COUNCIL OF THE EUROPEAN UNION

Brussels, 12 February 2008

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NOTE

From:	General Secretariat of the Council
to:	Delegations
Subject:	Council Opinion on the updated Stability Programme of Italy

Delegations will find attached the Council's Opinion on the updated Stability Programme presented by Italy, as adopted by the ECOFIN Council on 12 February 2008.

Attachment

ANNEX

COUNCIL OPINION

On the updated stability programme of Italy, 2007-2011

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[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:

(1) On 12 February 2008 the Council examined the updated stability programme of Italy, which covers the period 2007 to 2011.

(2) Real GDP growth in Italy has been below the euro area average since the 1990s and potential growth is estimated to have fallen from above 2% in the early 1990s to around 1½% over the last 15 years. On the positive side, Italy has enjoyed robust employment growth since the turn of the century and its unemployment rate has fallen substantially, also reflecting the impact of labour market reforms.

[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). 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.

But, while there remains a long way to go before Italy catches up with the EU average in terms of employment rates, the combination of dynamic employment growth and sluggish GDP growth highlights Italy's productivity problem. Notwithstanding the recent recovery, medium-term prospects for the Italian economy remain challenging under the strain of major structural weaknesses. These include in particular limited internal competition in services markets, which have started to be addressed in recent years. The structural weaknesses have fed into low productivity growth, a steady loss of external competitiveness and, until recently, a positive inflation differential with the euro area average. A public debt-to-GDP ratio above 100% and the still relatively high though declining, budgetary deficit, increase economic uncertainty and generate a high cost of debt service, making Italy vulnerable to increases in interest rates. They also prevent more productive uses of public resources and limit the ability of fiscal policy to allow automatic stabilisers to work effectively. Further containing the structural primary expenditure ratio, following its recent stabilisation, and increasing potential growth, also through an improvement of the quality of public finances, are key to rapidly reducing the debt ratio and putting public finances on a sustainable path.

(3) The macroeconomic scenario underlying the programme envisages that real GDP growth slows from 1.9% in 2007 to 1.5% in 2008. This would be followed by a mild but steady acceleration throughout the remainder of the programme period, whereby growth is expected to reach 1.8% in 2011. Taking into account recent developments, the growth assumption for 2008 in the programme appears to be rather favourable[2], as real GDP growth in 2008 is currently expected to be clearly below that of the programme, which may have implications for the level of the economic activity also after 2008. The programme's projections for inflation also appear to be on the low side for 2008 and plausible thereafter. These inflation prospects, and the underlying moderation in unit labour cost growth, appear to be consistent with a containment of the competitiveness losses of the Italian economy.

[2] The assessment also takes into account the Commission services' autumn forecast and the Commission assessment of the October 2007 implementation report of the national reform programme.

(4) For 2007, the general government deficit is estimated at 2.4% of GDP in the 2007 update of the stability programme, against a target of 2.8% of GDP set in the previous update. In the Commission services' autumn 2007 forecast, the deficit was expected at 2.3% of GDP. These lower deficit projections benefited from the 1.8 pp. higher nominal GDP growth in 2007 vis-à-vis the 2006 programme and from an effective implementation of the corrective measures in 2006 and 2007, partly offset by around 0.9% of GDP of additional expenditure, mainly social transfers and capital expenditure, decided in the course of 2007. In light of more recent information, the 2007 deficit could turn out substantially lower than estimated in the autumn forecast; hence, well below the 3% of GDP Treaty reference value. Budgetary implementation in 2007 is in line with the invitation in the Council opinion of 27 February on the previous update of the stability programme[3] related to the correction of the excessive deficit. The likely very positive 2007 budgetary outturn could have been even better if the above-mentioned additional expenditure had not been not adopted during the year, so it cannot be considered fully in line with the invitation to take advantage of better-than-expected budgetary developments for deficit reduction. The Council notes that the implementation of the 2007 budget is also not fully consistent with the April 2007 Eurogroup orientations for budgetary policies.

(5) The programme's budgetary strategy aims at pursuing fiscal consolidation towards the medium term objective (MTO) of a balanced position in structural terms, i.e. cyclically-adjusted and net of one-off and other temporary measures, which is planned to be reached by 2011. On the back of a similar economic outlook to the one in the previous programme, deficit targets for 2008-2011 are broadly unchanged. However, the projected adjustment in 2008 is around ½ pp. of GDP lower than envisaged in the previous update, as the unchanged target is planned against a better starting position. The government deficit is targeted to narrow by only 0.2 pp. of GDP in 2008 but by around ¾ pp. per year thereafter to turn into a balanced position in 2011. The composition of the adjustment is provided only for 2008, when the 0.2 pp. of GDP deficit reduction is planned mainly on the expenditure side.

[3] OJ C 70, 27.3.2007, p. 17.

After 2008, the programme only provides the overall size of the consolidation package that is required each year to achieve the budgetary targets relative to trends under an unchanged legislation scenario, without any indication on their composition. The gross debt-to-GDP ratio, estimated at 105% in 2007, i.e. far above the 60% of GDP Treaty reference value, is planned to decline by around 10 percentage points over the programme period.

(6) The risks to the deficit projections in the programme appear broadly balanced in 2008 but the budgetary outcomes could be worse than projected in the programme thereafter. While the likely positive outturn for 2007 would provide a favourable base effect for 2008, the 2008 budget law envisages that, after having secured the achievement of the budgetary target, better-than-expected permanent revenue may be used to fund tax cuts. In light of recent economic developments, the deficit outturn in 2008 is also subject to the risk of a significantly lower GDP growth. The achievement of the 2.2% of GDP deficit target in 2008 could imply a deterioration of both the headline and structural balance relative to 2007.[4] The scenario of unchanged legislation implies a significant underestimation of expenditure trends. This, together with the fact that no information is given on the composition of the necessary consolidation package on top of this scenario, implies clear risks. In particular, appropriate measures aimed at curbing expenditure developments remain to be spelled out. In view of these risks to the budgetary targets, from 2009 onwards the evolution of the debt ratio may be less favourable than projected in the programme.

[4] This is particularly true for the structural balance. The measure adopted on 31 December 2007 to discontinue the obligation by tax collectors to advance to government the payment of a certain amount of taxes to be collected in the following year could have a negative impact (0.3% of GDP) on the headline balance in 2007. However, it would not have any impact on the structural balance in 2007 because of its one-off nature.

(7) In view of this risk assessment, the budgetary stance in the programme is consistent with a correction of the excessive deficit in 2007 as recommended by the Council. However, a sufficient safety margin against breaching the 3% of GDP deficit threshold with normal macroeconomic fluctuations may not be secured before 2010 and the budgetary stance in the programme may not be sufficient to ensure that the MTO is achieved by the end of the programme period, as envisaged in the programme. In 2008, the structural balance risks deteriorating substantially, unless the better-than-projected 2007 starting position is carried through. For 2008, the adjustment towards the MTO implied by the programme is inadequate and should be strengthened to be 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. Furthermore, the Council notes that the budgetary stance in 2008 is not consistent with the April 2007 Eurogroup orientations for budgetary policies calling for a carefully designed fiscal policy for 2008 so as to accelerate the adjustment towards the MTO. From 2009 onwards, the budgetary stance in the programme should be backed up with measures. Finally, taking into account the risks to the debt projections mentioned above, the debt ratio may not be sufficiently diminishing towards the reference value over the programme period.

(8) Italy is at medium risk with regard to the sustainability of public finances. The long-term budgetary impact of ageing 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. Yet, pension expenditure as a share of GDP remains among the highest in the EU and the projections hinge upon the assumption that the recently adopted reforms are fully implemented, in particular that the revision of the actuarial coefficients is implemented as of 2010 as foreseen in the current legislation and without departing from the contributory principle underlying the reformed pension system. The budgetary position in 2007 as estimated in the programme, which is better than the starting position of the previous programme, contributes to offsetting the projected long-term budgetary impact of ageing but is still insufficient to fully cover future spending pressures, even when factoring in the likely better outturn. 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.

(9) The stability programme is fully consistent with the October 2007 implementation report of the national reform programme. In particular, budgetary developments and the fiscal policy strategy presented in the report are in line with those described, in more detail, in the stability programme. Although not in a systematic way, the budgetary projections in the programme explicitly take into account the public finance implications of the structural reform actions with a direct budgetary impact envisaged in the report, namely the package included in the Protocol agreement on Welfare, Competitiveness and the Labour market of 23 July 2007, as well as some actions in the area of research and development.

(10) The budgetary strategy in the programme is partly consistent with the country-specific broad economic policy guidelines included in the integrated guidelines and the guidelines for euro area Member States in the area of budgetary policies issued in the context of the Lisbon strategy. Italy should have pursued a more ambitious consolidation strategy given the favourable cyclical and budgetary developments. Measures aimed at improving the quality of public finances which have been undertaken include a reclassification of the budget and a spending review. Further measures aimed at curbing the upward trend in current primary expenditure and improving its efficiency and cost effectiveness remain to be spelled out.

(11) As regards to the data requirements specified in the code of conduct for stability and convergence programmes, the programme has gaps in the required and optional data.[5]

[5] In particular, there is no breakdown of the budget consistent with the deficit targets for the years 2009-2011.

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.

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) 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.

The Council also notes that such actions would be consistent with the April 2007 Eurogroup orientations for fiscal policies

		2006	2007	2008	2009	2010	2011
Real GDP (% change)	**SP Nov 2007**	**1.9**	**1.9**	**1.5**	**1.6**	**1.7**	**1.8**
	COM Nov 2007	1.9	1.9	1.4	1.6	n.a.	n.a.
	SP Dec 2006	*1.6*	*1.3*	*1.5*	*1.6*	*1.7*	*1.7*
HICP inflation (%)	**SP Nov 2007**	**2.2**	**1.9**	**2.0**	**2.0**	**1.8**	**1.9**
	COM Nov 2007	2.2	1.9	2.0	1.9	n.a.	n.a.
	SP Dec 2006	*2.2*	*2.1*	*1.7*	*1.5*	*1.5*	*1.5*
Output gap[1] (% of potential GDP)	**SP Nov 2007**	**-1.0**	**-0.6**	**-0.6**	**-0.6**	**-0.6**	**-0.6**
	COM Nov 2007[2]	-1.1	-0.8	-0.9	-1.0	n.a.	n.a.
	SP Dec 2006	*-0.9*	*-0.9*	*-0.8*	*-0.7*	*-0.5*	*-0.5*
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	**SP Nov 2007**	**-1.9**	**-1.3**	**-0.8**	**-0.6**	**-0.4**	**-0.2**
	COM Nov 2007	-1.9	-1.6	-1.5	-1.5	n.a.	n.a.
	SP Dec 2006	*-2.3*	*-2.0*	*-2.0*	*-2.0*	*-1.9*	*-1.8*
General government balance (% of GDP)	**SP Nov 2007**	**-4.4**	**-2.4**	**-2.2**	**-1.5**	**-0.7**	**0.0**
	COM Nov 2007	-4.4	-2.3	-2.3	-2.3	n.a.	n.a.
	SP Dec 2006	*-5.7*	*-2.8*	*-2.2*	*-1.5*	*-0.7*	*0.1*
Primary balance (% of GDP)	**SP Nov 2007**	**0.1**	**2.5**	**2.6**	**3.4**	**4.2**	**4.9**
	COM Nov 2007	0.1	2.5	2.4	2.5	n.a.	n.a.
	SP Dec 2006	*-0.9*	*2.2*	*2.8*	*3.4*	*4.2*	*5.0*
Cyclically-adjusted balance[1] (% of GDP)	**SP Nov 2007**	**-3.9**	**-2.0**	**-1.9**	**-1.2**	**-0.4**	**0.2**
	COM Nov 2007	-3.9	-1.9	-1.9	-1.8	n.a.	n.a.
	SP Dec 2006	*-5.3*	*-2.3*	*-1.8*	*-1.2*	*-0.4*	*0.3*
Structural balance[3] (% of GDP)	**SP Nov 2007**	**-2.7**	**-2.2**	**-2.0**	**-1.3**	**-0.5**	**0.2**
	COM Nov 2007	-2.7	-2.0	-2.0	-1.9	n.a.	n.a.
	SP Dec 2006	*-3.9*	*-2.5*	*-1.9*	*-1.2*	*-0.4*	*0.3*
Government gross debt (% of GDP)	**SP Nov 2007**	**106.8**	**105.0**	**103.5**	**101.5**	**98.5**	**95.1**
	COM Nov 2007	106.8	104.3	102.9	101.2	n.a.	n.a.
	SP Dec 2006	*107.6*	*106.9*	*105.4*	*103.5*	*100.7*	*97.8*

Notes:

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

[2]Based on estimated potential growth of 1.5%, 1.6%, 1.5% and 1.7% respectively in the period 2006-2009.

[3]Cyclically-adjusted balance excluding one-off and other temporary measures. According to the most recent programme and the Commission services' autumn forecasts, one-off and other temporary measures are: 1.2% of GDP in 2006, deficit-increasing; 0.2% of GDP in 2007, deficit reducing, and 0.1% of GDP per year, deficit reducing, from 2008 onwards.

Source:

Stability programme (SP); Commission services' autumn 2007 economic forecasts (COM); Commission services' calculations