COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 11.11.2009
SEC(2009) 1524 final

Recommendation for a

COUNCIL DECISION

on the existence of an excessive deficit in Italy

EXPLANATORY MEMORANDUM

1. THE APPLICATION OF THE STABILITY AND GROWTH PACT IN THE CURRENT CRISIS SITUATION

Many EU countries are presently facing general government deficits above the 3% of GDP reference value set in the Treaty. The often strong deterioration in the deficit as well as the debt positions must be seen in the context of the unprecedented global financial crisis and economic downturn in 2008/09. Several factors are at play. First, the economic downturn brings about declining tax revenue and rising social benefit expenditure (e.g. unemployment benefits). Second, recognising that budgetary policies have an important role to play in the current extraordinary economic situation, the Commission called for a fiscal stimulus in its November 2008 European Economic Recovery Plan (EERP), endorsed by the European Council in December. The Plan explicated that the stimulus should be timely, targeted and temporary and differentiated across Member States to reflect their different positions in terms of public finance sustainability and competitiveness and should be reversed when economic conditions improve. Finally, several countries have taken measures to stabilise the financial sector, some of which have impacted on the debt position or constitute a risk of higher deficits and debt in the future[1], although some of the costs of the government support could be recouped in the future.

The Stability and Growth Pact requires the Commission to initiate the excessive deficit procedure (EDP) whenever the deficit of a Member State exceeds the 3% of GDP reference value. The amendments to the Stability and Growth Pact in 2005 aimed at ensuring that in particular the economic and budgetary background was taken into account fully in all steps in the EDP. In this way, the Stability and Growth Pact provides the framework supporting government policies for a prompt return to sound budgetary positions taking account of the economic situation, and thereby ensuring long-term sustainability of public finances.

2. PREVIOUS STEPS IN THE EXCESSIVE DEFICIT PROCEDURE

Article 104 of the Treaty lays down an excessive deficit procedure (EDP). This procedure is further specified in Council Regulation (EC) No 1467/97 "on speeding up and clarifying the implementation of the excessive deficit procedure" [2], which is part of the Stability and Growth Pact.

According to Article 104(2) of the Treaty, the Commission has to monitor compliance with budgetary discipline on the basis of two criteria, namely: (a) whether the ratio of the planned or actual government deficit to gross domestic product (GDP) exceeds the reference value of 3% (unless either the ratio has declined substantially and continuously and reached a level that comes close to the reference value; or, alternatively, the excess over the reference value is

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[1] See the Eurostat decision of 15 July 2009 on the statistical recording of public interventions to support financial institutions and financial markets during the financial crisis, Eurostat News Release No 103/2009.

[2] OJ L 209, 2.8.1997, p. 6. Account is also taken of the Opinion of the Economic and Financial Committee on the "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, available at: http://ec.europa.eu/economy_finance/other_pages/other_pages12638_en.htm.

only exceptional and temporary and the ratio remains close to the reference value); and (b) whether the ratio of government debt to GDP exceeds the reference value of 60% (unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace).

Article 104(3) stipulates that, if a Member State does not fulfil the requirements under one or both of these criteria, the Commission has to prepare a report. This report also has to "take into account whether the government deficit exceeds government investment expenditure and take into account all other relevant factors, including the medium-term economic and budgetary position of the Member State".

On the basis of the data notified by the Italian authorities in April 2009[3] and taking into account the Commission services' spring 2009 forecast, the Commission adopted a report under Article 104(3) for Italy on 7 October 2009.

Subsequently, and in accordance with Article 104(4), the Economic and Financial Committee formulated an opinion on the Commission report on 27 October 2009.

3. THE EXISTENCE OF AN EXCESSIVE DEFICIT

According to data notified by the Italian authorities in April 2009, the general government deficit in Italy was planned to reach 3.7% of GDP in 2009, thus exceeding the 3% of GDP reference value. The Commission report under Article 104(3) considered that the planned deficit was not close to the 3% of GDP reference value but that the planned excess over the reference value could be qualified as exceptional within the meaning of the Treaty and the Stability and Growth Pact, on the basis of the information available at the time of the report. Furthermore, the planned excess over the reference value could not be considered temporary.

According to more recent data notified by the Italian authorities in October 2009, the general government deficit in Italy is now planned to reach 5.3% of GDP in 2009, above and not close to the 3% of GDP reference value. Based on the Commission services' autumn 2009 forecast, the planned excess over the reference value still qualifies as exceptional within the meaning of the Treaty and the Stability and Growth Pact. In particular, it results from a severe economic downturn in the sense of the Treaty and the Stability and Growth Pact. The Commission services' autumn 2009 forecast projects real GDP in Italy to contract by 4.7% in 2009, after decreasing by 1% in 2008. A moderate recovery is anticipated for 2010, strengthening in 2011. Furthermore, also on the basis of the Commission services' autumn 2009 forecast, the planned excess over the reference value cannot be considered temporary, since the deficit is projected to remain broadly stable in 2010 and decrease marginally in 2011, on a no-policy change basis. The discretionary measures taken with the successive recovery packages to respond to the crisis in line with the EERP (targeted to support low-income groups and key industrial sectors) are not expected to appreciably weigh on the government balance, as they are officially fully financed mainly by reallocating existing funds. The deficit criterion in the Treaty is not fulfilled.

[3] According to Council Regulation (EC) No 479/2009, Member States have to report to the Commission, twice a year, their planned and actual government deficit and debt levels. The most recent notification of Italy can be found at: http://epp.eurostat.ec.europa.eu/portal/page/portal/government_finance_statistics/procedure/edp_notification_tables

General government gross debt has been well above the 60% of GDP reference value since before the start of stage III of economic and monetary union. According to data notified by the Italian authorities in October 2009, it is planned to increase to 115.1% of GDP in 2009. The Commission services' autumn 2009 forecast projects the debt ratio to rise further, to 117.8% in 2011. The debt ratio cannot be considered as diminishing sufficiently and approaching the reference value at a satisfactory pace within the meaning of the Treaty and the Stability and Growth Pact. The debt criterion in the Treaty is not fulfilled.

In line with the provisions in the Treaty and the Stability and Growth Pact, the Commission also analysed in its report “relevant factors”. According to the Stability and Growth Pact, these can only be taken into account in the steps leading to the decision on the existence of an excessive deficit if the deficit satisfies the double condition of closeness and temporariness. In the case of Italy, the double condition is not met. Considered on their own merit, the relevant factors in the current case on balance present a mixed picture.

The opinion of the Economic and Financial Committee in accordance with Article 104(4) of the Treaty is consistent with the assessment in the Commission report under Article 104(3).

The Commission, having taken into account its report under Article 104(3) and the opinion of the Economic and Financial Committee under Article 104(4), is of the opinion that an excessive deficit exists in Italy. This opinion, adopted by the Commission on 11 November 2009, is herewith addressed to the Council according to Article 104(5). The Commission recommends that the Council shall decide accordingly, in conformity with Article 104(6). In addition, the Commission is submitting to the Council a recommendation for a Council recommendation to be addressed to Italy with a view to bringing the situation of an excessive deficit to an end according to Article 104(7).

4. RECOMMENDATIONS TO END THE EXCESSIVE DEFICIT SITUATION

According to Article 3(4) of Council Regulation (EC) No 1467/97, the Council recommendation under Article 104(7) has to establish a deadline of six months at most for effective action to be taken by the Member State concerned as well as a deadline for the correction of the excessive deficit, which “should be completed in the year following its identification unless there are special circumstances”. Article 2(6) of the Regulation implies that the “relevant factors” considered in the Commission report under Article 104(3) of the Treaty have to be taken into account in deciding whether special circumstances exist. Article 3(4) of the Regulation specifies that the Council has to recommend that the Member State achieves a “minimum annual improvement of at least 0.5% of GDP as a benchmark, in its cyclically adjusted balance net of one-off and temporary measures, in order to ensure the correction of the excessive deficit within the deadline set in the recommendation”.

In the case of Italy, special circumstances are considered to exist. A marked slowdown of economic activity was already underway before the deepening of the global financial crisis. In the second quarter of 2008, real GDP started declining at an increasing pace, initially driven by the impact of surging commodity prices and subsequently, as a result of the global crisis, by the collapse in global trade and rising risk aversion. After declining by 1% in 2008 as a whole, real GDP is set to contract by a further 4.7% in 2009 before returning to positive growth in 2010 and 2011. The general government deficit, planned to reach 5.3% of GDP by the authorities in 2009, is projected in the Commission services’ autumn 2009 forecast to remain at around that level in 2010 and, on a no-policy change basis, decrease marginally in 2011.

The government's response to the crisis has been appropriately mindful of the need to avoid a substantial deterioration of public finances, given the already very high gross debt in a context of increased global risk aversion. Targeted discretionary measures taken to support low-income groups and key industrial sectors, in line with the EERP, have an officially neutral impact on the budget, as they are fully financed mainly by reallocating existing funds. Thus, the widening deficit in 2009 is to a large extent the result of the working of the automatic stabilisers. On the revenue side, a significant contraction is expected in 2009 in both direct and indirect taxes, only mitigated by sizeable one-off capital taxes (0.4% of GDP). An extraordinary tax on repatriated assets that are illegally held abroad could further raise one-off capital revenues[4]. Primary expenditure is set to rise by over 4½% in 2009, significantly faster than planned in the February 2009 stability programme update. Public wage growth is expected to be above 2% and intermediate consumption is still increasing substantially despite the budgetary measures adopted to contain it. Social transfers are particularly dynamic due to a combination of pension indexation and recovery measures. Capital spending is being raised by almost 13% by bringing forward investment plans. The only significant item expected to decrease is interest expenditure thanks to historically low market interest rates.

The deep economic downturn, together with the discretionary policies supporting domestic demand in line with the EERP, has derailed the budgetary consolidation plan enshrined in the three-year fiscal package approved in summer 2008. However, the pledge to the expenditure-based adjustment that was spelled out in that package has been confirmed by the Economic and Financial Planning Document (DPEF) for 2010-13, adopted in July and updated in September 2009[5]. Accordingly, the Commission services' autumn 2009 forecast projects a marked slowdown in expenditure dynamics in 2010 and 2011 based on the customary no-policy change assumption. Still, the deficit is set to remain well above the 3% of GDP threshold in both years. Also thanks to a more favourable macroeconomic scenario, with real GDP growth projected at 2% in both years, the DPEF plans to bring the deficit below the reference value in 2012. To achieve this objective, an additional consolidation effort of 0.4% of GDP in 2011 and a further 0.8% 2012 is planned, but is not translated into specific corrective measures.

Against this background, it is appropriate to consider the correction of the excessive deficit in a medium-term framework with a deadline for the correction of 2012. Considering the special circumstances and the EERP framework, an average annual structural budgetary adjustment is recommended. The required adjustment should take into account the fiscal room for manoeuvre which is assessed on the basis of all factors relevant for achieving the fiscal policy objectives, starting with the level of the general government deficit and gross debt as well as other indicators, such as the current account position, the level of contingent liabilities of the financial sector, interest payments, risk premia and the expected change in age-related expenditure in the medium term. In calculating the average annual adjustment, the 2011 deficit in the Commission services' autumn 2009 forecast is taken as the starting point. The total structural adjustment needed to reach the nominal deficit target of 3% by the deadline is then calculated by assuming a gradual closure of the output gap by 2015.

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4 A reliable quantification of the revenues expected from this extraordinary tax is hampered by the complex rules governing it and the absence of an official estimate. For this reason, no estimation of the expected proceeds is included in the Commission services' autumn 2009 forecast.

5 The document is available at: http://www.tesoro.it/documenti/open.asp?idd=22421. The macroeconomic scenario underlying its budgetary projections is laid out in the forecast and planning report (RPP), also adopted by the government in September (http://www.mef.gov.it/documenti/open.asp?idd=22610).

In particular, in view of the very high debt ratio and the related interest payments, a credible and sustainable adjustment path would require the Italian authorities to implement the fiscal measures in 2010 as planned in the three-year fiscal package for 2009-2011 approved in summer 2008 and confirmed in the DPEF 2010-2013. Based on a less optimistic medium-term macroeconomic outlook than the one underlying the updated DPEF, the Commission services' autumn 2009 forecast indicates that an average annual structural budgetary adjustment of ½pp. of GDP over the period 2010-2012 will be necessary to bring the deficit below the 3% of GDP reference value by 2012. The budgetary consolidation should also contribute to bringing the government gross debt ratio back on a declining path that approaches the 60% of GDP reference value at a satisfactory pace by restoring an adequate level of the primary surplus. The Italian authorities should specify the measures necessary to achieve the correction of the excessive deficit by 2012 cyclical conditions permitting. In addition, a faster consolidation should be exploited if economic or budgetary conditions turn out better than currently expected.

Pursuing the recommended budgetary consolidation so as to bring the deficit ratio below the 3% reference value by 2012 would also stabilise the gross government debt ratio and contribute to bringing it back on a declining path in the medium term. According to the Commission services' autumn 2009 forecast, the debt ratio is expected to climb to 114.6% of GDP in 2009 and to continue to grow in 2010-2011 on a no-policy change basis. A simulation exercise beyond 2011, which excludes additional financial rescue or below-the-line operations, shows that the debt ratio would continue to grow until the end of the correction period. However, under a scenario of fiscal consolidation leading to a deficit below 3% of GDP by 2012, the debt ratio would start declining in the same year if nominal GDP growth is at least 2¾% in 2012 (in 2011, the autumn forecast has 3¼%). In addition, it is essential to seize any opportunity beyond the required structural budgetary adjustment to accelerate the reduction of the gross debt ratio towards the 60% of GDP reference value.

The summer 2008 multi-annual consolidation package, which enshrined in legislation detailed expenditure targets for the period 2008-2011 and spelled out the broad measures enabling their achievement, represented a significant improvement to Italy's medium-term budgetary framework. However, it was not followed up this year by a comparable document. The draft budget for 2010-12, presented to Parliament in September 2009, incorporates the budgetary impact of the changed economic outlook and of the recovery packages hitherto adopted on the summer 2008 package and foresees a limited number of additional measures with neutral budgetary impact, but is not instrumental to achieving the deficit targets for 2011-2012 that are planned in the updated DPEF. A reform of the budgetary process, currently under parliamentary discussion, will imply a change in the budgetary cycle and the planning and reporting instruments so as to allow a greater involvement of the sub-national administrations in setting the budgetary targets and the medium-term strategy for fiscal consolidation. Such improvements in fiscal governance are set to strengthen the enforceable nature of the medium-term budgetary framework and to enhance expenditure control, which is key to achieving the planned expenditure-based adjustment. In order to safeguard an adequate level of public services, this will also require improving efficiency and effectiveness of spending. In this context, the challenge for fiscal governance is to design a new framework for fiscal federalism that ensures the accountability of local governments and fosters efficiency.

In general, budgetary consolidation measures should secure a lasting improvement in the general government balance, while being geared towards enhancing the quality of the public finances and reinforcing the growth potential of the economy. Improving the composition of social spending to make it more supportive of adjustment in the labour market would help reinforce the growth potential of the economy, together with the following reforms: strengthening competition in product and services markets, simplifying legislation, reducing the administrative burden at all levels of government and, within a "flexicurity" approach and with a view to reducing regional disparities, improving the functioning of the labour market and the efficiency, outcomes and standards of the education system.

The long-term budgetary impact of ageing in Italy is lower than the EU average. However pension expenditure as a share of GDP remains among the highest in the EU and the projections hinge upon the assumption that the adopted reforms are fully implemented. Moreover, the current level of gross debt, which is well above the Treaty reference value, adds to the sustainability risk. Achieving high primary surpluses would therefore contribute to limiting the risk to the long-term sustainability of public finances, as defined by the Commission Communication[6] on 'Long-term sustainability of public finances for a recovering economy' and endorsed by the ECOFIN Council[7] on 10 November 2009.

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

Comparison of key macroeconomic and budgetary projections

		2008	2009	2010	2011	2012	2013
Real GDP (% change)	COM autumn 2009	**-1.0**	**-4.7**	**0.7**	**1.4**	n.a.	n.a.
	IT DPEF update		-4.8	0.7	2.0	2.0	2.0
Output gap[1] (% of potential GDP)	COM autumn 2009	**1.3**	**-3.6**	**-3.2**	**-2.5**	n.a.	n.a.
	IT DPEF update	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
General government balance (% of GDP)	COM autumn 2009	**-2.7**	**-5.3**	**-5.3**	**-5.1**	n.a.	n.a.
	IT DPEF update		-5.3	-5.0	-3.9	-2.7	-2.2
Primary balance (% of GDP)	COM autumn 2009	**2.4**	**-0.5**	**-0.6**	**0.1**	n.a.	n.a.
	IT DPEF update		-0.5	0.0	1.3	2.8	3.4
Cyclically-adjusted balance (% of GDP)	COM autumn 2009	**-3.4**	**-3.5**	**-3.7**	**-3.8**	n.a.	n.a.
	IT DPEF update	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Structural balance[2] (% of GDP)	COM autumn 2009	**-3.6**	**-3.7**	**-3.7**	**-3.7**	n.a.	n.a.
	IT DPEF update	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Government gross debt (% of GDP)	COM autumn 2009	**105.8**	**114.6**	**116.7**	**117.8**	n.a.	n.a.
	IT DPEF update		115.1	117.3	117.3	116.8	115.5

Notes:

[1] Based on estimated potential growth of 0.4%, 0%, 0.2% and 0.7% respectively in the period 2008-2011.

[2] Cyclically-adjusted balance excluding one-off and other temporary measures. One-off and other temporary measures are -0.2% of GDP in 2008, -0.2% in 2009 (deficit-reducing), 0% in 2010 and 0.1% in 2011 (deficit-increasing) according to the Commission services' autumn 2009 forecast.

Source:

Economic and Financial Planning Document (DPEF) published on 15 July and its update published on 22 September 2009; Commission services' autumn 2009 forecasts (COM); Commission services' calculations.

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

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

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THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community, and in particular Article 104(6) thereof,

Having regard to the recommendation from the Commission,

Having regard to the observations made by Italy,

Whereas:

(1) According to Article 104 of the Treaty Member States shall avoid excessive government deficits.

(2) The Stability and Growth Pact is based on the objective of sound government finances as a means of strengthening the conditions for price stability and for strong sustainable growth conducive to employment creation.

(3) The excessive deficit procedure (EDP) under Article 104, as clarified by Council Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure[8] (which is part of the Stability and Growth Pact), provides for a decision on the existence of an excessive deficit. The Protocol on the excessive deficit procedure annexed to the Treaty sets out further provisions relating to the implementation of the EDP. Council Regulation (EC) No 479/2009[9] lays down detailed rules and definitions for the application of the provision of the said Protocol.

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

(5) Article 104(5) of the Treaty requires the Commission to address an opinion to the Council if the Commission considers that an excessive deficit in a Member State exists or may occur. Having taken into account its report in accordance with Article 104(3) and having regard to the opinion of the Economic and Financial Committee in

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8 OJ L 209, 2.8.1997, p. 6.
9 OJ L 145, 10.6.2009, p. 1-9.

accordance with Article 104(4), the Commission concluded that an excessive deficit exists in Italy. The Commission therefore addressed such an opinion to the Council in respect of Italy on 11 November 2009[10].

(6) Article 104(6) of the Treaty states that the Council should consider any observations which the Member State concerned may wish to make before deciding, after an overall assessment, whether an excessive deficit exists. In the case of Italy, this overall assessment leads to the following conclusions.

(7) According to data notified by the Italian authorities in October 2009 the general government deficit in Italy is planned to reach 5.3% of GDP in 2009, thus exceeding and not close to the 3% of GDP reference value. The planned excess over the reference value can be qualified as exceptional within the meaning of the Treaty and the Stability and Growth Pact. In particular, it results from a severe economic downturn in the sense of the Treaty and the Stability and Growth Pact. The Commission services' autumn 2009 forecast projects real GDP in Italy to contract by 4.7% in 2009, after decreasing by 1% in 2008. A moderate recovery is anticipated for 2010, strengthening in 2011. Furthermore, the planned excess over the reference value cannot be considered temporary, since the deficit is projected to increase further in 2010 and, on a no-policy change basis, to decrease marginally in 2011. The discretionary measures taken with the successive recovery packages to respond to the crisis in line with the EERP (targeted to support low-income groups and key industrial sectors) are not expected to appreciably weigh on the government balance, as they are officially fully financed mainly by reallocating existing funds. The deficit criterion in the Treaty is not fulfilled.

(8) According to data notified by the Italian authorities in October 2009 general government gross debt has been well above the 60% of GDP reference value since before the start of stage III of economic and monetary union and is planned to stand at 115.1% of GDP in 2009. The Commission services' autumn 2009 forecast projects the debt ratio to rise further, to 117.8% in 2011. The debt ratio cannot be considered as diminishing sufficiently and approaching the reference value at a satisfactory pace within the meaning of the Treaty and the Stability and Growth Pact. The debt criterion in the Treaty is not fulfilled.

(9) According to Article 2(4) of Council Regulation (EC) No 1467/97, "relevant factors" can only be taken into account in the steps leading to the Council decision on the existence of an excessive deficit in accordance with Article 104(6) if the double condition - that the deficit remains close to the reference value and that its excess over the reference value is temporary - is fully met. In the case of Italy, this double condition is not met. Therefore, relevant factors are not taken into account in the steps leading to this decision.

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10 All EDP-related documents for Italy can be found at the following website: http://ec.europa.eu/economy_finance/netstartsearch/pdfsearch/pdf.cfm?mode=_m2.

HAS ADOPTED THIS DECISION:

Article 1

From an overall assessment it follows that an excessive deficit exists in Italy.

Article 2

This decision is addressed to the Italian Republic.

Done at Brussels,

For the Council
The President