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Implementing fiscal decentralization in Italy between crisis and austerity: Challenges ahead

by

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Abstract

Since 2010 the Italian central government has embarked on a challenging program of fiscal consolidation, which is hugely affecting sub-central government finances. Sub-national governments are involved in reaching general government fiscal targets through reduction in central government transfers, new fiscal rules, borrowing and expenditures limits. These restrictions risk to put the fiscal federalism reform to a standstill – despite the progress obtained in 2010 and 2011 with the approval of the implementing decrees of Law no. 42/2009. Conversely, carrying out the fiscal federalism reform in order to seek efficiency gains in the provision of public services and smoothing out intergovernmental relations may represent one of the most important structural measures to address consolidation needs.

Key-words

Fiscal federalism, fiscal consolidation, local taxation, economic crisis, public services

1. Introduction

Managing financial relationships among levels of government represents one of the most complex policy issues all over the world. Finding an efficient mix between different sources of revenue (taxes, non-taxes, transfers, borrowing) for sub-national governments is one of the main objectives of the normative fiscal federalism literature. However, a "one size fits all solution" is not viable and every country should find some sort of tailor-made model suitable to its own institutional peculiarities.

Italy has been facing this challenge since the early 1990s, when it embarked on a process of transforming its system of intergovernmental relations into a regionalized quasi-federal one. The process culminated – at least temporarily – in the constitutional amendment of 2001 that set up a multilayered system of territorial governance based on three autonomous levels: regional, provincial, and municipal. The new Constitution has extended the range of basic responsibilities assigned to regional governments to education and social protection as well as a number of other areas. It introduced, at the same time, an asymmetrical system of devolution, meaning that regional governments can themselves decide over the new functions they want to be assigned[1].

However, most of the constitutional mandates still have to be implemented. As for financial relationships, Law n.42 of 2009, after two years of discussions, set up the legal framework and authorized the government to issue several legislative decrees that will define the new revenue system of regional and local governments, without incurring extra costs and thus maintaining fiscal neutrality. So far, nine delegated decrees have been issued, but many of them merely replicate the provisions of Law n.42 and postpone the resolution of the most intriguing issues that mainly have to do with the new equalization system. Full implementation of the Law will require at least another five to six years.

This process has been hindered by the deepening of the economic and financial crisis and the central government's fiscal consolidation efforts over the last few years. As a matter of fact, Law n.42/2009 was implemented between 2009 and 2011. This timeframe is exactly the period when the ongoing financial crisis exacerbated fiscal pressures on all levels of government in Italy. This short note focuses on the impact of the crisis on local governments and their responses in terms of policy options according to the most recent data and evidence and in comparison with what has emerged from other EU countries. Moreover, we will investigate whether and how the current fiscal decentralization process is affected and hampered by the economic crisis.

This essay is divided into three sections. The first summarizes the main features of the revenue system of local governments taking into account the impact of the most recent reforms. The second describes the financial impact of the central government's fiscal consolidation policy on sub-national finance between 2007 and 2011 in Italy and also in comparison with other European countries. Finally, the last section examines the main challenges which must be addressed by sub-national governments in searching for reducing costs without harming public service delivery and the impending risk of a stalemate in the whole decentralization process due to the persisting Italian general government public finance distress.

2. Main features of the Italian sub-national revenue system: trends and issues

The main scope of Law n. 42/2009, complying with the indications of Art. 119 of the Constitution reformed in 2001, is to reduce the Italian historical mismatch between sub-national spending responsibilities and autonomous sources of revenue. In 2010, the Italian government defined this objective through an effective metaphor: "*straightening the crooked tree of public finance*" (Governo italiano, 2010), i.e. reducing the asymmetry between revenue and expenditure decentralization (fiscal gap). As a matter of fact, according to many scholars the excessive mismatch between revenue and expenditure responsibilities assigned to sub-national governments that must be covered by intergovernmental transfers and/or borrowing risks relaxing their fiscal discipline and accountability, thus softening the budget constraints felt at that level. In reality, Law n.42/2009 is a framework law that has set only the principles for the different elements of the whole fiscal decentralization process, leaving their implementation to legislative decrees.

These decrees, issued between 2010 and 2012, regulate the revenue assignment and transfers for all levels of government, the transfer of assets from the State to sub-national governments, and accounting and fiscal rules (sanctions and controls) for sub-national governments not complying and incurring an unplanned deficit[II]. We will concentrate on the first two issues, revenue assignment and transfer rules, which are directly tied to the above-mentioned issue of the fiscal gap.

As for the first topic (revenue assignment), the system of local taxation in Italy has actually already changed dramatically in the second half of the '90s in terms of fiscal autonomy – making the local finance tree much more straighter.

The move towards local financial autonomy was a response to strong political pressure in favour of a more decentralized government, deriving in turn from a growing dissatisfaction with the inefficiencies that still permeated the workings of the central government. In fact, until the early '90s, the system had been forced to pay a high price in terms of efficiency. Low tax autonomy and dependence on transfers from the centre had allowed local administrators to shirk their responsibilities and made taxpayers lose perception of the cost of local public services. Hence there was overspending as a result of the provision of non-requested or only inefficiently delivered services. It was the negative assessment of these outcomes that underpinned the reform in the 1990s.

Moreover, in the same period, the steady devolution of taxation powers to regional and local governments went hand-in-hand with the reallocation of spending responsibilities owing to the framework law (L.59/97), the so called Bassanini Act – after the name of the Minister who drove it through – which provided for a mechanism of devolution of powers to the regions in many important areas hitherto carried out by the State, and from the regions to provinces and municipalities over a multi-year period.

Turning to tax decentralization, it must be kept in mind that the process had already commenced in l993 with the introduction of the "municipal property tax" (ICI), which closely resembled the real estate tax administered by local governments across the world and which is considered "the most hated tax" around the world (Slack, 2011). The tax base was determined centrally according to a cadastral system, while the municipalities were free to determine their tax rates within a set range determined by the national government[III]. In 1998, municipal fiscal autonomy was bolstered by the introduction of a personal income tax surcharge, whereby the municipalities could levy a flat tax rate on the income tax base determined by the central government, with a maximum ceiling of 0.5 percent. New, important sources of own taxation were introduced also for regions and provinces. After a period of stalemate at the beginning of the new century, the framework Law n.42/2009 and the implementing legislative decrees[IV] introduced several innovations into sub-national governments' revenue system. A new form of property tax (IMU), very close to the former ICI, was introduced, updating the assessment of the tax base with a huge increase in the cadastral property values and modifying the range of rates freely applicable by municipalities. In addition, a share of these revenues was attributed to the central government: a most criticized model of upward sharing which misrepresents taxing responsibilities, reducing local governments to act as mere tax collectors on behalf of central government[V]. Regions and communes were also entitled to a share in the VAT, to impose further personal income tax surcharges, and also to introduce new taxes provided that they do not apply to central government tax bases (e.g. the new municipal tax on services, TARES, starting in 2013).

This revamping of local taxation, combined with an increased autonomy in setting the level of service fees and charges, is symptomatic of the drastically increased level of financial discretion of local governments compared with the 1980s. In 1980, sub-national governments accounted for about 3 percent of total general government tax revenues, but this share has risen to about 15 per cent in 2011. This can also be shown through the long-term evolution of the vertical fiscal imbalance (VFI) of local administrations (Figure 1). This indicator is calculated as 1 minus the share of sub-national governments' (SNG) autonomous revenue (tax and non-tax revenue) from total general government (GG) consolidated revenue (net of internal transfers) divided by the share of local administration expenditures from total general government consolidated expenditures.

Formally, the VFI of sub-national governments can be defined as:

$$\text{VFI} = 1 - \frac{\text{revenue decentralization}}{\text{spending decentralization}}$$

where:

$$\text{revenue decentralization} = \frac{\text{SNG own revenue}}{\text{GG revenue}}$$

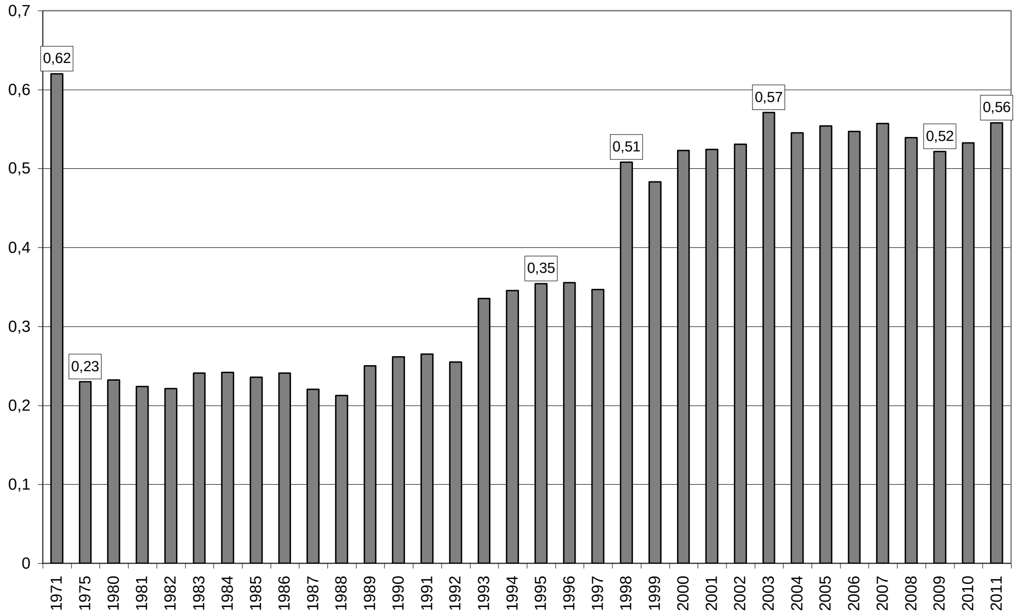
and

$$\text{spending decentralization} = \frac{\text{SNG own spending}}{\text{GG spending}}$$

The highest value in Italy was reached in 2003 (0,57), but it will probably be overtaken in 2012 and in the following years due to the increase in revenues collected through the new property tax (IMU). In this sense, the government's statement about the "crooked tree" in 2010 unfairly underestimated – probably for political reasons – the reduction in vertical fiscal imbalance achieved in Italy at the turn of last century. However, an optimal level of vertical fiscal imbalance has never been determined. Empirical literature based on cross-country evidence is scant – mainly because of limitations on data availability and homogeneity – and with non-univocal results, even though most studies have found that large VFIs are associated with lower fiscal discipline (IMF, 2011). Moreover, dealing with VFIs also implies addressing the issue of horizontal fiscal imbalances (HFI) and fiscal equalization. In fact, within each level of sub-national government, there are always some jurisdictions which are richer than others, with ensuing differences in revenue raising capacity and/or local service provision costs and needs. Thus, high regional disparities – like they exist in Italy – in the capacities to generate revenue require more expanded equalisation arrangements. Transfers from central government to match VFI therefore also have to take into account horizontal differences in order to allow sub-national governments to provide their citizens with a comparable offer of local public services at a similar level of tax burden[VI].

Conclusively, despite the re-introduction of significant tax autonomy, the finances of the Italian sub-national governments are still dependent on government transfers to match both vertical and horizontal fiscal imbalance. In addition, *de facto* individual grants have continued to be distributed on the basis of historical precedent. Italy could further reduce its vertical fiscal imbalance, but there is not much room for significant local tax autonomy increases after the recent reforms (Longobardi, 2013). The only way to reduce the VFI is to rely on the new tax sharing arrangements tied to equalization policies aimed to offset HFI.

Figure 1. Vertical fiscal imbalance of Local administrations in Italy from 1970 to 2011



Source: our calculations on data from Central statistical office. Higher values represent minor imbalance.

However, we must be careful in dealing with the concept of fiscal autonomy. More tax revenues deriving from tax sharing arrangements (e.g. VAT for regions and communes) can be assimilated to sub-national taxes according to the current accounting procedures[VII], however they resemble more central government transfers, for two reasons. First, tax sharing formulae can become very complex, breaking the link between what a sub-national government generates in terms of tax revenues and what it retains in its territory. Secondly, sub-national governments often have no discretion in determining tax base and rate over shared taxes. True, Law n.42/2009 has explicitly stated that the lion's share of central governments transfers to sub-national governments should be replaced with own taxes, but given that around 80 per cent of sub-national governments' expenditures are likely to be defined as essential and/or fundamental and are granted by the central government to its citizens (see below), there will arise the need for a big equalization fund, either horizontal or vertical (or both).

Until now, however, many attempts at reforming this system have failed in the last twenty years because redistributive conflicts among the different types of local governments have impeded the implementation of a new system of central grant distribution that is more clearly and fairly designed. In fact, while apparently all local governments are in favour of decentralization, there is no consensus about the best version of decentralization to adopt. The more well-off local governments – situated in the Northern and/or the more urbanized areas – emphasize the need for increased fiscal discretion and a laissez-faire approach to fiscal decentralization, while the poorest governments – mostly located in the South – are much more resistant to giving up the current "gap filling" procedure which guarantees their current level of expenditure.

Unfortunately, a new, viable equalization grants system for both regions and local governments, outlined by Law n.42/2009 and two legislative decrees[VIII], is still to be introduced; only preliminary steps toward implementation have been accomplished. Its main innovation is based on the substitution of the "historical spending assessment" through the "standard cost assessment" method, with a central government guarantee for the provision of a minimum level of public services in health, education, welfare and transport provided by regions and a still undefined set of services provided by local governments (municipalities and provinces) for all the "fundamental functions" of provinces and communes[IX]. Article 117 of the Constitution describes as the exclusive competence of the central government the definition of "essential levels of service provision" for a set of basic services at regional level that are considered "necessary to guarantee equality of basic individual and social entitlements across the whole nation" and the specification of fundamental functions of provinces and communes. The basic services include health, education and social protection and, in part, transport, whilst the fundamental functions of local governments have been determined only provisionally. According to current estimates, the whole set of these services will account for at least 70% of sub-national expenditure.

The new system for these basic services will be based on the following steps:

a. Definition, for each regional function, of the essential level of service provision (LEPs). There is no clarity about the concept and content of LEPs. Clearly they are standards. According to the prevalent interpretation LEPs are more than standards ensuring minimum levels, otherwise the Constitution would have termed them minimum levels of service. They also have to be standards ensuring sustainable levels of service provision, compatible with keeping a financial equilibrium.

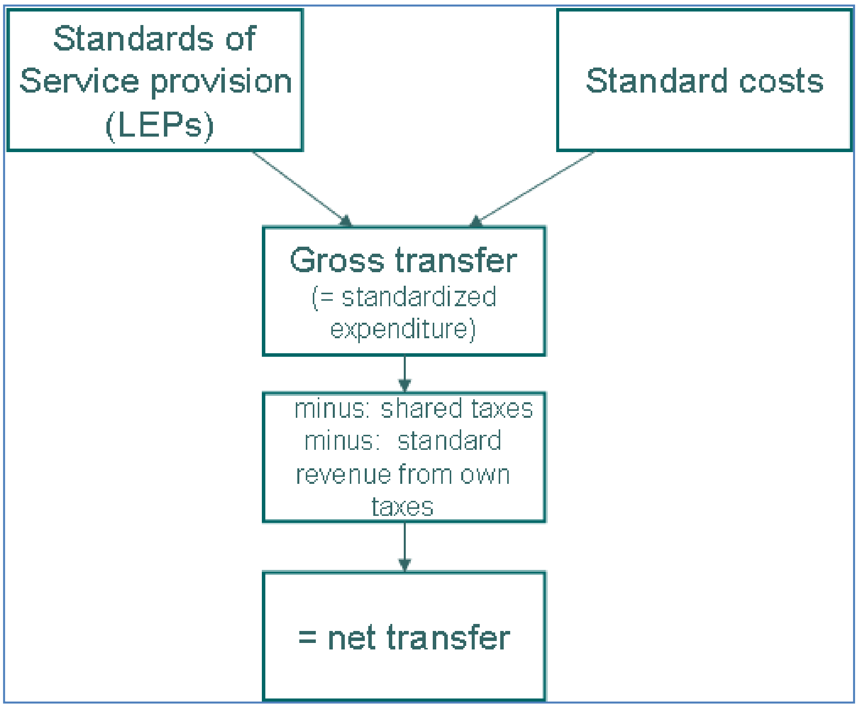
b. Estimating, for each sub-national unit and for each service, the standard (efficient) cost corresponding to the essential level.

c. Summing up the costs for all the concerned services.

d. Calculating the revenue deriving from levying, at a standardized rate, the own taxes notionally assigned to fund these functions, the revenue from the surcharge of the Personal Income Tax, and the revenue arising from a still to be determined share of the VAT and other shared taxes notionally pre-assigned to these services.

e. Determining the net transfer as the difference between d. and c.

Figure 2. The new transfer system for financing the essential levels of service (LEPs) provided by Regions



The role of own sub-national taxes has been specified by government decrees[X] leaving much room for taxes shared with the central government that are likely to play a relevant role in a system based on strong equalization principles (being based on levels of standard provision of services).

It must be noted that the rationale for financing the fundamental functions of provinces and communes is very similar. The main difference relates to the method used to assess the standardized expenditures, that is the objective expenditure needs, even though it is not still clear how and when it will be implemented[XI]. However, since functions related to basic services (e.g. social assistance) are often shared between regions and local governments, the issue of how to consistently assess the standardized expenditures for both levels of government it still far from being resolved.

As for regional expenditures not related to LEPs, transfers from central government will be determined by equalizing revenue capacity against a standard (average) personal income surcharge rate applied to their current tax bases. In other words, there will be a horizontal equalization fund financed by sub-central governments with per capita personal income surcharge revenues above average and from which sub-central governments with revenues below average will take extra resources. For "non-fundamental" local government expenditures an analogous mechanism of horizontal revenue equalization has been established.

It is well known, both at a theoretical and a practical level, that the definition and measurement of standardized expenditures – or establishing how much expenditure will be required to provide an adequate level of service – is one of the most controversial issues and requires a lot of analyses and experimentation before full implementation to avoid extra-costs which are not allowed by the law. It must be remarked that this last clause, fiscal neutrality, is probably too strict and, if partially relaxed, could allow for a "win-win" game that is politically more acceptable among sub-national governments during the phasing-in period of the reform, facilitating its effective implementation[XII]. This is the reason why the new system should also be put in place gradually, in order to avoid any disruption of services in those local governments that are supplying services inefficiently. In fact, the introduction of a new financing system would necessarily involve some reallocation of resources between units, but these shocks could be minimised during an adjustment phase.

It is beyond the scope of this note to describe the other relevant SNG sources of revenue such as user charges, borrowing, and sale of assets. It is more important to mention the role of the so called Domestic Stability Pact (DSP), which has established the most stringent limitations on the fiscal autonomy of local governments. The DSP is a typical fiscal rule, in use since 1999, and has become the primary tool for the central government to tighten fiscal discipline at the local level. By means of the DSP central government engages all levels of government in its effort to abide by the EU Stability and Growth Pact. Although originally intended as a means of reducing both budget deficits and the amount of debt at all levels of government, the DSP has gradually shifted its focus from controlling the budget balance of local governments to imposing specific ceilings on single items of expenditure and introducing financial and administrative sanctions rather than incentives to foster compliance. Fiscal limitations have varied both in kind and degree, including limits on expenditures and hiring practice. Moreover, despite its name it is not a pact *stricto sensu* since its rules have always been defined by state legislation without adequate consultation of sub-national governments. In this sense, the current Italian governance system has characteristics both of a centralized state, with its tight control over local spending and budget balances, and of a quasi-federal model, with its focus on local taxes as a means of financing a large part of local expenditure.

In conclusion, since 2009 fiscal decentralization in Italy has embarked on quite a demanding process of changing financial relationships between different level of governments. Yet, the ground-rule of fiscal neutrality set for this challenging reform has been hugely affected by the 2008-09 crisis and the necessary involvement of sub-national governments in national consolidation strategies.

3. The impact of central government fiscal consolidation policy on local governments' budgets and policies

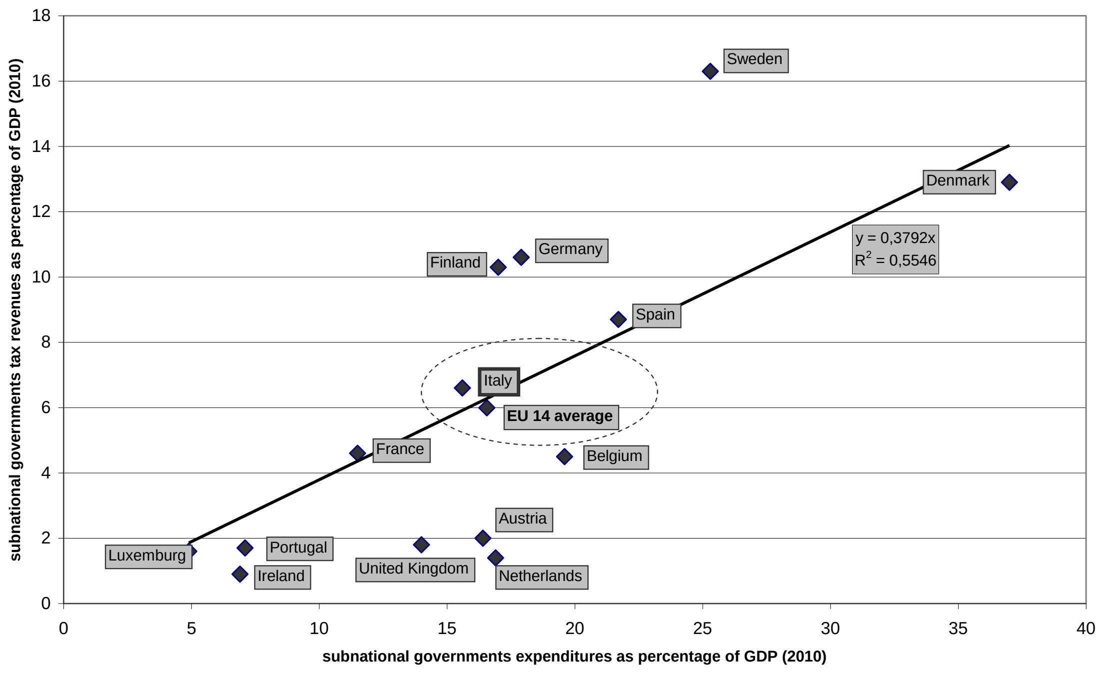
3.1 Recent trends in Italy

Sub-national governments in Italy have a significant role in fiscal policy making in the network of intergovernmental relations. There are several economic reasons which can explain why the financial health of sub-central governments is crucial for the maintenance of general government public finance soundness. First, their debt generates a number of potential risks, such as externalities affecting the reliability of central government debt, the risk of widespread contagion on the financial markets and "moral hazard", namely the anticipation of bailouts from central governments. In addition, the sub-central financial situation may affect the evaluation of the central government's possibilities to consolidate, and therefore threaten the credibility of central government's consolidation plans. Sub-central governments' consolidation targets in terms of deficit and debt reduction are often considerable, but their margin of manoeuvre to increase their own revenue is usually limited, inducing them to recur more to the reduction of expenditure by performing procyclically. In general, anti-cyclical performance can be guaranteed only by some extra-support from the central government.

Italy, compared with the other EU15 countries, has an average level of decentralization (Fig. 3), measured by the proportion of sub-national government expenditure and tax revenue from total GDP[XIII]. However, we must stress that Italy had ranked very low in terms of decentralization until the mid 1990s and only after that has reached the current level through an impressive dynamic in the weight of own tax revenues on GDP (Fig.4).

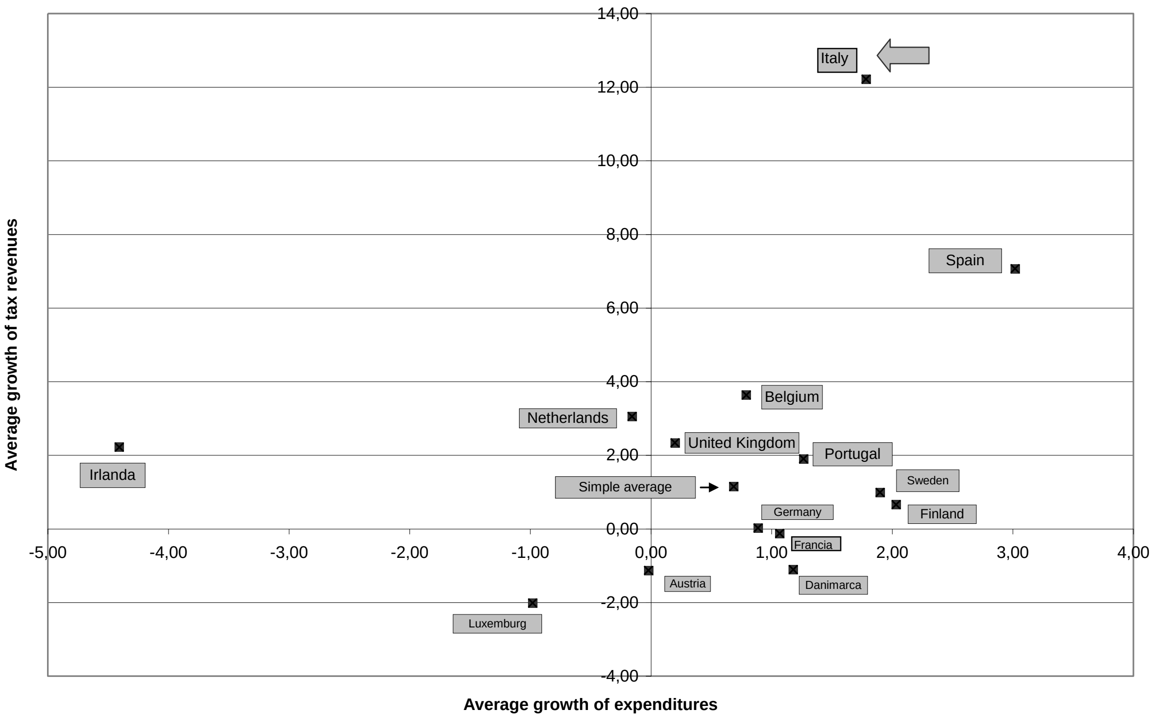
Unlike other countries, Italy has since the beginning of the crisis in 2008 not recurred to fiscal stimulus packages at either national or sub-national level due to its huge indebtedness. Therefore, fiscal consolidation never stopped and has hit hard on sub-national governments' finance. In practice, fiscal tightening in Italy has induced a reduction in vertical fiscal imbalance of sub-national governments without fully replacing state transfers with own local taxation (*fiscalizzazione*).

Figure 3. Decentralization in EU14 Countries in 2010



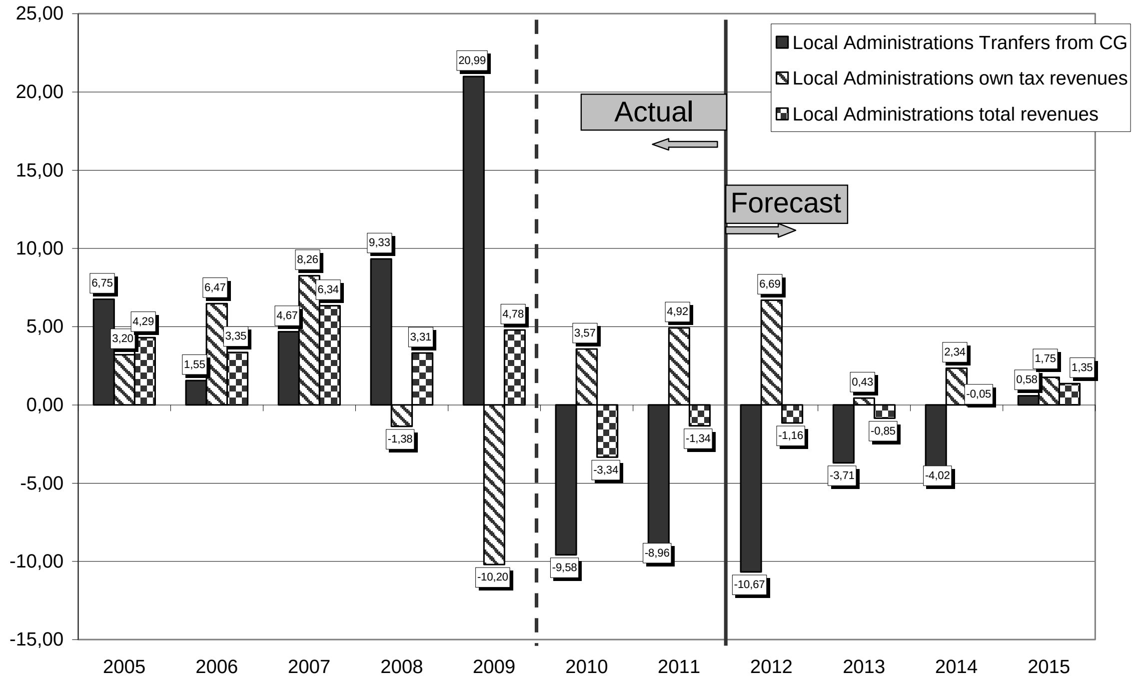
Source: OECD, data of Greece missing.

Figure 4. Yearly average growth of the share of sub-national governments tax revenues and expenditures from general government tax revenues and expenditures (2010-1995)



This has implied a restriction in total sub-national government revenue over the last two years (2010-2011) for which definite data are available. In fact, looking at the financial data (Fig. 5), the revenue pattern shows a clear turning point between 2009 and 2010 when local administrations' total revenues, for the first time, underwent a reduction of more than 3 per cent in monetary terms. It is worth looking at the pattern of municipalities' revenues (Fig. 6) because it can explain the negative tax revenue pattern of local administrations in 2008-2009. Actually, the reduction of own revenues was mainly due to the abolishment of the municipal property tax for first-owned occupied houses in 2007-2008, which was substituted by an equivalent amount of State transfers, enlarging the vertical fiscal imbalance (VFI) or, metaphorically speaking, making the Italian public finance tree more "crooked". For the foreseeable future, the trend based on official forecasts looks negative until, at least, 2014 (Fig.5).

Figure 5. Revenue patterns of local administrations in Italy 2005-2011 (yearly variations in percentage)



Source: Central Statistical Office and Ministry of Economy, Economic and Financial Document, 2012.

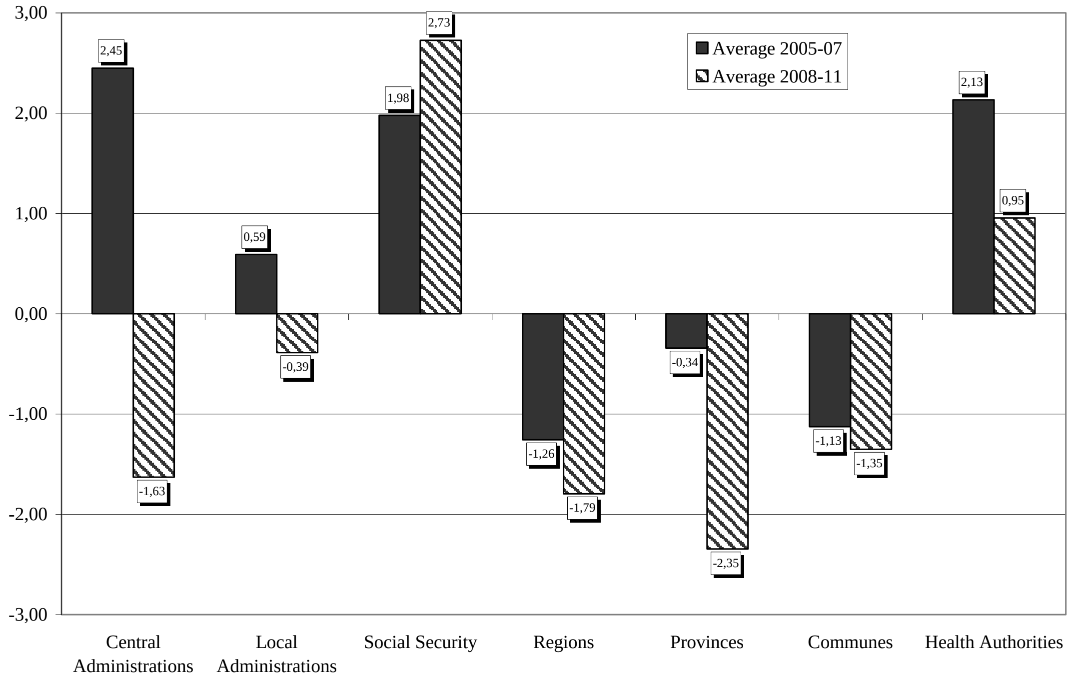
However, we cannot exclude a further tightening of the central government's restriction policy in the next few years in terms of transfer reductions and stricter fiscal rules (namely through the Internal Stability Pact).

As expected, the trend of revenues is specularly reflected by that of the expenditures. In general, breaking down according the different layers of government, a more precise framework emerges (Fig. 6):

i. there is a different trend in expenditures in real terms among the different levels of governments, as defined by general government accounts, for the period between 2005 and 2011, splitting this timeframe into two sub-periods: before (2005-2007) and after (2008-2011) the emergence of the economic crisis;

ii. among local administration expenditures only the health authorities, which are dependent on and tightly regulated by the regions and might be consolidated with them, show a positive rate of growth of expenditures in the post-crisis period;

Figure 6. Expenditure patterns of different levels of government in Italy in real terms 2005-2011 (yearly variations in percentage)

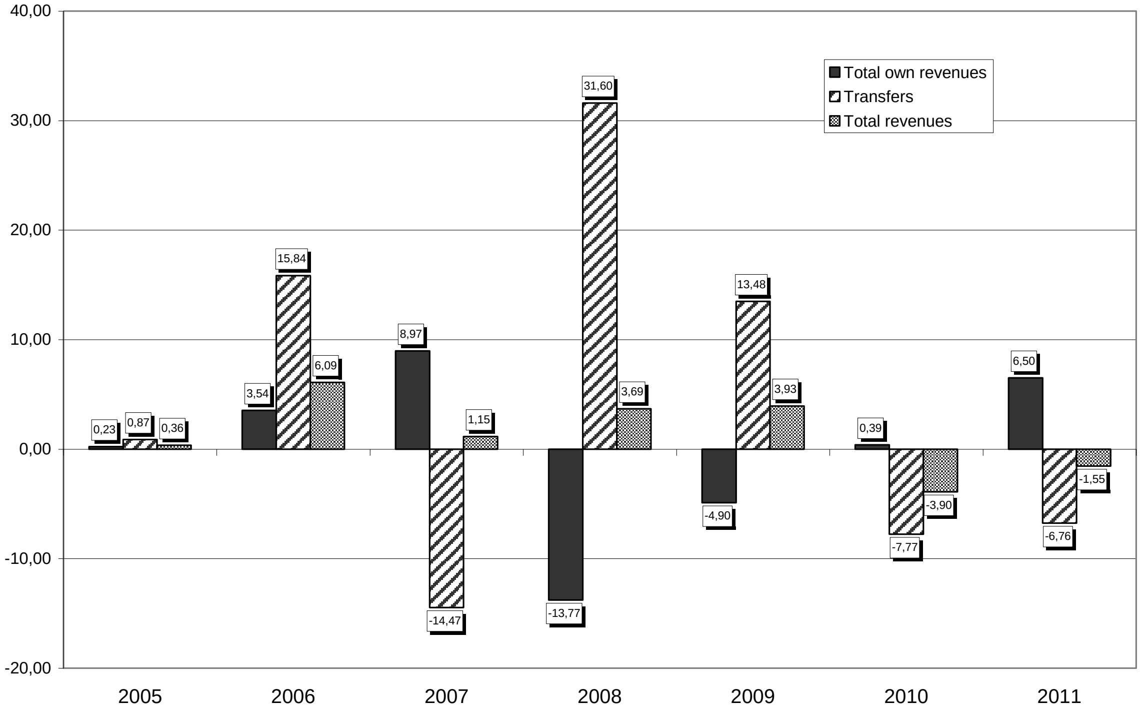


Source: Central Statistical Office. Local administrations cover all sub-national governments (including Health Authorities, other local governments and associations of municipalities). Values at constant prices 2005.

iii. in the central administration, only Social Security Fund expenditures[XIV] have maintained a positive rate of growth whilst the central administration *stricto sensu* displayed a significant reduction, inferior however to the ones evidenced by regions, provinces and communes.

However, it must be taken into account that the most stringent limitations on the fiscal autonomy of sub-central governments derive from the already mentioned Domestic Stability Pact (DSP). Actually, the most striking effect of the reduction of transfers joined to the limitations of the DSP has been the strong reduction of local administrations' final investments, more or less evenly distributed across the country. That had a significant impact upon the performance of the whole economy because sub-national governments, in particular the communes, are the most important public investors in Italy, like in other EU countries. In particular, they could have been able to finance "shovel ready" projects, capable of immediate execution, for urban maintenance. The decline of final investments from 2004 onwards is striking (Fig. 8): the reduction in final public investments by local administrations is equal to about 30 percent, due mainly to the reduction of municipalities' investments (-29,7 percent), against a mere reduction of 2,8 percent for central administrations. It must be remarked that the decline of investments is not due to sub-national governments' lack of cash resources, but mostly due to cash payments' limits introduced by the DSP.

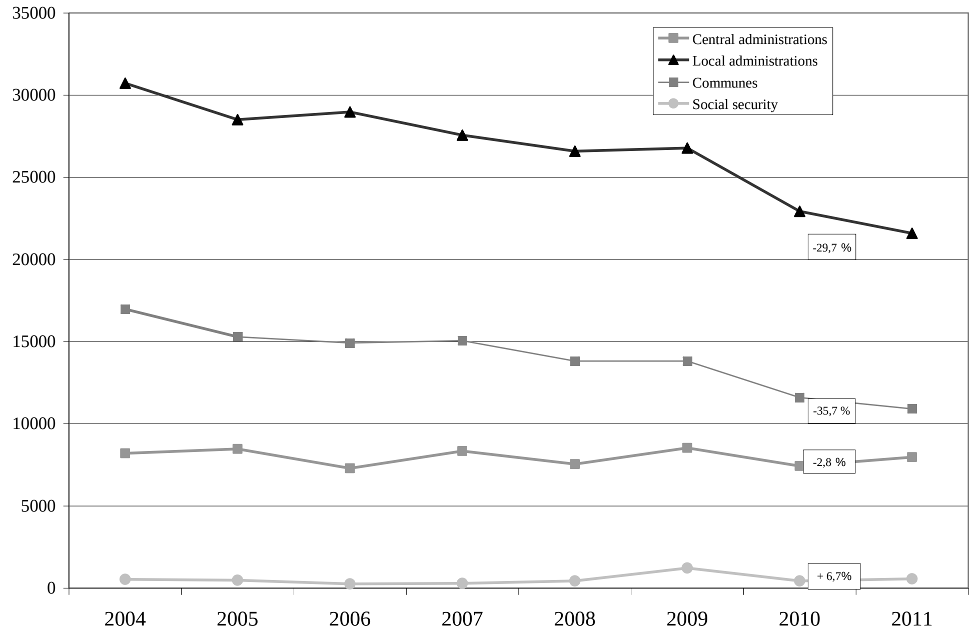
Figure 7. Revenue patterns of Municipalities in Italy 2005-2011 (yearly variations in percentage)



Source: Central Statistical Office.

Focusing on municipalities, apparently, it seems that in 2008-2009 there has been a shortfall in revenues compensated by transfers, as it so often happens in situations of economic crisis (Fig. 7). Actually, the shortfall was largely determined by the decision of the central government to abolish (against the opinion of most public finance experts in Italy) the property tax on owned and inhabited houses. Moreover, we can see how central government drastically reduced state transfers for communes (like also for the other levels of government) from 2011 onwards: -7,7 % in 2010 and -6,76% in 2011.

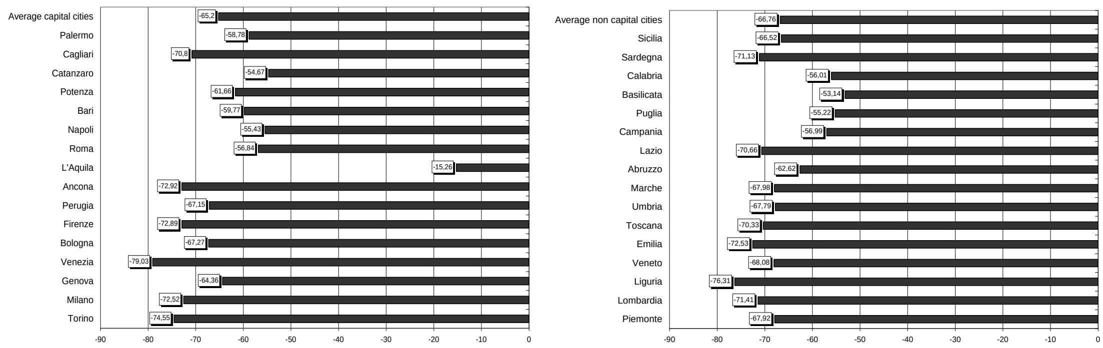
Figure 8. trend in final public investments by administration



Source: own elaborations with data from Istat. Rate of increase/decrease in real terms at constant prices 2005 inside the boxes.

As for communes, it is equally interesting to present some evidence about the variability in fiscal performance among different categories of municipalities according to their size. Historically, in Italy, the widespread network of medium-sized and large cities has performed a crucial role in driving the country's economic development. However, in our country there has never been an explicit national urban policy capable of coordinating and supporting the policies of the most important cities in order to support and valorise their economic and urban specialization. This is a critical issue because countries which have not adequately invested in cities are generally performing worse in a crisis. As a matter of fact, cities are on the front line when it comes to face the consequences of the crisis, especially with regard to employment and social problems. In this respect it also appears that cities are facing challenges similar to the ones they confronted during the mass industrial restructuring which took place twenty or thirty years ago, and that they can draw positively on their past experience. In Italy we lack a recognized definition of urban areas, but we can give some evidence about the financial patterns of Italian medium-sized and large cities through looking at the regional capitals.

Figure 9. Decline of average per capita transfers to municipalities by regions
(a) Regional capitals (b) Other regional cities



Source: own calculations on data from Istat. Note: regional capitals on the left side (a) correspond to regions on the right side (b). value for L'Aquila due to special state transfers for the earthquake of 2008. Even Rome had a special regime.

We should expect that central government supported the biggest cities more in order to meet their greater needs. However, comparing (in Fig. 9) the pattern of central government grants between the two groups (regional capital cities and other municipalities), this pattern is quite similar and the reduction appears to be more or less the same (-65,2% vs. -66,76%). We may reckon that the state's transfer policy has been tied to the historical expenditure approach, namely that it applied a mere linear reduction across all municipalities.

In conclusion, three aspects can be highlighted:

1) sub-national finance had a pro-cyclical impact in 2010-2011 (and also in 2012, according to still provisional data). In other words, the fiscal consolidation policy produced decreasing expenditures and/or the raising of taxes and other sources of autonomous revenue (fees etc.) to balance their budget – measures that were unable to make up for the decline in central government transfers[XV];

2) there has been an uneven distribution of cutbacks among the different sub-national governments, economic items of expenditures (e.g. pay freezes on local public employment, but no cuts in employment only a blockage of turnover, a huge decline of final investments) and expenditure functions (e.g. "urban maintenance", culture, etc.); more detailed evidence can be found in Dexia (2011);

3) moreover, it is likely that we have seen an uneven and inefficient distribution of cutbacks between urban and non-urban governments and different areas of the country

whose effects in terms of efficiency and equity are difficult to assess using the available evidence.

The final effect has been a significant shift in the weight of sub-national governments in the Italian economy, preventing them from performing a positive (anti-cyclical) role during the most acute phase of the current economic crisis. Moreover, the downside of this fiscal consolidation policy is that it relies on across-the-board cuts, which are difficult to sustain and do not address the roots of public expenditure inefficiency.

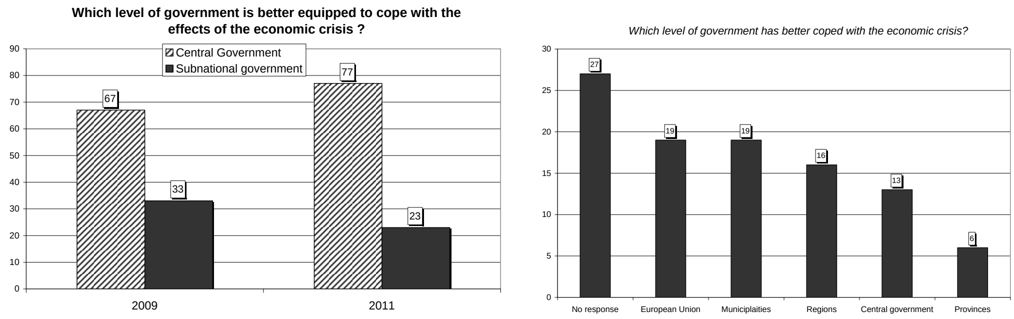
According to various sources, it turns out that sub-national governments, in particular municipalities, have addressed – at least until the beginning of 2012 – this situation of crisis using various alleviation strategies for their citizens and businesses, not mutually exclusive and often successful. Among others we can mention the following:

- reductions of user charges in social services (canteens, kindergartens, etc.);
- promotion of minor public works and maintenance of infrastructure, when allowed by the internal stability pact;
- various special welfare benefits to families in need;
- reductions of the local surcharge on the income tax for low-income categories;
- vouchers for temporary work for the unemployed;
- facilitating the relationship between companies and local banks to overtake "credit crunch" restrictions; and
- various forms of aid to come to the rescue of companies suffering from the crisis.

Conversely, it is also interesting to assess citizens' attitudes toward the crisis and about the role that local governments should perform to cope with it. Some recent surveys offer results that must be taken into consideration (Cittalia, 2011).

On one side, there is a vast awareness of the major role of central government in dealing with the crisis, significantly growing from 2009 to 2011. This seems to be a confirmation of Musgrave's principles for allocating functions among levels of governments, which imply that stabilization policies are the responsibility of the center. However, there is a better assessment of the role played by municipalities and regions (together with the EU) in responding to the crisis which is more positively rated than the State (Fig. 10).

Figure 10. Citizens' attitudes toward the crisis

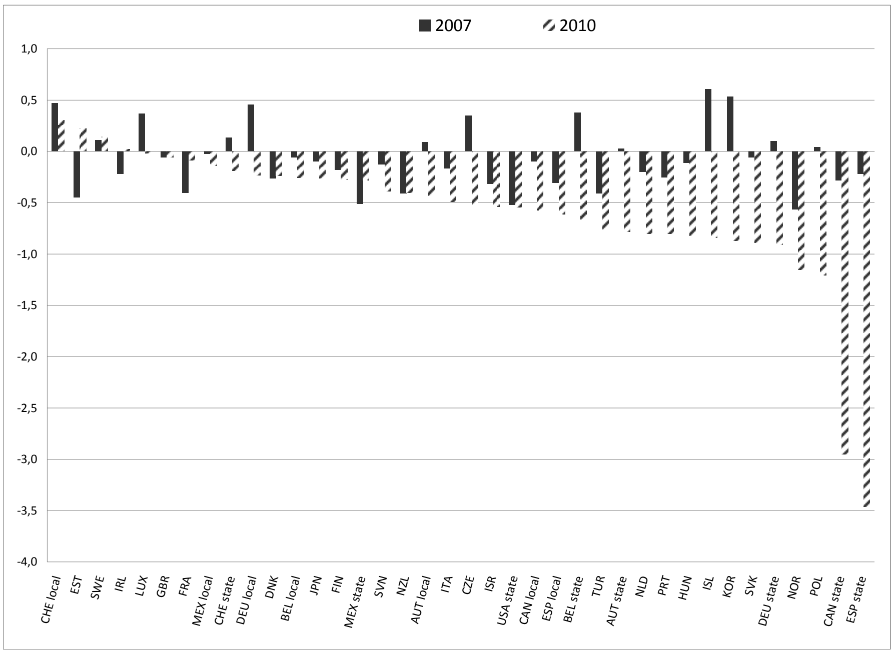


Source: Cittalia, November 2011

3.2 Recent trends in other countries

Since the worsening of the financial and economic crisis, national fiscal consolidation policies in Europe have required sub-national governments to contribute to their targets since they account, on average, for 13% of public debt and 13% of public deficits, and are responsible for 30% of public spending.

Figure 11. Evolution of sub-national government budget balances as a share of GDP 2007-10



Source, OECD, 2012. For federal states data are broken down by states and local governments.

After supporting sub-national governments during the crisis in 2008-09, central governments are now cutting transfers to lower levels of government. This has been done directly, by reducing discretionary transfers (see examples in table 1), or indirectly, due to falling central government revenues of which sub-national taxes represent a share or based on which the transfer formulas are calculated. As a result, in most countries sub-national deficits (Fig.11) and debt rose between 2007 and 2010, often going beyond what is permitted by self-imposed or central government imposed fiscal rules.

In general, however, the financial situation of these governments is still healthier than that of the central government. Therefore, some countries are exploring the possibility to increase sub-national government tax autonomy, to encourage them to expand into other types of revenue (such as fees and the sale of assets), and to increase the effectiveness of local public spending.

Table 1. Examples of discretionary reductions in transfers in Europe

		2009		2010		2011		2012	2013	2014
Estonia (million EUR)		-84,11		2,34		9,59		0	0	0
Finland		7,50%		6,80%	The central government has announced that it will reduce the grants by EUR 631 million during the government term (2011-15).					
France			Freeze of the value of the transfers at 2010 level.		Freeze of the value of the transfers at 2010 level.		Freeze of the value of the transfers at 2010 level.			
Greece (million EUR)					(total amount)	3,6	(variation from the previous year)	98	-344	178
Hungary (in nominal currency)		113,3		-49,1		-110,7	Fiscal planning in progress.			
(as % of SNG revenues)	*(-3.6%)*		*(-1.5%)*		*(-3.5%)*					
Italy, ordinary regions (million EUR)					-4 000		-4 500			
Italy, provinces (million EUR)						-300		-500		
Italy, municipalities (>5 000 inhabitants) (million EUR)					-1 500		-2 500			
Ireland		-15%		-18%						
(as % of SNG revenues)	*(+3%)*		*(+4%)*							
Portugal (million EUR)		-22		51		-146		-178		
(as % of SNG revenues)	*(-0.2%)*			*-0,50%*	*(-1.4%)*		*(-1.7%)*			
Sweden (billion SEK)				17		-9		-3		
United Kingdom (English Local Authorities) (million GBP)	+3 020		+2 659		-2 259		-1 150	-1 783		-633

Source: OECD Fiscal Network questionnaire, in OECD, 2013.

Sub-national governments have reacted in different ways to this new context of fiscal consolidation. Some of them protect politically sensible items of expenditures (e.g. social services or unemployment benefits), others reduce staff costs and/or intermediate consumption, while most of them scale back on investments (Tab. 2). Direct investments in 2010 – the last year for which data are available – plunged by 7,6 per cent on average in the EU27.

For the future we can forecast a further decline, taking into account the stricter European rules introduced with the Fiscal Compact and the new budget balance rules which, if applied strictly, will reduce the borrowing capacity of sub-national governments to finance investments. This new fiscal framework does not bode well for the future of the European economy because it will worsen the European recession. Only a well designed turnaround in EU economic policy could reverse this trend.

Table 2. Changes in sub-national revenues and expenditures in EU27 countries 2009-2010

	%		%
Taxes	-1,5	Personnel	0,7
Grants	-1	Intermediate consumption	1,4
User charges	2,3	Social expenditures	3,5
Sale of assets	-2,6	Direct investments	-7,6
Total revenues	-0,8	Financial charges	-0,7
GDP	1,8	Total expenditures	-0,01

Source: Dexia, 2011.

4. Challenges and risks for the decentralization process in Italy

The need to balance austerity with more stimulatory policies is now a global one. Yet we can expect fiscal consolidation to remain a prominent feature of economic policy in Italy. Fiscal consolidation is likely to be particularly contractionary when many countries consolidate simultaneously—two conditions relevant to Italy's current environment. This likely scenario makes subnational governments face a serious challenge that, in a nutshell, could be synthesized in the following question: can a national fiscal consolidation policy in the midst of profound institutional change aiming for greater fiscal decentralization create some sort of backlash effect which will drive the country toward recentralization? Against this background, the answer is likely to be affirmative. The economic and financial crisis in Italy between 2011 and 2012 has contributed to put the reform agenda to a standstill, notwithstanding the great expectations from which it had originated and despite the fact that the same conditions have led most other countries to plan and carry out structural reforms of the fiscal relations between levels of government in order to seek efficiency gains in the provision of local service without giving up on equitable distribution. Therefore, the risk of a profound slowdown in the implementation of law n. 42 is looming, and the issue of decentralization and fiscal federalism has nearly disappeared from the political debate in view of the 2013 national elections.

However, the international debate (CoE, 2010) even suggests a positive view of the effects of the economic slowdown on local governments trying to see the crisis not only like a threat, but also as an opportunity (even if it is now hard to sell this catchword to administrators and officers facing hard budget constraints…). Several countries besides Italy – e.g. France, Belgium, the Czech and the Slovak Republic, the United Kingdom, Finland, Greece, and Ireland – have embarked on structural reforms of intergovernmental financial relations and a territorial organization in order to improve their performance and accountability enhancing efficiency. These reforms aim at reshaping intergovernmental relations without giving up on the well-known advantages of decentralization. In this sense, it is undeniable that the acknowledged huge variability in the performance of local governments suggests potential efficiency gains. However, even in the absence of reforms, autonomous responses of sub-national governments might be directed toward effective objectives. Possible policy options, experimented with across the world, can be listed here for a mere illustrative purpose:

- a new strategy of territorial reorganization aimed at capturing scale and functional economies. So far, the extremely large number of very small municipalities has made economies of scale in the implementation of policies hard to realise, and measures to overcome this have at best been only partially successful. In theory, their opposition should be weaker than in times of prosperity in light of the expected financial savings that could overcome their budget squeeze;
- innovation in products and processes and diffusion of best practices among sub-national governments, also through incentives provided by higher levels of government (Dunleavy et al., 2011);
- the sale of underutilized assets; often sub-central governments own a huge amount of assets without being able to valorize them, despite their responsibilities in urban planning;
- more effective multilevel governance: competence is often shared between levels of government, obscuring accountability. According to many scholars, for instance, the Italian constitutional reform requires a revision and clarification of the degree of

prerogatives assigned to the different governments. Reorganising the system to avoid overlapping responsibilities and improving transparency and accountability in local government finance might therefore increase public administration effectiveness;

- improving the performance of local public services and investments; more accountability can be obtained by placing local officials' performance under closer public scrutiny through means such as external auditors, representative local assemblies, public interest bodies and civil society; and
- a more effective relationship (PPP) between the public and for-profit and non-profit private actors (i.e. greater cooperation with civil society) in order to maintain an adequate level of services despite the reduction in resources.

Therefore, in general, despite the hardness of the past three years (2010-2012) a silver lining can emerge from the recession as well. Local administrators are forced to take a hard look at their currently performed activities and make decisions about what really matters (ICMA, 2011). The austerity and fiscal restraint have required them to alter bad habits, removing waste and promoting social innovation, thus putting them "on the top of their toes" to respect their fiscal boundaries. In fact, even in Italy a lot of local governments' best practices have emerged across the country (OECD, 2011, pp.149-153).

On the other hand, it is undeniable that we have assisted to numerous cases of wrongdoing among Italian sub-national governments and consequent bailouts. Regions and municipalities have often recurred to various form of creative bookkeeping, hiding operating deficits and mitigating current cash flow problems. However, the answer cannot lie with "recentralization" policies, which in the past have not secured an effective control of local public finances either, but with a renewed commitment to decentralization. Therefore, in this context, the main question refers to what policy reforms must be prioritized to make fiscal decentralization compatible with fiscal discipline. We can offer two general indications.

First of all, the achievement of fiscal discipline can be facilitated through formal arrangements, such as strengthening the role of the existing Intergovernmental Committees (Conferences) linking central and local governments. In fact, inducing lower levels of government to greater responsibility for fiscal outcomes implies that sub-national governments have to be deeply involved in the devolution process. The Conferences have advisory functions and also 'co-manage' policies, in the sense that they should help, through agreements, to elaborate activities to steer and coordinate numerous sectors of the State, in particular the fiscal consolidation policy in order to respect EU rules such as the "six pack" and the "fiscal compact". To date, however, central government has imposed decisions regarding fiscal rules (domestic stability pact) without the adequate participation of sub-national governments. The new Intergovernmental committee for coordinating public finance, which should manage, in a cooperative way, the most relevant financial decisions, is not yet operational and should be put in place immediately after the 2013 elections. In the medium term this system should be consolidated through a constitutional review aimed at its transformation into a federal arrangement, which should also envisage the representation of regions through a new senate.

Secondly, further effective policy options can be found in new mechanisms of control and incentives, in addition to stricter accounting procedures, to improve fiscal performance. For instance, one of the legislative implementing decrees[XVI] in Italy introduces new tight reporting rules for all sub-central governments, in particular before elections. More precisely, the budgets of the sub-national governments must be audited by externals auditors and published on their websites. If the results are not consistent with the fiscal rules (Framework law on local governments, Italian Internal Stability Pact, stability laws, accounting rules), heavy sanctions may be imposed on the political officers, such as the automatic disqualification from office and a ten-year ban from taking part in elections and holding office. Moreover, these rules improve the possibility for the people to express their "voice" through the political process. However, and inexplicably, they have not yet been implemented.

In conclusion, addressing the fiscal challenges in Italy will not require more centralization – under the pretext of the crisis – but better decentralization, finalising the process underway since 2009.

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[I] However, to date no region has been entitled to perform new functions.

[II] An updated description of Law n.42/09 implementation can be found in the last report of the Bicameral commission for fiscal federalism; see Commissione parlamentare per l'attuazione del federalismo fiscale, 2013.

[III] The rate could originally be set from 4 to 7 per thousand. The new rates may range between 7,6 per thousand (4 per thousand for self-owned occupied houses) +/- 3 per thousand.

[IV] In particular, d.lgs. n. 216/2010 and n. 23/2011 for Communes and d.lgs. n.68/2011 for Regions and Provinces.

[V] It must be noted that the stability law approved at the end of 2012 partially corrected this anomaly.
[VI] "HFI might be interpreted as the VFI that is, so to speak, 'left over' when the VFI problem of revenue-expenditure imbalance is solved for the richest sub-national government" (Bird, Tarasov, 2004, p.81)
[VII] For instance personal income tax shared revenues were classified as own tax revenues and not grants in the municipalities' budgets even though they were not determined on a territorial basis.
[VIII] Namely d. lgs. n.216 /2010 and d. lgs. n.68/2011.
[IX] The "fundamental functions" should be precisely defined by a new framework law on local autonomies which is still pending in Parliament.
[X] In particular, d.lgs. n. 23/2011 for municipalities and n. 68/2011 for regions and provinces.
[XI] For province and communes it should be partially implemented as of 2013, while for regions it is already in place for health services, but neither designed nor experimented for the others.
[XII] For instance, Italy could follow the example of many countries in the developed and underdeveloped wolrd which have embarked on an ambitious decentralization process, introducing a contingency fund subject to clear and transparent rules to address unforeseeable situations.
[XIII] The relation between the two indicators can be interpolated with a straight line with a good fitting (R^2 = 0,55).
[XIV] Social security in Italy is performed by autonomous Funds managed at central level.
[XV] According to the OECD, sub-national governments had already performed a pro-cyclical role from 1980 to 2008 in Italy; see Blöchliger et al. (2010).
[XVI] We refer to d. lgs. N. 149/2011.

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