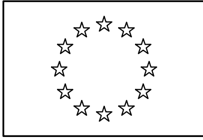

EUROPEAN COMMISSION

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Commission assessment of the 2003 update of the stability programme of Italy

Background

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 (formerly109c) of the Treaty (from 1 January 1999, 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].

Italy submitted its fifth and most recent update of the stability programme, covering the period 2003-2007, on 1 December 2003. The Commission services have carried out a technical evaluation of this updated programme, taking into account the information provided in accordance with the Code of Conduct, the Autumn forecasts as well as subsequent evaluations, the commonly agreed methodology for the estimation of cyclically-adjusted balances, the recommendations in the Broad Economic Policy Guidelines and the principles laid down in the Communication of the Commission to the Council of 27 November 2002 on strengthening the co-ordination of budgetary policies.[3] This evaluation warrants the following assessment:

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1 OJ L209, 2.8.1997. The documents referred to in this text can be found on the following website: http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm.

2 OJ C68, 11.3.1999.

3 COM(2002) 668 final, 27.11.2002

Commission assessment

The Italian authorities submitted the fifth update of the stability programme, covering the period 2003-2007, on 1 December 2003. The programme largely complies with the "Code of Conduct on the content and format of Stability and Convergence Programmes"[4]. As was the case with all previous updates of the Italian stability programme, the "future measures" bridging the difference between the "current legislation", or baseline, projections and the budgetary targets are not specified. Although consistent with the Italian budget process, this makes it difficult to determine whether the correction takes place on the expenditure and/or the revenue side and therefore to assess with precision the path and composition of the adjustment.

For 2003, the latest Commission estimate points to a general government deficit of 2.6% of GDP, with a contribution of well over 1½ percentage points of GDP from one-off measures. The cyclically-adjusted balance is estimated to have improved by 0.2 percentage point of GDP, but the deterioration in the cyclically-adjusted primary balance would suggest a more expansionary thrust of fiscal policy. The divergence with the original nominal deficit target is in the order of 1.1 percentage points of GDP, with lower than expected economic growth estimated to account for the major part of the slippage. Economic growth in 2003 fell clearly short of expectations and is likely to average ½ % for the year as a whole, almost 2 percentage points lower than in the macroeconomic forecast underpinning budgetary targets set out in the 2002 update. However, the growth effect also includes a significant element of excessive optimism in the growth outlook underpinning the original budgetary target, which was already perceived at the time of the presentation of the November 2002 programme update and highlighted in the Commission assessment. A non-negligible component of the total slippage can be attributed to an overestimation of revenues for the given growth assumptions and a higher than assumed deficit outturn in 2002.

In the medium term, the macroeconomic framework presented in the programme assumes a gradual acceleration of economic growth from 1.9% in 2004 to 2.6% in 2007. While less buoyant than in previous editions of the programme, the growth outlook remains optimistic. Investment is projected to expand at historically high rates, coupled with sustained export growth in the face of a strong euro and Italy's unfavourable trade specialization. Following the sharp deterioration in the past several years, the macroeconomic scenario implies a recovery in potential growth from 1.7% in 2003 to around 2.3% in 2007. This compares with a more cautious Commission assessment which estimates potential output growth to remain essentially unchanged at 1.5% over the coming years.

The updated programme revises the budgetary objectives for all the years which overlap with the previous programme period, namely 2003-2006. The government targets a general government deficit of 2.2% of GDP in 2004, compared to an expected deficit of 2.5% in 2003. In cyclically-adjusted terms, based on Commission calculations on the programme projections according to the commonly agreed methodology, there is an estimated improvement by 0.2 percentage point to 1.6% of GDP. For 2005, 2006 and 2007, the projections are for headline deficits of 1.5% and 0.7% of GDP and a balance in

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[4] *Revised Opinion of the Economic and Financial Committee on the content and format of stability and convergence programmes*, document EFC/ECFIN/404/01 – REV 1 of 27.6.2001, endorsed by the ECOFIN Council on 10.7.2001.

the final year, respectively. In cyclically-adjusted terms, in those years there would be an improvement of around half a percentage point of GDP on average. One-off measures, which accounted for a large part of the budgetary correction in the past few years, are planned to be progressively reduced and phased out by 2006.

The budgetary adjustment of the programme is backloaded and there is a lack of information on the measures envisaged. From 2005 onwards, the programme baseline expenditure projections are based on legislation currently in force and hence do not take into account future increases in compensation of employees (due to the renewal of contracts) and the impact of new future investment projects. Therefore, the "true" path of expenditure is likely to be higher than in the programme baseline projections. In turn, this would increase the amount of unspecified further measures necessary to achieve the budgetary targets beyond 2004. Given the government's stated policy intention to reduce the tax and social security contributions burden, the driving force of the adjustment would appear to be the reduction in the primary expenditure ratio, assuming that corrective measures would be concentrated on the expenditure side. The overall reduction in the primary expenditure share between 2004 and 2007 implied by the programme would be of unprecedented magnitude, in the order of 4% of GDP. The fact that this is to be achieved together with a progressive replacement of the one-off measures bolstering the previous years' targets provides a measure of the degree of (future) ambition underlying the programme targets.

Checking the plausibility of the targets against the Commission forecasts, it emerges that in 2004 the nominal budget deficit would approximate the 3% of GDP threshold; in cyclically-adjusted terms the deficit would increase compared to 2003 and would not allow for a safety margin. The difference with the programme target is due to a more cautious growth assumption, a marginal re-assessment of the corrective measures and a less optimistic evaluation of underlying fiscal trends. In essence, all this implies that the stated size of the planned correction is insufficient to achieve the budgetary targets. The size of the adjustment effort required in the outer years of the programme is highlighted when the official targets are set against the Commission's "no-policy-change" forecast for 2005 (i.e. a scenario incorporating a worse starting position inherited from 2004, somewhat weaker growth in 2005 and the expiry of temporary measures implemented in 2004), in which the deficit in both nominal and cyclically-adjusted terms would overshoot the 3%-of-GDP threshold. Hence the "close-to-balance" position would be reached later than envisaged in the programme.

It also needs stressing that since 1999, the cash-definition measure of the general government deficit has tended to exceed the Maastricht-definition deficit (on an accruals basis) by about 1.5% of GDP on average. The cash deficit of the general government in 2003 is likely to end up around 4% of GDP. Although this would be half a percentage point below the official estimates released during the year, it would still signify an increase of around 1 percentage point in the cash deficit compared to 2002. An analysis of the programme figures shows that the achievement of the close-to-balance objective in terms of the Maastricht-definition deficit would co-exist with a cash deficit in the order of 2½ percentage points of GDP in 2007. Such a worrying and large difference between the two definitions of deficit appears to indicate the presence of significant "below the line" expenditure.

The persisting high levels of the cash general government borrowing requirement, together with a marked deceleration in the process of disposal of financial assets, slowed the pace of debt reduction in recent years. In 2003 the debt ratio, still well above 100% of

GDP, is expected to decrease by about 2 percentage points to around 105% of GDP, a better development than envisaged in the programme. The decrease is obtained largely thanks to a resumption of privatisations, a sizeable reduction in cash assets held by the government with the Bank of Italy, a favourable exchange rate effect and other financial transactions (still to be examined by Eurostat) linked to the transformation of the *Cassa Depositi e Prestiti* (the government's savings and loans bank) into a joint-stock company at the end of 2003.

Some of the financial operations that have improved the debt ratio outturn in 2003 compared to plans may be expected to have a bearing on the path of debt reduction envisaged in the programme, in which the debt ratio is projected to decline from 106% of GDP in 2003 to slightly below 99% in 2007. However, the general considerations on the strategy of debt reduction envisaged in the programme retain validity. Sustained nominal GDP growth and recovering primary surpluses are the driving forces behind the reduction in the debt ratio projected by the Italian authorities, which is also conditional on sizeable annual disposals of financial assets, exceeding on an annual average those carried out in the 1995-2000 period. The risks to the programme deficit targets may imply a corresponding deterioration in the debt ratios.

On the basis of the current policies, there are risks with regard to the long-term sustainability of public finances. Commission indicators show that the conditions for the debt to GDP ratio to decline to 60% of GDP over the next 20 years are stringent, set against the slow progress in securing durable budgetary consolidation. The budgetary strategy outlined in the programme, mainly based on achieving and maintaining sustained primary surpluses to run down the debt before the impact of ageing takes place, is compatible with improving the sustainability of public finances; a contribution would also come from the pension reform proposal, which goes in the direction of increasing participation rates among elderly people and correcting pension expenditure trends. However, this conclusion needs to be qualified in the light of the risks attached to the programme's budgetary strategy, and of the broader public finance strategy of the government.

The economic policies as reflected in the updated programme are partly consistent with the recommendations of the Broad Economic Policy Guidelines for the 2003-2005 period[5], specifically those with budgetary implications. In particular, doubts persist about the planned replacement of one-off measures, the implementation of structural expenditure cuts and the pace of reduction in the debt ratio. Finally, the government pension reform proposal, while potentially dampening the projected increase in the ratio of pension expenditure to GDP over the next twenty years, is subject to non-negligible risks, *inter alia* because steps to curb pension expenditure trends are deferred to 2008.

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[5] Council recommendation of 25 June 2003 on the *Broad guidelines of the economic policies of the Member States and of the Community (for the 2003-05 period).*