COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 23.1.2007
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Recommendation for a

COUNCIL OPINION

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

On the updated stability programme of Italy, 2006-2011

(presented by the Commission)

EXPLANATORY MEMORANDUM

1. GENERAL BACKGROUND

The Stability and Growth Pact, which entered into force on 1 July 1998, 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. The 2005 reform of the Pact acknowledged its usefulness in anchoring fiscal discipline but sought to strengthen its effectiveness and economic underpinnings as well as to safeguard the sustainability of the public finances in the long run.

Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[1], which is part of the Stability and Growth Pact, stipulates that Member States have to submit, to the Council and the Commission, stability or convergence programmes and annual updates thereof (Member States that have already adopted the single currency submit (updated) stability programmes and Member States that have not yet adopted it submit (updated) convergence programmes). The first stability programme of Italy was submitted in December 1998. In accordance with the Regulation, the Council delivered an opinion on it on 8 February 1999 on the basis of a recommendation from the Commission and after having consulted the Economic and Financial Committee. In accordance with the same procedure, updated stability and convergence programmes are assessed by the Commission and examined by the Committee mentioned above, while the Council may examine them.

2. BACKGROUND FOR THE ASSESSMENT OF THE UPDATED PROGRAMME

The Commission has examined the most recent update of the stability programme of Italy, submitted on 4 December 2006, and has adopted a recommendation for a Council opinion on it (see box for the main points covered by the assessment).

In order to set the scene against which the budgetary strategy in the updated stability programme is assessed, the following paragraphs summarise:

(1) the economic and budgetary performance over the last ten years

(2) the country's position under the corrective arm of the Stability and Growth Pact (excessive deficit procedure)

(3) the most recent assessment of the country's position under the preventive arm of the Stability and Growth Pact (summary of the Council opinion on the previous update of the stability programme) and

(4) the Commission's assessment of the October 2006 national reform programme.

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[1] OJ L 209, 2.8.1997, p. 1. Regulation as amended by Regulation (EC) No 1055/2005 (OJ L 174, 7.7.2005, p. 1). 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

2.1. Recent economic and budgetary performance

In Italy, structural weaknesses feeding into low productivity growth and a loss of external competitiveness appear to be at the root of the country's dismal growth performance over the past decade. Real GDP growth has been below the euro area average since the mid 1990s and potential growth is estimated to have fallen from above 2% up to the early 1990s to 1¼% in the 2000s. Despite weak growth, inflation has remained slightly higher than the euro area average until 2005. On the positive side, Italy is one of the few countries to have enjoyed robust employment growth since the turn of the century and its unemployment rate has fallen substantially. But, while there remains a long way to go before Italy catches up with the EU average in terms of employment rates, the odd combination of dynamic employment growth and sluggish GDP growth highlights Italy's productivity problem. On the public finances front, the general government deficit has been above the 3% of GDP Treaty reference value since 2003 and the debt-to-GDP ratio remains very high and has started increasing again in 2005, to 106.6% of GDP. The cyclically-adjusted primary balance has steadily deteriorated since 1998 and the ratio of current primary expenditure to GDP has not ceased to increase since 2001.

2.2. The excessive deficit procedure for Italy

On 28 July 2005, the Council adopted a decision stating that Italy had an excessive deficit in accordance with Article 104(6). At the same time, the Council addressed a recommendation under Article 104(7) specifying that the excessive deficit had to be corrected by 2007. In particular, Italy was recommended to implement with rigour the 2005 budget; reduce the structural deficit by a minimum 1.6% of GDP by 2007 relative to its level in 2005, with at least half of this correction taking place in 2006; and, ensure that the debt-to-GDP ratio diminishes and approaches the reference value at a satisfactory pace.

On 22 February 2006, the Commission adopted a communication concluding that the actions taken by Italy, if fully implemented and effective, would be consistent with the Council recommendation. However, implementation uncertainties persist, which will require continuous monitoring.

2.3. The assessment in the Council opinion on the previous programme

On 14 March 2006, the Council adopted its opinion on the previous update of the stability programme, covering the period 2005-2009. The Council was of the opinion that “the programme can be considered as consistent with a correction of the excessive deficit by 2007, subject to a full and effective implementation of the 2006 budget and the specification and adoption of further substantial measures for 2007. In the light of the recommendations made by the Council under Article 104(7) of the Treaty on 28 July 2005, and in order to strengthen the sustainability of public finances, the Council invited Italy to:

(i) achieve the structural efforts envisaged in the programme for 2006 and 2007 in order to ensure the correction of the excessive deficit by 2007 in a credible and sustainable manner;

(ii) spell out the broad measures underlying the adjustment path in 2007 and the outer years of the programme and ensure that the adjustment towards the medium-term objective remains in line with the Stability and Growth Pact requirements;

(iii) ensure that the debt-to-GDP ratio is declining towards the 60% of GDP Treaty reference value at a more rapid pace including by paying particular attention to factors other than net borrowing which contribute to the change in debt levels; and

(iv) improve the budgetary process by increasing its transparency and by an effective implementation of the past and new mechanisms to monitor, control and report expenditure.

2.4. The Commission assessment of the October 2006 national reform programme

The Implementation Report of the National Reform Programme of Italy, provided in the context of the renewed Lisbon strategy for growth and jobs, was submitted on 19 October 2006. Italy's National Reform Programme identified as key challenges/priorities: ensuring long-term fiscal sustainability; extending the area of free choice for citizens and companies; granting incentives for scientific research and technological innovation; strengthening education and training; upgrading infrastructure; protecting the environment.

The Commission's assessment of this programme (adopted as part of its December 2006 Annual Progress Report[2]) showed that, compared to last year's National Reform Programme, the Italian Implementation Report presents a clearer strategy, covering all policy areas and the synergies between them and is thus more ambitious. Progress is most extensive in the micro-economic field. Strategies and measures proposed in the macro area are generally appropriate but implementation is crucial. Employment policy needs to be reinforced in certain key areas.

Against the background of the identified strengths and weaknesses, Italy was recommended to take action in the areas of: long-term sustainability of public finances; competition in products and service markets; regional disparities in employment; and lifelong learning and education.

[2] Communication from the Commission to the Spring European Council, "Implementing the renewed Lisbon strategy for growth and jobs - A year of delivery" - COM(2006) 816, 12.12.2006.

Box: Main points covered by the assessment

As required by Article 5(1) (for stability programmes) and Article 9(1) (for convergence programmes) of Council Regulation (EC) No 1466/97, the assessment covers the following points:

- whether the economic assumptions on which the programme is based are plausible;
- the medium-term budgetary objective (MTO) presented by the Member State and whether the adjustment path towards it is appropriate;
- whether measures being taken and/or proposed to respect that adjustment path are sufficient to achieve the MTO over the cycle;
- when assessing the adjustment path towards the MTO, whether a higher adjustment effort is made in economic good times, whereas the effort may be more limited in economic bad times, and, for euro-area and ERM II Member States, whether the Member State pursues an annual improvement of the cyclically-adjusted balance, net of one-off and other temporary measures, of 0.5% of GDP as a benchmark to meet its MTO;
- when defining the adjustment path to the MTO (for Member States that have not yet reached it) or allowing a temporary deviation from the MTO (for Member States that have), the implementation of major structural reforms which have direct long-term cost-saving effects (including by raising potential growth) and therefore a verifiable impact on the long-term sustainability of public finances (subject to the condition that an appropriate safety margin with respect to the 3% of GDP reference value is preserved and that the budgetary position is expected to return to the MTO within the programme period), with special attention for pension reforms introducing a multi-pillar system that includes a mandatory, fully-funded pillar;
- whether the economic policies of the Member State are consistent with the broad economic policy guidelines.

The plausibility of the programme's macroeconomic assumptions is assessed by reference to the Commission services' autumn 2006 forecast, using also the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances. The assessment of consistency with the broad economic policy guidelines is made against the broad economic policy guidelines in the area of public finances as included in the integrated guidelines for the period 2005-2008.

The assessment also examines:

- the evolution of the debt ratio and the outlook for the long-term sustainability of the public finances, which should be given "sufficient attention in the surveillance of budgetary positions" according to the Council report of 20 March 2005 on "Improving the implementation of the Stability and Growth Pact". A Commission Communication of 12 October 2006 sets out the approach to the assessment of long-term sustainability[3];
- the degree of integration with the national reform programme, submitted by Member States in the context of the Lisbon strategy for growth and jobs. In its cover note of 7 June 2005 to the European Council on the broad economic policy guidelines for the period 2005-2008, the ECOFIN Council stated that the national reform programmes should be consistent with the stability and convergence programmes;
- compliance with the code of conduct[4], which inter alia prescribes a common structure and set of data tables for the stability and convergence programmes.

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[3] Communication from the Commission to the Council and the European Parliament, "The long-term sustainability of public finances in the EU" - COM(2006) 574, 12.10.2006 - and European Commission, Directorate-General for Economic and Financial Affairs (2006), "The long-term sustainability of public finances in the European Union", European Economy No 4/2006.

[4] "Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes", endorsed by the ECOFIN Council of 11 October 2005.

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On the updated stability programme of Italy, 2006-2011

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 policies[5], 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 [27 February 2007] the Council examined the updated stability programme of Italy, which covers the period 2006 to 2011.

(2) The macroeconomic scenario underlying the programme envisages that real GDP growth will initially decline from 1.6% in 2006 to 1.3% in 2007. Afterwards, economic growth will gradually pick up, to reach 1.7% in 2011. Assessed against currently available information, this scenario appears to be based on plausible growth assumptions. The programme's projections for inflation appear to be on the low side in the outer years.

(3) The 2006 stability programme update projects the 2006 deficit at 5.7% of GDP[6]. This contrasts with the 4.7% of GDP in the Commission services' autumn 2006 forecast. The Commission scenario does not take account of the 0.9% of GDP slippage due to the cancellation of railway company's debt related to the high speed project (*Ferrovie*

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5 OJ L 209, 2.8.1997, p. 1. Regulation as amended by Regulation (EC) No 1055/2005 (OJ L 174, 7.7.2005, 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

6 The tables in the 2006 Stability Programme do not incorporate the 0.9% of GDP higher one-off government expenditure due to the cancellation of the railway company's debt, which the programme text refers to. This additional expenditure brings the targeted deficit for 2006 to 5.7% of GDP, from the 4.8% reported in the tables, and also affects other budgetary data.

dello Stato – RFI/TAV)[7], following a decision taken in the final phase of the budgetary process. In turn, the Commission services' autumn forecast for the general government deficit is higher than the 3.5% of GDP set in the previous update of the stability programme. The 1.2% of GDP difference is essentially explained by the different impact of one-offs (0.8% of GDP) and the permanent negative impact of the European Court of Justice's ruling on VAT on company cars (around 0.4% of GDP).

(4) The budgetary strategy in the programme aims at correcting the excessive deficit in 2007 (the deficit is planned to decline to 2.8% of GDP). Thereafter, the government balance is planned to continue improving steadily over the programme period, to turn into a positive 0.1% of GDP in 2011. The primary balance is planned to improve from -0.9% of GDP in 2006[6] to 5% in 2011. Until 2007, the adjustment is essentially revenue-based, driven by additional direct taxation and social contributions. Beyond 2007, the information is limited to the size of the correction required to achieve the budgetary targets relative to trends. Compared with the previous programme, the targets from 2007 onwards are broadly unchanged against a less favourable macroeconomic scenario but, due to the much higher 2006 deficit starting point, the adjustment in 2007 is much higher.

(5) The structural balance (i.e. the cyclically-adjusted balance net of one-off and other temporary measures) calculated according to the commonly agreed methodology is planned to improve from a deficit of around 4% of GDP in 2006 to a surplus of ¼% at the end of the programme period (2011). As in the previous update of the stability programme, the medium-term objective (MTO) for the budgetary position presented in the programme is a balanced budget in structural terms, which the programme aims to achieve by 2010. The previous update of the programme did not plan to reach the MTO within the programme period (which stopped in 2009). As the MTO is more demanding than the minimum benchmark (estimated at a deficit of around 1½% of GDP), achieving it should fulfil the aim of providing a safety margin against the occurrence of an excessive deficit. The MTO lies within the range indicated for euro-area and ERM II Member States in the Stability and Growth Pact and the code of conduct and adequately reflects the debt ratio and average potential output growth in the long term.

(6) The budgetary outcomes could be better than projected in the programme in 2006 and worse than projected in the programme after 2007. For 2007 the risks to the budgetary projections in the programme appear broadly balanced. On the positive side, in view of the developments of cash data, the 2006 deficit could turn out lower than the projected 5.7% of GDP, implying a better-than-projected base effect for 2007. However, considerable risks are attached to the effectiveness of several measures included in the 2007 budget. Risks to public finances in the medium term cannot be excluded, in particular stemming from the repeated overruns in health care expenditure. In addition, after 2007, no details are given on the adjustment strategy, increasing the risks attached to the planned fiscal consolidation.

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[7] Following a Eurostat decision of 23 May 2005 (see Eurostat News Release No 65/2005), according to which this railway company's debt was already booked as government liability, the government decision has no impact on the debt.

(7) In view of this risk assessment, the budgetary stance in the programme seems broadly consistent with a correction of the excessive deficit by 2007 as recommended by the Council, provided the budget measures are fully and effectively implemented. Overall, there are negative risks to the 1¼% of GDP planned structural adjustment in 2007. However, available data pointing to a better-than-projected structural adjustment in 2006 (¼% of GDP) could imply a better carry-over into 2007. The budgetary stance may not provide a sufficient safety margin against breaching the 3% of GDP deficit threshold with normal macroeconomic fluctuations before 2010. Furthermore, it may not be sufficient to ensure that the MTO is achieved within the programme period, as envisaged in the programme. In the years following the correction of the excessive deficit, the pace of the adjustment towards the MTO implied by the programme is broadly in line with the Stability and Growth Pact, which specifies that, for euro-area and ERM II Member States, the annual improvement in the structural balance should be 0.5% of GDP as a benchmark and that the adjustment should be higher in good economic times and could be lower in bad economic times.

(8) Government gross debt is officially estimated to have reached 107.6% of GDP in 2006, far above the 60% of GDP Treaty reference value. The programme projects the debt ratio to gradually decline to reach around 98% of GDP in 2011. The evolution of the debt ratio is likely to be more favourable than projected in the programme in 2006 given cash data developments. The risks to the projected evolution of the debt appear to be broadly balanced in 2007. After 2007, the lack of details on the adjustment strategy increases the risks attached to the planned debt reduction. In view of this risk assessment, the debt ratio be may not be sufficiently diminishing towards the reference value over the programme period.

(9) The long-term budgetary impact of ageing in Italy is lower than the EU average, with pension expenditure showing a more limited increase than on average in the EU, thanks to the pension reforms adopted, assuming they are fully implemented, notably including the planned periodical actuarial adjustment in line with life expectancy. Increasing the employment rate, notably of older workers, would improve workers' pensions in the future and contribute to the success of the pension reforms. The initial budgetary position, albeit slightly improved compared with 2005, constitutes a risk to sustainable public finances even before the long-term budgetary impact of an ageing population is considered. Moreover, the current level of gross debt is well above the Treaty reference value and reducing it will require high primary surpluses to be achieved and maintained over a long period. Overall, Italy appears to be at medium risk with regard to the sustainability of public finances.

(10) The stability programme contains a qualitative assessment of the overall impact of the October 2006 implementation report of the national reform programme within the medium-term fiscal strategy. It provides some information on the direct budgetary costs or savings of the main reforms envisaged in the national reform programme and its budgetary projections seem to take into account the public finance implications of the actions outlined in the national reform programme. The measures in the area of public finances envisaged in the stability programme seem consistent with those foreseen in the national reform programme. In particular, both programmes address the issue of fiscal sustainability and envisage the implementation of a cut in the labour tax wedge over 2007-2008.

(11) The budgetary strategy in the programme is broadly consistent with the broad economic policy guidelines included in the integrated guidelines for the period 2005-2008.

(12) As regards the data requirements specified in the code of conduct for stability and convergence programmes, the programme has gaps in the required and optional data[8].

The overall conclusion is that the programme is broadly consistent with a correction of the excessive deficit by 2007, subject to the full and effective implementation of the 2007 Budget. After 2007, the planned adjustment is in line with the requirements of the Stability and Growth Pact and would allow reaching the MTO by the end of the programme period. However, no details are given on the adjustment strategy, which itself represents a risk for the achievement of the budgetary targets after 2007 and hinders a proper assessment of the consolidation strategy.

In view of the above assessment and also in the light of the recommendation under Article 104(7) of 28 July 2005, Italy is invited to:

(i) achieve the planned fiscal consolidation in 2007 so as to correct the situation of excessive deficit in line with the Council recommendation under Article 104(7);

(ii) ensure, after the excessive deficit has been corrected, adequate progress towards the MTO so as to achieve it by the end of the programme period and ensure that the debt-to-GDP ratio is reduced accordingly;

(iii) in view of the very high level of debt, fully implement the adopted pension reforms so as to avoid significant increases in age-related spending; and

(iv) improve the budgetary process by increasing its transparency, spelling out the budgetary strategy with a longer time perspective and effectively implementing mechanisms to monitor and control expenditure, especially health care expenditure.

Italy is also invited to improve compliance with the data requirements of the code of conduct.

[8] In particular, there is no breakdown of the budget consistent with the deficit targets for the years 2008-2011.

Comparison of key macroeconomic and budgetary projections

		2005	2006	2007	2008	2009	2010	2011
Real GDP (% change)	**SP Dec 2006**	**0.0**	**1.6**	**1.3**	**1.5**	**1.6**	**1.7**	**1.7**
	COM Nov 2006	0.0	1.7	1.4	1.4	n.a.	n.a.	n.a.
	SP Dec 2005	*0.0*	*1.5*	*1.5*	*1.7*	*1.8*	*n.a.*	*n.a.*
HICP inflation (%)	**SP Dec 2006**	**2.2**	**2.2**	**2.1**	**1.7**	**1.5**	**1.5**	**1.5**
	COM Nov 2006	2.2	2.3	2.0	1.9	n.a.	n.a.	n.a.
	SP Dec 2005	*2.3*	*2.3*	*2.2*	*2.0*	*2.0*	*n.a.*	*n.a.*
Output gap (% of potential GDP)	**SP Dec 2006[1]**	**-1.3**	**-0.9**	**-0.9**	**-0.8**	**-0.7**	**-0.5**	**-0.5**
	COM Nov 2006[5]	-1.4	-1.0	-1.0	-1.1	n.a.	n.a.	n.a.
	SP Dec 2005[1]	*-1.5*	*-1.2*	*-1.0*	*-0.8*	*-0.6*	*n.a.*	*n.a.*
General government balance (% of GDP)	**SP Dec 2006[7]**	**-4.1**	**-5.7**	**-2.8**	**-2.2**	**-1.5**	**-0.7**	**0.1**
	COM Nov 2006	-4.1	-4.7	-2.9	-3.1	n.a.	n.a.	n.a.
	SP Dec 2005	*-4.3*	*-3.5*	*-2.8*	*-2.1*	*-1.5*	*n.a.*	*n.a.*
Primary balance[6] (% of GDP)	**SP Dec 2006[7]**	**0.7**	**-0.9**	**2.2**	**2.8**	**3.4**	**4.2**	**5.0**
	COM Nov 2006	0.5	-0.1	1.8	1.7	n.a.	n.a.	n.a.
	SP Dec 2005	*0.6*	*1.3*	*1.9*	*2.6*	*3.2*	*n.a.*	*n.a.*
Cyclically-adjusted balance (% of GDP)	**SP Dec 2006[1 7]**	**-3.5**	**-5.3**	**-2.3**	**-1.8**	**-1.2**	**-0.4**	**0.3**
	COM Nov 2006	-3.4	-4.1	-2.4	-2.5	n.a.	n.a.	n.a.
	SP Dec 2005[1]	*-3.5*	*-2.9*	*-2.3*	*-1.7*	*-1.2*	*n.a.*	*n.a.*
Structural balance[2] (% of GDP)	**SP Dec 2006[1 3]**	**-4.0**	**-3.9**	**-2.5**	**-1.9**	**-1.2**	**-0.4**	**0.3**
	COM Nov 2006[4]	-3.9	-3.6	-2.5	-2.6	n.a.	n.a.	n.a.
	SP Dec 2005[1]	*-4.1*	*-3.2*	*-2.3*	*-1.7*	*-1.2*	*n.a.*	*n.a.*
Government gross debt (% of GDP)	**SP Dec 2006**	**106.6**	**107.6**	**106.9**	**105.4**	**103.5**	**100.7**	**97.8**
	COM Nov 2006	106.6	107.2	105.9	105.7	n.a.	n.a.	n.a.
	SP Dec 2005	*108.5*	*108.0*	*106.1*	*104.4*	*101.7*	*n.a.*	*n.a.*

Notes:

[1] Commission services calculations on the basis of the information in the programme

[2] Cyclically-adjusted balance (as in the previous rows) excluding one-off and other temporary measures

[3] One-off and other temporary measures taken from the programme (0.5% of GDP in 2005, 0.1% in 2007 and 2008; deficit-reducing. In 2006, 1.4% of GDP deficit-increasing)

[4] One-off and other temporary measures taken from the Commission services' autumn 2006 forecast (0.5% of GDP in 2005, 0.1% in 2007 and 2008; deficit-reducing. In 2006, 0.5% of GDP deficit-increasing).

[5] Based on estimated potential growth of 1.2%, 1.3%, 1.4% and 1.5% respectively in the period 2005-2008.

[6] Data on the primary balance in the programme and in the Commission services' forecasts are not directly comparable because of a different treatment of FISIM. Data in the programme follow the definitions required by the code of conduct. To be comparable with data in the programme, Commission data on the primary balance need to be adjusted by around +0.2% of GDP.

[7] The budgetary data in the programme for 2006 have been amended to include 0.9% of GDP of expenditure due to the cancellation by the State of the railway company's debt related to the high-speed project, announced in the stability programme and approved with the final amendment to the 2007 Budget Law.

Source:
Stability programme (SP); Commission services' autumn 2006 economic forecasts (COM); Commission services' calculations