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Intergovernmental Fiscal Relations in Italy: Recent Developments

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“While central governments usually seem to push down part of fiscal adjustment efforts to the sub-national level («passing the bulk» by requesting adjustments in excess of lower layers revenue capacity or expenditures responsibilities), the jury is still out on whether they have done this in an even or uneven fashion in recent years”

(from Ahrend, Curto-Grau, Vammalle, *Passing the bulk? Central and sub-national governments on times of fiscal stress*, OECD Regional Development Working Papers 2013/05)

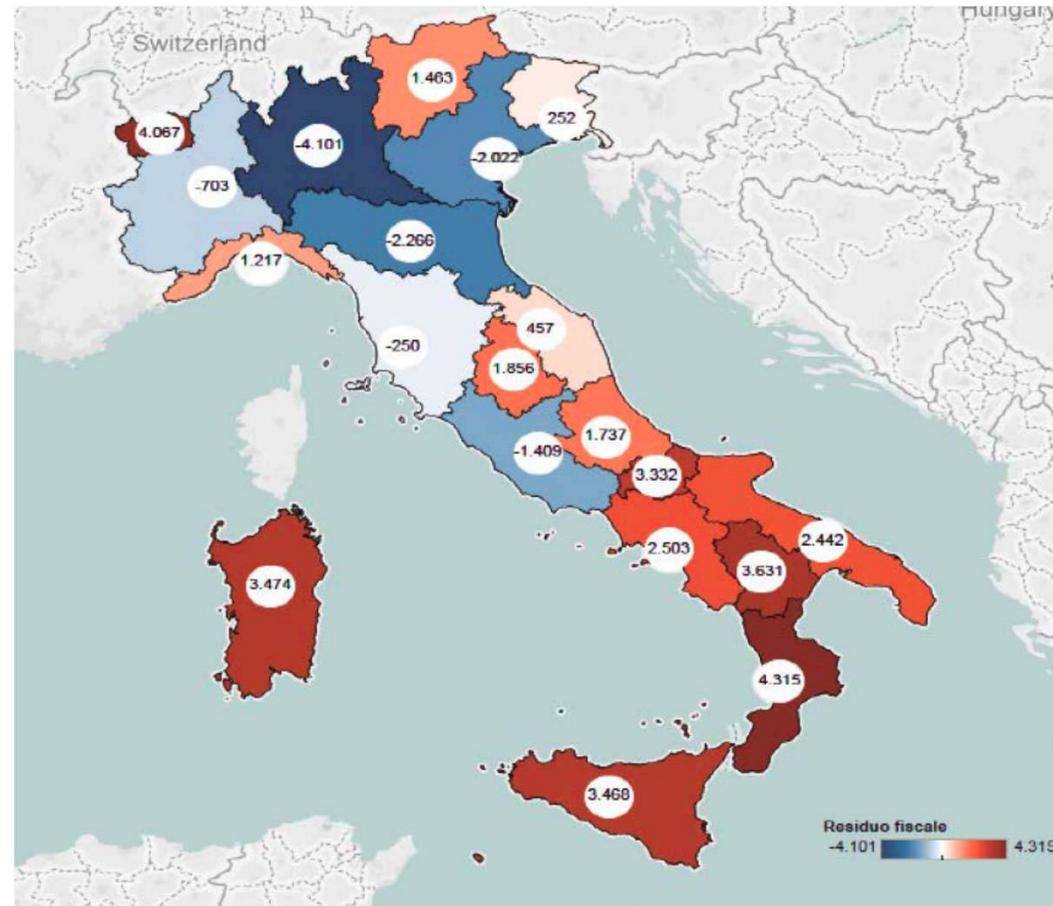
- Has the «passing the bulk» of the consolidation burden characterized also fiscal adjustment strategies in Italy?
- How the fiscal adjustments followed the 2008 economic crisis affected the system of inter-governmental fiscal relations in Italy?

Italy: key features

- Five layers of government: State, Regions, Provinces, Municipalities and Metropolitan Authorities
- 15 Ordinary Regions, 5 Special Regions, 102 ordinary Provinces (that are going to be abolished) and more than 8,000 Municipalities ranging in size from a small village to a large town
- Stark economic, structural, institutional differences across territories. Strong interregional variability in the provision of public services
- Strong interregional redistribution carried out by the public budget (expenditures and taxation) => decentralization dominated by redistributive concerns
- In the '90s a significant process of fiscal decentralisation assigned new taxing powers and spending responsibilities to Regions and Municipalities
- In 2001 a major Constitutional reform was adopted to consolidate the decentralization process

Strong interregional redistribution by public budget

Per-capita fiscal balances (exp-rev) (euro average values 1996-2013)



The 2009 reform of “fiscal federalism”: main principles

Three main building blocks :

Efficiency in the provision of public service and accountability of local authorities

- More certainty and transparency in fiscal resources assignment to SNGs: discretionary grants from CG substituted by own taxes, surcharges and shared taxes assigned to Regions and Municipalities
- Resources assignment across jurisdictions based on well-founded criteria: evaluation of standard indicators of expenditure needs and standard fiscal capacity for each local jurisdictions
- No bail-out commitment by CG
- Reform of the financial accounts system of local governments and public health sector (integrated accounts system, a program-based budget classification)

The 2009 reform of “fiscal federalism”: main principles

Taxing autonomy

- Large taxing powers to SNGs to set local tax rates above/under standard tax rates

Equalization

- Equalization transfers system to fill the gap between standard expenditure needs indicators and standard tax capacity for main municipal services
- No equalization of differences in local tax yields resulting from autonomous fiscal efforts above standard tax rates

The expected result was a further increase of expenditure and revenue decentralization after the wave of the '90s.

Economic crisis and fiscal federalism

Since 2009 the Italian CG had been embarked on a challenging program of fiscal consolidation which hugely affected SNGs finances

SNGs were involved in reaching general government fiscal targets through reduction in CG transfers, new fiscal rules, borrowing and expenditures limits

These restrictions have put the implementation of fiscal federalism reform to a substantial standstill

Fiscal adjustment measures (1)

CG has deployed a full array of (frequently revised) fiscal measures to assure SNGs participation to national fiscal consolidation efforts:

- reduction of CG transfers to SNGs (or tax revenue sharing)
- tightening budget deficit targets (municipalities) or expenditure limits (regions) imposed by the so-called Internal Stability Pact (ISP) - with no change in the total resources assigned to SNGs
- heavy sanctions in the case of fiscal rules breaking
- SNGs borrowing allowed only to finance public investment
- ceilings to SNGs debt service annuities (as a share of current revenues)
- caps on specific categories of expenditure (local employment)

Fiscal adjustment measures (2)

- greater autonomy allowed to SNGs in setting the rates of own taxes – above the standard level – in order to compensate stricter deficit requirements
- interference of CG on taxes allocated to SNGs (increase of rates/broadening of bases) and assignment of resulting tax yields to CG
- incentives to SNGs to fight tax evasion (even on CG taxes)
- efforts to harmonize accounting rules across levels of government
- obligation for SNGs to deposit their cash balances in a specific account (*Tesoreria Unica* regime) where interests are paid back to the CG

Cumulative effects of fiscal adjustment measures (billions of euros, 2008-14)

	2008	2009	2010	2011	2012	2013	2014
Central government	1.0	11.1	12.1	31.5	67.5	78.3	77.1
Subnational governments	-0.7	-1.2	5.3	15.4	32.8	33.0	45.0
Social Security	0.0	0.0	-0.3	-1.0	5.2	11.5	13.3
Total	0.3	9.9	17.2	45.9	105.4	122.8	135.5
<i>of which:</i>							
expenditures	-1.6	4.1	10.7	33.7	54.0	67.3	73.7
revenues	1.9	5.8	6.5	12.2	51.4	55.5	61.8

- The cumulative effects of consolidation measures adopted during the crisis has been above 135 billions of euros (8% GDP) particularly concentrated between 2011 and 2012
- Massive involvement of SNGs in consolidations plans: more than 33% of total fiscal adjustment from 2008

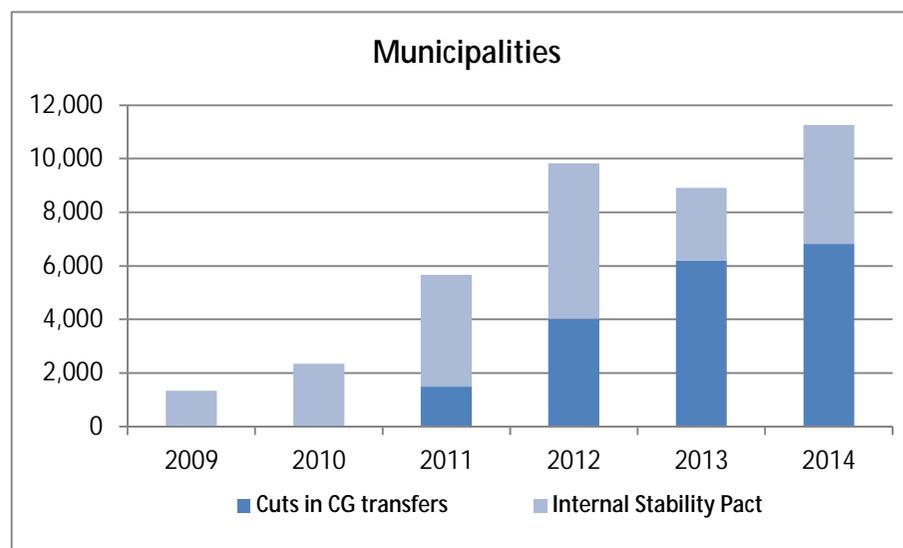
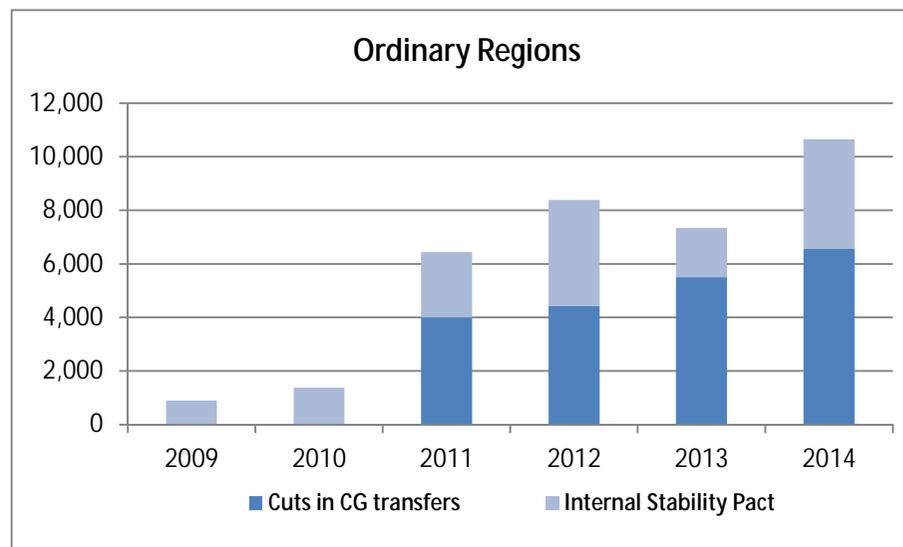
Composition of fiscal adjustment measures for SNGs (%, 2009-14)

	2009	2010	2011	2012	2013	2014
Ordinary Regions	100.0	100.0	100.0	100.0	100.0	100.0
Cuts in CG transfers	0.0	0.0	62.1	53.0	74.9	61.6
Internal Stability Pact	100.0	100.0	37.9	47.0	25.1	38.4
Special Regions	100.0	100.0	100.0	100.0	100.0	100.0
Cuts in CG transfers	0.0	0.0	0.0	4.7	19.8	27.2
Internal Stability Pact	100.0	100.0	100.0	95.3	80.2	72.8
Municipalities	100.0	100.0	100.0	100.0	100.0	100.0
Cuts in CG transfers	0.0	0.0	26.5	41.0	69.6	60.6
Internal Stability Pact	100.0	100.0	73.5	59.0	30.4	39.4
Provinces	100.0	100.0	100.0	100.0	100.0	100.0
Cuts in CG transfers	0.0	0.0	23.4	33.9	75.6	62.4
Internal Stability Pact	100.0	100.0	76.6	66.1	24.4	37.6

Over the years:

- increasing role of cuts in CG transfers
- progressive slackening of the budget deficit targets imposed by ISP
- across-the-board cuts which are difficult to sustain and do not address the roots of public expenditure inefficiency

Composition of fiscal consolidation measures for SNGs (millions of euro, 2009-14)

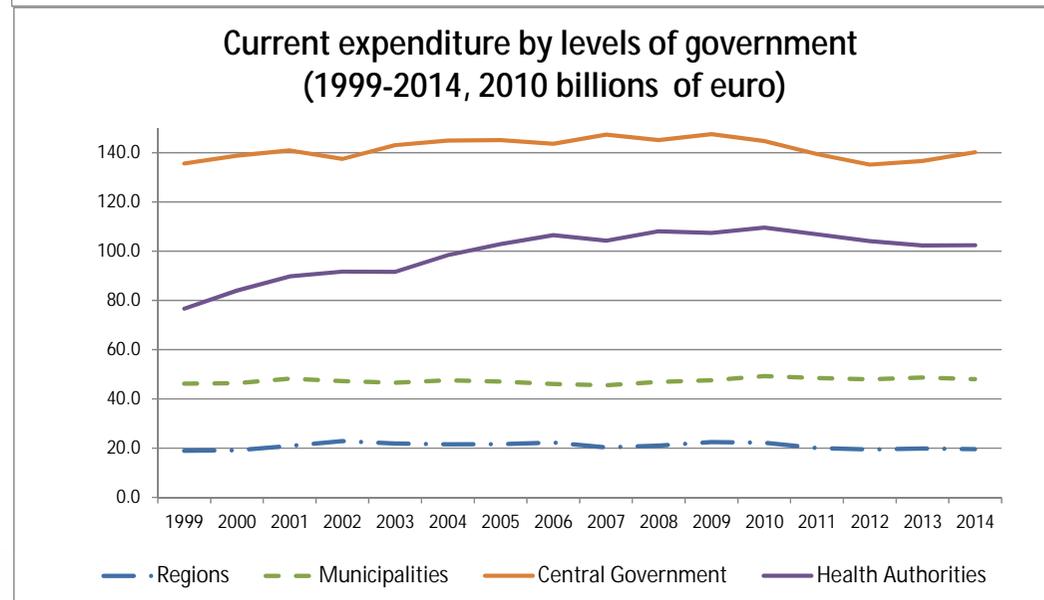
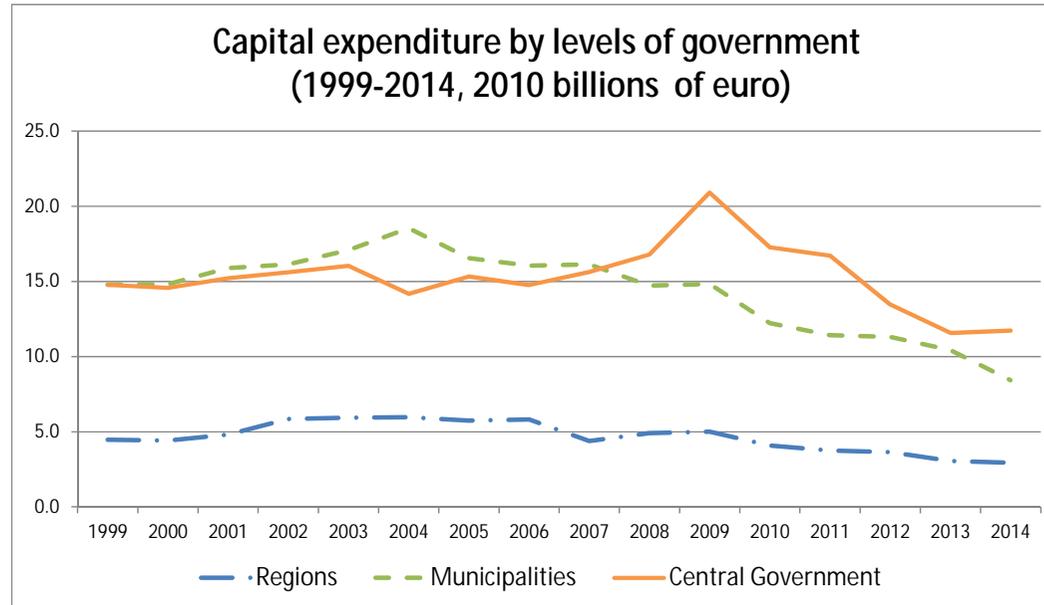


Limits of the Internal Stability Pact

There are serious difficulties in using ISP as the unique instrument to control public deficit formation at subnational level:

- increasing budget surpluses imposed to many local governments \Rightarrow inefficient allocation of public resources, a huge amount of resources ends up being locked
- partial ineffectiveness and distortions due to window-dressing operations carried out by municipalities (overestimation of tax assessment, substantial increase in residual assets)
- strong incentive of municipalities to reduce investment payments due to accounting rule of the ISP (accrual accounting for current expenditure + cash accounting for capital expenditure)
- inconsistency of ISP with the external rule imposed by Fiscal Compact at the national level

Huge decline of investments by SNGs



The implementation of fiscal federalism reform

The increased financial effort imposed on SNGs has dramatically stressed the implementation of fiscal federalism reform:

- **Budgetary autonomy:** inability of SNGs to autonomously manage their own budget given the financial targets (often surplus) imposed by the ISP
- **Budget programming:** difficulty for local authorities to predict the actual amount of available resources, subject to repeated and discretionary cuts by the CG
- **Fiscal accountability:** weakening of the “benefit principle” in local taxation (particularly at municipal level) given the increasing “central component” imposed by CG on local taxes and the use of the fiscal effort by SNGs as compensation for cuts in CG transfers

The implementation of fiscal federalism reform

Municipalities: fiscal effort as compensation device (billions of euro)

	2010	2011	2012	2013
Transfers from CG	16.1	14.1	9.3	3.1
Municipal taxes (standard tax rate)	10.4	10.4	11.8	16.2
Internal Stability Pact (-)	0.3	1.2	1.8	2.8
Total standard resources	26.1	23.3	19.4	16.5
Fiscal effort	2.9	2.9	7.2	8.1
Total resources	29.0	26.2	26.6	24.6

- Municipalities have used autonomous fiscal effort to (at least partially) compensate transfers cuts from CG rather than topping up national levels of social service guaranteed by CG
- Variability in responses of single municipalities to fiscal stress
- Many municipalities (especially big cities) are now close to exhaust all margins to increase revenue from the tax effort

The impact of fiscal consolidation on tax and expenditure decentralization

Tax revenues and expenditures of SNGs

	1995	2000	2005	2010	2012	2013	2014
Tax decentralization							
Tax revenue of SNGs as % of tax revenue of General Government	11.5%	20.4%	22.8%	21.3%	21.9%	21.5%	21.8%
Tax autonomy							
Tax revenue of SNGs as % of total revenue of SNGs	23.5%	42.3%	42.6%	39.4%	43.8%	43.3%	44.4%
Expenditure decentralization							
Net of interest expenditure of SNGs as % of net of interest expenditure of General Government	30.2%	34.3%	35.1%	34.0%	32.2%	32.0%	31.1%

During the period of economic crisis:

- tax decentralization remained unchanged: the increase of local tax yield (at standard rates) was assigned to CG
- tax autonomy increased: municipalities used autonomous fiscal effort to compensate cuts in CG transfers
- expenditure decentralization declined as the result of cuts in transfers and tightening in budget deficit targets

From Internal Stability Pact to Balanced Budget

The budget bill 2016-18 (according to the Constitutional Law of 2012) substitutes from 2016 the ISP with the “balanced budget principle” provided by the EU system of fiscal rule for Member States

All SNGs are required to meet a (nominal) balanced budget target defined in accrual terms for total “final” expenditure and revenue (i.e. net of operations of take out or repay debts). No cash limit on capital expenditure

From Internal Stability Pact to Balanced Budget

To support investment expenditures financing SNGs are allowed:

- to (partially) use surplus (revenue exceeding expenditure - “avanzo di amministrazione”) (only for 2016)
- to resort to public borrowing under the condition that:
 - ✓ for the complex of local governments in each region (including the regional government itself) the overall balanced budget is respected in the same year (“territorial flexibility”) as a result of territorial agreements
 - ✓ each local government repays the debt within a three-year period

From Internal Stability Pact to Balanced Budget: open issues

- How to make the mechanism of “territorial flexibility” operational in each region to support debt financing of local investments?
- How to make structural the financing by surplus of local investments, making this channel more convenient than debt financing?
- The determination of balanced budget rule in nominal rather than in structural terms inhibits the SNGs to adopt counter-cyclical fiscal policy measures
How to allocate to SNGs part of the deficit allowed by EU rules to GG in bad times (or when exceptional circumstances occur)?
Difficult to estimate subnational cyclical component

Challenges for fiscal decentralization

However, fiscal consolidation pressures have spurred CG to promote strategies to enhance SNGs performance and accountability

- rationalization of the number of governments: elimination of provinces, introduction of metropolitan cities and forced aggregation of small municipalities in political “unions” for the provision of local services
- increasing resort to indicators of standard costs and needs in the allocation/equalization of resources across local governments
- sharper separation on Constitutional ground of legislative responsibilities between CG and Regional governments by limiting the area of overlapping competencies
- strengthening of bankruptcy procedurals (Municipalities’ financial distress)
- improvements in quality, homogeneity, and timeliness of SNG accounting to monitor local finance developments and enforce budgetary discipline

Thank for your attention