COMMISSION OF THE EUROPEAN COMMUNITIES

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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, 2008-2011**

# EXPLANATORY MEMORANDUM

## 1. GENERAL BACKGROUND

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. 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. In particular, it introduced greater flexibility in the application of the rules governing the excessive deficit procedure, notably with regard to definition of "exceptional circumstances" and the setting of deadlines for the correction of an excessive deficit.

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 each Member State has to submit, to the Council and the Commission, a stability or convergence programme 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.

## 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 6 February 2009, and has adopted a recommendation for a Council opinion on it[2].

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

(1) the Commission Communication of 26 November 2008 (“A European Economic Recovery Plan”);

(2) 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).

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[1] OJ L 209, 2.8.1997, p. 1. The documents referred to in this text are available at: http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm.

[2] The Stability and Growth Pact requires the Commission to prepare a report under Article 104(3) of the Treaty when an actual or planned deficit exceeds the 3% of GDP reference value. In view of the great uncertainty surrounding the current economic juncture, the Commission considers it appropriate that reports based on planned deficits for 2009 in excess of the reference value take account of further information as provided in the forthcoming EDP notification and Commission services' forecasts.

## 2.1. The Commission Communication of 26 November 2008 (“A European Economic Recovery Plan”)

In view of the unprecedented scale of the global financial and economic crisis, the European Commission has called for a European Economic Recovery Plan (EERP)[3]. The plan proposes a co-ordinated counter-cyclical macro-economic response to the crisis in the form of an ambitious set of actions to support the economy consisting of (i) an immediate budgetary impulse amounting to € 200 bn. (1.5% of EU GDP), made up of a budgetary expansion by Member States of € 170 bn. (around 1.2% of EU GDP) and EU funding in support of immediate actions of the order of € 30 bn. (around 0.3 % of EU GDP); and (ii) a number of priority actions grounded in the Lisbon Strategy and designed to adapt our economies to long-term challenges, continuing to implement structural reforms aimed at raising potential growth. The plan calls for the fiscal stimulus to be differentiated across Member States in accordance with their positions in terms of sustainability of government finances and competitive positions. In particular, for Member States outside the euro area with significant external and internal imbalances, budgetary policy should essentially aim at correcting such imbalances. The plan was agreed by the European Council on 11 December 2008. In this context, the examination of how measures (budgetary measures as well as structural measures) contribute to the recovery process in the short term is made in the opinions of stability or convergence programmes.

## 2.2. The assessment in the Council opinion on the previous update

In its opinion of 12 February 2008, the Council summarised its assessment of the previous update of the stability programme, covering the period 2007-2012, as follows.

"The overall conclusion is that the programme is consistent with a correction of the excessive deficit in 2007, which should be achieved by a good margin. The 2007 budgetary outturn is likely to outperform expectations due to the favourable cyclical and budgetary developments. This result could have been even better in the absence of the additional expenditure approved during the year. In 2008, the structural balance risks deteriorating substantially, unless the better-than-projected 2007 starting position is carried through. The planned adjustment towards the MTO is back-loaded to the outer years of the programme. The programme provides no information on the composition of the fiscal consolidation strategy after 2008, which hinders its proper assessment. In particular, appropriate measures aimed at curbing expenditure developments remain to be spelled out. In the light of these risks, the MTO may not be achieved by 2011 as planned in the programme and the debt ratio may not be sufficiently diminishing towards the 60% of GDP reference value over the programme period. With regard to the sustainability of public finances, Italy is at medium risk but this assessment assumes the full implementation of the pension reforms."

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[3] Communication from the Commission to the European Council of 26 November 2008 - COM(2008) 800.

In view of this assessment, the Council invited Italy to:

"(i) building on the positive results of 2007, strengthen the budgetary target for 2008, so as to secure an ambitious adjustment; and implement the planned fiscal consolidation thereafter, with specified measures to ensure adequate progress towards the MTO, so as to achieve it within the programme period and thus accelerate the pace of debt reduction;

(ii) in view of the very high level of government debt, fully implement the pension reforms, notably the planned periodical actuarial adjustment, so as to avoid significant increases in age-related spending; and

(iii) spell out the budgetary strategy within a medium time perspective in line with the SGP and its Code of Conduct, continue the effort to improve the quality of public finances by focussing on their composition, increasing the transparency of the budgetary process and effectively implementing mechanisms to monitor and control expenditure".

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, 2008-2011

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[4], 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 [10 March 2009] the Council examined the updated stability programme of Italy, which covers the period 2008 to 2011.

(2) Adding to the long-standing structural weaknesses that have prevented satisfactory productivity growth for several years, the global downturn is severely hitting the Italian economy, even though the low indebtedness of the Italian private sector and a relatively solid financial system have so far provided some shelter from the direct impact of the financial crisis. A marked slowdown of real GDP growth in Italy was already under way in mid-2007, well before the deepening of the financial market crisis. It turned into recession in the second half of 2008, driven by faltering domestic demand and declining exports. Restoring business and consumer confidence, ensuring access to credit, in particular for SMEs, facilitating adjustment in the labour market to deal with rising unemployment and improving the conditions for productivity growth and enhanced cost competitiveness are key near-term challenges. In light of the very high government debt and the associated interest burden, the Italian government's response to these challenges must be carefully balanced with the need to avoid a substantial deterioration of public finances. In response to the European Economic Recovery Plan (EERP), the recovery package adopted in November 2008 aims at supporting low-income households and firms, while accelerating public investment.

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

Further measures were adopted in February 2009 to support demand for energy-efficient durable goods. The negative budgetary impact of these measures is projected to be limited, if not nil according to the programme's projections. Still, the economic downturn is weighing heavily on the Italian public finances.

(3) The macroeconomic scenario underlying the programme envisages that, after falling by 0.6% in 2008, real GDP will contract further in 2009, by 2%. Real GDP growth is expected to recover mildly, to 0.3%, in 2010 and more decisively, to 1%, in 2011. These macroeconomic projections take into account the recovery measures adopted on 28 November, the expected economic impact of which is however not quantified. Assessed against currently available information,[5] economic growth could be even lower than projected in the programme. Also in the light of this, the 2009 projections for employment in the programme seem to be rather optimistic, in particular as concerns hours worked. By contrast, the projections for inflation appear realistic. The programme's inflation prospects and the underlying moderation in unit labour cost growth in the medium-term imply some containment of the competitiveness loss that Italy has been experiencing since the late 1990s.

(4) The Commission services' January 2009 interim forecast estimates that the general government deficit increased to 2.8% of GDP in 2008, compared to the 2.2% deficit target in the November 2007 update of the programme. The higher-than-expected outcome occurred in spite of a positive base effect, as the 2007 deficit is now reported at 1.6% of GDP as against 2.4% expected in the previous programme. The better 2007 starting position was more than offset by developments in 2008, partly related to the adverse economic conditions. In addition, higher interest rates entailed increased debt servicing costs. A shortfall in revenue growth going over and above the impact of the economic slowdown reflects the implementation of various discretionary measures, namely: the take up by employers in 2008 of the cut in the labour tax wedge (for workers on permanent contracts) foreseen for 2007, the complete abolition of the tax on primary residential property and the postponement to 2009 of some tax payment deadlines adopted with the economic recovery package at the end of 2008. The structural deficit – that is, the cyclically-adjusted deficit net of one-off and other temporary measures – is estimated to have increased by ½ percentage point of GDP relative to 2007. This compares with ¼ percentage point improvement planned in the November 2007 update of the programme.

(5) According to the programme, the deficit is targeted to increase to 3.7% of GDP in 2009, above the 3% of GDP deficit reference value, from 2.6% of GDP in 2008. This compares with a projection of a deficit of 3.8% in the Commission services' interim forecast. The widening of the deficit reflects the operation of the automatic stabilisers, while the recovery package is assumed to have a neutral budgetary impact. In particular, primary expenditure growth, albeit moderate by historical standards (3.1% in nominal terms compared to 4.5% on average during the period 1999-2007), is assumed to largely outpace nominal GDP growth. Revenue growth would slow down considerably, but by less than the tax base, also reflecting a combination of one-off and permanent discretionary measures adopted with the recovery and the three-year fiscal packages, as well as positive social contribution developments mainly on the

[5] The assessment notably takes into account the Commission services' January 2009 forecast, but also other information that has become available since then.

back of the relatively favourable employment projections. Lower interest rates would drive interest expenditure marginally down, despite a higher debt, thus providing some limited relief to the public finances. As a result of these developments the structural balance recalculated by the Commission services on the basis of the information in the programme would improve by ¼ percentage point of GDP compared to 2008.

(6) Regarding the medium-term budgetary strategy, the programme confirms the commitment to the medium-term objective (MTO) of a balanced budgetary position in structural terms, but not the 2011 target date for its achievement. The economic downturn implies a delay in the budgetary consolidation plan enshrined in the three-year fiscal package approved in the summer 2008. The pledge to the expenditure-based adjustment that was spelled out in that package is restated, in particular by broadly confirming the medium-term projections for individual spending categories and the measures for its achievement. However, although planned to be budgetary neutral, the implementation of the recovery package implies some backloading of the expenditure-based adjustment, due to the acceleration of investment and the one-off payments to households in 2009. After the sharp increase projected in 2009, the primary expenditure-to-GDP ratio would gradually return to a level similar to that estimated for 2008 thanks to improved economic conditions and very subdued annual increases planned over 2010-2011 (0.8% on average in nominal terms). The revenue-to-GDP ratio is projected to increase slightly between 2008 and 2011. After peaking in 2009, the headline deficit is planned to decline to 3.3% of GDP in 2010 and 2.9% of GDP in 2011. A projected rebound in interest expenditure from 2010 implies that the primary balance is planned to improve at a faster pace. The recalculated structural balance would continue improving in 2010 and 2011, by a cumulative 1 percentage point of GDP. The planned fiscal consolidation over 2010-2011 is driven by the constraints stemming from the very high government debt. Having increased to just below 106% of GDP in 2008, also reflecting the precautionary accumulation of liquid assets held with the Bank of Italy, the government gross debt ratio is projected to continue increasing in 2009 and 2010, to a peak of 112% of GDP, before slightly declining to 111.6% in 2011. The main drivers of these developments are the planned low primary surpluses and subdued nominal GDP growth. The "stock-flow" adjustment projected in the programme is relatively small but it does not incorporate the possible implementation of the bank recapitalisation scheme adopted with the recovery package, as it has not yet been utilized.

(7) The deficit outcomes could be higher than projected in the programme throughout the covered period. First, economic growth could be lower. Second, the subdued increase in primary expenditure planned over 2010-2011 requires strict implementation, at all levels of government, of the expenditure-based adjustment underlying the three-year package adopted in the summer 2008. Third, the programme's projections for social contributions, notably for 2009, may not materialise, also given the rather favourable underlying assumptions for employment growth. Finally, although planned to be fully financed, the recovery package adopted in November 2008 and the new fiscal incentives for the purchase of durable goods adopted in February 2009 (not incorporated in the programme) might affect the 2009 budgetary outcome. For the same reasons, the evolution of the debt ratio from 2009 onwards might be less favourable than projected in the programme. The gross debt ratio could also be affected by possible capital injections into the banking sector.

(8) 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 adopted pension reforms. Yet, 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, in particular that revised actuarial coefficients that are fully consistent with the contributory principle underlying the reformed pension system are applied as of 2010. Additional measures could be considered, notably a further increase in the retirement age, in particular for women. This would allow reallocating social expenditure so as to put in place a more comprehensive and uniform unemployment benefit system that ensures appropriate work incentives and effective activation policies. The budgetary position in 2008 as estimated in the programme, which is worse than the starting position of the previous programme, would be sufficient to stabilise the current debt ratio but would not contribute to offsetting the projected long-term budgetary impact of ageing. Moreover, the current level of gross debt is well above the Treaty reference value. Achieving and maintaining high primary surpluses over the medium term would contribute to reducing the medium risks to the sustainability of public finances.

(9) Significant progress has been achieved in recent years to improve the fiscal framework, a key pre-condition for a credible medium-term strategy of expenditure-based adjustment underpinned by enhanced cost-effectiveness and efficiency of public expenditure. The three-year fiscal package adopted in the summer 2008 strengthens the medium-term fiscal framework by spelling out detailed yearly caps for individual expenditure items and backing them up with broad measures. Several other initiatives were introduced to improve budgetary institutions. The structure of the state budget was rationalised by introducing a programme-based classification that allows better allocating resources in line with government policy objectives. Enhanced flexibility is allowed to line ministries to reallocate resources between spending programmes according to priorities. A pilot spending review exercise was conducted in five ministries to assess cost-effectiveness of public expenditure and there is now the intention to make this an integral part of the budgetary process. Enforcement mechanisms of the Domestic Stability Pact, governing fiscal relations between the different levels of government, have been strengthened. Finally, important steps are being taken to improve the efficiency and cost-effectiveness of the public administration, *inter alia* by promoting a more rational use of available resources and better rewarding merit. Going forward, a major challenge for fiscal governance is to design a new framework for fiscal federalism that ensures the accountability of local governments and fosters efficiency.

(10) At the end of 2008, in response to the global financial crisis, the Italian authorities adopted a series of measures aimed at protecting savers and maintaining adequate levels of bank liquidity and capitalization. These allow the government, until end 2009, to inject capital into banks in situations of capital inadequacy and to guarantee new bank liabilities for up to five years. Moreover, a supplementary state guarantee for retail bank deposits was offered, further strengthening Italy’s already relatively high level of protection offered by the interbank deposit insurance scheme (that provides coverage for just above €100,000). Finally, with the aim to strengthen the system's overall ability to finance economic activity, the Ministry of Economy and Finance has been allowed to underwrite financial instruments issued by sound listed banks that would qualify as regulatory capital. The public intervention, estimated in the

programme at € 10 bn (around 0.7% of GDP), is intended to be temporary and banks availing of it must commit to lending to households and SMEs on appropriate terms and conditions.

(11) In line with the EERP, the recovery package adopted by the government injects new resources into the economy amounting to around 0.4% of GDP in 2009 and 0.2% in 2010. Measures to support disposable income of households and restore consumer confidence include a one-off cash transfer to low-income households, extensions of unemployment benefits to atypical workers and freezes on some utility tariffs. Support to companies is granted mainly in the form of the postponement of tax payment deadlines and a reduction of the corporate income tax burden. Tax relief on performance-related pay tries to foster productivity while reducing labour costs. Finally, the government is trying to re-allocate available EU or national funds so as to accelerate the implementation of priority infrastructural projects. The measures are targeted and timely, provided that the planned acceleration of public investment is achieved, and most of them are temporary in nature. Thus, their reversibility is ensured, although not in full. In any case, the budgetary impact of the measures is, according to official estimates, fully offset by one-off revenues and some permanent tax increases, mostly originating from fighting tax evasion and avoidance. The package is an adequate response to the economic downturn in view of the very high debt ratio. In this context, and given the need to address the productivity challenge and improve the external competitive position, structural reforms, including strengthening the framework for competition, are particularly relevant for Italy. A number of announced structural measures, if already operational in 2009, may further support the recovery and improve the resilience of the economy. These include initiatives to foster industrial innovation, promote the use of renewable sources and energy saving and reduce the administrative burden. Recent steps by the social partners to modify the wage bargaining framework, supported by the above-mentioned fiscal incentives on performance-related pay, may lead to better alignment of wage and productivity developments. These measures are related to the medium-term reform agenda and the country-specific recommendations proposed by the Commission on 28 January 2009 under the Lisbon Strategy for Growth and Jobs.

(12) After further increasing in 2009, the deficit is projected to progressively narrow over the programme period. However, a reduction of the headline deficit below 3% of GDP by 2011, as envisaged in the programme, will require strong commitment to fiscal discipline and standing ready to adopt additional measures if necessary. The debt ratio will be increasing over the programme period, moving further away from the reference value.

(13) As regards the data requirements specified in the code of conduct for stability and convergence programmes, the programme provides all required and most of the optional data[6].

The overall conclusion is that the economic recovery package is in line with the European Economic Recovery Plan (EERP) and can be regarded as adequate in view of the very high debt ratio. Reflecting the strong economic downturn associated with the financial crisis, the headline deficit is expected to significantly increase in 2009 to above the 3% of GDP

6 Gaps in the optional data include expenditure by function and some details on the breakdown of general government debt developments.

reference value. In 2010 and 2011, the programme foresees an expenditure-based adjustment, which would bring the deficit just below 3% of GDP in 2011. However, the achievement of the deficit targets throughout the programme period might be hampered as economic growth could be even lower than planned. In addition, possible slippages in the implementation of the planned restraint in primary expenditure may materialise, even though the improved fiscal framework enhances the conditions for fiscal discipline and spending efficiency. The debt ratio is set to increase from 104.1% of GDP in 2007 to over 111% of GDP by the end of programme period. The gross debt ratio might increase further also as a result of possible capital injections into the banking sector. Finally, important structural weaknesses still hamper sustained productivity growth in Italy and weigh on its external competitive position, while the current composition of social spending is not supportive of adjustment in the labour market.

In view of the above assessment, Italy is invited to:

(i) Implement the budgetary measures for 2009 as planned and carry out with determination the structural adjustment path planned over the programme period. Once the economy recovers, pursue an ambitious budgetary consolidation in order to set the very high debt ratio on a steadily declining path and ensure the long-term sustainability of public finances;

(ii) Continue the progress made to improve fiscal governance and develop a new framework for fiscal federalism that ensures the accountability of local governments and underpins fiscal discipline;

(iii) Pursue efforts to improve the quality of public finances by focussing on spending efficiency and composition, also by reallocating social expenditure so as to create room for a more comprehensive and uniform unemployment benefit system that ensures appropriate work incentives and effective activation policies, without compromising the fiscal consolidation process.

## Comparison of key macro economic and budgetary projections

| | | 2007 | 2008 | 2009 | 2010 | 2011 |
|---|---|---|---|---|---|---|
| Real GDP (% change) | **SP Feb 2009** | **1.5** | **-0.6** | **-2.0** | **0.3** | **1.0** |
| | COM Jan 2009 | 1.5 | -0.6 | -2.0 | 0.3 | n.a. |
| | *SP Nov 2007* | *1.9* | *1.5* | *1.6* | *1.7* | *1.8* |
| HICP inflation (%) | **SP Feb 2009** | **2.0** | **3.5** | **1.2** | **1.7** | **2.0** |
| | COM Jan 2009 | 2.0 | 3.5 | 1.2 | 2.2 | n.a. |
| | *SP Nov 2007* | *1.9* | *2.0* | *2.0* | *1.8* | *1.9* |
| Output gap[1] (% of potential GDP) | **SP Feb 2009** | **1.7** | **0.3** | **-2.3** | **-2.7** | **-2.5** |
| | COM Jan 2009[2] | 1.8 | 0.3 | -2.3 | -2.7 | n.a. |
| | *SP Nov 2007* | *-0.6* | *-0.6* | *-0.6* | *-0.6* | *-0.6* |
| Net lending/borrowing vis-à-vis the rest of the world (% of GDP) | **SP Feb 2009** | **-1.6** | **-1.6** | **-1.3** | **-1.1** | **-0.9** |
| | COM Jan 2009 | -1.6 | -2.2 | -1.3 | -1.5 | n.a. |
| | *SP Nov 2007* | *-1.3* | *-0.8* | *-0.6* | *-0.4* | *-0.2* |
| General government revenue (% of GDP) | **SP Feb 2009** | **46.6** | **46.4** | **46.8** | **46.8** | **46.6** |
| | COM Jan 2009 | 46.6 | 46.4 | 46.5 | 46.5 | n.a. |
| | *SP Nov 2007* | *46.2* | *46.3* | *45.9* | *45.8* | *45.7* |
| General government expenditure (% of GDP) | **SP Feb 2009** | **48.2** | **49.0** | **50.5** | **50.0** | **49.5** |
| | COM Jan 2009 | 48.2 | 49.2 | 50.3 | 50.2 | n.a. |
| | *SP Nov 2007* | *48.6* | *48.5* | *47.9* | *47.3* | *47.0* |
| General government balance (% of GDP) | **SP Feb 2009** | **-1.6** | **-2.6** | **-3.7** | **-3.3** | **-2.9** |
| | COM Jan 2009 | -1.6 | -2.8 | -3.8 | -3.7 | n.a. |
| | *SP Nov 2007* | *-2.4* | *-2.2* | *-1.5* | *-0.7* | *0.0* |
| Primary balance (% of GDP) | **SP Feb 2009** | **3.4** | **2.5** | **1.3** | **1.9** | **2.6** |
| | COM Jan 2009 | 3.4 | 2.3 | 1.0 | 1.2 | n.a. |
| | *SP Nov 2007* | *2.5* | *2.6* | *3.4* | *4.2* | *4.9* |
| Cyclically-adjusted balance[1] (% of GDP) | **SP Feb 2009** | **-2.4** | **-2.7** | **-2.6** | **-1.9** | **-1.6** |
| | COM Jan 2009 | -2.5 | -2.9 | -2.7 | -2.4 | n.a. |
| | *SP Nov 2007* | *-2.0* | *-1.9* | *-1.2* | *-0.4* | *0.2* |
| Structural balance[3] (% of GDP) | **SP Feb 2009** | **-2.5** | **-2.9** | **-2.7** | **-2.0** | **-1.7** |
| | COM Jan 2009 | -2.6 | -3.1 | -2.8 | -2.5 | n.a. |
| | *SP Nov 2007* | *-2.2* | *-2.0* | *-1.3* | *-0.5* | *0.2* |
| Government gross debt (% of GDP) | **SP Feb 2009** | **104.1** | **105.9** | **110.5** | **112.0** | **111.6** |
| | COM Jan 2009 | 104.1 | 105.7 | 109.3 | 110.3 | n.a. |
| | *SP Nov 2007* | *105.0* | *103.5* | *101.5* | *98.5* | *95.1* |

Notes:

[1] Output gaps and cyclically-adjusted balances according to the programmes as recalculated by Commission services on the basis of the information in the programmes.

[2] Based on estimated potential growth of 1.1%, 0.9%, 0.6% and 0.7% respectively in the period 2007-2010.

[3] Cyclically-adjusted balance excluding one-off and other temporary measures. One-off and other temporary measures are 0.1% of GDP in 2007, 0.2% in 2008 and 0.1% 2009-2011; all deficit-reducing according to the most recent programme and in the Commission services' January interim forecast.

*Source:*

*Stability programme (SP); Commission services' January 2009 interim forecasts (COM); Commission services' calculations.*