IP/08/714

Brussels, 7 May 2008

Commission recommends abrogation of excessive deficit procedure for Italy, Portugal, the Czech Republic and Slovakia

The European Commission today recommended that the Council abrogates the excessive deficit procedure (EDP) for Italy and Portugal since their budget deficit fell below 3% of GDP in 2007 and is projected to remain below this ceiling also in 2008 and 2009. This means that for the first time since 2002 not a single euro-area Member State is subject to the close surveillance of its public finances provided for in the 'corrective arm' of the Stability and Growth Pact. Today, the Commission concluded that the conditions were also met to close the EDP procedures concerning the Czech Republic and Slovakia, which in the latter case also clears a hurdle for adopting the euro (see separate press release IP/08/715). Assuming the Council endorses the recommendations, only two countries will be left in EDP (Poland[1] and Hungary), compared with 12 in spring 2006 – the most ever to be simultaneously in EDP.

“The 'corrective arm' of the Pact is working, and it is working well. Not only have deficits been corrected, to the point that not one single euro area country is presently under close surveillance, but they are also being corrected through significant structural measures," *said Joaquín Almunia, European Commissioner for Economic and Monetary Affairs. He added: "*Italy must build on the 2007 result to achieve a balanced budget as soon as possible and put the national debt firmly on a downward path to free up resources for growth-enhancing measures. Portugal is to be praised for correcting its deficit one year ahead of schedule and encouraged to pursue the course of budgetary adjustment and structural reforms in order to create more growth and jobs. In the Czech Republic, even though the government deficit is projected to decline to historically low levels the reform effort, notably with respect to pensions and health care, should be intensified as the long-term sustainability of the country's public finances remains at high risk. As for Slovakia, it must be more ambitious in terms of budgetary consolidation given the strong growth conditions that it has been enjoying. Its upcoming membership of Economic and Monetary Union makes this particularly important."

[1] The deficit in Poland fell to 2% in 2007 and is expected to remain below 3% in the Commission's spring forecast – see IP/08/649 – but the Commission has yet to assess the country's Convergence Programme before considering a possible closing of the procedure.

ITALY

The Commission today recommended that the Council of EU finance ministers (Ecofin) closes the procedure concerning Italy, as it considers that the excessive deficit situation has been corrected in a credible and sustainable way.

The deficit in Italy fell to 1.9% of GDP in 2007 from 3.4% in 2006. The 2007 result is also much lower than initially targeted thanks to a better outcome in 2006, when examined net of one-off expenditures, and the effective implementation of corrective measures adopted by the government. That being said, the result could have been better still had it not been for additional expenditure, mainly social transfers and capital expenditure.

In 2007, Italy benefited of an increase in government revenues of 1.2 percentage points (pp) of GDP, spurred by large increases in personal and corporate income taxes, mostly thanks to a widening of the tax bases. The share of primary expenditure to GDP decreased by almost ¾ pp of GDP in 2007 relative to 2006, while total expenditure declined by less, or around ¼ pp, as interest expenditure surged.

The structural balance (cyclically-adjusted and net of one-off and other temporary measures) is estimated to have improved by 1¼ pp of GDP in 2007. Over the 2006-2007 period, the correction of the structural deficit amounted to three pp of GDP, exceeding by a comfortable margin the minimum 1.6 pp. required by the July 2005 Council recommendation.

According to the Commission's spring forecast, the deficit for 2008 is projected to increase to 2.3% of GDP as a result of lower real GDP growth but also budgetary measures. The structural deficit is projected to deteriorate by around ⅓ pp of GDP compared with 2007. Under the no-policy change assumption, risks to the budgetary projections for 2008 emanate from pending court rulings on the non-deductibility of the regional tax on productive activities (IRAP). Risks also arise from the economic growth outlook.

For 2009, and based on the usual no-policy-change assumption, the deficit is forecast at 2.4% of GDP, with real GDP growth at 0.8%. This modest increase is driven by falling tax receipts, particularly lower corporate income taxes, as a result of both discretionary measures and the downturn in the economic cycle.

In 2007, the debt-to-GDP ratio was reduced by 2½ percentage points to 104%. 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, on a no-policy-change basis the debt ratio is expected to decline only slightly in 2008 and 2009, thus remaining above 100%.

These budgetary developments suggest that the deficit has been brought below the 3% reference value in a credible and sustainable manner. However, fiscal consolidation in Italy needs to continue. In its opinion on the November 2007 update of the Stability Programme, the Council invited Italy to strengthen the budgetary target for 2008 and implement the planned fiscal consolidation thereafter to ensure adequate progress towards the MTO to be able to achieve it by 2011.

The excessive deficit procedure was initiated in June 2005.

PORTUGAL

The Commission today recommended that the Ecofin Council also closes the procedure concerning Portugal, one year in advance of the 2008 deadline established by the recommendation of 2005.

Against a background of low but gradually improving economic growth (0.9% in 2005, 1.3% in 2006 and 1.9% in 2007), the headline deficit was reduced from 6.1% of GDP in 2005 to 2.6% of GDP in 2007.

The correction was achieved mainly through the implementation of structural consolidation measures, involving both reduced expenditure (nearly 2 pp of GDP between 2006 and 2007) and increased revenue. This reflected pension reforms, a decline in unemployment benefits and lower public employment costs and public investment, on the expenditure side. Revenues were increased by a two pp rise in the VAT standard rate to 21%, discretionary increases in other tax rates and gains from improved tax administration and tax compliance.

The structural deficit decreased by three pp of GDP from 5¼% of GDP in 2005 to 2 ¼ % in 2007, a better result than recommended by the Council in 2005.

With real GDP growth this year projected at 1.7% in the Commission's spring forecast, the deficit is expected to decline to 2.2% of GDP in 2008. Despite the reduction of one pp in the VAT rate, which will enter into force in July 2008, tax revenues are projected to increase faster than nominal GDP as a result of improved tax compliance as well as discretionary measures. The expenditure-to-GDP ratio is forecast to remain stable. Under the no-policy-change assumption, the deficit for 2009 is expected to rise to 2.6% of GDP, reflecting the full impact of the VAT cut and possibly lower revenues reflecting slower growth. The current backdrop of higher-than-usual uncertainties about financial and economic developments also creates a number of negative risks to public finances.

The structural balance is expected to improve by ¼ pp of GDP in 2008 but to deteriorate by the same percentage in 2009, to reach 2.2% of GDP.

The general government gross debt declined to 63.6% of GDP in 2007 from 64.7% the year before, but is expected to bounce back to 64% in 2008 and to 64¼% in 2009, against a backdrop of low growth rates and still relatively high deficits.

Overall, these figures suggest that the deficit has been brought below the 3% of reference value in a credible and sustainable manner. But the figures show that Portugal needs to stay on the fiscal consolidation path and, as was recommended by the Council in its recent Opinion on the Stability programme, strive to achieve the objective of a structural deficit of 0.5% of GDP by 2010.

The EDP procedure was also initiated in June 2005.

CZECH REPUBLIC

Outside the euro area, the Commission recommended to close the procedure on the Czech Republic, also one year in advance of the 2008 deadline set by the Council.

The headline deficit was 1.6% of GDP in 2007 from 3.6% of GDP in 2005. The fiscal consolidation in the last couple of years has been the result of better-than-expected revenues, spurred by higher-than-projected employment and economic growth. A number of measures on the expenditure side also helped.

The Commission's spring forecast projects the deficit to fall further, reaching 1.4% of GDP in 2008 and, under the assumption of unchanged policies, 1.1% in 2009. This is due to the "stabilisation package" that came into force at the beginning of 2008. It shifted the overall tax burden from direct to indirect taxation and pursued further expenditure restraint. This is estimated to reduce the deficit by around 0.3% of GDP for both 2008 and 2009.

The structural deficit is expected to improve to around 2% of GDP in 2008 from 2¼% in 2007.

General government gross debt declined from 29.4% of GDP in 2006 to 28.7% in 2007, well below the 60% of GDP reference value, and is expected to fall further.

The figures show that the deficit has been brought below the 3% reference value in a credible and sustainable manner. However, the Czech Republic should continue with its reform efforts, notably in the pension and health care domains in view of the increase in age-related spending which puts the long-term sustainability of the public finances at high risk. In its recent opinion on the Convergence Programme, the Council invited the Czech Republic to exploit the high rate of growth in the economy so as to strengthen the pace of fiscal adjustment and build a safety margin against breaching the reference value and achieve its medium-term objective of a structural deficit of 1% of GDP by 2012 at the latest.

The excessive deficit procedure was initiated in May 2004 upon EU accession.

SLOVAKIA

Finally, the Commission also recommended closing the procedure regarding Slovakia.

The government deficit was reduced to 2.2% of GDP in 2007 from 3.6% in 2006.

The fiscal consolidation in Slovakia was driven by a buoyant GDP, employment and revenue growth. Expenditure restraint and expenditure reforms such as substantial restrictions on social benefits also played a role.

In 2006, the deficit deteriorated significantly, part of which can be attributed to the introduction of the second funded pension pillar in 2005 with transfers estimated to have increased from 0.8% of GDP in 2005 to 1.2% and 1.3% in 2006 and 2007, respectively. In addition, increases in taxes on cigarettes, the announcement of which led to large-scale pre-stocking, caused extra tax receipts in 2003, 2005 and 2007, followed by subsequent revenue shortfalls.

The spring forecast expects the deficit to fall further to 2.0% of GDP in 2008 as a result of some revenue increasing measures. In 2009, under the no-policy-change assumption, the deficit is set to increase again to 2.3% of GDP.

General government gross debt declined to 29.4% in 2007, well below the 60% of GDP reference value, and is expected to remain broadly stable over the forecast horizon under the no-policy-change assumption.

These figures show that the Slovak deficit has also been brought below the 3% reference value in a credible and sustainable manner. However, the structural balance is expected to deteriorate by a further ¼% of GDP in 2008 and, on a no-policy change basis, again by ¼ pp in 2009. This trend goes against the requirements of the Stability and Growth Pact which specify that euro-area and ERM II countries should achieve an annual improvement in the structural balance of 0.5% of GDP as a benchmark and a higher improvement in good times. Slovakia needs to take advantage of the strong economic growth that it has been enjoying to reduce its deficit faster towards its medium term objective of a structural deficit of just below 1% of GDP. In its opinion on the latest Convergence Programme, the Council urged Slovakia to be more ambitious in order to achieve that objective in 2010.

The EDP procedure was also started in 2004 upon EU accession

Countries still in EDP

If, as is expected, the June Council abrogates the procedure for Italy, Portugal, the Czech Republic and Slovakia, for the first time since 2002 no euro-area Member States will be under an excessive deficit procedure. For the two countries left, Poland and Hungary, the deadlines for the correction are 2007 and 2009, respectively. Poland submitted in March, following the change in government, a new update of its Convergence Programme, which is expected to be assessed by the Commission in June. Against the background of the 2007 outcome of a deficit of 2.0% of GDP, and in the light of this assessment and the spring forecast the Commission could recommend closing the EDP for Poland as well.

The Council closed the EDP procedures for France, Germany, Greece, Malta and the United Kingdom in 2007. They were closed for Cyprus in 2006 and for the Netherlands in 2005.

The texts of the Commission's assessment of Italy, Portugal, the Czech Republic and Slovakia can be found at:

http://ec.europa.eu/economy_finance/thematic_articles/article12538_en.htm

The following tables present the four countries' budgetary projections as set out in the Commission services' 2008 spring economic forecast, published on April 28.

ITALY

Budgetary developments, 2003-2009

% of GDP, unless indicated otherwise	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**[(2)]
General government balance	**-3.5**	**-3.5**	**-4.2**	**-3.4**	**-1.9**	**-2.3**	**-2.4**
- Total revenues	44.8	44.2	43.8	45.4	46.6	46.4	46.4
- Total expenditure	48.3	47.7	48.0	48.8	48.5	48.7	48.7
Of which: interest expenditure	*5.1*	*4.7*	*4.5*	*4.6*	*5.0*	*4.9*	*4.9*
gross fixed capital formation	*2.5*	*2.4*	*2.4*	*2.4*	*2.4*	*2.4*	*2.4*
One-off and temporary measures	**1.7**	**1.3**	**0.6**	**-0.4**	**-0.2**	**0.1**	**0.0**
Structural balance[(1)]	**-5.1**	**-4.7**	**-4.5**	**-2.8**	**-1.5**	**-1.9**	**-1.6**
Government gross debt	**104.3**	**103.8**	**105.8**	**106.5**	**104.0**	**103.2**	**102.6**
Pm Real GDP growth (%)	*0.0*	*1.5*	*0.6*	*1.8*	*1.5*	*0.5*	*0.8*

[(1)] Cyclically-adjusted balance excluding one-off and temporary measures
[(2)] No-policy-change assumption
Sources: Eurostat and Commission services' spring 2008 forecast

PORTUGAL

Budgetary developments, 2005-2009

% of GDP, unless indicated otherwise	**2005**	**2006**	**2007**	**2008**	**2009**[(2)]
General government balance	**-6.1**	**-3.9**	**-2.6**	**-2.2**	**-2.6**
- Total revenues	41.6	42.4	43.1	43.6	43.3
- Total expenditure	47.7	46.3	45.7	45.7	45.9
Of which: interest expenditure	*2.6*	*2.8*	*2.8*	*2.8*	*2.7*
gross fixed capital formation	*2.9*	*2.3*	*2.4*	*2.4*	*2.4*
One-off and temporary measures	**-0.1**	**0.0**	**0.1**	**0.2**	**0.0**
Structural balance[(1)]	**-5.2**	**-3.2**	**-2.2**	**-1.9**	**-2.2**
Government gross debt	**63.6**	**64.7**	**63.6**	**64.1**	**64.3**
Pm Real GDP growth (%)	*0.9*	*1.3*	*1.9*	*1.7*	*1.6*

[(1)] Cyclically-adjusted balance excluding one-off and temporary measures
[(2)] No-policy-change assumption
Sources: Eurostat and Commission services' spring 2008 forecast

CZECH REPUBLIC

Budgetary developments, 2003-2009

% of GDP, unless indicated otherwise	2003	2004	2005	2006	2007	2008	2009[(2)]
General government balance	**-6.6**	**-3**	**-3.6**	**-2.7**	**-1.6**	**-1.4**	-1.1
- Total revenues	40.7	42.2	41.4	41.0	40.8	40.7	40.7
- Total expenditure	47.3	45.2	44.9	43.6	42.4	42.2	41.8
Of which: interest expenditure	*1.2*	*1.2*	*1.2*	*1.1*	*1.2*	*1.1*	*1.1*
gross fixed capital formation	*4.5*	*4.8*	*4.9*	*5.0*	*4.8*	*4.8*	*4.9*
One-off and temporary measures	**0.0**	**-0.7**	**-1.1**	**-0.2**	**0.0**	**0.0**	**0.0**
Structural balance[(1)]	**-5.5**	**-1.3**	**-2.1**	**-2.9**	**-2.3**	**-1.9**	**-1.5**
Government gross debt	**30.1**	**30.4**	**29.7**	**29.4**	**28.7**	**28.1**	**27.2**
Pm Real GDP growth (%)	*3.6*	*4.5*	*6.4*	*6.4*	*6.5*	*4.7*	*5.0*

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

(2) No-policy-change assumption

Sources: Eurostat and Commission services' spring 2008 forecast

SLOVAKIA

Budgetary developments, 2003-2009

% of GDP, unless indicated otherwise	2003	2004	2005	2006	2007	2008	2009[(2)]
General government balance	**-2.7**	**-2.4**	**-2.8**	**-3.6**	**-2.2**	**-2**	**-2.3**
- Total revenues	37.4	35.4	35.3	33.5	34.7	34.3	33.8
- Total expenditure	40.2	37.8	38.1	37.2	36.9	36.3	36.1
Of which: interest expenditure	*2.5*	*2.2*	*1.7*	*1.5*	*1.4*	*1.4*	*1.4*
gross fixed capital formation	*2.6*	*2.4*	*2.1*	*2.2*	*1.9*	*1.9*	*1.9*
One-off and temporary measures	**-0.4**	**0.0**	**-0.9**	**0.0**	**-0.1**	**0.1**	**0.0**
Structural balance[(1)]	**-1.4**	**-1.4**	**-1.0**	**-3.1**	**-2.6**	**-2.8**	**-3.1**
Government gross debt	**42.4**	**41.4**	**34.2**	**30.4**	**29.4**	**29.2**	**29.7**
Pm Real GDP growth (%)	*4.8*	*5.2*	*6.6*	*8.5*	*10.4*	*7.0*	*6.2*

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

(2) No-policy-change assumption

Sources: Eurostat and Commission services' spring 2008 forecast