



*Al Ministro
dell'Economia e delle Finanze*
Prot. 7201R

Rome, 27 October 2016

Dear Valdis, Dear Pierre

Thank you for your letter dated 25 October, in which you seek clarifications concerning Italy's 2017 Draft Budgetary Plan (DBP).

In particular, you are enquiring about the revision of Italy's fiscal targets with respect to the commitments made last spring.

The macroeconomic outlook has worsened since last spring due to external factors, including increased geopolitical risks, which have caused a slowdown in European growth and a lowering of projected global trade growth. Italy's official real GDP growth forecasts for 2016 and 2017 in the DBP have been reduced as a result. The output gap is now projected at -1.7 percent of potential output, down from a previous estimate of -1.1 percent in the Stability Program. Furthermore, inflation remains at ultra-low levels that complicate the effort of reducing the debt-to-GDP ratio¹. All this implies that the Italian economy is still experiencing difficult cyclical conditions and thus suggests a more gradual adjustment towards the Medium Term Objective, which remains a balanced structural budget in 2019.

On the subject of the output gap, I note that some progress is being made at the technical level on the estimation of member states' potential output. However, the Italian government believes that further enhancements of the 'agreed methodology' are necessary to achieve output gap estimates that are consistent with macroeconomic evidence (such as core inflation and wage growth differentials among member states) and to minimise the risk of pro-cyclical fiscal policies. There is urgent need to address concerns regarding the uncertainty of output gap estimates and the consistency of related policy guidance. If we based the analysis of Italy's fiscal policy on alternative potential growth estimates, which also imply a slower closure of the output gap in coming years, Italy's fiscal strategy for 2017 would appear in quite a different light².

¹ This argument was analysed in depth in the Report on Relevant Factors Influencing Italy's Debt that we sent to the Commission in May of this year.

² Italy's 2016 Stability Program shows highly promising results obtained by replacing the CUBS indicator of capacity utilization in the production function model with an alternative indicator of labour hoarding. CUBS is used to estimate the cyclical component of Total Factor Productivity.

Given that your letter also mentions our commitments in terms of public investment and structural reforms, I also take the opportunity to confirm that the Government is implementing a coherent plan of investment and structural reforms in order to boost the growth potential of the economy and to steer the expectations of economic agents towards sustained GDP growth.

On investment, further legislative measures have been adopted in 2016 to support public works and to streamline authorisation procedures while reinforcing anti-corruption policies. Some measures have been specifically designed to accelerate the implementation of programs co-financed by the European Union. The 2017 Budget envisages a steady increase in public investment during the 2017-2019 period, reinforcing the turnaround effected in 2015-2016.

The commitment made with respect to the investment clause is a government priority and its fulfillment is the object of specific monitoring to address bottlenecks and ensure a swift and smooth execution of co-financed public investment. In addition, significant fiscal resources in the 2017 Budget are devoted to supporting private investment, innovation, and productivity. These policy areas are aligned with the Country Specific Recommendations to Italy.

As for structural reforms, attention is currently focused on the upcoming referendum on the Constitutional reform, the impact of which on the economy can be significant. Meanwhile, however, work to fulfil our reform commitments has continued apace, notably in the domain of the labour market, public administration, governance of the banking system and insolvency procedures. Moreover, Parliament is currently reading important reforms tabled by the government, such as the Competition Law and the reform of the penal code and the statute of limitations³. A major reform of the tax administration aimed at improving collection procedures, streamlining administration and merging the tax collection agency with the revenue agency is also included in the Budget Law for 2017.

Returning to the subject of the structural balance, besides cyclical considerations, the change in the 2017 target compared to the 2016 Stability Program is largely explained by extraordinary expenditures relating to immigration and seismic risks.

For immigration, we foresee additional extraordinary expenditures in excess of 0.2 percent of GDP in 2017. The number of immigrants and refugees landing on our shores or rescued by our navy and coast guard has soared this year, and there are concrete risks that this trend will persist in 2017. As of 26 October, 156,705 individuals have been rescued so far this year, more than in the whole of 2015.

The number of migrants arriving in Italy in 2016 is more than three times the level in 2013 and even higher than 2011-2012, the period following the 'Arab Spring' (see Figure 1 in the Annex). Furthermore, Italy's effort started earlier than for other EU countries, as it has been

³ The DBP reviews recent reform initiatives and updates the reform timetable in light of the 2016 Country Specific Recommendations issued by the European Council.

facing unprecedented pressure since 2014 due to the conflict and the lax border controls in Libya. The intensity of the flows and the large number of women and minors involved raises the humanitarian severity of the crisis.

External borders should be a matter of common responsibility. Italy is playing a critical role in securing Europe's external borders and has made an exceptional financial effort on behalf of the European Union to fulfil its humanitarian obligations. Since the outbreak of the emergency, close to half a million people were saved at sea. At its October meeting, the European Council acknowledged the emergency in tackling migratory flows and notably the prevention of illegal immigration along the Central Mediterranean route. The Council also recognized "the significant contribution, including of financial nature, made by frontline member states in recent years."

To this aim, immigration expenditure should not be evaluated only in terms of year-on-year changes, but relative to the situation Italy would experience if it were not the EU external border. Expenses for rescue operations, first provision of health care assistance, shelter and education for the more than 20,000 unaccompanied minors are estimated at €3.3 billion euro (net of EU contributions) in 2016 and €3.8 billion (0.22 percent of GDP) in 2017 in a steady-state scenario. Should the influx continue to grow at the recent pace, the expenditure would rise to €4.2 billion (0.24 percent of GDP), as shown in the DBP. It should be underlined that, unlike other member states, Italy's estimates do not include the additional cost of social integration for migrants, as they are not directly related to the management of the 'European border.' As a result, let me stress that these estimates are very low compared to what has been put forward by other member states, most recently in their Draft Budgetary Plans.

Most of the costs incurred are related to rescue at sea, identification, shelter, clothes and food. On an accounting basis, they translate into higher personnel costs, operating costs and amortization of ships and aircraft. In the appendix to this letter, we present a quantification of these expenditures by EAS and functional categories for the steady-state scenario (table 1 and 2), gross and net of the EU share of the External Borders Fund, the Return Fund, Refugee Fund and Integration Fund for non-EU country nationals.

I would also like to recall that Italy is mostly viewed by migrants as a transit country, which reduces the medium to long-term economic benefit resulting from the enlargement of the labor force.

Moreover, given the difficulties in implementing the EU relocation plans foreseen by the Justice and Internal Affairs Council last year, Italy has been forced to take further measures to relieve the pressure on provinces and municipalities where the presence of migrants is highly concentrated. To this purpose, the law decree approved by the Council of Ministers on 21 October introduces a new national 'reception plan' based on relocating migrants and refugees among Italian municipalities based on proportionality and sustainability criteria.

As concerns seismic risks, the government in 2017 will incur considerable expenses for earthquake assistance and reconstruction totaling €2.8 billion. Furthermore, given the frequency of destructive earthquakes and the suffering they have caused the Italian population, the government intends to carry out an additional program addressing seismic risks more forcefully and promptly than has been the case in the past. This action is necessary to secure for instance our 42 thousand school buildings, 30 per cent of which are either in need of structural maintenance or must be completely rebuilt.

We thus decided to earmark a relevant share of the additional public investment in the 2017 Budget to anti-seismic infrastructure, schools and public offices. In addition, tax incentives for anti-seismic investment are increased, targeting private dwellings. The budgetary cost in 2017 of anti-seismic incentives is estimated at €2 billion. Taken together, increased public investment and anti-seismic tax incentives entail budgetary costs of close to 0.2 percent of GDP.

We remain at the Commission's disposal should you wish to discuss any of the above points in greater detail.

Yours sincerely,



Pier Carlo Padoan

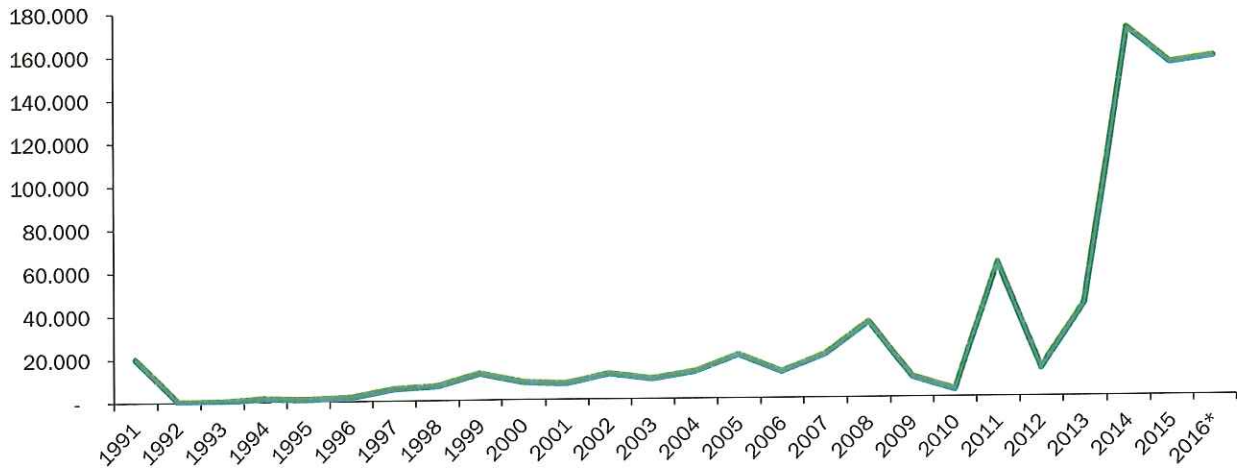
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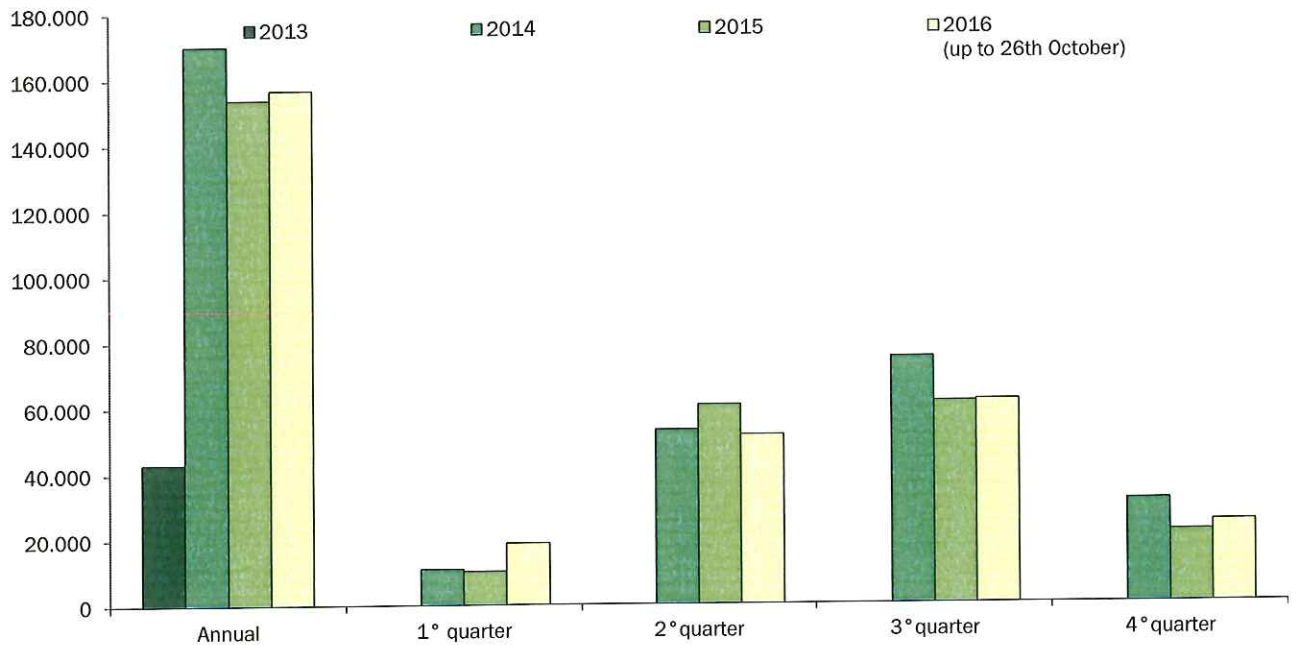
Annex

FIGURE 1: ARRIVALS OF MIGRANTS ON ITALY'S COASTS (1991-2016)



Source: Port authorities and Ministry of Internal affairs.

FIGURE 2: ARRIVALS OF MIGRANTS ON ITALY'S COASTS. ANNUAL AND QUARTERLY DATA, 2013-2016.



Source: Ministry of Internal affairs.

TABLE 1: IMPACT ON THE HEADLINE BALANCE OF EXPENDITURE INCURRED FOR MIGRANT CRISIS IN STEADY STATE SCENARIO - BREAKDOWN BY ESA CATEGORIES, 2011-2017 (IN € MN)

	2011	2012	2013	2014	2015	2016	2017
1. Compensation of employees (D.1)	97,1	82,7	81,0	84,3	88,1	89,1	88,9
2. Intermediate consumption (P.2)	190,0	198,6	218,0	346,8	429,6	349,1	388,0
3. Social payments (D.62, D.63)	149,1	160,2	306,0	636,6	1.172,3	1.720,9	2.215,2
4. Subsidies (D.3)	-	-	-	-	-	-	-
5. Gross fixed capital formation (P.51)	39,5	62,7	288,7	340,1	253,7	423,0	391,5
6. Capital transfers (D.9)	-	-	-	-	-	-	-
7. Other	446,5	394,4	462,1	797,0	791,7	848,4	830,6
8. Total impact on headline deficit (8) = Σ(1..7)	922,1	898,6	1.355,8	2.204,7	2.735,6	3.430,6	3.914,1
9. Compensation from EU	94,3	65,2	100,7	160,2	120,2	112,1	87,0
10. Total impact on headline deficit net of EU contributions (10) = (8) - (9)	827,8	833,5	1.255,0	2.044,5	2.615,4	3.318,5	3.827,1
11. Total impact on headline deficit net of EU contributions (% GDP)	0,05	0,05	0,08	0,13	0,16	0,20	0,22

Note: The data do not include the expenditure related to the so-called “Arab Spring emergency”, initiated during 2011 and officially ended on 1 January 2013. Approximations made when unit costs were not available by ESA category. More specifically, the ongoing costs of Defense are considered entirely as intermediate consumption and education, health, contributions to Turkey (excluded from the EU budget) and EU funds and national co-financing related are classified as other expenditures.

Source: State General Accounting Department

TABLE 2: IMPACT ON THE HEADLINE BALANCE OF EXPENDITURE INCURRED FOR MIGRANT CRISIS IN STEADY STATE SCENARIO - BREAKDOWN BY ESA CATEGORIES, 2011-2017 (IN € MN)

	2011	2012	2013	2014	2015	2016	2017
1. Initial reception costs*	244,6	269,7	479,0	683,5	1.304,1	1.883,7	2.364,0
2. Transport (including rescue operations)	347,4	280,5	525,6	982,7	837,5	881,7	860,8
3. Health-care	74,6	86,5	137,7	207,8	243,7	250,0	250,0
4. Administrative costs (incl. processing applications for asylum)	44,2	43,2	38,5	43,7	40,3	38,5	30,4
5. Contributions to Turkey Facility (excluding through EU Budget)	0,0	0,0	0,0	0,0	0,0	66,6	98,9
6. Other costs and measures**							
education	211,2	218,7	174,9	287,1	310,0	310,0	310,0
7. Total impact on headline deficit (7) = Σ(1..6)	922,1	898,6	1.355,8	2.204,7	2.735,6	3.430,6	3.914,1

Note: The data do not include the expenditure related to the so-called “Arab Spring emergency”, initiated during 2011 and officially ended on 1 January 2013.

Source: State general Accounting Department