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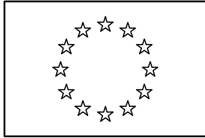

COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 7.5.2008
SEC(2008) 574 final

Recommendation for a

COUNCIL DECISION

abrogating Decision 2005/694/EC on the existence of an excessive deficit in Italy

(presented by the Commission)

EXPLANATORY MEMORANDUM

1. BACKGROUND

Article 104 of the Treaty establishes that Member States should avoid excessive deficits and lays down a procedure for their identification and correction. The excessive deficit procedure (EDP) is further specified in Council Regulation (EC) No 1467/97 on "speeding up and clarifying the implementation of the excessive deficit procedure"[1], which is part of the Stability and Growth Pact. According to Article 104(2) of the Treaty, the Commission must monitor compliance with budgetary discipline on the basis of two criteria, namely: (a) whether the planned or actual government deficit exceeds the reference value of 3% of GDP (unless either the deficit 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 only exceptional and temporary and the ratio remains close to the reference value); and (b) whether government debt exceeds the reference value of 60% of GDP (unless the debt ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace).

In accordance with the Protocol on the excessive deficit procedure annexed to the Treaty, the Commission provides the data for the implementation of the EDP. As part of the application of this Protocol, Member States must notify data on government deficits and debt and other associated variables twice a year, namely before 1 April and before 1 October, in accordance with Article 4 of Council Regulation (EC) No 3605/93[2,3].

On 7 June 2005, the Commission initiated the EDP for Italy with the adoption of a report under Article 104(3), based on a general government deficit of 3.1% of GDP and government debt at around 106-107% of GDP in both 2003 and 2004[4]. On 28 July 2005, the Council decided, on a recommendation from the Commission, that Italy was in excessive deficit according to Article 104(6)[5]. At the same time, and also based on a Commission recommendation, the Council addressed recommendations under Article 104(7) to Italy with a view to bringing the situation of an excessive government deficit to an end, by 2007 at the latest[6]. Specifically, to that end, the Italian authorities were recommended to: implement with rigour the 2005 budget; take the necessary measures to ensure a cumulative reduction in the cyclically-adjusted deficit, net of one-off and other temporary measures, of at least 1.6% of GDP over 2006-2007 relative to its level in 2005, with at least half of this correction taking place in 2006. In addition, the Italian authorities were recommended to ensure that the government gross debt ratio diminishes sufficiently and approaches the reference value at a satisfactory pace, in line with the correction of the excessive deficit, by restoring in the medium term an adequate level of the primary surplus. Furthermore, the Italian authorities

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1 OJ L 209, 2.8.1997, p. 6. Regulation as amended by Regulation (EC) No 1056/2005 (OJ L 174, 7.7.2005, p. 5).

2 OJ L 332, 31.12.1993, p. 7. Regulation as last amended by Regulation (EC) No 2103/2005 (OJ L 337, 22.12.2005, p. 1).

3 The most recent notification of Italy can be found at: http://epp.eurostat.ec.europa.eu/portal/page?_pageid=2373,58110711&_dad=portal&_schema=portal.

4 SEC(2005) 750. After successive revisions, the general government deficit is currently reported at 3.5% of GDP in both 2003 and 2004. For the same years, the debt ratio has been revised downwards to around 104% of GDP, essentially due to the present higher estimate of nominal GDP.

5 OJ L 266, 11.10.2005, p. 57

6 All EDP-related documents for Italy can be found at the following website: http://ec.europa.eu/economy_finance/sg_pact_fiscal_policy/excessive_deficit9109_en.htm.

were recommended to pay particular attention to factors other than net borrowing, such as below-the-line operations, which contribute to the change in debt levels. In addition, the Council invited the Italian authorities to ensure that budgetary consolidation towards the medium term position of government finances close to balance or in surplus is sustained through a reduction in the cyclically-adjusted deficit, net of one-off and other temporary measures, by at least 0.5% of GDP per year after the excessive deficit has been corrected.

Finally, the Council urged the Italian authorities to further improve the collection and processing of general government data.

Table 1: Adjustment endorsed by the Council on 28 July 2005

% of GDP, unless indicated otherwise	**2005**	**2006**	**2007**
General government balance	-4.3	deficit clearly < 4	deficit clearly < 3
Temporary measures	*0.4*	-	-
change in structural balance		*+1.6 in 2006-2007 over 2005 (at least)*	
		at least half of this in 2006	
p.m.: Real GDP growth (%)	0	1.5	1.5

Note: structural balance = cyclically-adjusted balance excluding one-off and other temporary measures
Source: Council recommendation under Article 104(7), quoting the Commission services' spring 2005 forecast and including subsequent evaluations

On 22 February 2006, i.e. after the expiry of the deadline for taking action set in the Council recommendation, the Commission adopted a communication to the Council, which concluded that action taken until then by Italy seemed to be consistent with the Council recommendation and that, while the budgetary situation remained vulnerable, no further steps under the EDP were necessary at that stage[7]. In its meeting of 14 March 2006, the Council concurred with this assessment.

According to Article 104(12), a Council decision on the existence of an excessive deficit is to be abrogated, on the basis of a Commission recommendation, when the excessive deficit in the Member State concerned has, in the view of the Council, been corrected.

2. RECENT DEFICIT DEVELOPMENTS

Data released by the national statistical office on 29 February 2008 confirmed the general government deficit of 3.5% of GDP in both 2003 and 2004, after successive revisions of the original 3.1% of GDP that prompted the Commission to initiate the EDP for Italy in 2005. The deficit in these two years would have been even higher in the absence of one-offs, worth 1¾% and 1¼% of GDP respectively. From almost 5% of GDP at the end of the 1990s, the primary surplus fell rapidly to 1.2% in 2004. In 2005, when GDP stagnated, the general government deficit attained 4.2% of GDP, notwithstanding ½% of GDP of deficit-decreasing one-offs, and the primary surplus was almost fully eroded.

[7] SEC(2006) 238.

Data reported by Italy before April 2008 show that a significant budgetary adjustment took place in 2006, when the general government deficit reached 3.4% of GDP[8]. This compares with a targeted deficit of 3.5% of GDP set in the December 2005 update of the stability programme[9]. The headline deficit was negatively affected by the government decision to cancel the debt of the railway company related to the high-speed project, which resulted in a 0.9% of GDP increase in the deficit. The almost 0.9 pp. of GDP nominal adjustment between 2005 and 2006 was driven by buoyant revenues coupled with a slight reduction in the ratio of current primary expenditure to GDP, obtained thanks to almost flat intermediate consumption. This outweighed the mentioned railway debt cancellation. The substantial increase in many revenue items was related to a number of measures in the 2006 Budget Law and in an additional budgetary package adopted at mid-year. VAT receipts, as well as personal and corporate income taxes, each rose by 0.3 pp. of GDP year-on-year.

In 2006, revenues net of one-offs finished at 1½ pp. of GDP higher than in 2005, whereas expenditure net of one-offs declined by more than ¼ pp. of GDP. Excluding one-off and temporary measures[10], the 2006 deficit declined to 3% of GDP from 4.8% in 2005.

In 2006, the structural balance, i.e. the budget balance net of cyclical and one-off effects, improved by 1.7 pp. of GDP relative to 2005, well above the at least 0.8 pp. required in the July 2005 Council recommendation under Article 104(7).

Based on data provided by the Commission (Eurostat) following the reporting by Italy before April 2008[11], the general government deficit in 2007 was at 1.9% of GDP. There is a very low probability that potential future revisions in government accounts would raise the 2007 deficit ratio in excess of 3% of GDP[12].

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[8] The 2006 deficit was revised downwards from the 4.4% of GDP notified before April 2008 (Eurostat News Release No 55 of 23 April 2007 and No 142 of 22 October 2007). The revision is mainly the result of lower capital expenditure due to the decision to accrue VAT refunds, which are related to the ruling issued by the European Court of Justice (ECJ) on VAT on company cars, in the years in which the filed claims are validated, rather than in 2006 as originally planned.

[9] The programme, as well as its assessment by the Commission and the Council, can be found at: http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm.

[10] One-off and temporary measures increased the 2006 deficit by 0.4% of GDP in 2006. On top of the deficit-increasing debt cancellation, the following transactions are treated as deficit reducing one-off: sales of real estate (0.1% of GDP) and taxes on the revaluation of companies' assets (0.4% of GDP). By contrast, the 2005 update of the stability programme projected deficit-reducing one-off measures at 0.3% of GDP in 2006.

[11] Eurostat News Release No 54 of 18 April 2008.

[12] Deficit ratios are usually revised - upwards or downwards - after the publication of the first outcome in the spring notification. Some past revisions in Italy have been quite significant. However, the gap between the currently reported deficit for 2007 and the deficit reference value is large enough to suggest that any revision should not bring the 2007 deficit above 3% of GDP.

The 1.9% of GDP deficit reported for 2007, including 0.2% of GDP overall deficit-increasing one-offs[13], is much lower than the 2.8% of GDP targeted in the 2006 stability programme, which included 0.1% of GDP of deficit-decreasing one-offs. This better-than-planned result is due to the positive base effect from the 2006 deficit net-of-one offs, which turned out 1.5 pp. of GDP lower than estimated in the 2006 update of the stability programme. The implementation of the corrective measures adopted with the 2007 Budget Law was effective; however, the better starting position was to some extent offset by the partial implementation of some additional expenditure, mainly social transfers and capital expenditure, which was decided in the course of 2007.

The 1½ pp. of GDP headline adjustment in 2007 relative to 2006 was largely achieved thanks to a further substantial increase, by 1.2 pp., in the revenue-to-GDP ratio. A surge in both personal and corporate income taxes largely offset the reduction in both the temporary revenue, stemming from the revaluation of company assets, and the indirect taxes/GDP ratio, mainly due to a decline of excise duties on oil products. The diversion of the severance pay scheme TFR to the Italian social security institute explains almost 0.4 pp. of the rise in social contributions as a share of GDP[14]. On the expenditure side, substantially lower (one-off) capital expenditure relative to 2006 was partly offset by the surge in interest expenditure. The share of current primary expenditure to GDP decreased marginally between 2006 and 2007, as subdued growth of compensation of employees, reflecting the absence of the sizeable arrears paid in 2006, was largely compensated by an increase of social transfers other than in kind. Overall, primary expenditure fell by almost ¾ of a percentage point of GDP, while total expenditure declined by around ¼ of a percentage point of GDP in 2007.

In 2007, revenues net of one-offs increased by 1½ pp. of GDP compared with 2006, whereas expenditure net of one-offs rose by more than ¼ pp. of GDP. Excluding this and other one-off and temporary measures, the 2007 deficit was 1.7% of GDP.

The structural balance, i.e. the cyclically adjusted budgetary balance excluding one-off measures, is estimated to have improved by about 1¼ percentage points of GDP in 2007. Over the 2006-2007 period, the correction of the structural deficit amounted to 3 pp. of GDP. This exceeds by a comfortable margin the at least 1.6 pp. required by the July 2005 Council recommendation under article 104(7).

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13 The 0.2% of GDP estimate of the deficit-increasing impact of one-off measures in 2007 is the result of 0.2% of GDP deficit-decreasing one-offs, comprising proceeds from the sale of real estate and taxes on the revaluation of company assets, and the 0.4% deficit-increasing one-offs, which consisted of (i) the decision, adopted on 31/12/2007, to discontinue the obligation on tax collectors to advance to government the payment of a certain amount of taxes to be collected in the following year (0.3% of GDP); and (ii) reimbursement claims filed by taxpayers following the ECJ ruling against Italy's VAT regime for company cars (less than 0.1% of GDP).

14 The 2007 Budget Law ruled that employers with at least 50 employees should divert the severance pay scheme (*Trattamento di Fine Rapporto* – TFR) flows that employees decide not to transfer to private pension schemes towards a new scheme set up within the Italian social security institute (*Istituto Nazionale della Previdenza Sociale* - INPS). The flows accumulated in the new INPS scheme are recorded as government revenue that reduces the deficit, but the liabilities they generate for the government in the form of severance payments to employees will gradually translate into additional public expenditure. The deficit-reducing impact of this provision is projected to decrease over time, and within 8-9 years additional revenue and expenditure are expected to balance out.

In line with the invitation in the Council recommendation under Article 104(7) that Italy further improve the collection and processing of general government data, Italy has reduced statistical discrepancies. The development of online government is leading to a more efficient collection of information on budgetary transactions. Some shortcomings remain, like for instance a significant discrepancy between accrued and collected social contributions in 2006 and 2007, Following the September 2005 EDP notification, Eurostat published Italy's data with no pending issues.

3. DEFICIT PROJECTIONS FOR 2008 AND BEYOND

According to the Commission services' spring 2008 forecast, the general government deficit for 2008 is projected to increase to 2.3% of GDP, with real GDP growing at 0.5%. Net of one-off and temporary measures, i.e., proceeds from the sale of real assets and the final instalments of some one-off taxes, the 2008 deficit would still be below the reference value, at 2.4% of GDP. In the November 2007 update of the stability programme of Italy, the official deficit objective for 2008 was 2.2% of GDP, also including around 0.1% of GDP of deficit-decreasing one-offs. Despite the better-than-estimated 2007 deficit outturn, the official deficit projection for 2008 was revised upwards on 12 March, to 2.4% of GDP, later confirmed in the April 2008 notification. The revision incorporates lower expected real GDP growth (0.6% as compared to 1.5% of GDP in the update), but also budgetary slippages. The slightly lower projection for the 2008 deficit in the spring forecast is explained by the assumption that some delays will continue to be experienced in the budgetary execution of investments. The spring forecast also projects lower interest expenditure.

The 2.3% of GDP deficit in 2008 in the Commission services spring 2008 forecast would represent a rise in nominal terms close to ½ of a percentage point of GDP compared to 2007, despite the sharp drop of capital expenditure, which reflects the substantial one-off expenditure accrued in 2007. The projected worsening in the nominal deficit reflects not only lower economic growth, but also the negative budgetary impact of the 2008 budget, as well as some expansionary measures originally planned in 2007 and others adopted in the first few months of 2008. Specifically, the 2008 budget envisages the financing of the public sector wage agreement at local level for the period 2006-2007, including the due arrears (in the official projections, the wage bill increases by more than 6% in 2008 and slightly declines in 2009), cuts in local property taxes, lower revenue due to rent deductibility and some increase of unemployment benefits. The budget law also stipulates a reform of both the tax rates on corporate income (IRES) and the regional tax on productive activity (IRAP), the budgetary impact of which would turn from positive in 2008 to negative in 2009, before becoming neutral in the following years. Some additional social transfers and investments approved in 2007, as well as cuts in IRAP in the 2006 budget law, will have a delayed adverse budgetary impact in 2008. A number of minor measures involving additional expenditure and lower revenue were adopted by Parliament in February 2008. Overall, in 2008, expenditure net of one-offs should increase by 0.5 pp. of GDP, as a modest decline in the ratio of both interest expenditure and capital expenditure net of one-offs would be more than offset by a surge of current primary expenditure. Revenues net of one-offs should decline by almost 0.2 pp. of GDP in 2008.

Under unchanged policies, risks to the budgetary projections for 2008 emanate from pending court rulings, in particular concerning the non-deductibility of IRAP from the tax base of income taxes. Risks also arise from the economic growth outlook. In addition, the outcome of the substantial changes in corporate taxation is subject to considerable uncertainty in both directions.

For 2009, the Commission services spring 2008 forecast, based on the conventional no-policy change scenario and real GDP growth at 0.8%, envisages that the general government deficit will rise slightly to 2.4% of GDP. This projected modest increase is driven by a falling tax burden, particularly lower corporate income taxes, as a result of both discretionary measures and the negative economic cycle. The November 2007 update of the stability programme targeted a deficit of 1.5% of GDP, with real GDP growing by 1.6%. As highlighted in the Council Opinion on the 2007 update of the Italian stability programme[15], no corrective measures underlying the budgetary adjustment were spelled out in the programme.

The projected deterioration of the structural position in 2008 compared to 2007, by more than ¼ of a percentage point of GDP, is clearly not in line with the at least 0.5% of GDP annual reduction that is stipulated in the Stability and Growth Pact and recalled in the Council decision under Article 104(7) after the excessive deficit has been corrected. In its opinion on the November 2007 update of the stability programme, which projected an improvement in the structural position of ¼ pp. of GDP in 2008, the Council noted that the structural balance risked deteriorating substantially in 2008, unless the better-than-projected 2007 starting position was carried through and concluded that the MTO might not be achieved by 2011 as planned in the programme. Accordingly, the Council invited Italy to 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, i.e. 2011.

4. DEBT DEVELOPMENTS AND PROJECTIONS

Data released by the national statistical office on 29 February 2008 showed a general government debt at around 104% of GDP in both 2003 and 2004, after successive revisions of the original 106-107% of GDP that was observed at the time the EDP for Italy was initiated essentially due to a higher estimate of the GDP level. In 2005, the debt-to-GDP ratio increased for the first time in a decade, by 2 pp. Primary surplus provided almost no contribution to its reduction whereas, due to sluggish economic growth, the implicit interest rate on government debt largely exceeded nominal GDP growth, implying a significantly negative "snow ball" effect. The government debt ratio increased again in 2006 despite an increasing primary surplus and a less negative "snow ball' effect. In that year the "stock-flow" adjustment provided a particularly negative contribution to debt development, essentially because of the accumulation of liquid assets to finance the estimated VAT reimbursements following the ECJ ruling on VAT on company cars (see Footnote 8). In 2007, the government debt-to-GDP ratio decreased by 2.5 pp., to 104% of GDP, back to the level recorded in 2004. This result was achieved thanks to an increased primary surplus exceeding 3% of GDP. The "stock-flow" adjustment also contributed to the fall in the debt ratio as state liquid assets were reduced substantially at the end of 2007 relative to the previous year given the much smaller-than-anticipated amount of VAT reimbursements actually claimed by taxpayers. In addition,

[15] OJ C 49, 22.2.2008, p. 49.

the "stock-flow" adjustment in 2007 benefited from a distribution of capital amounting to around 0.2% of GDP by a state-owned company (SACE SpA).

The debt reduction over 2006-2007, based on an increasing primary surplus and without significant debt-increasing operations below the line, appears in line with the correction of the excessive deficit. However, as the primary surplus is projected to fall in 2008 and measures to raise it again in the medium-term have not been spelled out, the debt ratio is expected to decline only slightly in 2008 and 2009 (on a no-policy change basis).

The Commission services' spring 2008 forecast, based on the no-policy change assumption, projects a continued reduction in the government debt ratio in 2008 and 2009, albeit at a slower pace due to a worsening primary surplus and dismal economic growth. Risks associated with economic growth and budgetary developments also apply to the debt-to-GDP ratio.

5. CONCLUSIONS

The general government deficit increased from 3.5% of GDP in 2003 and 2004 to 4.2% of GDP in 2005. It then declined to 3.4% of GDP in 2006 and 1.9% in 2007, below the 3% of GDP reference value. The measures underlying the deficit reduction are mainly permanent in nature. Indeed, the deficit in 2006 and 2007 would have been even lower in the absence of one-offs. The structural balance, i.e. the cyclically-adjusted balance net of one-off and other temporary measures, improved by 3 pp. of GDP during 2006-2007, well above the fiscal effort of at least 1.6 pp. of GDP recommended by the Council. According to the Commission services’ spring 2008 forecast, the nominal deficit is expected to increase to 2.3% of GDP in 2008 (still including one-offs amounting to about 0.1% of GDP, without which the deficit would nonetheless still be below 3% of GDP) and, on a no-policy change basis, to 2.4% in 2009. This indicates that the deficit has been brought below the ceiling of 3% of GDP in a credible and sustainable manner.

After decreasing for a decade to just below 104% of GDP in 2004 (from more than 121% of GDP in 1994), the government debt ratio increased by 2 percentage points of GDP in 2005 and by further 0.6 of a percentage point in 2006. The debt ratio fell again to 104% of GDP in 2007. The development of the debt ratio was significantly affected by a temporary debt-increasing financial operation in 2006 and its reversal in 2007. Without this operation the debt ratio would have remained broadly stable in 2006, reflecting the improvement in the primary surplus in line with the Council recommendation. According to the Commission's spring 2008 forecast, under the assumption of unchanged policies the debt ratio is projected to fall to around 102½% by 2009. The debt ratio can be considered to have diminished in line with the correction of the excessive deficit in 2007.

From an overall assessment, it follows that the excessive deficit situation in Italy has been corrected. Accordingly, the Commission recommends that the Council abrogates its decision on the existence of an excessive deficit in Italy.

Table 2: Budgetary developments, 2003-2009

% of GDP, unless indicated otherwise	2003	2004	2005	2006	2007		2008		2009	
					outturn	SP [2]	COM	SP [2]	COM[3]	SP[2]
General government balance	**-3.5**	**-3.5**	**-4.2**	**-3.4**	**-1.9**	**-2.4**	**-2.3**	**-2.2 (-2.4)**	**-2.4**	**-1.5**
- Total revenues[5]	44.8	44.2	43.8	45.4	46.6	46.2	46.4	46.3	46.4	45.9
- Total expenditure[5]	48.3	47.7	48.0	48.8	48.5	48.6	48.7	48.5	48.7	47.9
Of which: - interest expenditure	*5.1*	*4.7*	*4.5*	*4.6*	*5.0*	*4.8*	*4.9*	*4.9 (5.0)*	*4.9*	*4.9*
- gross fixed capital formation	*2.5*	*2.4*	*2.4*	*2.4*	*2.4*	*2.7*	*2.4*	*2.5*	*2.4*	*2.6*
Primary balance	**1.6**	**1.2**	**0.3**	**1.3**	**3.1**	**2.5**	**2.6**	**2.6 (2.6)**	**2.5**	**3.4**
One-off and temporary measures	1.7	1.3	0.6	-0.4	-0.2	0.2	0.1	0.1	0.0	0.1
Structural balance[1]	**-5.1**	**-4.7**	**-4.5**	**-2.8**	**-1.5**	**-2.2**	**-1.9**	**-2.0 (-2.2)**	**-1.6**	**-1.3**
Structural primary balance[1]	0.0	0.0	0.0	1.8	3.5	2.6	3.1	2.9	3.3	3.6
Government gross debt[4]	**104.3**	**103.8**	**105.8**	**106.5**	**104.0**	**105.0**	**103.2**	**103.5 (103.0)**	**102.6**	**101.5**
Change in debt ratio (a) = (b) + (c) + (d)	-1.3	-0.5	2.0	0.6	-2.5	-1.8	-0.8	-1.6	-0.6	-2.0
Contributions: - primary balance (b)	*-1.6*	*-1.2*	*-0.3*	*-1.3*	*-3.1*	*-2.5*	*-2.6*	*-2.6*	*-2.5*	*-3.4*
- "snow ball" effect (c)	*1.9*	*0.5*	*1.9*	*0.9*	*1.1*	*0.1*	*1.5*	*0.9*	*2.0*	*1.5*
- stock-flow adjustment (d)	*-1.6*	*0.3*	*0.5*	*1.0*	*-0.5*	*0.6*	*0.4*	*0.2*	*-0.1*	*-0.1*
Pm Real GDP growth (%)	*0.0*	*1.5*	*0.6*	*1.8*	*1.5*	*1.9*	*0.5*	*1.5 (0.6)*	*0.8*	*1.6*
Pm Output gap	*-0.2*	*0.0*	*-0.6*	*-0.3*	*-0.3*	*-0.6*	*-1.0*	*-0.6*	*-1.6*	*-0.6*

(1) Cyclically-adjusted (primary) balance excluding one-off and temporary measures.

(2) Cyclically-adjusted and structural balances and output gaps according to the programme as calculated by Commission services on the basis of the information in the programme.

(3) No-policy change assumption.

(4) The change in the gross debt ratio can be decomposed as follows:

$$\frac{D_t}{Y_t} - \frac{D_{t-1}}{Y_{t-1}} = \frac{PD_t}{Y_t} + \left(\frac{D_{t-1}}{Y_{t-1}} * \frac{i_t - y_t}{1 + y_t}\right) + \frac{SF_t}{Y_t}$$

where t is a time subscript; *D, PD, Y* and *SF* are the stock of government debt, the primary deficit, nominal GDP and the stock-flow adjustment respectively, and i and y represent the average cost of debt and nominal GDP growth. The term in parentheses represents the "snow ball" effect.

(5) Budgetary data provided in the SP for 2009 are trends based on unchanged legislation. In order to achieve the targeted general government balance, additional measures with a positive impact of 0.4% of GDP were envisaged.

Sources: Commission services' spring 2008 forecast (COM)and November 2007 update of the stability programme (SP) (in brackets new official projections based on unchanged legislation of March 2008).

Recommendation for a

COUNCIL DECISION

abrogating Decision 2005/694/EC on the existence of an excessive deficit in Italy

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community, and in particular Article 104(12) thereof,

Having regard to the recommendation from the Commission,

Whereas:

(1) By Council Decision 2005/694/EC[16], following a recommendation from the Commission in accordance with Article 104(6) of the Treaty, it was decided that an excessive deficit existed in Italy. The Council noted that the general government deficit was above but close to the 3% of GDP reference value in both 2003 and 2004, while general government gross debt stood at around 106-107 % of GDP in both years, clearly above the 60 % of GDP Treaty reference value, and it had not declined at a satisfactory pace over recent years.

(2) On 28 July 2005, in accordance with Article 104(7) of the Treaty and Article 3(4) of Council Regulation (EC) No 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure[17], the Council made, based on a recommendation from the Commission, a recommendation addressed to Italy with a view to bringing the excessive deficit situation to an end by 2007 at the latest. The recommendation was made public.

(3) In accordance with Article 104(12) of the Treaty, a Council Decision on the existence of an excessive deficit is to be abrogated when the excessive deficit in the Member State concerned has, in the view of the Council, been corrected.

(4) In accordance with the Protocol on the excessive deficit procedure annexed to the Treaty, the Commission provides the data for the implementation of the procedure. As part of the application of this Protocol, Member States are to notify data on government deficits and debt and other associated variables twice a year, namely before 1 April and before 1 October, in accordance with Article 4 of Council Regulation (EC) No 3605/93 of 22 November 1993 on the application of the Protocol

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[16] OJ L 266, 11.10.2005, p. 57.

[17] OJ L 209, 2.8.1997, p. 6. Regulation as amended by Regulation (EC) No 1056/2005 (OJ L 174, 7.7.2005, p. 5).

on the excessive deficit procedure annexed to the Treaty establishing the European Community[18].

(5) Based on data provided by the Commission (Eurostat) in accordance with Article 8g(1) of Regulation (EC) No 3605/93 following the notification by Italy before 1 April 2008 and on the Commission services' spring 2008 forecast, the following conclusions are warranted:

– the general government deficit, after rising from 3.5 % of GDP in 2004 to 4.2% of GDP in 2005, was reduced to 3.4% of GDP in 2006 and finally to 1.9 % of GDP in 2007, which is below the 3% of GDP deficit reference value. Net of the budgetary impact of one-off measures, the deficit would be 1.7% of GDP in 2007. This compares with a target of 2.8% of GDP set in the December 2006 update of the stability programme,

– the adjustment was driven by an increase in permanent tax revenues over the 2006-2007 period, which largely exceeded expectations. This was mostly thanks to a higher-than-expected effectiveness of the adopted measures and somewhat higher-than-projected economic growth. After an estimated worsening by ¼ of a percentage point of GDP in 2005, the structural balance (i.e. the cyclically-adjusted balance net of one-off and other temporary measures) is estimated to have improved by 1¾ and 1¼ percentage points of GDP in 2006 and 2007, respectively,

– for 2008, the spring 2008 forecast projects an increase in the deficit to 2.3% of GDP, including 0.1% of GDP one-offs proceeds from the sale of real estate. The envisaged worsening of the budgetary balance will be driven by both a rise in the ratio of current primary expenditure to GDP and lower current taxes. This is partly offset by an anticipated decline of capital expenditure, which reflects the substantial one-off expenditure accrued in 2007. Although the 2.3% of GDP deficit projection is only slightly above the official deficit target of 2.2% of GDP set in the November 2007 update of the stability programme, the latter was projected using an estimated deficit outturn in 2007 significantly higher than the reported outcome. For 2009, the spring forecast projects, on a no-policy change basis, a deficit of 2.4% of GDP. This implies that the deficit has been brought below the 3% of GDP ceiling in a credible and sustainable manner. The structural balance is projected to worsen by more than ¼ of a percentage point of GDP in 2008 and, on a no-policy change basis, to improve by ¼ of a percentage point in 2009. This has to be seen against the need to make progress towards the medium-term objective (MTO) for the budgetary position, which for Italy is a balanced position in structural terms,

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[18] OJ L 332, 31.12.1993, p. 7. Regulation as last amended by Regulation (EC) No 2103/2005 (OJ L 337, 22.12.2005, p. 1).

– after decreasing for a decade to just below 104% of GDP in 2004 (from more than 121% of GDP in 1994), the government debt ratio increased by 2 percentage points of GDP in 2005 and by further 0.6 of a percentage point in 2006, to 106½% of GDP. The debt ratio fell again to 104% of GDP in 2007. The development of the debt ratio was significantly affected by a temporary debt-increasing financial operation, i.e. the accumulation of liquid assets, in 2006 and its reversal in 2007. Without this operation the debt ratio would have remained broadly stable in 2006, reflecting the improvement in the primary surplus in line with the Council recommendation. According to the Commission's spring 2008 forecast, under the assumption of unchanged policies the debt ratio is projected to fall to around 102½% by 2009. The debt ratio can be considered to have diminished in line with the correction of the excessive deficit in 2007.

(6) In the view of the Council, the excessive deficit in Italy has been corrected and Decision 2005/694/EC should therefore be abrogated.

HAS ADOPTED THIS DECISION:

Article 1

From an overall assessment it follows that the excessive deficit situation in Italy has been corrected.

Article 2

Decision 2005/694/EC is hereby abrogated.

Article 3

This Decision is addressed to the Republic of Italy.

Done at Brussels,

For the Council
The President