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MAKING ITALY SAFER, BUT NOT MORE IN DEBT

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While one could apply the EU's flexibility clause to the reconstruction effort after the 2016 earthquake in Italy, it should not be extended to the country's long-term public investment plan to strengthen seismic protection. A better path would be to pursue other options, eliciting involvement from both private entities and the European Union.

1. Financing the reconstruction effort and strengthening seismic protection after the earthquake in Valle del Tronto risks sparking a new controversy between the Italian government and the European Union, particularly when it comes to compliance with EU rules governing public deficit and public debt. The need for a financial solution to the human tragedy and loss of social capital brought about by the earthquake is at odds with the fragility of the Italian public budget, which needs to comply with the EU's rules on public deficits and with the Fiscal Compact. Beyond shedding light on past mistakes connected to oversight of construction in the area, the earthquake shows how a high level of public debt makes fair and efficient management of negative events more difficult and how, in this manner, it can become a hindrance to balanced and long-term economic and social growth.

This policy brief shows that, given the need for sound management of public finance, European regulations actually do allow economic problems stemming from the Valle del Tronto reconstruction effort to be confronted and that, as opposed to what seems to have been suggested in heated public rhetoric, there are no specific reasons for tensions to emerge between Italy and European institutions. The European Commission has indicated, through a press release by spokeswoman Vanessa Mock, that "According to Community rules, short-term emergency costs in response to major natural disasters can be considered a one-off and be excluded from the calculations of the structural effort of a nation when evaluating its adherence to the Stability and Growth Pact." This principle has been applied in the recent past for the earthquakes in Abruzzo and Emilia-Romagna. A possible source of tension resides in the fact that the Italian government seems to want to also request the exclusion of public investments related to a long-term plan to strengthen seismic protection in the country. In this regard, the Commission declined to comment on a plan that has not yet arrived, but added that the January 2015 Communication on flexibility is very specific about the types of investments that can be excluded from budget calculations. This position has incited strident reactions from Italian political representatives and commentators.

A clash between national and European institutions needs to be avoided. Partial political advantages stemming from a confrontational stance against Europe would only reinforce confusion, anti-European sentiments, and the country's isolation. Italy has cogent reasons for pursuing an ambitious and protracted plan to secure its territory against seismic activity, but it can and must find the resources to do so without resorting to shortcuts. Other solutions—less onerous but equally effective preventative measures—should be explored.

2. European regulations on budgetary discipline allows special treatment of expenses that an EU member state incurs in the immediate aftermath of a natural disaster. When implementing the Stability and Growth Pact, each country should avoid significant deviation in their annual budgets from their medium term budgetary objective (MTO). The MTO is defined "in cyclically adjusted terms, net of one-off and other temporary measures." One-off and temporary measures are "measures having a transitory budgetary effect that does not lead to a sustained change in the intertemporal budgetary position."[1]

The MTO pursues a triple aim: providing a safety margin with respect to the 3% of GDP deficit limit; ensuring rapid progress towards sustainability, as assessed against the need to ensure the convergence of debt ratios towards prudent levels; and allowing room for budgetary manoeuvre, taking into account the needs for public investment in particular. The *Specifications on the implementation of the Stability and Growth Pact and Guidelines on the format and content of Stability and Convergence Programmes* further states that "In exceptional cases, the change in the structural balance is also adjusted to take account of large-scale unexpected events requiring a budgetary response, such as natural disasters."[2] Among examples of one-off and temporary measures "are the sales of nonfinancial assets; receipts of auctions of publicly owned licenses; *short-term emergency costs emerging from natural disasters*; tax amnesties; revenues resulting from the transfers of pension obligations and assets" (emphasis added).[3]

In January 2015 and then in the *Commonly agreed position on Flexibility in the Stability and Growth Pact*, published 30 November 2015, conditions consenting margins of flexibility for the pursuit of the medium term objective (MTO) were introduced and elaborated. Three specific policy dimensions that would justify temporary deviation from the MTO's trajectory include: (i) exceptionally difficult cyclical economic conditions; (ii) major, fully-implemented structural reforms that have direct long-term positive budgetary effects; and (iii) government investments aiming at, ancillary to, and economically equivalent to major structural reforms.[4] For 2016's budget, Italy took advantage of this flexibility, with a cumulative deviation of 0.75% of GDP with respect to public deficit.

The logic behind the European Commission's position is evident. Its priority is to ensure the sustainability of the fiscal and economic-social position of a country, using, above all, public debt and real rate of economic growth with respect to potential growth as a measurement.

The reconstruction of Amatrice, Accumoli, and Arquata requires limited financial resources on the national scale and is not of a magnitude that would result in a significant deviation from the fiscal trajectory of the country as projected prior to the dramatic event. It would not be

[1] *Specifications on the implementation of the Stability and Growth Pact and Guidelines on the format and content of Stability and Convergence Programmes.* European Commission. 5 July 2016. Pg. 4.
[2] Ibid. pg. 32.
[3] Ibid. pg. 4.
[4] *Commonly agreed position on Flexibility in the Stability and Growth Pact*. The Council of the European Union. Brussels, 30 November 2015. Pgs. 3-4, 7-8.

difficult for the European Commission to, therefore, exclude public spending related to reconstruction from the medium term objective.

The problem stems from the fact that the request for "flexibility" does not seem to only exclude the spending related to reconstruction but also the projected expenses related to the actualization of another, deserving initiative proposed by the Prime Minister: a multi-year preventative plan, "Casa Italia," to make Italy safer against earthquakes, which involves ensuring that buildings and infrastructure in the most seismically vulnerable areas comply with earthquake resistant standards.

"Casa Italia" is defined by the Prime Minister as a long-term project that would take years, and perhaps a couple of generations, in order to be realized. On 29 August 2016, he added that the plan would not only involve anti-seismic provisions, but also "ongoing improvements with respect to schools, suburbs, hydrogeological instability, drainage and purification systems, highway and railway systems, dams, low-income housing, sporting facilities, broadband, energy efficiency, maintenance, cultural heritage, and the symbols of our community."

This intervention is, by definition, not temporary. Additionally, if realized, it would lead to an estimated 1-2.5% of GDP increase in public spending, introducing a significant and permanent deviation to Italian public debt with respect to its medium term objective. From a technical standpoint, therefore, it is easy to understand why the European Commission preemptively stated that including this plan under the Flexibility Clause would be problematic. In this context, opening a negotiation, in which the financing of "Casa italia" and already authorized flexibility for structural reforms are put on the same plate, risks being truly counterproductive for the Italian government.

Additionally, "Casa Italia" is an ambitious political project that should be planned out in detail and confronted with possible alternative solutions. After an initial feasibility and efficacy study, it should also undergo a financial sustainability analysis, leading to a credible estimate of total spending, timeframe, and impact on the economy. Finally, after a sustainability evaluation, its implementation should be preceded by institutional changes that would guarantee proper execution over time through definitive anti-corruption oversight.

3. Due to its nature being long-term and largescale, the financing of "Casa Italia" should not be achieved through margins of "flexibility" authorized by European authorities in the immediate aftermath of a natural disaster. It might seem counterintuitive that European regulations would favor reconstruction over prevention, so it is important to expand upon the differences and possible connections between these two types of spending.

The starting point is the sustainability of both types of spending, namely their impact on the debt-to-GDP ratio, a particularly important parameter for a high-debt country such as Italy. It makes sense that an expenditure targeted at reconstruction of public and private infrastructure after a catastrophe such as an earthquake be financed through debt. The reasoning behind this is that the expenditure is temporary in nature, with the narrow scope of reconstructing destroyed material capital and compromised social capital, without which production levels and, consequently, tax income would decline. Spending targeted at reconstruction has a high positive impact on the area's income and could generate, over time, resources that would eventually make up for the initial expense, making the debt sustainable. The reasoning is the same as giving an affected area special tax treatment or subsidies, with the aim of accelerating a return to its initial productive capacity. In other words, the alternate scenario, which is to finance the reconstruction through taxation, would result in a worsened debt dynamic.

On the other hand, it would be problematic to exclude from the public debt and deficit calculation expenditures related to prevention, such as those contained in the long-term "Casa Italia" initiative. As with other types of spending of this nature, which are aimed at lowering risk (e.g., military or healthcare spending), it is difficult to argue the potential impact of the expenditure on economic growth, i.e., that the expenditure would later generate additional productive resources so as to, over time, make up for its effect on the budget and public debt.

Distinguishing spending on reconstruction from prevention is not necessarily easy. In the case of recurring natural disasters, money spent on prevention today could lead to future savings in reconstruction, with a high probability of realization. If the "prevention" is effective, it would reduce the future costs to a degree that the future income of the country increases, as in the case of a successful structural reform. Thus, the spending could fall under the type of investment allowed by the European Commission's November 2015 Communication on Flexibility. In principle, part of this spending could be financed through debt, as opposed to taxation, because an increase (or smaller decrease) in potential income benefits future generations and not only the present. On the other hand, if a country is subject to recurring natural disasters with huge effects on the economic system, the medium-term growth rate should be recalculated down, which would have a negative impact on the sustainability of public debt. Even if the spending on prevention could be excluded from deficit and debt calculations with respect to European regulations, it cannot be ignored when it comes to debt sustainability.

Regardless of the definition of preventative expenditures and their projected effect on future income, it is evident that the scope of the "Casa Italia" project grossly exceeds what could be, in principle, admissible under European flexibility regulations. The very fact that the project is not short-term but extends over decade-long arcs and multiple generations makes the concept of flexibility inapplicable. The costs of implementing "Casa Italia" must, therefore, be covered by the national public budget. This would imply an increase in taxes or, auspiciously, structural savings deriving from the Spending Review.

4. In conclusion, the position of the European Commission that distinguishes between emergency spending for the reconstruction and those for future prevention, as far as budgetary rules are concerned, is justified. Starting a battle to demand an extra margin of "flexibility" within the Italian public budget in order to finance "Casa Italia" risks not only having limited success, but it could also damage the already tenuous trust between member states and reduce Italy's negotiating room on other important fronts (immigration and Banking Union, among them).

It would be useful to investigate two alternative ways to fund "Casa Italia" through public resources, which could be applicable both on the national and European scale. The first is to transfer the direct burden of the (lack of) prevention to private entities via the institution of obligatory insurance against earthquake damage. Insurance companies, called upon to offer policies against such damage, would have strong incentives to carefully discriminate against potential clients based on their location and previous or contextual actions to reduce risk of seismic damage. This would group insurance policy holders into different classes based on risk, allowing insurance companies to differentiate when it comes to fees and types of policies. The state would offer proprietors belonging to the highest risk levels some form of tax exemption that would bridge the divide between the cost of prevention (necessary for being assigned to a lower risk group) and subsequent decrease in fees. This would incentivize the creation of building standards and improve the use of public resources, similar to what is theorized in "Casa Italia." Additionally, the negative impact on the public budget resulting from tax exemptions to building owners at high seismic risk would be made up for during future seismic events, through a reduction of the negative shock on the public budget, which would have increased debt or diverted resources from other obligations. The public burden could thus be limited to the care of material and immaterial infrastructure.

The second path is to use "Casa Italia" to rethink the entire system of European structural funds, which are used with little efficacy in Italy. With a budget of €454bn for 2014-2020, European Structural and Investment Funds are the primary instrument for the EU's investment policy. By the end of 2016, the Commission will have to present to the European Parliament a mid-term re-examination regarding the workings of the Multiannual Financial Framework, taking into account the economic situation at the time, as well as updated macroeconomic projections. Additionally, in November 2014, the European Commission launched the nominally ambitious Juncker Plan, which should have catalyzed a considerable increase in investment in the real European economy, but which has had modest results up to this point. In this context, the Italian government is in the position to present a detailed plan to orient structural funds or resources from the Juncker Plan toward the objectives described in "Casa Italia." This would mean sharing Italy's long-term preventative plan with European institutions and authorities, as well as transnational enterprises.

Considering the country's past misuse of European funds, a transparent and professional initiative to improve the area's buildings, as well as its social and cultural heritage, could be a new, constructive addition to the relationship between Italy and the European Union. The relative size of the Italian economy within the EU is such that the solution to any new problem, which carries a relevant impact on public spending, such as the financing of the reconstruction effort and strengthening seismic protection in the context of sustainable public financing, would have an effect on the entire area. The probability of success inevitably depends on shared interests, rather than opposition.