(2002) 668 final, 27.11.2002.

- The programme aims at gradually reducing the nominal budget deficit from an expected outturn of 2.9% of GDP in 2004, via a deficit target of 2.7% of GDP in 2005 to 0.9% of GDP in 2008. Hence, the programme does no longer target a medium term close to balance or in surplus position. Compared to the previous update the deficit figures are more than one percentage point higher and the planned adjustment is back-loaded against a somewhat less favourable macroeconomic scenario. However, since the cyclical conditions, as measured by the output gap, are almost unchanged the largest part of the revision of the deficit can be taken to be structural.
- In cyclically-adjusted terms the budget balance is projected to improve by 1.1 percentage points over the programme period, with the bulk of the adjustment (0.5 percentage point) expected to take place in 2006. No improvement in cyclically-adjusted terms is expected in 2005.
- The assessment of the stability programme highlights clear risks that the budgetary outcome could be worse than projected in the programme. The budgetary objectives are built upon a somewhat favourable macroeconomic outlook, especially in 2005. In parallel, there are several uncertainties linked to the implementation of the 2005 budget including the classification of ANAS, the company in charge of road maintenance, as well as of a number of temporary revenue increasing measures. Further uncertainties refer to 2006, the year in which the largest improvement in cyclically-adjusted terms is projected to take place and when the Government plans to fully replace one-off measures with measures of a permanent nature. The programme does not provide information about how the adjustment is expected to be achieved. Given past experience, it cannot be excluded that in the years 2006 and beyond the gap between the unchanged legislation deficit and the deficit target presented in the programme underestimates the required fiscal consolidation.
- Overall, the budgetary targets in the programme do not provide a sufficient safety margin against breaching the 3% of GDP threshold with normal cyclical fluctuations at least up until 2006. In view of the downside risks to the macroeconomic scenario as well as the risks attached to the implementation of the 2005 budget, additional measures may be required to achieve the nominal deficit target and, more specifically, to prevent the nominal deficit to exceed the 3% of GDP reference value in 2005. Additional measures may also be required in 2006 and beyond.
- In 2004 the debt-to-GDP ratio, which still stands at 106%, is expected to decline only marginally in spite of significant privatisation proceeds. The virtual standstill compared to 2003 results from a slippage in the primary balance and significant debt increasing operations other than the deficit. The pace of debt reduction is expected to pick up again over the 2005-2008 period on the back of the projected improvement in the primary balance, an ambitious privatisation programme and the gradual acceleration of economic growth. However, the positive impact of the planned privatisation proceeds is largely offset by unspecified debt-increasing below-the-line operations. The debt-to-GDP ratio is projected to fall below the 100% threshold only in 2007, four years later than the 2003 deadline to which Italy had committed itself in 1998 with a view to the entry into EMU.
- The fiscal strategy in the programme is dominated by the need to significantly curb current primary expenditures in order to achieve fiscal consolidation and at the same time allow for a reduction of taxes. While officially expected to be deficit neutral, the 2005 tax reform risks having a negative effect on the budget balance. Similarly, the 2% cap on the annual increase in primary expenditure as well as a further revision of the internal stability pact

are not entirely bolstered by credible enforcement mechanisms. The framework law on the pension reform adopted in 2004 is an important step towards addressing the budgetary consequences of aging population. A full implementation of the reform is expected to reduce expenditure by around 0.6-0.7% of GDP between 2011 and 2033 with the tightening of eligibility conditions scheduled to take effect only in 2008 taking the form of a sudden and sharp increase of the retirement age required for seniority pensions. The programme also includes a plan for the disposal of financial assets of on average 1.6% of GDP per year without however providing the relevant details. Finally, several budgetary measures produce a beneficial effect in the short run at the expense of gradually reversing the impact in the future.

- With regard to the long-term sustainability of public finances, Italy appears to be at some risk. Conditional on the full implementation of the budgetary targets and the recently adopted pension reform, Italy would achieve a sustainable path. Hence, in view of the risks to the budgetary targets a prompt correction of any departure from the strategy of running large primary surpluses is instrumental to ensure the long-term sustainability of public finances.
- The economic policies outlined in the update are partly consistent with the country-specific Broad Economic Policy Guidelines in the area of public finances. First, the programme does not envisage a medium-term close to balance or in surplus position. Second, the budgetary targets do not ensure an improvement in cyclically-adjusted terms of at least 0.5 percentage point per year. Third, the planned tax cut is not fully financed in 2005 through structural cuts in current primary expenditure. Finally, the programme does not provide sufficient information on how the mechanisms for strengthening expenditure control would work nor does it outline a clear source of financing regional expenditure.
- In view of the above assessment it would be appropriate for Italy to (i) do the necessary to ensure the achievement of the 2005 deficit target, (ii) make the necessary effort in structural terms in 2006 and beyond to achieve a budgetary position of close to balance by the end of the period covered by the programme (iii) ensure that the debt-to-GDP ratio is declining towards the 60% of GDP Treaty reference value at a more rapid pace, paying particular attention to factor other than net borrowing which contribute to the change in debt levels.

Based on this assessment, the Commission has adopted the attached recommendation for a Council Opinion on the updated stability programme of Italy and is forwarding it to the Council.

Recommendation for a

COUNCIL OPINION

**in accordance with the third paragraph of Art. 5 of
Council Regulation (EC) No 1466/97 of 7 July 1997**

On the updated stability programme of Italy 2004-2008

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

Having regard to Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies⁴, and in particular Article 5(3) thereof,

Having regard to the recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

- (1) On [17 February 2005] the Council examined the updated stability programme of Italy, which covers the period 2004 to 2008. The programme complies partly with the data requirements of the “code of conduct on the content and format of stability and convergence programmes”. For the years 2006 and beyond only the size of the future fiscal correction is indicated not its composition and the breakdown of the budget is not consistent with the budgetary targets presented in the programme. Accordingly, Italy is invited to achieve compliance with the requirements of the code of conduct.
- (2) The macro-economic scenario underlying the programme reflects the information set available at around mid-year 2004. It envisages real GDP growth to pick up from 1.2% in 2004 to 2.1% in 2005 and to average at around 2.3% over the rest of the programme period. On the basis of currently available information, this scenario seems to reflect somewhat favourable growth assumption because both (i) projected growth in 2005 appears on the high side of the current forecasting range and (ii) the projected evolution of growth in the medium term appears relatively optimistic. The programme’s projections of price developments as measured by the GDP deflator appear realistic⁵.

⁴ OJ L 209, 2.8.1997, p. 1. The documents referred to in this text can be found at the following website: http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm.

⁵ The projections for HICP inflation presented in the programme are not forecasts. They rather represent reference values generally intended to be used in the wage bargaining process.

- (3) The programme aims at gradually reducing the nominal budget deficit from an expected outturn of 2.9% of GDP in 2004, via a deficit target of 2.7% of GDP in 2005 to 0.9% of GDP in 2008. Hence, the programme does no longer target a medium term close to balance or in surplus position. In cyclically-adjusted terms the budget balance is projected to improve by 1.1 percentage points over the programme period, with the bulk of the adjustment (0.5 percentage point) expected to take place in 2006. No improvement in cyclically-adjusted terms is expected in 2005. Compared to the previous update the nominal deficit figures are more than one percentage point higher and the planned adjustment is back-loaded against a somewhat less favourable macroeconomic scenario. However, since the cyclical conditions, as measured by the output gap, are almost unchanged the largest part of the revision of the deficit can be taken to be structural.
- (4) There are clear risks that the budgetary outcome could be worse than projected in the programme. In particular, concerning 2005, where the margins are very narrow, lower than projected economic growth, small deviations from the planned budgetary correction of more than 2% of GDP, risks linked to some one-off measures as well as the possible re-classification of ANAS, the company in charge of road maintenance, entail a risk of breaching the 3% of GDP reference value. In the year 2006 and beyond a complete assessment of budgetary developments is complicated as the programme does not detail the measures necessary to achieve the budgetary objectives. Over the same period, given past experience it cannot be excluded that the fiscal adjustment needed to achieve the targets presented in the programme is underestimated.
- (5) In view of this risk assessment, the budgetary stance in the programme does not seem to provide a sufficient safety margin against breaching the 3% of GDP deficit threshold with normal macroeconomic fluctuations at least up until 2006. It is also insufficient to ensure that the Stability and Growth Pact's medium-term objective of a budgetary position of close to balance is achieved by the end of the programme period.
- (6) The debt ratio is estimated to have reached 106% of GDP in 2004, only marginally below the level recorded in 2003 and far above the 60% of GDP Treaty reference value. The programme projects the debt ratio to decline by over 8 percentage points over the programme period mainly on account of an ambitious privatisation plan coupled with an improving primary balance and accelerating economic growth. A more rapid pace of debt reduction is hampered by debt increasing below-the-line operations of more than 2 percentage points of GDP on average per year. The evolution of the debt may be less favourable than projected given (i) the risks to the budgetary targets mentioned above (ii) the high degree of ambition of the privatisation programme.
- (7) With regard to the long-term sustainability of public finances, Italy appears to be in a relatively favourable position, provided the budgetary targets are fully implemented and the expected savings from the recently adopted pension reform achieved. Hence, in view of the risks to the budgetary targets a prompt correction of any departure from the strategy of running large primary surpluses is instrumental to ensure a sustainable path of public finances.

- (8) The economic policies outlined in the programme are partly consistent with the country-specific Broad Economic Policy Guidelines in the area of public finances. First, the programme does not envisage a medium-term close to balance or in surplus position. Second, the budgetary targets do not ensure an improvement in the cyclically-adjusted budget balance of at least 0.5 percentage point per year. Third, the planned tax cut is not fully financed in 2005 through structural cuts in current primary expenditure. Finally, the programme does not provide sufficient information on how the strengthening of mechanisms for expenditure control would work nor does it outline a clear source of financing regional expenditure.

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In view of the above assessment, the Council is of the opinion that Italy should:

- (i) do the necessary to ensure the achievement of the 2005 deficit target;
- (ii) make the necessary effort in structural terms in 2006 and beyond to achieve a budgetary position of close to balance by the end of the period covered by the programme; and
- (iii) ensure that the debt-to-GDP ratio is declining towards the 60% of GDP Treaty reference value at a more rapid pace, paying particular attention to factors other than net borrowing which contribute to the change in debt levels..

Comparison of key macroeconomic and budgetary projections

		2004	2005	2006	2007	2008
Real GDP (% change)	SP 2004	1.2	2.1	2.2	2.3	2.3
	COM Oct 2004	1.3	1.8	1.8	-	-
	SP 2003	1.9	2.2	2.5	2.6	
HICP inflation (%)	SP 2004¹	2.2	1.6	1.5	1.4	1.4
	COM Oct 2004	2.3	2.3	2.0	-	-
	SP 2003	1.8	1.5	1.4	1.4	-
General government balance (% of GDP)	SP 2004	-2.9	-2.7	-2.0	-1.4	-0.9
	COM Oct 2004	-3.0	-3.0	-3.6	-	-
	SP 2003	-2.2	-1.5	-0.7	0.0	-
Primary balance (% of GDP)	SP 2004	2.4	2.4	3.3	4.0	4.7
	COM Oct 2004	2.0	2.1	1.5	-	-
	SP 2003	2.9	3.5	4.4	5.1	-
Cyclically-adjusted balance (% of GDP)	SP 2004²	-2.1	-2.1	-1.6	-1.2	-1.0
	COM Oct 2004	-2.4	-2.6	-3.4	-	-
	SP 2003 ²	-1.6	-1.0	-0.4	0.1	-
Government gross debt (% of GDP)	SP 2004	106.0	104.1	101.9	99.2	98.0
	COM Oct 2004	106.0	104.6	104.4	-	-
	SP 2003	105.0	103.0	100.9	98.6	-
<p><u>Note:</u></p> <p>¹ Planned inflation from 2005 onwards.</p> <p>² Commission services calculations on the basis of the information in the programme.</p> <p><u>Sources:</u></p> <p>Stability programme (SP); Commission services autumn 2004 economic forecasts (COM); Commission services calculations.</p>						