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, 2002-2006

(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 co-ordination of economic policies[1], stipulated that countries participating in the single currency were 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 the assessments prepared by the Commission and the Committee set up by Article 114 of the Treaty (the Economic and Financial Committee). The Commission adopted a recommendation on each programme. On the basis of this recommendation and after having consulted the Committee set up by Article 114, the Council delivered an opinion, following its examination of the programme.

Italy's first stability programme covering the period 1998-2002 was submitted on 22 December 1998 and assessed by the Council on 8 February 1999[2].

According to the Regulation, the updated stability programmes, to be presented annually, may also be examined by the Council in accordance with these same procedures. The first annual update covering the period 1999-2003 was submitted on 19 January 2000 and examined by the Council on 28 February 2000[3]. The second update, covering the period 2000-2004, was submitted on 20 December 2000 and examined by the Council on 12 February 2001[4]. The third update, covering the period 2001-2005, was submitted on 16 November 2001 and examined by the Council on 12 February 2002[5].

Italy submitted its fourth updated stability programme, covering the period 2002-2006, on 20 November 2002. The Commission services have carried out a technical evaluation of this updated programme, namely taking into account to the Communication of the Commission to the Council of 27 November 2002 on strengthening the co-ordination of budgetary policies[6]. This evaluation warrants the following assessment:

> The updated programme broadly complies with the data requirements of the revised "code of conduct on the content and format of stability and convergence programmes"[7], although minor inconsistencies persist in the aggregation of expenditures and revenues in ESA 95 terms. However, it critically falls short of the

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1 OJ L209, 2.8.1997.
2 OJ C68, 11.3.1999.
3 OJ C98, 6.4. 2000.
4 OJ C77, 9.3.2001.
5 OJ C51, 26.2.2002
6 COM (2002) 668 final of 27.11.2002
7 *Revised Opinion of the Economic and Financial Committee on the content and format of stability and converge programmes*, document EFC/ECFIN/404/01 – REV 1 of 27.6.2001 endorsed by the Ecofin Council on 10.7.2001.

requirement in the code to “describe the budgetary and other economic policy measures… proposed to achieve the objectives of the programme.” Instead, the budgetary targets from 2004 onwards are presented as being achieved only after taking into account significant but unspecified “future measures”. This does not even allow to determine whether the correction takes place on the expenditure and/or the revenue side and therefore makes very difficult an assessment of the adjustment planned in the medium term.

The programme complies only in part with the Broad Economic Policy Guidelines for 2002. Specifically, the recommendations in the BEPG concerning the preparation of the 2003 Budget law have been, to a considerable extent, disregarded.

Following the much worse deficit in 2001 than estimated in last year’s programme and the delayed recovery in the economy, and in spite of corrective measures adopted in the course of the year, the projected deficit for 2002, at above 2% of GDP, significantly exceeds the original objectives. In turn, this implies that the adjustment path has moved further away from the “close-to-balance” position, which, according to the government’s own projections, would not be reached before 2004. As in recent years, the deficit for 2002 could be higher when measured in cash terms[1], implying the continued existence of large and not fully explained “below-the-line” operations. As a consequence, and in spite of a large transaction between the Italian Treasury and the Bank of Italy aimed at the redemption of non-marketable government debt held in the latter’s asset and resulting in a one-off reduction in outstanding government debt, the decline in the debt ratio has slowed considerably since 2001 and the reduction of the debt ratio below 100% of GDP is now envisaged by the government to occur only in 2005, two years later than according to the commitment originally made by Italy in 1998.

The programme’s macroeconomic scenario assumes a gradual pick-up in economic activity, which in the short term reflects the expected recovery of the world economy. In 2003 the pace of the recovery is somewhat stronger than the current consensus view. In the years 2004-06 real GDP growth is projected to average around 3% per annum. The implicit acceleration in the rate of potential output growth after 2003 – if estimated according to a correct application of the commonly agreed production function methodology to the data in the programme – reflects a set of markedly favourable assumptions about the underlying determinants of growth, particularly the evolution of the labour market, specifically a strong increase in the participation rate and a marked decline in the non-accelerating inflation rate of unemployment. Therefore, in the medium term, the macroeconomic scenario does not appear consistent with the degree of caution that should underpin a prudent fiscal strategy.

The adjustment path over the programme period builds on a projected recovery in the primary surplus ratios to levels close or above 5% of GDP following the deterioration experienced since 2000. The programme projects such surpluses to be accompanied by reduced revenue and expenditure shares. However, the credibility of the fiscal strategy is weakened by the questionable quality of the measures already announced, specifically the large recourse to one-off measures, and by the lack of indications on those that will have to be taken.

[1] General government cash borrowing requirement net of settlement of debts outstanding and disposals of financial assets.

The budgetary target for 2003 relies heavily, as in the previous year, on one-off measures, including the sale of publicly-owned real estate assets through securitisation operations, an accelerated tax litigation settlement scheme and a new tax amnesty. Even assuming that such one-off measures yield the expected results, achieving the 2003 budgetary target may prove difficult, on account of the risks to the trend budgetary projections, particularly on the revenue side. The cyclically-adjusted budget position may therefore fail to improve as planned. Indeed, taking into account such risks, the Commission 2002 Autumn forecast foresees only a marginal improvement in both the actual and cyclically-adjusted deficits. Irrespective of the risks to the 2003 budgetary projections, no significant improvement over the 2002 estimated outcome can be expected in the underlying deficit (calculated by deducting from the cyclically-adjusted balance the effect of the above-mentioned one-off measures). This does not appear to be in line with the minimum required adjustment of 0.5% of GDP. The underlying balance would remain significantly distant from the "close-to-balance" objective of the Stability and Growth Pact. All this calls for a strict and attentive surveillance of budgetary developments.

Attainment of the budgetary targets for 2004 and beyond hinges crucially on the replacement of the main one-off measures implemented in 2003 by measures of more permanent character together with an additional sizeable correction in structural terms. Hence, the crucial year in the programme is 2004, when the main temporary measures have to be replaced and the most significant correction would need to be implemented in order to approach the "close-to-balance" objective. However, as indicated above, the programme does not provide information on the measures that are proposed to achieve the targeted adjustment. By contrast, combining a more prudent assessment of public finance trends, in particular the implementation of the 2002 and 2003 budget, with lower growth assumptions, as in the Commission 2002 Autumn forecast, leads to the conclusion that in the absence of corrective measures the deficit might breach 3% of GDP. The size of the total structural correction that would be needed in 2004 – exceeding by a very large margin the minimum required adjustment of 0.5% of GDP – is such as to make achievement of the close-to-balance objective by that year implausible. The credibility of the targets in the remaining years of the programme is correspondingly undermined.

As for the path for the reduction of the government debt ratio, the upward shift compared to the previous programme results from a substantially higher level of debt in 2001 and 2002[1]. Comparing the figures for changes in the level of debt with those for net government borrowing suggests the persistence of large and unexplained "below-the-line" operations throughout the programme period. The impact of such operations appears to be particularly strong and positive in 2005 and 2006, resulting in a marked slowdown in the pace of debt reduction. The risks to the programme deficit targets that have been identified above imply a corresponding deterioration in the debt ratios. The resulting path of actual debt reduction would become considerably slower, and might even be reversed under adverse cyclical circumstances.

[1] In 2001 the debt was 109.9% of GDP (107.5% of GDP in the previous update). In 2002 the objective is 109.4% of GDP (104.3% of GDP in the previous update) including, at least in part, the effect ofg the redemption of non-marketable government bonds held by the Bank of Italy. On 31 December the Ministry of Economics communicated that the conversion of all the bonds with a 1% interest rate had taken place. Hence, the impact of the operation is estimated to reduce the nominal debt level by 1.9% of GDP in 2002.

The programme reviews the progress in the government's structural reform programme, particularly concerning tax reform, changes in labour market regulation and the reform of the social security system. Based on recent experience, especially concerning the labour market, the supply-side effects of the reform programme can be expected to be positive. However, while the immediate negative impact on the budget, in particular of the imminent tax reduction in 2003, can be quantified, the eventual pay-off in terms of an increased tax base is uncertain and to some extent subject to the approval of further legislation, specifically changes in labour market regulation. Overall, the financing of the reform programme does not appear ensured.

The achievement of a position of underlying budget balance in the medium term is critical to placing public finances on a sustainable footing. Given Italy's high debt, large primary surpluses will be required for many years, including the avoidance of debt-increasing financial operations. The analysis of long-term trends suggests that, although, following the 1990s' reforms of Italy's pension system, the future increase in age-related expenditure will be relatively low, the risk of emerging public imbalances cannot be excluded. The relative low increase in pension expenditure depends crucially on Italy's ability to achieve very large increases in the participation rate. It also depends on the full and effective implementation of the 1990s' reforms, including adjusting future entitlements to reflect changes in life expectancy. The announced changes in the social security system, while promoting the expansion of the underdeveloped privately-funded pension sector, do not address the outstanding critical issue in the public pension system, namely, the excessively long transition period to the new contributions-based system. Moreover, the planned reductions in contributions for newly-hired workers, if not matched by corresponding reductions in workers' entitlements, could put into question the long-term balance of the system.

Based on this assessment, the Commission has adopted the attached recommendation for a Council opinion on the Stability Programme update of Italy and is forwarding it to the Council.

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, 2002-2006

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 co-ordination of economic policies[1], 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:

On [21 January 2003] the Council examined Italy's updated stability programme, which covers the period 2002-2006.

The new update broadly complies with the data requirements of the revised "code of conduct on the content and format of stability and convergence programmes"[2], although some minor inconsistencies exist in the aggregation of expenditures and revenues in ESA 95 terms. However, contrary to the prescriptions of the code of conduct, the programme does not provide any information on the additional measures foreseen to achieve the budgetary targets beyond 2003.

The programme complies only in part with the Broad Economic Policy Guidelines for 2002. Specifically, the recommendations in the BEPG concerning the preparation of the 2003 Budget law have been, to a considerable extent, disregarded.

The Council welcomes Italy's goal of keeping high primary surpluses throughout the programme period, while allowing for some easing in the tax burden. However, it notes that, following a much worse deficit in 2001 than estimated in last year's programme and the delayed recovery in the economy, and in spite of corrective measures adopted in the course of

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1 OJ L209 of 2.8.1997.

2 *Revised Opinion of the Economic and Financial Committee on the content and format of stability and converge programmes*, document EFC/ECFIN/404/01 – REV 1 of

the year, the projected deficit for 2002 significantly exceeds the original objectives. In turn, this implies that the adjustment path has been moved further away from the "close-to-balance" position, which, according to the government's own projections, would not be reached before 2004. The Council notes with concern that, as in recent years, the deficit for 2002 could be higher when measured in cash terms. One consequence of this, which the Council regrets, is that the decline in the debt ratio has slowed down considerably since 2001 and the reduction of the debt ratio below 100% of GDP is now envisaged by the government to occur only in 2005, two years later than according to the commitment made by Italy in 1998.

The programme's macroeconomic scenario assumes a pick-up in economic activity, which in the short term reflects the expected recovery of the world economy and in domestic demand. However, the implicit acceleration in the rate of potential output growth after 2003 reflects a set of markedly favourable assumptions about the determinants of growth, particularly the evolution of the labour market. Therefore, at least in the medium-term, the macroeconomic scenario does not appear consistent with the degree of caution that should underpin a prudent fiscal strategy.

The Council observes that the budgetary target for 2003 relies heavily, as in the previous year, on one-off measures. Even assuming that such one-off measures yield the expected results, the cyclically-adjusted budget position may fail to improve as planned on account of the risks to the trend budgetary projections. Irrespective of such risks, no significant improvement over the 2002 estimated outcome can be expected in the underlying deficit (calculated by deducting from the cyclically-adjusted balance the effect of the above-mentioned one-off measures). This does not appear to be in line with the minimal required adjustment of 0.5% of GDP. The underlying balance would remain significantly distant from the "close-to-balance" objective of the Stability and Growth Pact. The Council urges Italy to step up the structural correction planned for 2003, so that, as a minimum, an improvement in the cyclically-adjusted balance of 0.5% of GDP is ensured and such an improvement is obtained by measures of permanent nature. This should result in an improvement in the underlying balance of at least the same amount.

The Council notes that attainment of the budgetary targets for 2004 and beyond, including the achievement of the close-to-balance objective, hinges crucially on the replacement of the main one-off measures implemented in 2003 by measures of more permanent character together with an additional sizeable correction in structural terms. The Council is concerned that in the absence of such measures, and taking into account the risks to the underlying

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27.6.2001 endorsed by the Ecofin Council on 10.7.2001.

budgetary projections, the deficit might breach the 3% of GDP threshold. As a matter of urgency, the Council asks Italy to spell out at the latest by March the broad measures of permanent nature that would ensure that a minimum improvement in the cyclically-adjusted of 0.5% of GDP per year is pursued until the close-to-balance objective can be considered achieved. More in general, the Council invites Italy to clarify at the same time its fiscal strategy, particularly in the light of the goal of reducing the tax burden, which the Council shares, but which can be safely and effectively achieved only within a comprehensive reform plan on both the expenditure and the revenue side. In this respect the Council notes that the government structural reform programme entails risks for the budget, as its financing does not appear ensured.

The Council considers that Italy's very high debt ratio requires a minimum pace of reduction that is significantly faster than is the experience of the past years. It notes the slowdown in the rate of debt reduction projected toward the end of the programme period in connection with the apparent persistence of large and unexplained "below the line" operations. The Council is especially concerned that the risks to the programme deficit targets would imply an unacceptably slow pace of reduction in the debt ratio. The Council therefore urges Italy to act on all the factors under the government's control to ensure that debt is sufficiently diminishing. In this respect, it recommends that measures of transitory nature, particularly sales of assets through securitisation operations, be considered as a means to accelerate the reduction of the debt and not as a substitute for corrective action on the deficit side.

The Council stresses that the achievement of a position of underlying budget balance in the medium term is critical to placing public finances on a sustainable footing. Given Italy's high debt, large primary surpluses will be required for many years, including the avoidance of debt-increasing financial operations. The Council notes that Italy's ability to cope with the budgetary consequences of ageing depends on the full and effective implementation of the major pension reforms adopted in the 1990s and on the achievement of a very large increase in the participation rate. In line with its Opinion on the previous updated programmes and the Broad Economic Policy Guidelines for 2002, the Council encourages Italy to adopt further measures to promote supplementary privately-funded pension schemes and to address the outstanding critical issue in the public pension system, namely, the excessively long transition period to the new contributions-based system. This should be coupled with the measures necessary to raise participation rates and to control the evolution of age-related expenditures.