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**Italy and the Stability and Growth Pact**

How the 2005 reformation of the SGP affected the assessment of Italy and how the state fulfilled the debt and deficit criteria

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## Abstract

The vision of an economic and monetary union came to be realized within three stages. The limitations for capital movements were removed, the Economic Monetary Institute was founded and when the convergence criteria were met, the joint currency was launched. Italy did not pass the debt criterion to enter into the third stage of the Economic and Monetary Union (EMU) but passed all the other criteria and was accepted.

The Stability and Growth Pact (SGP) was founded in 1997 to strengthen the budgetary surveillance of countries within the EMU. It consisted of two Council regulations and a Council resolution.

In 2005 the SGP was reformed and from that point a lot clearer to interpret. For example, it had been hard to interpret the importance of the Other Relevant Factors (ORF) and which to include in the decision making of an excessive deficit with the unreformed SGP but after 2005 there were clear guidelines to follow.

The same year as the reformation the Commission filed a report regarding Italy, the state had a deficit above the 3% reference value and might have an excessive deficit. The Commission found that the deficit was neither temporary nor exceptional which suggested that the deficit criterion of the SGP was not fulfilled. They also found that the debt ratio was not sufficiently diminishing and approaching the reference value at a satisfactory pace and thereby they did not fulfil the debt criterion. The Commission was of the opinion that there existed an excessive deficit in Italy. The Council was of the same opinion and gave Italy strong recommendations to follow for a correction of the excessive deficit.

In 2006 and 2008, two follow-up reports about action taken by Italy for the correction was sent from the Commission to the Council. The first one found that there was no meaning to continue the Excessive Deficit Procedure (EDP) and the second one, sent in 2008, was about an abrogation of the decision of the existence of an excessive deficit in 2005. The Council also carried this out.

No more than a year after the abrogation a new process started and Italy was once again found with an excessive deficit. The EDP was anew in full action. In a report in 2010 the Commission found that Italy had under the circumstances, amongst other the widely spread economic downturn, taken the adequate action for a correction of the excessive deficit within its time limit. The Council once again agreed and no further steps of the EDP were taken at this stage.

Italy has, under the entire time period presented in this paper, failed to reach the debt and deficit criteria and have been acted on in accordance with the SGP. The changes or clarifications if you rather call it that, of the SGP has been of major help to the Commission and Council in their opinions, decisions and recommendations regarding the existence of an excessive deficit and its correction. Without the changes, the outcome for Italy might have been different.



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## **Abbreviation**

**ECB-** European Central Bank

**ECOFIN-**Economic and Financial Affairs Council

**EDP-** Excessive Deficit Procedure

**EERP-** European Economic Recovery Plan

**EMI-** Economic Monetary Institute

**EMU-** Economic and Monetary Union

**EU-** European Union

**GDP** – Gross Domestic Product

**ISTAT-** Italian Institute of Statistics

**ITL-** Italian Lira

**MTO-** Medium-Term Objective

**ORF-** Other Relevant Factors

**PP-** Percentage point

**R&D-** Research and Development

**RUEF-** The Combined Report on the Economy and Public Finances

**SGP-** Stability and Growth Pact

# 1 Introduction

## 1.1 Background to the essay

If you have been watching the news for the last couple of years you can hardly have missed the sovereign debt crisis and the commotion around the most economically troubled countries gathered under the acronym PIGS (i.e. Portugal, Ireland Greece and Spain). The television has produced pictures of people in Greece raging, protesting against their government and the acute reforms necessary to put their country's economy on the right track again. Statesmen and economists from the EU countries have been frowning their foreheads and giving troubled speeches and demands for the government to take measures.

Recently the PIGS acronym has been spelled PIIGS since one of Europe's largest economies and one of the most indebted ones, has entered into the spotlight, namely Italy. The country's economy has been in the shadows, hiding behind its charismatic leader and his personal scandals and outbursts. Now it is in the open for the entire world to see and it is not a particularly pretty sight. With a public debt of over 125 % of the GDP in 2010 according to the OECD country statistical profile<sup>7</sup> and a low growth rate, people are starting to realise that Italy will have a difficult time paying the debt. This creates further turbulence to the already troubled market.

Italy's debt problem is not a new one; for more than ten years the state have had a gross government debt over 100% of GDP. Italy entered the third stage of the Economic and Monetary Union (EMU) in 1998 without managing the debt criteria from the Maastricht treaty. Around the same time the state signed the Stability and Growth Pact (SGP) and promised to follow its regulations and procedures to keep a stable monetary union.

The fact that Italy entered into the union without fulfilling all criteria necessary made me curious to see how they have been doing economically in regard to the regulations and procedures of the SGP. That is the reason why I chose Italy as the state in focus of this paper.

The SGP was reformed in 2005 due to both external and internal criticism. I wanted to see the changes and their impact on how states are evaluated regarding excessive deficit.

## 1.2 Purpose

The purpose of this paper is to look at the SGP and Italy during a period of time and to view Italy's economical situation in regard to the SGP and find out whether the changes made in the SGP in 2005 are being implemented in the handling of Italy.

## 1.3 Delimitation

Since this paper only has room to scratch the surface of the subject at hand, there has to be some limitations. I have decided to limit this paper to the years 2005-2010.

## **1.4 Sources and Methods**

This is a theoretical study and the sources are in majority from the Official sites of the European Union and the communications and publications from several of its organs.

## **1.5 Structure**

The first part of this paper will give a small introduction to the EMU, and the SGP. There will be a section explaining the resolution and regulations in the SGP and also showing the changes made in the reformation in 2005. There is also a mentioning of how well Italy fulfilled the criteria to enter into the EMU.

The second part includes an abbreviation of the reports and decisions made by the Commission and Council from 2005 to 2010.

The third part includes a conclusion, which tells us if the changes made in the SGP 2005 reformation have been implemented upon Italy. In the third part there is also a short discussion on whether Italy would have been acted on in a different manner should the SGP not have been reformed.

# **2 The Stability and Growth Pact, original and reformed**

## **2.1 The start of the third stage of the EMU**

As can be seen below in a shortened extract from the publication *The road to EMU*<sup>1</sup> on the European Commissions website, the pursuit of an economic and monetary union within the EU came to fulfilment in three stages.

The first stage involved taking away the limitations for capital movements. In November 1993 this stage was accomplished in most of the member countries.

The second stage was the establishment of the Economic Monetary Institute (EMI), which was a predecessor of the European Central Bank (ECB).

In 1998 a formal decision was announced exposing the eleven EU-countries that would be the original members of the third stage of the EMU. The membership had its foundation in the convergence criteria and for a country to enter the third stage of the European Monetary Union the criteria needed to be fulfilled. At the beginning of the next page there is a table showing what was measured, how it was measured and the convergence criteria.



<b>What is measured:</b>	Price stability	Sound public finances	Sustainable public finances	Durability of convergence	Exchange rate stability
<b>How it is measured:</b>	Consumer price inflation rate	Government deficit as % of GDP	Government debt as % of GDP	Long-term interest rate	Deviation from a central rate
<b>Convergence criteria:</b>	Not more than 1.5 percentage points above the rate of the three best performing Member States	Reference value: not more than 3%	Reference value: not more than 60%	Not more than 2 percentage points above the rate of the three best performing Member States in terms of price stability	Participation in ERM II for at least 2 years without severe tensions

Table 1<sup>1</sup>. Source: The European Commission. (2011) Who can join and when? Slightly altered to fit the paper.

When the convergence criteria were met, the third stage started. In January 1999, the joint currency, the Euro, was launched. The members' exchange rates were locked towards each other and the responsibility for the monetary and currency policy was now in the hands of the ECB.

At the end of the year 2002 the Euro had replaced the national currencies.

## 2.2 Italy passing the criteria to enter into the EMU

Italy joined the third stage of the EMU at its start in 1998 and regarding its fulfilment of the convergence criteria there is an extraction from the 98/317/EC Council decision<sup>3</sup> below:

“- The average inflation rate in Italy in the year ending in January 1998 stood at 1.8%, which is below the reference value.

-Italy is not the subject of a council decision on the existence of an excessive government deficit.

-Italy rejoined the ERM in November 1996; in the period from March 1996 to November 1996, the Italian Lira appreciated vis-à-vis the ERM, the ITL has not been subject to severe tensions and Italy has not devalued, on its own initiative, the ITL bilateral central rate against any other Member States currency.

-In the year ending in January 1998, the long-term interest rate in Italy was, on average, 6.7% which is below the reference value.”

With this, the Council concludes that Italy fulfils the necessary conditions for the adoption of the single currency.

## **2.3 The Resolution and Regulations in the original Stability and Growth Pact**

The stability and Growth Pact was adopted in 1997 and consisted of two European Council regulations and a European Council resolution. The purpose was to give more detailed rules and procedures for budgetary surveillance for the countries within the Economic and Monetary Union.

### **2.3.1 The Council Resolution**

The Resolution of the European Council on the Stability and Growth Pact Amsterdam, 17 June 1997<sup>4</sup> in short includes four parts. The first part is about the Council's acknowledgement, at a meeting in Madrid in December 1995, of the extreme importance of securing budgetary discipline in stage three of the EMU. It continues with the meeting in Dublin in December 1996, where the European Council reached an agreement on the main elements of the Stability and Growth Pact.

The second part regards the member states; They are to respect the medium term budgetary objectives and to take the corrective budgetary actions they deem necessary to meet the objectives of their stability or convergence programmes, whenever they have information indicating expected or actual significant divergence from those objectives or have received warnings in the form of Council recommendation.

The third part regards the European Commission and how they are to prepare and present, without any delay, necessary reports, opinions and recommendations to enable the council to adopt decisions regarding deficits. They also have to present to the council the reasons why, if they find a deficit exceeding 3% of GDP not excessive.

In the fourth part focus is on the Council. It should be committed to a rigorous and timely implementation of all the elements of the Stability and Growth Pact and in its competence take the necessary decisions regarding deadlines, sanctions and fines. They have to state in writing why, if it did not act or follow the Commission's recommendations and in that case also make public the member states' votes in the matter.

### **2.3.2 The two Council regulations**

Council regulation (EC) no. 1467/97<sup>5</sup> of 7 July 1997, on speeding-up and clarifying the implementation of excessive deficit procedures calls for a fiscal discipline. If a participating member state does not take efficient actions to correct excessive deficits there will be a time period of ten months, counting from the first reports of the deficit until a necessary decision regarding sanctions is made, to pressure the member state to take such actions. This proceeding will rest if the correct measures are taken but will be set to action again if the measures are not realized or are insufficient. A non-interest bearing deposit will be used as a discouraging effect and this will, if the excessive deficit is not corrected, turn in to a fee.

There are some exceptions when the deficits in the public sector shall be considered exceeding the reference value by way of exceptions and transient. Inter alia when it is caused by some unusual occurrence that is outside of the member states' control, caused by a serious economic downturn or if the Commission's budgetary projections find that the deficit will turn below the reference value after the affection factors have ceased. For the exceeding of the reference value to be considered temporary in the case of an economic downturn there has to

be a fall in the real GDP of 2% per annum or between 0.75% and 2% of real GDP if there is further supporting evidence.

The other Council regulation, (EC) no. 1466/97<sup>6</sup> of 7 July 1997, is about the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies.

In this regulation there is a part regarding member states that are non-participating in the third stage of EMU that will not be mentioned since these states are irrelevant to the subject of the paper.

Every participating member state needs to give the Council and the Commission the information necessary for a regular multilateral surveillance through a Stability program. According to the regulation (EC) no.1466/97<sup>6</sup>, this should include:

- A Medium-Term Objective (MTO), close to or exceeding the convergence criteria, for its budgetary position and the development of the public sector debt ratio.
- The main assumptions regarding the expected economic development and economic variables relevant for the realization of the stability program.
- A description of the measures planned or taken to fulfill the target.
- An analysis of how the changes in the economic assumptions can affect the public finances and debt ratio.
- A yearly renewal of the Stability programs.

In this regulation the Council is obligated to view whether the medium-term objects in the stability programs are realistic. They monitor the implementation of the programs and when discovering deviations they give early warning heads-up. If the situation deteriorates they will send a recommendation to take immediate action.

### **2.3.3 Changes in the Stability and Growth Pact**

With a common goal of reaching the convergence criteria needed to adopt the Euro, in the mid- to late 90s the Euro area members made a considerable progress in consolidating their fiscal positions. After the year of 1999 the fiscal performances has varied.

When the economic downturn began in 2001, an increasing number of Member states ran the risk of or incurred excessive deficits as their fiscal balances deteriorated. At the same time, the ECOFIN council did not always implement the rules and procedures of the Stability and Growth Pact in a rigorous manner. This plus an increasing reluctance to follow agreed rules and procedures deteriorated the confidence in the EU fiscal framework.

Escalating criticism of the Stability and Growth Pact led to intense discussions and proposals to reform the Pact. In March 2005 the ECOFIN Council adopted a report regarding proposals for improving the implementation of the Stability and Growth Pact and the European Council soon endorsed this. Changes made in the reformation in 2005 can be seen in the table below.

<b>1. Changes under the preventive arm</b>		
	<b>Before</b>	<b>After</b>
<b>Medium-term objective (MTO)</b>	All member states (MS) have a Medium-term Objective of close-to balance-or – in-surplus	<ul style="list-style-type: none"> <li>Country specific differentiation of MTOs according to stock of public debt and potential growth.</li> <li>MTOs for the euro area and the ERMII MS are set between -1% of GDP and balance or surplus (in cyclically-adjusted terms and net of one-offs)</li> <li>Implicit liabilities to be taken into account at a later stage when modalities for doing so are agreed by the Council.</li> </ul>
<b>Adjustment path towards the MTO</b>	No specific provision	<ul style="list-style-type: none"> <li>MS to take active steps to achieve the MTO.</li> <li>Annual minimum adjustment for MS of the euro zone or of the ERM-II of 0.5% of GDP.</li> <li>The effort should be higher in ‘good times’.</li> <li>‘Good times’ are identified as periods where output exceeds its potential level, ‘taking into account tax elasticities’.</li> </ul>
<b>Early policy advice</b>	Early warnings are adopted/addressed by the Council, upon recommendation of the Commission.	In addition, the Commission can issue direct early policy advice to encourage MS to stick to their adjustment path. To be replaced by ‘early warnings’ in accordance with the Constitution once applicable.
<b>Structural reforms</b>	No specific provision	Reforms will be taken into account when defining the adjustment path to the MTO and may allow a deviation from it under the following condition: <ul style="list-style-type: none"> <li>Only major reforms (direct/indirect impact on sustainability).</li> <li>Safety margin to the 3% reference value is guaranteed;</li> <li>The deficit returns to the MTO within the programme period;</li> <li>Detailed information is provided in the Stability Convergence Programmes.</li> </ul> Special attention to systematic pension reforms.
<b>2. Differences in the corrective arm</b>		
	<b>Before</b>	<b>After</b>
<b>Preparing a report under Article 104(3)</b>	No obligation for the Commission to prepare a report if deficit exceed 3%.	<ul style="list-style-type: none"> <li>The Commission will always prepare a report in case of a deficit above 3%.</li> <li>The report will examine whether the exceptions in Article 104(2) apply.</li> <li>It will account whether the deficit exceeds government investment expenditure and</li> </ul>

		all other relevant factors.
<b>Severe economic downturn</b>	<p>‘Severe economic downturn’ if there is an annual fall of real GDP of at least 2% for the preparation of report under Article 104(3) by the Commission and in decisions under 104(6) by the Council, if observations by member state concerned show that the downturn is exceptional in light of evidence of abruptness of the downturn and the accumulated loss of output with respect to past trends. The members states commit not to invoke the severe economic downturn when growth is above -0.75%.</p>	<p>An economic downturn may be considered ‘severe’ in case of a negative growth rate or accumulated loss of output during a protracted period of very low growth relative to potential growth.</p>
<b>‘Other relevant factors’</b>	<p>No specific definition of ‘ORF’ and their role in the excessive deficit procedure.</p>	<p>The Commission report under Article 104(3) will take into account:</p> <ul style="list-style-type: none"> <li>• Developments in the medium-term economic position (potential growth, cyclical conditions, implementation of policies);</li> <li>• Developments in the medium-term budgetary position (public investment, quality of public finances as well as fiscal consolidation in ‘good times’, debt sustainability);</li> <li>• Any other factor, which in the opinion of MS are relevant in order to assess the excess over the reference value.</li> </ul> <p>‘ORF’ will be considered in the steps from Article 104(4) to (6)) only if the excess over reference value is temporary and the deficit remains close to reference value. Any deficit above 3% that is neither close to the reference value nor temporary will be considered excessive.</p> <p>If the council has decided that an excessive deficit exists, the ORF will also be considered in the subsequent procedural steps of article 104 (except in Article 104(12) i.e. abrogation, and when deciding to repeat steps in EDP.</p>

<b>Systematic pension reforms</b>	No specific provision	<ul style="list-style-type: none"> <li>• These are treated like an ‘ORF’, but under strict conditions also with a role in abrogation.</li> <li>• Consideration to the net cost of the reform will be given regressively for the initial five years after a MS has introduced the reform (or five years after 2004).</li> </ul>
<b>Increasing the focus on debt and sustainability</b>	No specific provision	<ul style="list-style-type: none"> <li>• The debt criterion, and in particular the concept of a debt ratio ‘sufficiently diminishing and approaching the reference value at a satisfactory pace will be applied in qualitative terms.</li> <li>• The Council will formulate recommendations on the debt dynamics in its opinions on the stability and convergence programmes.</li> </ul>
<b>Extending deadlines for taking effective action and measures</b>		<p>Deadlines are extended:</p> <ul style="list-style-type: none"> <li>• For a decision under 104(6)- from 3 to 4 months after notification;</li> <li>• For taking effective action following 104(7)- from 4 to 6 months;</li> <li>• For moving to 104(9)- from 1 to 2 months;</li> <li>• For taking action following a notice under 104(9)- from 2 to 4 months.</li> </ul>
<b>Minimum fiscal effort</b>	No specific provision	Countries in excessive deficit are required to achieve a minimum fiscal effort of at least 0.5% of GDP as a benchmark.
<b>Initial deadline for correcting excessive deficit</b>	The excessive deficit has to be corrected in the year following its identification, unless there are ‘special circumstances’	The rule remains; possible extension by 1 year based on ‘ORF’ and on the condition that minimum fiscal effort has have been taken.
<b>Repetition of steps in EDP</b>	Not foreseen	<p>Deadlines for correcting the Excessive deficit can be extended if:</p> <ul style="list-style-type: none"> <li>• Effective action has been taken by MS concerned in compliance with the initial recommendation notice, and</li> <li>• Unexpected adverse economic events with major unfavourable budgetary effects occur during the correction phase.</li> </ul>

Table 2<sup>2</sup>. Source: Lena Frej Ohlsson. Working paper no 268. Statistical implications of the Stability and Growth Pact: Creative Accounting and the role of Eurostat, (2007) page 80.

### 3 Italy and the Stability and Growth Pact 2005-2010

In this part we will examine how Italy managed their finances during the period 2005-2010 and how the Commission and Council implemented the regulations and procedures of the Stability and Growth Pact.

#### 3.1 Decision regarding excessive deficit 2005

##### 3.1.1 The Commissions report

Both in the old and in the reformed SGP, the Commission is supposed to write a report to the Council, if the deficit is found to be excessive. It is only in the 2005 reform the Commission is obligated to write a report if the deficit is above 3% and to start investigating whether an excessive deficit exists. This was the case on the 23 of May 2005 when the Commission according to Article 104(3) prepared the report SEC(2005) 750 final<sup>18</sup> to the council.

According to economic statistics from Italy concerning the years 2003 and 2004, the deficit had been on the level of 3.1% of GDP and the debt ratio had been around 106-107% of GDP. The ISTAT (the Italian Institute of Statistics) made a slightly upward revision of these figures and that was enough to provide for the Commission:

Prima facie evidence of the existence of an excessive deficit in Italy in 2003 and 2004, within the meaning of the definitions set out in the Treaty and the Stability and Growth Pact. (SEC(2005) 750 final)<sup>18</sup>

By this the Commission initiated the Excessive Deficit Procedure (EDP) for Italy. Since the 2005 reformation their report had to address whether the exceptions in article 104(2) were applicable in the case of Italy or if any other relevant factors were to be considered in the decision-making if there existed an excessive deficit.

Could the excessive deficit be exceptional? The rate of economic growth had been low but stayed positive during 2003-2004 and if you compared the cyclical slowdown with the rate of output, growth was not protracted. The economic growth in Italy had been slow for more than a decade due to a number of mutually reinforcing structural weaknesses. Comparing the cumulated loss of output relative to potential, it was comparatively small and not at all in the same size as in episodes of recession in the past decade. With this in consideration the Commission found that the excess over the 3% of GDP reference value was not exceptional and that the occurrence of the excessive deficit in Italy did not qualify as a severe economic downturn.

The Commission also found that the excess over reference value was not temporary. The deficit had been higher than the reference value during the last two years (2003-2004) and the Commission Services spring 2005 forecast had projected an even higher deficit of 3.6%

of GDP in 2005 and 4.6% of GDP in 2006. Economic growth was very low and they expected a downward revision, which in turn would keep the deficit above the reference level in the coming years.

With the excessive deficit neither exceptional nor temporary the Commission analysis did suggest that the requirements concerning the deficit criterion was not fulfilled.

In the original SGP there were no special provisions regarding debt and sustainability but since 2005 there is a focus on the debt criterion and the concept of a debt ratio. This was regarded in the Commissions report (EC (2005) 750 final)<sup>18</sup> During the two years preceding this report the debt to GDP ratio had been 106-107% and that was well above the reference value of the Treaty. The pace of the debt reduction had since 2001 slowed down and since 2003 the debt ratio had practically been standing still. This even though the interest rates had reached historically low levels, which made the cost of servicing the debt, reduced. The Commission had found an explanatory factor in the shrinking primary surplus, and also in the existence of debt-increasing below-the-line operations. If the debt-to-GDP ratio would continue to decline in the same average pace as recorded in the years 2001-2004, “it would take more than 30 years to approach the 60% Treaty reference value”(EC (2005) 750 final)<sup>18</sup> The Commission’s analysis was suggesting that the treaty requirement concerning the debt criterion was not fulfilled.

In the original SGP resolution and regulations the definition of Other Relevant Factors was unclear and likewise was the ORF role in the Excessive deficit procedure. This was thus cleared up in the ECOFIN report on 20 march 2005<sup>1</sup> and there was from that point forward a framework, within such relevant factors should be taken into account. Included in that framework were:

1. Medium-term economic position;
2. Medium-term budgetary position;
3. Other relevant factors;

The Commission report contains a detailed declaration of the ORF. Under the Medium-term economic position:

- Cyclical condition and potential growth  
The pace of acceleration of economic growth towards the potential was expected to be moderate and the structural reforms implemented so far had given higher employment growth but had not increased potential economic growth. There were still many structural weaknesses hampering factor efficiency that were still unaddressed. There was a need for more ambitious fiscal targets to allow a reduction in debt ratio.
- Recent structural reforms  
In the 1990’s, labor market reforms may have had a positive effect on public finances through higher revenue. In 2004 there was a pension reform with no direct budgetary costs and in March 2005 the government had tried to increase and improve the competitiveness by reforming R&D subsidies and reducing red tape and reforming the bankruptcy laws. This would have a budgetary impact calculated approximately about less than 0.1% of GDP annually.



Under the Medium-term budgetary position:

- Public investment  
Since 2001 the general government deficit had consistently exceeded gross fixed capital formation.
- Structural deficit  
There was a high level of structural deficit i.e. the deficit net of cyclical factors and one-off measures. This showed a lack of fiscal consolidation and the projected level of structural deficit did not ensure a decline in debt ratio.
- Fiscal consolidation efforts in good times  
In 2000 and in 2001, when actual economic growth had been above potential growth and the output gap had been positive, the Italian authorities had loosened its fiscal position net of both cyclical factors and one-off measures. The Commission therefore concluded that:

The worsening of the structural budgetary position in Italy has its roots in the implementation of a strongly pro-cyclical fiscal policy in good times and was masked by the heavy recourse to temporary revenue increasing and expenditure reducing measures. ( EC(2005) 750 final)<sup>18</sup>

- Expenditure on education and R&D  
Was in line with EU average
- Temporary measures
- Long-term sustainability of public finances  
In the matter of long-term sustainability the Commission was of the opinion that Italy appeared at some risk. The effectiveness of the Pension reform that had been approved in 2004 was not expected to reduce expenditure before the year 2011 and the effectiveness of it remains to be seen.

To guarantee the respect of the government's inter-temporal budget constraint, the primary net of cyclical factors and one-off measures had a minimum level of 4% of GDP. In Italy the projected levels for 2005 and 2006 were around 1% of GDP, if the interest rates would start to rise again it could have a significant negative impact on the budget and the long-term sustainability of the public finances.

The ORF was also to be considered and the Commission report (EC (2005) 750 final)<sup>18</sup> regarded four important factors.

- They found that the budget plans made by Italy had been repeatedly build upon overoptimistic assumptions. This had lead to budgetary slippages in implementation.
- The effectiveness of Italy's series of initiatives, launched with the goal of controlling expenditures had been disappointing. Especially the implementation of these initiatives on a regional and local level.
- There seemed to be a problem in statistical governance. Government data from the year 2000 to 2004 had to be revised and Eurostat had not validated the data.
- There seemed to be a lacking of efficiency in the process leading to the adoption of the budget law.

With everything taken into consideration the Commission found that Italy did not fulfill the debt or deficit criteria and that the consideration of the other factors strengthened their conclusion.

### **3.1.2 The Commissions opinion**

The Italian government answered the Commission report with a letter, putting forward additional factors that they thought was relevant and might change the Commission's mind regarding the fulfilment of the debt and deficit criteria.

In (SEC(2005) 886 final)<sup>8</sup> the Commission stated that before other relevant factors were to be taken into account they needed to find that “the excess of the reference value is temporary and the deficit remains close to the reference value.” They found that in the case of Italy this condition was not met. Therefore the Commission opinion in accordance with Article 104(5) and the council decision in accordance with Article 104(6) found that other relevant factors were not to be taken into account. Which meant that the factors Italy had brought to the table would not be considered in the assessment.

The Commission was of the opinion that there was an excessive deficit in Italy and that the council should act accordingly in conformity with the SGP.

### **3.1.3 The Commissions recommendation**

Seen below is a shortened version of the Commission's recommendation for a council decision 29 of June 2005 (SEC(2005) 916 final)<sup>14</sup>.

- The excessive deficit situation in Italy should be put to an end as quickly as possible and at the very latest the situation must be changed by 2007 in accordance with Article 3(4) of Council regulation (EC) No1467/97<sup>5</sup>. The Council should also establish a deadline to the 12 November 2005 for the Italian government to take action to change the situation.
- In 2007 the deficit should be brought under the 3% reference value and this should be done in a credible and sustainable manner. With this the Commission meant that the Italian authorities should implement, with sternness, the 2005 budget and make sure of a cumulative reduction in the deficit of at least 1.6% of GDP over 2006-2007 comparing with the level in 2005. At least half of the correction should be taking place in 2006.
- There should be further improvement in the collecting and processing general government data.
- The gross debt ratio must be reduced and approach the reference value in a contented pace. The Italian government should ensure this by restoring an adequate level of the primary surplus and by paying attention to factors other than net borrowing such as below-the-line operation.

### **3.1.4 Council decision**

The Council decided (Council decision 11912/05)<sup>21</sup>, in accordance with the Council regulation (EC) No 1467/97<sup>5</sup> that there existed special circumstances in the case of Italy and the deadline for the correction of the excessive deficit was moved from 2006 to 2007.

The major reason for the prolonged deadline was Italy's deep-rooted structural problems that had affected the Italian economy since the last decade. The council said that, "The excessive deficit needs to be framed within a comprehensive reform strategy" and this off course is not made in a day.

The Council recommended in addition to the Commission's recommendation that the Italian authorities was to ensure budgetary consolidation towards a medium-term position of government finances close to balance or in surplus. This was to be done by reducing the cyclically adjusted deficit and net of one-off and other temporary measures by at least 0.5% of GDP per year after the excessive deficit had been corrected.

### 3.1.5 Action taken

In the follow-up report from the Commission to the Council in 2006 (SEC(2006) 238 final)<sup>10</sup>, the Commission seemed to be satisfied with the action taken by Italian authorities.

Below is a shortened extraction of what Italy had done according to the Commission.

- Italy appeared to have achieved the 4.3% of GDP target for 2005.
- Italy had adopted measures in the 2006 budget law that would ensure progress toward correcting the excessive deficit within the time limits set by the Council. But, this only if the budgetary law was fully implemented and that economic development were in line with Council recommendation.
- Italy had set a nominal deficit target below 3% for 2007 and had planned for a structural adjustment that went in line with the Council recommendations for 2007 and the years following.
- Italy had planned to return the debt to a declining path with the help of rising primary surpluses and a realization of large privatization plans and by scaling back on debt-increasing below-the-line operations.
- Italy had taken initiatives to improve the quality of general government data.

The Commission was concerned that the correction of the excessive deficit by its time limit and the reduction of the debt ratio were subjects to significant uncertainties. The success of the correction and of the reduction relied upon effective implementation. Even though concerned the Commission saw no reason for continuing the excessive deficit procedure at that time.

The council agreed with the Commission's opinion (6917/06 (Presse 64)<sup>23</sup> and would together with the Commission continue to closely monitor the budgetary developments in the light of the fragile situation of public finances to ensure that adequate action was taken.

In 2008 the Council received a new recommendation (SEC(2008) 574 final)<sup>15</sup>, regarding abrogating Decision 2005/694/EC, from the Commission. During 2006 and 2007 the general government deficit had declined reaching 3.4 % of GDP in 2006 and 1.9% of GDP in 2007. The report found that the deficit would have been even lower in the absence of one-offs. They found that the structural balance had improved. This indicated that the deficit was being brought below the ceiling of the 3% of GDP in a sustainable manner.

The Italian government debt ratio increased by 0.6 percentage points in 2006 but fell in 2007 to 104% of GDP. The Commission found that the debt ratio had been affected by a temporary debt-increasing financial operation in 2006 and its reversal in 2007. If this

operation had not occurred, the debt ratio in 2006 should have been relatively stable and would have reflected the improvement in the primary surplus that goes hand in hand with Council recommendation.

The 2008 spring forecast showed that the debt ratio would fall even further to around 102.5% by 2009, if of course the policies were unchanged. This fall in debt ratio was considered to be in line with the correction of the excessive deficit in 2007.

The Commission found that the excessive deficit situation in Italy had been corrected and they thereby recommended the Council to abrogate its decision on the existence of such a situation. This was also done in Council Decision (2008/560/EC)<sup>20</sup>.

## **3.2 Decision regarding excessive deficit 2009**

### **3.2.1 The Commissions report**

Only a little more than a year after the Council Decision (2008/560/EC)<sup>20</sup> the Commission presented a new report (SEC (2009) 1271 Final)<sup>19</sup>. The report included a section about the current world economic downturn and a section about Italy and whether the criteria of the treaty and SGP were fulfilled.

The economic downturn in 2008 and 2009 had brought about a decline in tax revenues and a rising of social benefit expenditure. The European Commission had called for fiscal stimulus in the European Economic Recovery Plan (EERP) in November of 2008; the European council had also endorsed this in December the same year. The fiscal stimulus was not to be the same for all member states since they had different positions in terms of public finances, competitiveness and sustainability. The fiscal stimulus was also to be reversed as soon as conditions improved again. Because of the economic downturn several countries had taken action to stabilize the financial sector. This could effect the debt position and create a larger deficit for the countries.

In 2009 the deficit in Italy was in the April 2009 EDP notification planned to be 3.7% of GDP but new projections published in July showed a government deficit of 5.3% of GDP. The Commission found that the planned deficit value was well above the 3% of GDP reference value and even though it could be qualified as exceptional within the meaning of the treaty and the SGP, it could not be considered temporary and this suggested that the deficit criterion in the treaty was not fulfilled.

For 2009 the government debt ratio was planned to be 115.1% of GDP. The planned debt ratio was well above the 60% reference value and could not be considered diminishing or approaching the reference value at a satisfactory pace. This suggested that the debt criterion was not fulfilled.

The ORF mentioned in the report (SEC (2009) 1271 Final)<sup>19</sup> under the medium-term economic position are shown in a shortened version below.

- Cyclical condition and potential growth  
Since the 1990's the real GDP growth had been low and below the average in the euro area. There was a slowdown even before the economic downturn and Italy reached a recession in the spring of 2008. Even though the growth estimates were influenced by the downturn in 2009, the recovery were likely to be slow because of the structural weakness that was the root of the slow productivity dynamics.

The ORF mentioned in the report (SEC (2009) 1271 Final)<sup>19</sup> under the medium-term budgetary position are shown in a shortened version below.

- Structural deficit and fiscal consolidations in good times  
During 2006 and 2007 the structural balance i.e. the cyclically adjusted balance and net of one-off and other temporary measures improved. This period could be qualified as good times in Italian economy. It worsened in 2008 and was expected to improve in 2009 only to slightly worsen again in 2010 due to higher interest expenditures. The structural balance remained away from the Medium Term Objective of a balanced budgetary position.
- Public investment  
The Commission services spring forecast said that the Italian deficit ratio would continue to exceed the public investment ratio in 2009 and in 2010.
- Quality of public finances  
The high cost of debt service and pension spending were to crowd out more productive expenditure as well as other social spending that would have loosened the rigidity of Italy's public spending.

Other factors considered relevant by the Commission are mentioned in the text below.

Thanks to financing measures, the successive recovery packages taken in response to the crisis were not expected to appreciably weigh on the government balance as they were planned to have an overall neutral budgetary impact. This was in line with the recommendations of the EERP. With Italy's debt ratio in mind the Commission found the successive recovery packages to be an adequate response to the economic downturn.

Due to a series of measures adopted in late 2008 and early 2009 to ensure the stability of the financial system and guaranteeing higher protection for savers and adequate levels of bank liquidity and capitalisation, the Ministry of Economy and Finance had been allowed to underwrite financial instruments issued by sound listed banks.

The Council would have liked to see Italy carrying out, with determination, the adjustment path planned over the programme period to set the debt ratio on a steadily declining path and ensure long-term sustainability of public finances. This because the Council thought that the achievement of the deficit targets 2009 to 2011 might be prevented by a lower-than-planned economic growth and by possible slippages in the implementation of the planned restraint in primary expenditure.

On 26 August 2009 the Italian authorities put forward some factors they found relevant in accordance with Article 2(3) of council Regulation (EC) No 1467/97<sup>5</sup>. They claimed unexpected outlays related to the Abruzzo earthquake, which was around 0.04% of GDP in 2009 and in 2010. The Italian authorities also put forward the 0.5% of GDP contribution to the EU budget and expenses for peacekeeping operations and development aid. Another factor mentioned was the one-off public investment in the repurchase of previously securitised real estate that cost about 0.1% of GDP 2009.

The Commission found that even though these factors added relevant information, they did not alter the assessment of the debt and deficit criteria presented.

### **3.2.2 The Commissions opinion**

In Commission Opinion SEC(2009) 1523 final<sup>9</sup>, the Commission aired its view on the existence of an excessive deficit. They found that in the case of Italy the deficit criterion was not met, neither was the debt criterion. Other relevant factors were not to be considered since the double condition was not met.

The Commission was of the opinion that there existed an excessive deficit in Italy, and did act in accordance with article 104(3) of the Treaty.

### **3.2.3 The Commissions recommendation**

Now that there was an opinion that an excessive deficit existed in Italy there was the question about the deadline. In the Commission's recommendation for a council decision SEC(2009) 1524 final<sup>16</sup>, they found that there existed special circumstances in the case of Italy and that the deadline should be longer than that under Article 104(7). The Commission found that, due to the financial and economic crisis, Italy's already pressured economic situation had worsened. The Italian government in turn had responded to the crisis appropriately mindful of the need to avoid substantial deterioration of public finances. Measures had been taken to support key industrial sectors and low-income groups, all in line with the EERP. These measures taken would have an officially neutral effect on the budget since they were fully financed by a reallocation of existing funds.

The widening of the deficit in 2009 was for most part the result of the automatic stabilizers. Italy was expecting a significant contraction both in direct and indirect taxes. One-off capital revenues could increase by an extraordinary tax on repatriated assets that were illegally held abroad.

In the February 2009 Stability Program update the primary expenditure was expected to rise faster than planned, in 2009 by over 4.5%. Even though budgetary measures adopted contained intermediate consumption, it was still increasing. The only significant factor that was expected to decrease was the interest expenditures, this due to incredible low market interests. The Capital spending in Italy was being raised by around 13% by the bringing forward of investment plans.

With these facts at hand the Commission found it appropriate that a correction of the excessive deficit should be in a medium-term framework and must be completed by the year 2012.

### 3.2.4 Council decision

On January 10, 2010 there was a publication (2010/286/EU)<sup>26</sup>, of the Council decision regarding Italy in the Official Journal of the European Union.

The Council found that the existing deficit was not close to the reference value. The excess could not be considered temporary but could be qualified as exceptional due to the financial crisis. They found that Italy did not meet the deficit criteria.

The Commission services' autumn 2009 report projected that the Italian government debt was to rise from 115.1% to 117.8% in 2011. The debt ratio was not diminishing sufficiently or moving towards the reference value at a satisfactory pace, which was needed to fulfil the debt criterion of the SGP and the Treaty.

Relevant factors should be taken into account if the double criterion was fulfilled: that deficit remains close to the reference value and that the excessive deficit is temporary. In this case the Council found that the double criterion was not fulfilled. The other relevant factors would not be taken into account in the decision on the existence of an excessive deficit.

After the overall assessment the council was in the opinion that there existed an excessive deficit in Italy.

### 3.2.5 The Council recommendation

On 2 December 2009 the Council had reached a decision that there was an excessive deficit in Italy in accordance with Article 104(6). The council found that there were special circumstances and that the deadline for correction should be allowed in a medium-term framework.

In Recommendation SEC (2009) 1525 final<sup>17</sup>, for a Council recommendation, the following was suggested;

- The Council found that Italy's budgetary position in 2009 for the most part was a result of automatic stabilizers and measures taken in response to the economic downturn and therefore the deadline for a correction of the excessive deficit was prolonged to 2012.
- The general government deficit should be brought below 3% of GDP in a medium-term framework. This should be performed in a sustainable and credible way by;
  1. Implementing the budgetary measures as planned 2010.
  2. Ensuring structural budgetary adjustment of 0.5 PP of GDP annually over the years 2010-2012. This should also help restore an adequate level of primary surplus and thereby lower the debt ratio.
  3. Specifying the measures necessary for achieving the correction of the excessive deficit by its set deadline. If the budgetary and or economic conditions turns out to be better than expected Italy should speed up the process of the reduction of the deficit.
- The Council recommended the Italian authorities to seize every opportunity beyond the structural adjustment to speed up the process of debt reduction.

- The Italian government had a deadline to June 2, 2010 to take effective action to implement the fiscal measures in 2010 as planned. They also had to outline the measures that would be needed for a correction of the deficit. The Commission services' autumn forecast would in their assessment take into account whether effective action had been taken.

The Council also invited the Italian authorities to increase the efforts in;

- Strengthening competition in product and service markets.
- Simplifying legislation.
- At all levels, reducing the administrative burden.
- Improving the functioning of the labour market and the efficiency outcomes and standards of the education system.
- Trying to reduce regional disparities.

Italy was also invited to implement reforms in order to raise potential GDP growth. This would include reforms conducive to enhancing the quality of public finances and strengthen further the enforceable nature of the medium-term budgetary framework. They should in an efficient manner implement mechanisms to monitor and control expenditure and improve composition and effectiveness of spending. They should also develop the framework for forthcoming fiscal federalism in such a manner that it completely supports these objectives.

When the final Council recommendation for Italy came (15757/09)<sup>22</sup> there was no major divergence in opinion from the initial one.

### 3.2.6 Action taken

The Commission, in a communication to the Council (COM (2010) 329)<sup>11</sup>, did the follow-up of the action taken by the Italian government to correct the excessive deficit. They found that the outlook for the Italian economy in the near future had not changed significantly since the Commission Services' autumn 2009 forecast, which underpinned the council recommendation. The fiscal package for 2009 to 2011 was adopted in summer 2008 and with that measures aiming for a restraint in expenditures and underlying the 2010 deficit target. The 2010 deficit ratio was targeted to decrease by 0.3%, from 5.3% of GDP in 2009 to 5% of GDP in 2010.

In the 2010 budget, additional measures were taken to support low-income workers and health and social expenditures as well as military missions abroad. The cost of 0.4% of GDP was claimed by the authorities to be fully financed mainly through the one-off revenues from the extraordinary tax on illegally expatriated assets.

Italy's budget strategy for 2010 could be assessed to be in line with the Council recommendation, but it has also some additional measures that imply some deviation. According to the Commission Services spring 2010 forecast, the structural deficit was going to improve by 0.25 PP. of GDP in 2010. This was a smaller improvement than the annual fiscal effort of 0.5 PP. of GDP recommended under Article 126(7).

To reach the deficit target of below 3% of GDP by 2012 the authorities had targeted a gradual reduction. The efforts to achieve the gradual target of 3.9% of GDP in 2011 would be doubled.



A decree law that specifies the measures that underpin the additional consolidation efforts for 2011 to 2012 had been adopted on 25 May 2010. These measures included cuts in expenditure, half of which was to be borne by local authorities, restraint in wages and recruitment throughout the public sector and cuts to ministerial expenditure and the postponement by some months to retirement for those meeting seniority conditions.

Tax evasion would be fought stronger and was expected to yield higher revenues, 0.1% of GDP in 2011 and 0.5% of GDP in 2012.

In the Council opinion of 26 of April 2010 they saw some risks to Italy's medium-term budgetary strategy, these were also addressed with the downward revision of the growth assumptions. However the Commission found that the deficit outcomes in the entire period could still be worse than targeted.

The Combined Report on the Economy and Public Finances (RUEF) contained an upward revision of the debt projections 2010 to 2012. The revision was caused by the 2009 higher starting position because of a lower nominal GDP growth and a less favourable stock-flow adjustment development. The projected decline in debt ratio occurs one year later than in the Stability Program.

On the information given, the Commission found that Italy had taken adequate action for a correction of the excessive deficit within its time limit. Especially the consolidation measures in 2010, which were being broadly implemented as recommended by the Council. The Commission was of the opinion that there were no need for any further steps in the EDP at present, but they would continue to monitor Italy's budgetary developments in accordance with the Treaty and the SGP.

In Press release 12076/10<sup>24</sup>, the Council shared the view of the Commission regarding the action taken by Italy to correct the excessive deficit and found likewise that no additional steps in the Excessive deficit procedure was necessary at this stage.

## 4 Conclusion

During the entire period 2005 to 2010, Italy has failed to reach the deficit reference value and the debt to GDP reference value. The Commission and Council have also acted on Italy in accordance with the regulations and procedures of the SGP.

In the reports, opinions, recommendations and decisions you can see that the reforms made in the SGP in 2005 are well-used and important tools in the decision-making whether there exists an excessive deficit. Below are examples of some of the major changes and clarifications made in the reform 2005 that are used in the decision-making:

- In the reports from 2005 and 2009 you will find long explications of the ORF. The developments in Medium-term budgetary position, Medium-term economic position and other factors relevant for Italy, are examined. There are also discussions and later conclusions, whether the excess value is temporary and if the deficit remains close to the reference value. This is done to clarify if the factors mentioned above even should be taken into consideration in the decision of an existence of an excessive deficit.
- There is a focus on debt sustainability and both in 2005 and 2009 the Commission and Council were watching to see if the debt to GDP ratio was sufficiently diminishing and approaching the reference value at a satisfactory pace. If so, though not in the case of Italy, the debt criterion would have been accepted.
- The recommendations include a MTO adjustment of 0.5% of GDP annually and also an expectation that there in good times are taken higher efforts towards the correction of the excessive deficit.

If the reform of the SGP in 2005 never took place, had Italy been acted on in a different manner? The closest you can get to an answer to that question without viewing and analyzing the reports from before 2005, is maybe. The ORF and their role in the excessive deficit procedure, has no specific definition in the unreformed SGP. This means that the Commission and the Council might have found them relevant and considered them even though the excess value was not considered temporary and the deficit value was not close to the reference value. Without the clarification and guidelines it is hard to decide what to take into account. But even so, their conclusion might as well have been the same as the ones made after the reformation. If we look at the debt criterion I find it hard to see that it could be anything than unfulfilled regardless if the decision was made before or after the reformation of the SGP. Italy's debt ratio has been well above the reference value for a long time. But then again I cannot be 100% sure. One thing that can be said is that if an excessive deficit were found, the deadline for its correction would have been prolonged by a year regardless if the decision were made before or after the reformation. This due to that the Council still would have found special circumstances in the deep-rooted structural problems of Italy.

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