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Filling Fiscal Gaps in Italy: a Challenging Task for the Federal Reform

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1. The Ongoing Fiscal Federalism Reform: an Update

The enactment in May 2009 of the framework law providing for the reform of the system by which Italy's Regions and Municipalities are funded (Law 42/2009) marks a step forward towards the decentralization of public finances in Italy. However, the law only offers a number of very loose guidelines concerning future government decrees to be adopted over the subsequent two-year period, while providing for a further five-year transitional phase leading to full implementation of the reforms. Thus we are only at the very beginning of a lengthy, difficult reform made more difficult by substantially different points of departure of Italy's different regions, by the limited availability of resources, by technical difficulties and by considerable differences in the political stances of those involved in the implementation of reform.

Up until now (November 2010) only one decree has actually been enacted, and this only relates to a minor issue, namely the devolution to Italy's Regions and Municipalities of Central Government's real estate. Detailed plans for the main building blocks of the reform – tax assignment and the equalizing system for Regions and Municipalities – are yet to be finalised. Moreover, the government has still not provided any official estimates or simulations of the impact of the new financing arrangements on the level and the assignment of resources to local jurisdictions, or any general framework with which to evaluate how the various different aspects of the reform are actually to be coordinated.

2. The Current Scenario

In order to grasp the difficulties involved in implementing fiscal federalism in Italy, one really needs to analyse the current distribution of own taxes, charges and expenditure across the country. Such an analysis shows that the aggregate (national) financial gap (current expenditure minus own taxes and charges) for Italy's Regions in 2008 was 1,268 euro per capita, while the corresponding municipal financial gap was 266 euro per capita, 48% and 31% of current expenditure, respectively.

These gaps, which are characteristic of all federal nations, derive from territorial differences in expenditure and revenue. In fact, the main taxes currently assigned to sub-national governments vary substantially (in per capita terms) from one area of the country to another, reflecting significant inter-regional economic disparities. Per capita expenditure, on the other hand, appears to be more uniformly distributed across the country. Figures 1 and 2 give a region-per-region picture of the differences between tax and expenditure distribution, for Regional and Municipal Governments respectively. If we look at the Regions (Fig. 1) we observe that per capita own taxes and charges range from 1,406 euro per capita in the North (Liguria, Emilia Romagna, Lombardia, Toscana, Piemonte and Veneto) to 616 euro per capita in the South (Molise, Campania, Calabria, Puglia and Basilicata); as regards current expenditure, average expenditure in the Northern Regions (2,235 euro per capita) is almost the same as that in the South (2,408 euro per capita). As a result, Italy's northern Regions raise 114% more resources per capita than its southern Regions, whereas both spend roughly the same amount per capita.

Regional differences in the case of Italy's Municipalities are a little less striking, although there are larger territorial differences in terms of own resources than in terms of expenditure. It should be pointed out that the current expenditure of northern Municipalities is 887 euro per capita, while that of the southern Municipalities is 771 euro per capita; on the other hand, the former collect 627 euro per capita of own taxes and charges, while the latter only collect 446 euro per capita. Hence, Municipalities in the North raise 40% more per capita revenue than those in the South, while spending only 15% more.

However the relative uniformity in regional and municipal per-capita expenditure among territories actually conceals substantial differences in the quantity and quality of the services provided at the decentralized level. The statistics available show that the South lags some way behind the rest of the country (Franco [2010]). A recent study (Pamolli and Salerno [2010]) estimating the efficient "frontier" of Regional health spending paints a picture of a country split in two, with the northern-central Regions boasting much higher levels of efficiency and quality of expenditure than their southern counterparts.

For an overview, see Pola (2009).
3. Open Issues

Given the stark differences in fiscal gaps across the country, it is clear that the debate over implementation of fiscal federalism is largely dominated by equalizing concerns. Richer Regions complain of the inefficiency of poorer Regions in using the strong interregional flows they receive, whereas the poorer Regions complain about the inability of inadequate public resources to fully finance national standards of decentralized expenditures, given these Regions’ limited fiscal capacity.

This explains why the key issue of the ongoing reform is the design of expenditure needs equalization. The reform provides for a system of equalizing transfers for most of the Regions and Municipalities’ expenditure programs (about 80% of their current expenditures): equalizing transfers from Central government...
should fully fill the gap in each area between (centrally determined) national standards and local fiscal capacity (own taxes and charges). One merit of the reform is its pegging of equalization grants to standardized expenditure, thus overcoming the arbitrary criteria by which Central government’s equalization funds are currently apportioned locally.

Central and sub-national governments are currently hotly debating about the question of the level of the aforesaid national standard and, above all, the method of assessing expenditure needs for spending responsibilities assigned to Regions and Municipalities. Generally speaking, sub-national levels of government argue that standard expenditure should be viewed as the amount of resources required in order to provide a standardized basket of decentralized services valued according to efficiency costs (the bottom-up approach). This approach does not guarantee that the expenditure needs calculated in this manner are going to be covered by the share of the national budget assigned to funding local public services. Conversely, Central government is in favour of a different approach that reflects overall public budget priorities and external constraints. This top-down approach firstly establishes an aggregate level of affordable local resources (similarly to what currently happens in the health-care sector, the main public sector currently assigned regional government), and then apportions this overall amount to sub-national governments, according to the main drivers of local needs (population size and composition by age, land area, population density, economic development, etc.). The advantage of this approach is the control it affords over public spending; the drawback is a possible gap between population needs and financial resources for local expenditure.

These two different visions of expenditure needs – on the one hand the guarantee of a standard level of public services (in qualitative-quantitative terms) throughout the country, and on the other hand the definition of a “financial” rule by which to apportion an exogenously determined equalization fund on the basis of variable territorial needs and costs – are both clearly present in the current fiscal federalism reform. The key issue of any future implementation of fiscal federalism in Italy is how these two dimensions are to be interrelated in order to maintain national standards requiring such high levels of expenditure that these standards become inoperable, on the one hand, and in order that Central government, in setting the size of equalizing funds for sub-national governments, does not unduly weaken the scope of interregional equalization, on the other. The interrelation of the two could be achieved, for example, by:

- improving Central government’s budget-setting process with the addition of information regarding the effects that financial decisions can have on local public service provision;
- further encouraging those sub-national governments that currently provide poor local services, in quantitative and qualitative terms, to improve their performance by conditioning the payout of equalizing transfers on actual progress toward national standards;
- enforcing a system of penalties not only against those local authorities that depart from fiscal requirements and standards (such as raising local taxes), but also against those that perform poorly when it comes to delivering public services, compared with similar units (by systematically monitoring outputs and outcomes, by supporting horizontal or vertical cooperation among governments in order to promote best practices, by subjecting local authorities to the supervision and control of a special commissioner, and by preventing ineffective local politicians from standing for further office).

However, the equalization of expenditure needs makes sense if transfers are directed towards territories endowed with appropriate infrastructures. In Italy, the distribution of infrastructures (transportation infrastructures and networks, schools, waterworks, information technology, nursery and long-term care facilities, etc.) varies enormously from one area to another, especially between the North and the South. Bridging this interregional infrastructural divide is one of the aims of the reform: a system of conditional equalizing transfers is being introduced in order to reduce, for each Region and Municipality, the gap between current infrastructure endowments and standard infrastructure expenditure needs. However, while the reduction in the interregional infrastructural divide is only a long-term goal, in the short-term there is the problem of how to coordinate local infrastructural endowments with the equalizing mechanism regarding current expenditure. Differences in the facilities currently available to local authorities clearly affect local provision of public services, which gives rise to differing costs. If, when calculating standard expenditure needs and monitoring actual performance, no account is taken of these differences in infrastructural endowments, then there will be a serious danger of creating an unrealistic, unfeasible mechanism.

Lastly, the functioning of the equalizing mechanism is further complicated by the greater powers over the coordination of municipal finance entrusted to regional government by fiscal federalism. At present, central government grants go directly to both regional and local authorities, with only limited grants flowing to local authorities from their respective regional governments. The new reform partially modifies this institutional setting by introducing a “cascade” equalizing mechanism: financial resources are transferred from central government to Italy’s Regions, and then from the Regions to the Municipalities. So each Region receives equalizing transfers based on the total gap between municipal expenditure needs and Municipalities’ own resources.

2 For an evaluation of the possible effects of fiscal decentralization on the degree of interregional income redistribution accomplished by the Italian National Health Service, see Ferrario and Zanardi (2010).

3 For example, a detailed discussion of territorial differences with regard to health infrastructures can be found in CERM (2010).
evaluated at the regional level. Each Region may agree with its own municipalities to apportion these funds to local authorities according to different criteria (such as the evaluation of local expenditure needs and local fiscal capacity) from those established by central government. However, this framework, whilst creating a certain scope for interregional differentiation in municipal equalization, is at present riddled with uncertainty. Will this new mechanism actually work? Will Regions succeed in overcoming the traditional hostility of Municipalities against Regions? Which collective decisional rule adopted at the regional level could facilitate the redistributive solution as opposed to the one established by central government?

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* Some preliminary results about the potential conflict between municipal fiscal needs estimates (at regional level) and actual expenditure are in Rizzo, Ferraresi, Mastrorocco (2010).