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Economic crisis and fiscal federalism in Italy

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Abstract

For almost two decades, starting from the early '90s, Italy experienced the strongest wave of decentralization reforms in its post II World War history. The causes were both economic and political. Yet, in recent years, again economic and political causes seem to call for opposite reforms. Along with a second wave of scandals, this time interesting local politicians, the crisis that has hit our country since 2008 is having relevant effects on the relationships between central and local governments. The aim of this paper is to assess dimension and direction of these effects. We first review the situation of "fiscal federalism" in Italy before the crisis, summarizing the decentralization process in the '90s, its consequences in terms of financing and functions for local governments, the constitutional reform of 2001 and the implementation problems this created. We then look at the numbers of the crisis; the "double dip" of the economic cycle in the period 2007-2013, the policies implemented to contrast the financial market confidence crisis and the distribution of the burden of the fiscal consolidation across levels of government. We also discuss the institutional features of the implemented policies, in particular referring to number of local governments and to the financial relationships between level of governments, including taxes, transfers, fiscal rules and bankruptcy procedurals. Finally, we look at the future: what consequences will the new European rules, as enshrined in the new art. 81, have on the financial relationships between levels of government? And how is the balance of power between the center and the periphery going to change in lieu of the new proposed Constitutional reform?

JEL classification: H50, H60, H70

Keywords: crisis; fiscal federalism; decentralization

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1. Introduction

The most effective way to describe the situation of regional and local public finance in Italy, at the end of the worst recession and financial crisis the country has experienced since the Second World War, is by using the expression "war economy". In the attempt of re-gaining markets confidence in the midst of the Euro crisis, the late Berlusconi government and particularly the new "technical" government by Mario Monti in 2011-2012, launched a massive fiscal adjustment program, meant to reduce public deficit and debt, in a country already weakened by the 2008-09 recession. The fiscal stance of the following governments was again tight, for the need to respect the European fiscal rules, although less recessive than the previous ones. The cumulate fiscal adjustment in the five years between 2008 and 2012 amounted at about 8 points of GDP, mostly concentrated in the period 2011-13. Necessarily, this massive program had to affect local governments too, as in Italy regions and lower levels of government control large part of public expenditure, and as local taxation is also an important component of tax revenues. But, as we will discuss, in so doing national governments took a number of actions versus local governments that could only have been possible and justified by a perceived situation of extreme risk for the country, analogous to an international conflict. Thus, local governments were not just simply "squeezed" by the central government, but were also forced to raise money, through forced savings, to finance the general government budget. Indeed, the policies implemented or proposed by the national government were so invasive of local governments' autonomy to stretch to the limit the precepts of the Italian "regional" constitution (reformed in 2001). The European *fiscal compact*, that in Italy entered in force, via a constitutional amendment, in January 2014, again imposes a continuous severe fiscal consolidation process on all levels of government, especially for a country that is not yet growing (GDP real rate of growth in 2014 will probably be between 0.2-0.4%) and that has lost 10 points of GDP from the last pre-crisis year (2007). Most worryingly, the new budget rules leave little room for public investments at both national and local level, in spite of the fact that public investments have already been drastically reduced during the crisis. Low public investments may impair future growth.

The crisis then changed the *de facto* balance of power between levels of government; and it appears increasingly likely that this new equilibrium will also be consolidated *de jure*, by a further constitutional reform, currently under review in Parliament. The reform has the main objective to overcome the Italian "perfect" bicameral system, by transforming the upper house in a Senate of local representatives[1]. But it has also the purpose to change radically number and responsibilities of sub-central governments, weakening the constitutional role of regions and definitely eliminating one level of sub-regional government (provinces). In particular, not only the functions of regions will be reduced in number and importance, but the new constitution also contains a "supremacy clause" that gives the upper hand to central government in all cases of conflict with regions.

Yet, not all the proposed interventions should be judged negatively, even in the narrow perspective of intergovernmental relationships. The truth is that the system of fiscal federalism that evolved in Italy during the 2000s, as a result of the constitutional reform of 2001 and a confuse national policy of implementation of the reform, had largely betrayed the promises of a more efficient and more responsive system of local governments. The 2001 Constitution remained largely not applied on

[1] Currently, the Italian Senate is directly elected by citizens, its vote is necessary to approve all laws, and in order to rule, the executive needs to have a majority in both houses. According to the reform, in the future the Senate will not be elected but composed of representatives of regional councils and mayors of the main Italian cities, and its role will be mostly advisory, except for constitutional legislation and the election of the President of the Republic. Of course, a vote of confidence from this new Senate will be no longer necessary for the national government to rule.

financial grounds, letting regions and other levels of governments be strongly dependent on central government money. And the (very large) category of “shared” functions between the central and the regional governments, rather than becoming (as planned) an avenue for limited regional differentiation of policies inside a common national framework, has become a source of continuous conflict between the two levels of government in front of the constitutional court. This created uncertainty, so limiting economic activity, and imposed additional costs on both citizens and firms, thus reducing popular support for decentralization, which was strong in the ‘90s. This support has been further reduced by an apparently never ending chain of political scandals and alleged appropriations of public money by elected regional officials, so paving the way for a re-centralization of regional functions.

Moreover, as a consequence of the increased financial effort imposed on local governments, the central government was forced to increase tax autonomy at the local level, by reintroducing and enhancing municipal taxation on real estate and by anticipating the introduction of the autonomous sources of financing for regional governments - already dictated by a 2009 “framework law” but over a longer time span. Somewhat paradoxically, as we will see, local governments are now more autonomous on their financing side that they were before the crisis –although admittedly this extra autonomy has been introduced so far in order to make local governments better able to collect resources to the benefit of general government budget. The rationalization of the number of governments (with the elimination of provinces, the introduction of metropolitan cities and the forced aggregation of small municipalities in political “unions” for the provision of all services, decided by law at the beginning of 2014), although still clearly not enough, is also a long awaited step in the right direction. Finally, the crisis and the need to strengthen budget discipline will also hopefully force the government to increasingly face the “soft budget constraints” problems that still remain embodied in the Italian structure of local governments, in particularly in the south of the country. Once the financial emergence will have subdued, there is then at least the hope to rebuild local finance on more rational bases.

The rest of the paper is organized as follows. Section 2 reviews the situation of “fiscal federalism” in Italy before the crisis, summarizing the decentralization process in the ‘90s, its consequences in terms of financing and functions for local governments, the constitutional reform of 2001 and the implementation problems this created. Section 3 looks at the numbers of the crisis; the “double dip” of the economic cycle in the period 2007-2013, the policies implemented to contrast the financial market confidence crisis and the distribution of the burden of the fiscal consolidation across levels of government. Section 4 discusses in greater detail the institutional features of the policies that have been introduced during the crisis, in particular referring to the number of local governments and to the financial relationships between level of governments, including taxes, transfers, fiscal rules and bankruptcy procedurals. Section 5 looks at the future; it first discusses the new financial relationships between levels of government that emerge by the Italian constitutional interpretation of the European fiscal compact, and then summarizes what would be implied by the proposed Constitutional reform currently under discussion in the Italian parliament. Section 6 concludes.

2. Setting the stage: fiscal federalism in Italy before the crisis, 1992-2007

2.1 Backgrounds: the political and economic context of decentralization

During the fifteen years previous to the 2008 crisis, Italy experienced the strongest wave of decentralization reforms in its post II World War history (see Ambrosanio and Bordignon, 2007a, and Ambrosanio, Bordignon and Cerniglia, 2010).

The causes were both economic and political. On the economic side, during the ‘80s, Italy lost control of its public finances, experiencing an impressive increase in public debt (at the national and at the local level) that brought the public debt/GDP ratio above 100% at the beginning of the ‘90s. Moreover, in 1992 Italy (together with several other European countries) experienced a strong currency devaluation, followed by the exit of the country from the European Exchange Rate Mechanism. The financial crisis that ensued, and later the need to meet the Maastricht criteria for gaining access to the common currency in 1997, called for a strong fiscal consolidation, of which fiscal decentralization was thought of being an important part. On the political side, at the beginning of the ‘90s several corruption scandals put an end to the so-called “First Republic” and an entire generation of politicians and political leaders experienced trials and sentences. The old parties that had ruled the country for 40 years disappeared and new parties, some of which with a strong territorial constituency (e.g. Lega North), gained votes and consensus.

Hence, the new national governments of the beginning of the ‘90s – made up for a large part by “tecnici”, meaning university professors and highly ranked public officials coming from top institutions (mostly, the Bank of Italy), without a preceding political career - decided to grant more taxing autonomy to regional and local authorities (along with additional functions) and to harden their budget constraints. The objective was to respond to the demand for more local autonomy coming from the new political forces and to search for increasing efficiency and more fiscal responsibility at the local level. There was also a re-distributive component; in particular, the Lega North’s political agenda deliberately asked for a reduction in the financial flows - going through the national budget - from the “productive” North to the “assisted” South (e.g., see Bordignon, 2005)[2]. However, this never happened, not even when Lega North became the main partner of Forza Italia (later Partito della Libertà) in the long list of Berlusconi’s Center-Right governments that dominated Italy for an entire decade, from the national elections in 2001 up to 2011[3], when the then premier, Silvio Berlusconi, was forced to resign in the midst of the financial crisis. In all this period, “fiscal federalism” ranked high in the political agenda of all Italian governments, although its meaning became more vague and more evanescent as time went by.

As a result of this process, in the ‘90s new local taxes were assigned to regions and sub-regional levels of government. All these new revenues substituted previous grants and transfers from the

[2] International developments at the European level also played a role. The increasing functions devolved to the European Union and the launch of the unique market at the beginning of the ‘90’s supported the idea that the role of the national states was going to decline, with the EU taking the place of the old national states in the provision of fundamental public services, such as defense, security, basic infrastructures and the openings of market. The continent could then safely evolve in a “Europe of Regions”. The European Commission itself supported this view, organizing its main transfer system (“structural funds”) on a regional basis, that as an effect led many European countries to create or to reinforce their regional governments. Indeed, decentralization was quite common in Europe in the 90’s, with important developments taking place in Spain, Belgium but also France and the UK. This view was halted by the French referendum in 2006, rejecting the federal constitution for Europe proposed by the Convention, and by the Lisbon treaty of 2011, that re-institutionalized the role of national countries in the European Council.

[3] With the exception of a eighteen months period, from 2006 to 2008, where a composite Center-Left coalition was in power.

national government and gave more taxing power to local authorities[4]. As we will see, the same happened following the 2008 crisis, although in a completely mutated scenario.

2.2 New financial tools

As regards to municipalities[5], in 1992 a new municipal tax on real estate property was created, with the tax base computed on the basis of the national cadastre (ICI). Mayors could fix the tax rate within a range established by the national law (0.4% - 0.7%), discriminate the tax rate according to the use and nature of the building, and introduce tax rate allowances for the house of main residence of the tax payer. ICI soon became the main source of municipal revenue, covering on average more than 50% of total tax revenues of municipalities. Because of the large differences in the tax base across municipalities, the new tax had however deeply different effects in the different part of the country. While in the rich north, ICI made municipalities almost totally autonomous financially (with a share of transfers on total revenues dropping below 20-30% of total revenues) the same was not true for the cities in the poorer south, that still remained heavily dependent on national grants to finance their expenditure (see Bordignon, Gamalerio and Turati, 2013). This affected their effective degree of autonomy[6]. ICI was reformed in 2008, when the tax on the main residence was abolished, and then eventually cancelled in 2012 (see next section).

ICI was followed in 1998 by a municipal surcharge on the personal income tax (IRPEF), which is still applied by local authorities (see Bordignon, Grembi and Piazza, 2013 for further details). Originally, this surcharge was composed of a compulsory part (even though this was never applied) and by a discretionary part up to 0.5%. The central government later froze the tax rates in 2003 and 2004 (and again in 2005 and 2006 but only if the surcharge had already been used), and then again from 2008 to 2011. In the meantime, it also gave mayors the possibility to increase the tax rate up to 0.8%, to discriminate it according to IRPEF brackets, and to introduce tax exemptions for lower incomes.

Finally, in 2007 mayors were assigned a new earmarked tax in order to co-finance capital investments. More precisely, this new tax could finance only a subset of investments, such as urban public transportation, roads, parks, public parking, schools, and so on. This tax could not collect more than 30% (later increased to 100%) of the total investment costs, could not be imposed for more than five years (later increased to ten years) and had to be given back to taxpayers in case the investments was not carried over. The tax base overlapped with the ICI one and the tax rate could not be fixed above 0.05%
As regards to regions, the other main sub-central level of government in Italy[7], in 1992 they were granted health contributions and motor vehicle taxes, followed in 1995 by a share of the excise on gasoline, in 1997 by a new tax on productive activities (IRAP), which substituted health contributions and other minor taxes, and finally, in 1998, a surcharge on the personal income tax (IRPEF), with features similar to the Municipal surcharge. IRAP is levied on entrepreneurs and firms (individual and companies, public and private) and its tax base is constituted by the net

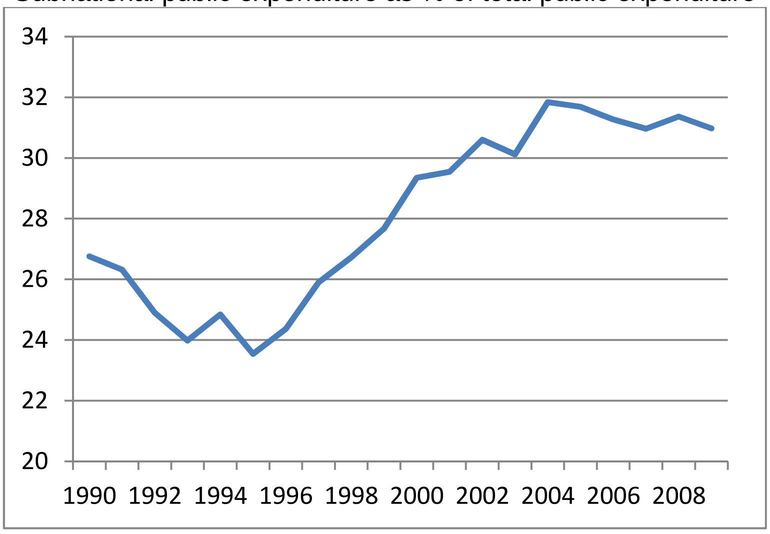
[4] The decentralization of the 90s mostly occurred on the revenue side. But some extra functions were given to regions and local governments (through the so called Bassanini Decrees at the end of the 90s) and the level of autonomy in some previously allocated functions (such as Health care for regions) was increased.
[5] See Balduzzi (forthcoming a)) for more details.
[6] Bordignon, Gamalerio and Turati (2013) argue that the different degree of autonomy also affected the selection of the local political class and the degree of efficiency in the provision of local public services.
[7] The third is province, but it always mattered less in terms of functions and resources. Plus, as we discuss below, it has been now substituted by a political union of municipalities.

added value they produce within the region (sum of wages, passive interests and profits; see Bordignon, Giannini and Panteghini, 1999). In 1997 the tax rate was established at 4.25% (later reduced at 3.9% in 2008), with a possible discretionary variation up to 0.92%, differentiated for sectors and categories.

The regional surcharge on the personal income tax (IRPEF) is composed of a compulsory part (originally 0.9%, now 1.23%) and by a discretionary part (currently under revision).

Graphs 1 and 2 summarize the effect of the decentralization period on both local expenditure and local taxation, respectively. As shown, the effect is robust in both cases, although much stronger on the revenue than on the expenditure side. Of course, data must be taken with care. Local taxation also includes tax shares of national taxes[8], where autonomy is by definition very limited; and the total amount of local expenditure says little on the effective autonomy of local governments to manage this expenditure.

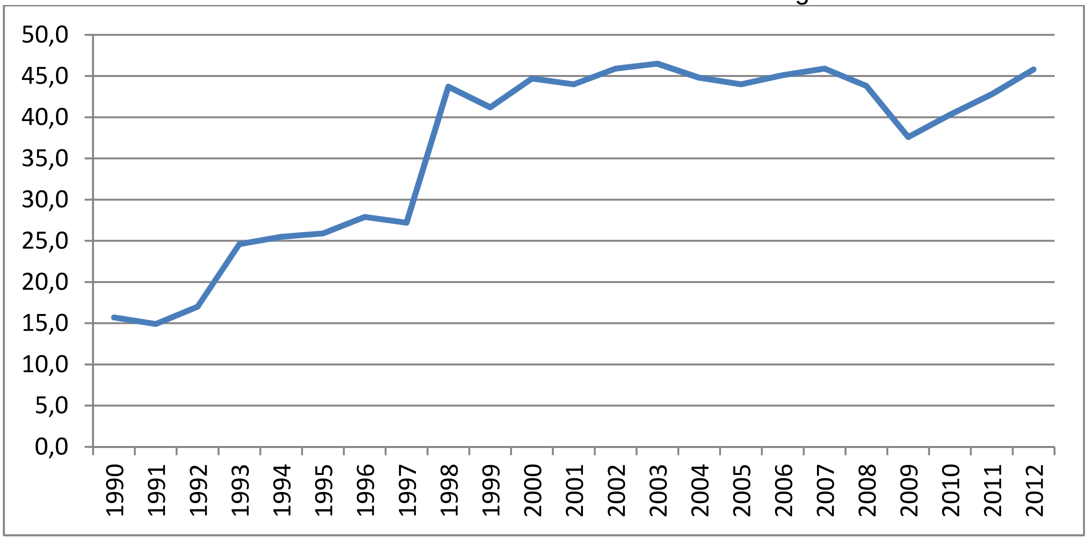
Graph 1
Subnational public expenditure as % of total public expenditure



* Source: Our calculations based on ISTAT data,
Spesa delle Amministrazioni Pubbliche per funzioni, 2012

[8] In particular, the VAT tax share of regions that is needed to finance Health care provision. Health care, the main function of regional governments, is as a matter of fact a jointly provided function, where the central government defines standard levels of provision of services and guarantees financing though the VAT share that is given adding to the regional taxes earmarked to health financing, and regions organize the net to offer services through the local Health units, both territorial and hospitals. See note 12 for further details.

Graph 2
Own tax revenues as % of total revenues of subnational governments*



*Source: ISTAT, *Conto economico consolidato delle Amministrazioni pubbliche, schema semplificato a due sezioni, 1990-2010*

2.3 The Internal stability pacts

As anticipated, during these years the national government also passed reforms to contrast financial irresponsibility at the local level and the consequent ex post bailing out of local and regional governments by the central government[9]. Hence, in 1999 explicit fiscal rules were introduced for regions and other local authorities under the label of *Internal Stability Pact*. After its introduction, the Pact has been changed almost every year, with regard to subjects, targets, sanctions, monitoring procedures, and incentives. This approach caused extreme uncertainty for the activity of regions, provinces and municipalities. Rather than presenting a detailed list of interventions[10], we briefly summarize the main reforms which occurred during the period.

At the beginning, all municipalities were subject to the Pact; from 2001 to 2004 municipalities below 5,000 citizens were excluded; in 2005 and 2006 only municipalities below 3,000 were excluded, but in 2007 the threshold was set again at 5,000 citizens. Furthermore, since 2002, different rules have been introduced for regions and the other local governments (provinces and municipalities)[11].

As regards to targets, for regions they were initially fixed in terms of overall budget balance, but in 2002 they were replaced by a constraint on expenditure growth. In addition since 2000, regional

[9] Problems of soft budget constraints have always been endemic to the Italian structure of governments, beginning with the massive bailout of cities' debts at the beginning of the 80's (the so called „Stammati decrees"). See Bordignon and Turati (2009) for a theoretical and empirical analysis of soft budget constraint problems at the regional level concerning health expenditure.
[10] A comprehensive survey of the development of the Internal Stability Pact is in Ambrosanio and Balduzzi (forthcoming). See also Ambrosanio and Bordignon (2007b) for international comparisons.
[11] Exploiting the heterogeneity of the municipal fiscal rules along time and for different population size of municipalities, several authors have investigated the effect of the fiscal rules on local government's behavior. See Balduzzi and Grembi (2011) and Grembi, Nannicini and Troiano (2013). Results are somewhat mixed.

health expenditures have been excluded by the regional pact and subject to different rules (the so called “Patto per la salute”)[12].

As for local governments, targets have been usually defined in terms of pre-determined reduction of their deficits, except for 2005 and 2006 when a system of ceilings on the annual increase of nominal local expenditure (including investments) was introduced. Notice that, as long as local authorities have some tax autonomy, budget rules leave more freedom to fulfil the goal by increasing revenues, cutting expenditures or a combination of both; whereas expenditures ceilings aim only at reducing the dimension of the (local) public sector. The definition of budget balance has also changed over time: first it referred to cash current budget only (with a number of exclusions both on the revenues and on the expenditures side); then it referred to cash and accrual current budget; in 2007 it was defined as comprehensive financial budget (see next section).

Originally the Pact did not include specific sanctions in case of missed annual targets. Sanctions were introduced in 2003 and were differentiated for regions and local governments. They were also modified many times and often not applied. For regions, non-compliance of the Pact mainly led to an automatic increases in some tax rates (IRAP and the surcharge on IRPEF), and a loss in autonomy in managing health expenditure; for municipalities, non-compliance typically implied a reduction in grants and a freeze on hiring.

Monitoring is also an important part of the Pact: since 2007, local authorities are requested to send to the Ministry of Economy and Finance information on the cash and accrual accounts on a quarterly basis (recently, every six months). The relevance of the monitoring process relies on the fact that if local governments do not submit to the Ministry of Economy and Finance a certification about the compliance of targets relative to the previous year, they are then obliged to adopt all necessary measures to meet the targets if they do not want to incur in sanctions. As regards to regions, monitoring of health spending is carried out in the context of a computerized system (the so-called *Tavolo di monitoraggio*), accessible by all participating entities and maintained by the Ministry of Economy and Finance.

2.4 The local political system and the new Constitution

Decentralization in the period did not only affect financing tools and fiscal rules. With the idea of improving political accountability and financial responsibility, reforms were also introduced on the local political system. In particular, in the ‘90s new electoral laws were passed to allow for direct election of mayors and presidents of regions and to move from a proportional-based system to a more majoritarian one. The reforms were different for the different levels of government[13], but had

[12] Italy is somewhat peculiar in so far as the main function attributed to regions is the management of the National Health System; indeed, health expenditure covers more than 80% of total expenditure of the Italian Ordinary Regions (all of them, except the two Islands and three small regions at the northern border of the country, that have Special Statutes, a different system of financing and more functions; see Ambrosanio, Bordignon and Cerniglia 2010). Health care provision is however heavily regulated by the central government that fix the basic services that have to be supplied and that directly (through transfers) or indirectly (through regional taxes as IRAP and the regional surcharge on IRPEF that de facto or de jure are earmarked to health expenditure) guarantees the funding of the services. This explains the difference of treatment of this type of expenditure in terms of the internal pacts. The overlapping of competences between the central and the regional governments in the health sector have reduced accountability and supported soft budget constraints problems; see again Bordignon and Turati, 2009.

[13] See for instance Bordignon, Nannicini and Tabellini (2013) on the new electoral rules for electing the mayor. The reform at the municipality level certainly worked in strengthening the political legitimacy of mayors; it is not a coincidence

all the aim and the effect of strengthening the political importance and the powers of mayors and presidents with respect to their own majority and the political parties. The enhanced role assumed by the directly elected representatives was also determinant in leading to the main political reform in the decentralization process, namely the 2001 Constitutional reform. This reform constitutes the apex of the Italian decentralization process of the '90s, and somewhat paradoxically, it also marked a turning point towards a re-centralization of the system, given the difficulties met in trying to implement it. The reform modified a number of articles (from 114 to 133) in the Title V of the 1948 Constitution that concern the powers of sub-national governments and their financial relationships with the central government. The most important elements of this reform could be summed up as follows[14].

First of all (art.117 of the new Title V), the central government retained the possibility to legislate alone only on a limited subset of functions (defence, justice, public order, currency, international treaties etc.), while all other functions were given to (ordinary) regions, to be legislate by regions only (exclusive regional functions) or to be shared between the central government and regions (concurrent legislation)[15]. In particular, the latter category is very large, including all main public activities (health, education, energy, transports, environment, regulation of markets, etc.)[16]. In theory, the central government should have limited itself in the field of shared function to fix the main principles, letting regions legislate the details. However, the distinction between principles and detailed legislation has never been very clear and the financial importance of the shared functions (excluding pensions and interests on public debt, about 80% of the remaining total public expenditure refers to functions included under this label) has made the central government unwilling to seriously give up powers and responsibility in this field. The consequence has been a dramatic increase in conflict between regions and the central government in front of the Constitutional Court. Worse, the ensuing uncertainty about which legislation, if regional or national, was in place, delayed economic activity, imposed extra costs on citizens and firms, and eventually reduced the popular consensus in favour of the decentralization process, that was very high in the 90s.

The new art. 119 describes the new fiscal relations among the different levels of government. It has a strong decentralization flavour; for example, it establishes that local governments' activities should to be financed totally with own revenues and tax shares; and that transfers from the central government could only be used to reduce the differences in the fiscal capacity of the different regions or municipalities, without strings attached (no earmarked grants). However, this article

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that mayors are the only component of the Italian political class that escaped the loss of consensus induced by scandals and the dire conditions of the country during the recent crisis. The present prime minister is an ex-mayor and many ex-mayors are currently part of the national government.

[14] See Giarda (2001, 2004 and 2009) for a detailed discussion of the new Constitution and its implications for the Italian version of fiscal federalism. See also Bordignon (2005) and Ambrosanio, Bordignon and Cerniglia (2010) for further discussions of the new Constitution financial implications.

[15] The new Constitution also included a provision for "asymmetric federalism", a detailed procedural according to which a single Region could ask the national Parliament to obtain exclusive competence on some policies whose competence was initially shared. However, this clause was never activated. It is hard to understand while Italian Constitutional lawmakers never seriously considered the possibility of a two-speed federalism in a country so divided, not only on economic grounds, but also in terms of administrative ability of local and regional governments. A sort of two-speed federalism has been de facto introduced on public health care, as most of the centre-south regions have presently lost their full autonomy and are under control of central government officials (because they were not able to respect the "Patto per la Salute" mentioned earlier, accumulating deficits that have been partially covered by the central government).

[16] An important exception is the pay-as-you-go public pension system that remained under the control of the central legislator. Pensions in Italy covers about 30% of total expenditure. Regions could however legislate on the second pillar of the pension system (integrative regional funds) and some did.

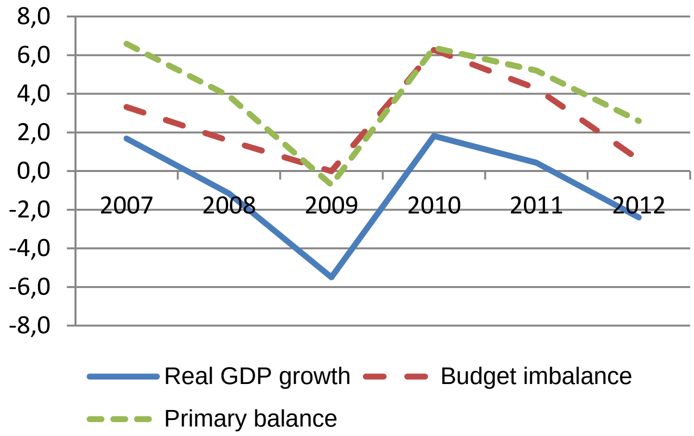
turned out to be simply inapplicable, given the huge differences in economic activities and tax bases across the country, and given the fact that central government still retain the power to set up uniform standards and levels for the provision of all fundamental services, even in those fields the constitution assigns to the exclusive competence of regions. The contrast between the constitution and the true funding practises has negatively affected the transparency of the funding system of regional and local governments and made largely inapplicable the last attempt to provide a plausible "interpretation" of the constitution (in order to reduce the constitutional conflict between regions and central government), through the 2009 "framework law" (see below)[17].

It is within this framework that in 2008 the financial crisis erupted, followed by an even more severe sovereign debt crisis in 2011. What has been the impact of these shocks on the Italian fiscal federalism? We look first at the economic consequences and then at the political/institutional ones.

3. Fiscal federalism in Italy during the crisis: economic consequences

Italy has been interested by two waves of the crisis (Graph 3). The first wave hit in 2008, causing a sharp fall in GDP in 2009 (-6%); then, after a small recover in 2010, the Italian GDP collapsed again in 2011-13 causing an impressive "double dip" in economic activities.

Graph 3
The two waves of the crisis



While overall negative, the effect was differentiated across the country. In percentage terms the fall in economic activity was largest in the south than in the rest of the country; however, as the south was much poorer to begin with, the absolute distance between north and south was reduced during the crisis. Besides, the loss in GDP in the centre-north was mostly due to the fall in private economic activity (industrial production shrank by a fourth during the crisis), while the south suffered for the reduction in public expenditure, which is in relative term much more important in this part of the country.

[17] As discussed in section 5, partly because of these problems and partly as a consequence of the financial crisis, Title V is currently under review in the Parliament. A previous attempt to change the constitution, proposed by the Centre-Right Government in 2005, was rejected by a national referendum in 2006. See Bordignon (2005) for details.

Table 1
GDP per capita* (euro)

	2007	2012
North-West	30.184	27.687
North-East	30.358	27.241
Centre	27.701	24.969
Centre-North	29.488	26.739
South	16.966	15.197
Italy	25.140	22.807

* Source: ISTAT, *100 statistiche per capire il Paese in cui viviamo*, 2014

One of the consequences of the fall in GDP was an automatic worsening of all the relevant fiscal indicators. Table 2 illustrates the evolution of debt-to-GDP ratio, that hit the 100% threshold before the crisis and has been continuously rising since then, up to 133% in 2013. On the contrary, debt of local governments, both in term of GDP and as a percentage of total public debt, has been falling during the period, as a result of the fiscal consolidation measures adopted during the crisis (but see section 4.5 on off budget debts).

Table 2
General Government Debt

	Total (% of GDP)	Municipalities		Regions and Autonomous Provinces	
		% of GDP	% of total public debt	% of GDP	% of total public debt
2005	105,7	2,86	2,69	2,39	2,26
2006	106,3	3,08	2,90	3,04	2,86
2007	103,3	3,03	2,93	2,90	2,80
2008	106,1	3,04	2,86	2,64	2,49
2009	116,4	3,17	2,73	2,77	2,38
2010	119,3	3,14	2,63	2,64	2,21
2011	120,7	3,13	2,59	2,59	2,15
2012	127,0	3,11	2,45	2,61	2,06
2013	132,6	3,03	2,28	2,41	1,82

*Our calculations based on Bank of Italy data, *The Public Finances, borrowing requirement and debt*

The downturn in GDP was intensified by the reaction of national governments. Differently from what happened in other countries, the situation of public finance did not allow for countercyclical fiscal policy[18]. During the first crisis, the (Berlusconi) government first denied any need for intervention and then eventually reacted with a delay in 2010. During the second crisis, the risk of a devastating financial crisis of the country led the governments (Berlusconi first and then the Monti government) to impose an even harsher correction, in the hope to re-establish trust in the financial markets and to gain the support of the other European countries and the ECB. As an effect, the government fiscal stance as measured by both total and primary deficit has been strongly *pro-cyclical* for all the period (see again Graph 3).

The cumulative effect of financial measures adopted during the crisis has been above 120 euro billions, namely almost 8% of the GDP (Tables 3 and 4), particularly concentrated in the period between 2011 and 2012 (Berlusconi and Monti Government).

[18] See Ambrosanio and Balduzzi (2013) and Balduzzi (forthcoming b)) for further details.

Table 3
Cumulative effects of financial measures (% of the GDP)*

	2008	2009	2010	2011	2012	2013
Central Administration	0,06	0,73	0,78	1,81	4,28	5,00
Local Administration	-0,04	-0,08	0,34	1,09	2,09	2,10
Social Security	0,00	0,00	-0,02	0,00	0,37	0,77
Total	0,02	0,65	1,11	2,91	6,73	7,87

* Source: COPAFF (Technical Commission for Fiscal Federalism), *First Report*, 2014

Fiscal consolidation was made up of almost 56 euro billions of additional fiscal revenues, 46 euro billions of current expenditure reduction[19] and 20 euro billions of capital expenditures cut. As regards the contribution of different levels of government to the fiscal adjustment, around 65% was due to the central government whereas around 25% was due to local governments. In 2012 a massive reform was also introduced on the public pension system, but as shown by Table 3, its short term effects were limited[20].

Table 4
Cumulative effects of financial measures (euro billions)*

	2008	2009	2010	2011	2012	2013
Central Administration	1,00	11,13	12,11	28,62	66,97	77,99
Local Administration	-0,66	-1,21	5,34	17,26	32,75	32,78
Social Security	-0,01	-0,03	-0,28	0,02	5,72	12,05
Total	0,34	9,89	17,17	45,89	105,44	122,83
of which:						
- current expenditures	1,55	-0,46	-4,78	-16,34	-30,34	-46,20
- capital expenditures	0,01	-3,60	-5,95	-17,35	-23,38	-20,83
- revenues	1,89	5,84	6,45	12,20	51,72	55,80

* Source: COPAFF (Technical Commission for Fiscal Federalism), *First Report*, 2014

However, a deeper look at the characteristics of the fiscal adjustment shows that the contribution of subnational governments to the reduction of primary expenditure was slightly higher than the central government one (Table 5). More precisely, local administration (regions, provinces, municipalities and local health units, ASL) experienced a reduction of about 28 euro billions, around 52% of total primary expenditure reduction. This means that additional fiscal revenues were mainly granted to the central government.

The numbers in Tables 4 and 5 refer to savings with respect to predicted or forecast public expenditure (e.g. what would have happened to public expenditure growth in the absence of any interventions). As shown in Graph 4, general government current expenditure in percentage of GDP actually jumped up in 2008-9 to about 50% of GDP as an effect of falling GDP, and it has fluctuated around this threshold since. Public investment instead dropped by 1% on GDP, more than halving in nominal terms as GDP also collapsed.

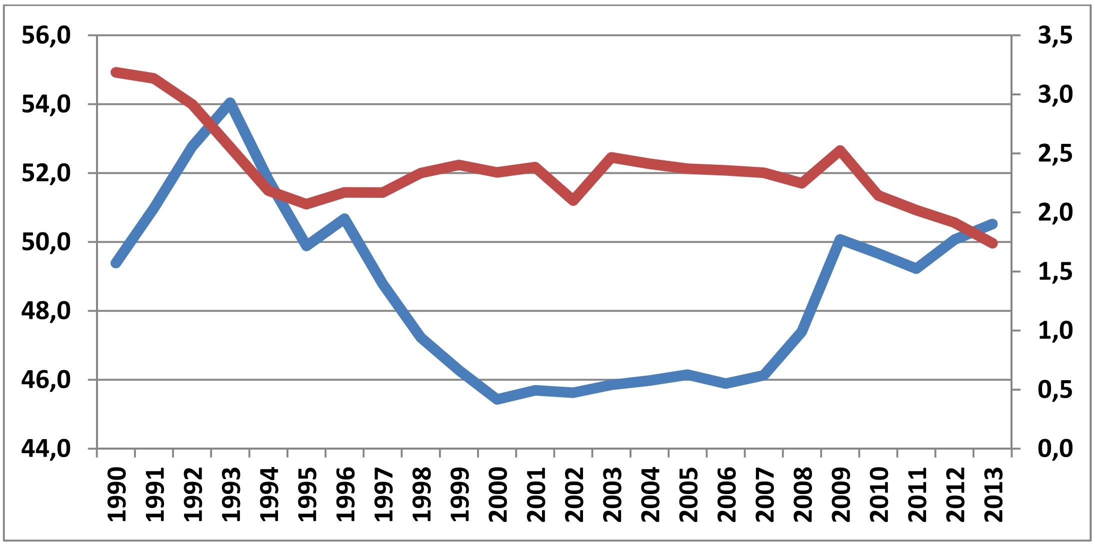
[19] The tightening of the Internal Stability Pacts is interpreted in these computations as a reduction in expenditures. As a matter of fact, local governments met the harsher requirements by increasing taxation too, so that the increase in taxes as been higher and the reduction in expenditure lower than these figures would led one to believe.
[20] The reform postponed retirement ages for most people and reduced the distance in benefits from the old and more generous system (reformed in 1995 but that still applies to most workers) and the new one.

Table 5
Cumulative effects of financial measures
on primary expenditure by level of government (euro billions)

	2009	2010	2011	2012
Central Administration	-6,13	-6,23	-16,47	-20,98
Social Security	0,86	0,46	-0,42	-5,05
Regions	-1,52	-2,32	-8,17	-12,34
Provinces	0,24	-0,55	-1,28	-2,88
Municipalities	0,96	-1,74	-4,67	-8,41
Health Units	1,42	-0,33	-2,50	-4,13
	As % of primary expenditure			
Central Administration	-3,2	-3,5	-9,4	-12,2
Social Security	0,3	0,2	-0,1	-1,6
Regions	-4,0	-6,5	-24,2	-38,5
Provinces	2,0	-4,8	-11,7	-27,8
Municipalities	1,5	-2,8	-7,6	-14,3
Health Units	1,3	-0,3	-2,2	-3,7

* Source: COPAFF (Technical Commission for Fiscal Federalism), *First Report*, 2014

Graph 4
Current (left scale, blue line) and capital expenditure (right scale, red line) in percentage of GDP
General government



What was the content of the national budget laws concerning local governments? For Regions, the answer is quite easy: transfers to finance health care were reduced to some extent and more severally for other types of expenditure[21]. A series of relevant transfer cuts were imposed on municipalities as well; moreover, the Internal Stability Pact was also reformed in several aspects (see section 4).

[21] It should be added that fiscal consolidation measures where heavier on Special Statute regions than on ordinary ones (see Bordignon, 2013). Special Statute regions have traditionally enjoyed a more generous financing system than ordinary ones and the central government took the opportunity of the crisis to re-balance somewhat the situation.

All these measures had an impact on the financial distribution of resources across governments. The following tables help to clarify how the country has changed between 2007 and 2012. As regards municipalities (Table 6), current revenues increased from 2007 to 2012 by an average growth rate of almost 3%. This increase was totally driven by an increase of tax revenues (by almost 7%), only partially compensated by a decrease in grants from regional and national governments. All main taxes increased between 2007 and 2012, despite the fact that ICI lost an important part of its levy and the IRPEF surtax was often frozen by the central government. The raise in TARSU's revenues (fees on waste collection) was due to the necessity, dictated by the law, to provide a full coverage with the revenues from this tax of the costs of garbage collection and disposal.

Fiscal autonomy further increased (Table 7). Own revenues passed from 65% of total current revenues to almost 73%. On the contrary, the share of non-tax revenues did not change much. Within tax revenues, it is easy to note the decrease in importance of ICI following the 2008 reform[22], even if still in 2012 (that is, before the Monti reform discussed below) it accounted for half of the municipal tax revenues.

Table 6
Municipalities' revenues (euro billions and % growth rate)*

Revenues	2007	2012	Growth rate (%)	Average year growth rate (%)
Current revenues	52,6	60,4	14,7	2,8
Tax revenues	22,0	30,8	39,9	6,9
Current grants	19,0	16,4	-13,3	-2,8
IRPEF surtax	2,5	3,9	57,7	9,5
Property tax (ICI)	12,7	15,6	22,3	4,1
TARSU	4,4	7,3	68,3	11,0
Non tax revenues	11,7	13,2	12,8	2,4

* Source: Our calculations based on ISTAT data, *I bilanci consuntivi delle Amministrazioni Comunali*

Table 7
Municipalities' revenues shares (%)*

Revenues	2007	2012
Tax revenues as % of current revenues	41,8	51,0
Current grants as % of current revenues	36,0	27,2
Non tax revenues as % of current revenues	22,2	21,8
IRPEF surtax as % of tax revenues	11,2	12,7
Property tax as % of tax revenues	57,9	50,6
TARSU as % of tax revenues	19,8	23,8

* Source: Our calculations based on ISTAT data, *I bilanci consuntivi delle Amministrazioni Comunali*

It is also interesting to detail these measures by areas of the country (Table 8 and 9). Despite showing a tiny convergence between 2007 and 2012, it is clear that municipalities in the north of are characterized by a larger fiscal autonomy. The difference is striking regarding tariffs too, which represents a rough measure of the ability to offer and finance additional services to citizens.

[22] Which abolished ICI on the dwelling of main residence of the taxpayer, except for a handful of very rich houses.

Grants are still a very important part of revenues for municipalities in the south (44.4% in 2012 versus 18.4% in the north). The relatively low importance of tax revenues in the south may be explained in two ways: on the one hand, there may be a lower propensity to use fiscal autonomy as traditionally grants have served as main financing tool. But on the other hand, the lack of a tax base may have had a role (this should be particularly true for the IRPEF surtax). In the Centre-north, it is interesting to observe that the two groups of municipalities acted differently during the crisis; municipalities in the North have compensated the fall in grants by increasing mostly tariffs; in the centre, by mostly increasing taxes.

Table 8
Municipalities' revenues, by areas (euro billions and % growth rate)*

	Current revenues	Tax revenues	Current grants	IRPEF surtax	TARSU	Property tax	Non tax revenues
	2007						
Italy	52,6	22,0	19,0	2,5	4,4	12,7	11,7
North	24,4	10,8	7,3	1,2	1,7	6,7	6,3
Centre	11,2	4,8	3,5	0,7	0,7	3,1	2,9
South	17,1	6,4	8,2	0,6	2,1	3,0	2,6
	2012						
Italy	60,4	30,8	16,4	3,9	7,3	15,6	13,2
North	28,1	14,1	5,2	1,9	2,4	8,1	7,6
Centre	13,6	7,8	2,9	1,0	1,9	3,9	2,9
South	18,7	8,8	8,3	1,0	3,0	3,6	2,7
	% growth rate						
Italy	14,8	40,0	-13,7	56,0	65,9	22,8	12,8
North	15,2	30,6	-28,8	58,3	41,2	20,9	20,6
Centre	21,4	62,5	-17,1	42,9	171,4	25,8	0,0
South	9,4	37,5	1,2	66,7	42,9	20,0	3,8

* Source: Our calculations based on ISTAT data, *I bilanci consuntivi delle Amministrazioni Comunali*

Table 9
Municipalities' revenues shares, by areas (%)*

	Italy		North		Centre		South	
	2007	2012	2007	2012	2007	2012	2007	2012
Tax revenues as % of current revenues	41,8	51,0	44,3	50,3	43,1	57,7	37,4	47,2
Current grants as % of current revenues	36,1	27,2	29,9	18,4	31,2	21,3	48,2	44,4
Non tax revenues as % of current revenues	22,2	21,9	25,7	27,1	25,7	21,0	15,0	14,5
IRPEF surtax as % of tax revenues	11,4	12,7	11,0	13,2	13,9	13,4	10,0	11,1
Property tax as % of tax revenues	57,7	50,6	61,7	57,5	63,4	50,1	46,7	40,2
TARSU as % of tax revenues	20,0	23,7	15,6	16,7	13,6	24,8	32,3	34,0

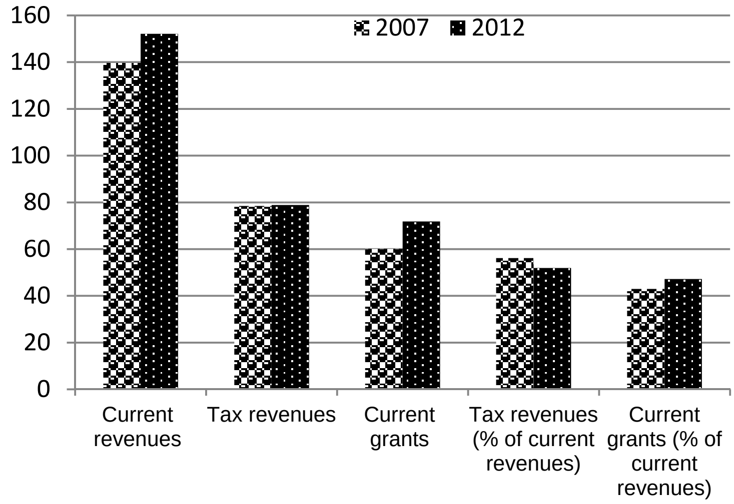
* Source: Our calculations based on ISTAT data, *I bilanci consuntivi delle Amministrazioni Comunali*

Regarding regions (Graph 5 and Table 10), netting the growth of tax revenues by the VAT sharing and correctly relabeling it with current grants[23], it emerges that between 2007 and 2012 tax

[23] Regional vat shares are computed by the Central government in order to finance Health expenditure. They are akin to ear-marked grants. See note 7.

revenues basically did not change (they grew by 0.5% in five years), whereas current grants grew by almost 20% (3.6% on average). Hence, regions seem less autonomous in 2012 that in 2007: the share of tax revenues over current revenues decreased from 56% to 52% and the share of grants increased from 43% to 47%. It is also worth recalling that in 2008 the IRAP basic tax rate was lowered from 4.25% to 3.9%, thus partially explaining the negative 3.3% average growth rate in this tax revenues.

Graph 5
Regions' revenues (euro billions)*



* Source: Our calculations based on ISTAT data, *Conto economico delle Amministrazioni Regionali*.
Current grants are comprehensive of VAT Sharing

Table 10
Regions' tax revenues (euro billions and growth rate)*

Revenues	2007	2012	Growth rate (%)	Average year growth rate (%)
Irap	39.4	33.2	-15,6	-3,3
Irpef Special Regions	11.0	12.5	13,8	2,6
VAT Special Regions	5.4	6.3	16,5	3,1
Excise on mineral oils	3.4	4.0	18,7	3,5
Irpef surtax	7.4	10.7	45,2	7,7
Motor vehicles taxes	7.6	8.5	11,3	2,2
Total	78.5	78.9	0,5	0,1

* Source: Our calculations based on ISTAT data, *Conto economico delle Amministrazioni Regionali*

Table 11 illustrates the dramatic fall in investments by all local governments (regions and municipalities). This is both a consequence of the crisis, that forced local governments to save (and it is easier to save on capital expenditure), and a consequence of the strengthening of the Internal Stability Pact that during the crisis was extended to capital expenditure too (see next section for details).

To counteract the fall in public investments, the central government introduced some incentives in the form of a "flexible" Pact. The general idea is to exploit the lumpy nature of investments by municipalities, to allow for more capital expenditure while still controlling aggregate local public expenditure growth. More specifically, there are three possible forms of flexible pact: *regional horizontal Pact*, *regional vertical Pact* (in two versions: ordinary and incentivized), *national horizontal Pact*. In all cases, local governments subject to the Pact that do better than their targets may lend their surplus to others (still subject to the Pact) who otherwise would not comply. With a regional horizontal Pact, municipalities exchange financial resources within the region they belong to, whereas with a national horizontal Pact, they can exchange resources with any other municipality in the country. Vertical pacts are different in the sense that a region simply gives some of its resources to municipalities, conditional to the fact that the region itself must have left enough resources to respect its own pact. Municipalities who lend resources obtains both a discount on their target for the next two years and their money back after the same time period. Municipalities who borrow resources do the opposite but they do not incur in any sanction and are obliged to use these resources for capital expenditures only[24]. It is easy to understand that municipalities prefer vertical Pacts (they do not need to refund the region) but national horizontal Pacts could be useful whenever a region has not resources enough left to create a vertical Pact.

Table 11
Local Administration Expenditures
(accrual, euro billions and growth rate)

	2007	2012	Growth rate (%)
Municipalities			
Current expenditures	49,4	54,3	9,9
Investment expenditures	27,8	13,0	-53,2
Regions			
Current expenditures	129,3	138,6	7,2
Investment expenditures	4,2	3,4	-19,0

*Source: Our calculations based on ISTAT data,
Conto economico delle Amministrazioni Regionali e delle Amministrazioni Comunali

The experience with these flexible pacts was overall not positive. So far only the Vertical Pact (in the richest regions of the north) worked; there were very few examples of Horizontal Pact, regional or national. Municipalities with a surplus, in a condition of crisis and continuous uncertainty, did not trust to lend their resources; and rules were too rigid to allow for a "market" (of the rights of raising debt to finance investments) to develop at the regional or national level. We will come back to this in section 5.

Finally, one of the consequences of the fiscal consolidation in the period is a sharp reduction in the number of regional and municipal public employees, following both restrictions in the ability to hire new personnel and explicit rules to reduce turn-over. The fall in local governments' employees is in line with what observed for the central administration, except for health units (Table 12).

[24] Thus, the system mimics a "market" for the rights of raising debt in order to finance public investments, except of course that in a market prices are not defined ex ante but let adjust to clear demand and supply.

Table 12
Public Sector Employees (thousands of units)

Administration	2007	2012	Diff.	Growth rate (%)
Central Administration	2.042,9	1.859,4	-183,5	-9,1
Local Administration*	1.519,9	1.450,1	-69,8	-4,6
of which: Regions, provinces, Municipalities	619,1	568,4	-50,7	-8,2
Social Security	55,5	47,3	-8,2	-14,8
Total	3.618,3	3.356,8	261,5	-7,2

*Includes employees in the Regional Health Care Units
Source: ISTAT, *Unità di lavoro delle Amministrazioni pubbliche per sotto-settore*, 1990 – 2012

4. Fiscal federalism in Italy during the crisis: institutional and political consequences

Along with financial interventions, the central government also approved a number of different reforms which were not designed to directly collect or save public money but rather to change, one more time, the relationship among the central and other levels of government. In this section we analyse the content and consequences of these political and institutional reforms.

4.1 Local taxation

After 2007 the national government passed a lot of reforms concerning local taxation. For municipalities in particular, these reforms affected real estate taxation in a schizophrenic way[25]. First of all, in 2008, the Berlusconi government abolished ICI on the main residence, which at the time represented a non-negligible revenue for municipalities, promising to compensate the loss in local revenue with ordinary transfers. In 2011, as a consequence of the 2009 Framework Law, the same government passed a decree to introduce, from 2014, a new real estate local tax called IMUP (principal municipal tax). This tax was due to entirely substitute ICI, with some differences: it could not tax the main residence; the basic tax rate was fixed at 0.76%, but mayors could vary it in the interval 0.46% - 1.06%[26]. Moreover, municipalities could introduce tax allowances for particular categories of buildings (e.g., whether they were rented or not).

Nonetheless, this reform never took place, as in 2012 a different government (Monti) “anticipated” the introduction of IMUP (now called IMU) to 2012 but by changing it quite substantially. First of all, the tax base was (approximately) doubled by revising accordingly cadastral values. Second, the tax could also be levied on main residence. In this case, the basic tax rate was fixed at 0.4% and mayors could vary it in the interval 0.2% - 0.6% (for other buildings, the 0.76% tax rate still applies). A fiscal deduction of 200 euro on the main residence tax was also introduced (plus an additional 50 euro for any co-living child younger than 26 years old – up to a maximum number of eight children). However, while the proceeds of the tax on the main residence of the taxpayers went directly to municipalities, the central government *forced* municipalities to transfer back half of their revenues on the rest of buildings; more precisely, municipalities could choose a different rate

[25] This schizophrenic behavior is a result on the varying majority in government during the period. 80% of Italians own the house in which they live and the abolition of the property tax on the main residence has long been a political token for Center Right parties.

[26] Another important difference is that while with ICI the presumed rents on real property for not rented houses were still subjected to personal taxation through IRPEF, this was no longer the case with IMU. As IRPEF is progressive and second houses owners are generally richer than the average, this implied a reduction in the overall tax burden for these tax payers.

on the value of these buildings, but they were anyhow obliged to transfer an amount equal to the tax base multiplied by 0.38%, that is half the statutory tax rate.

Again things changed in 2013, when a new government again abolished IMU on main residence. The final reform states that from 2014 there is a "single municipal tax" (IUC), composed of three parts: 1) IMU, levied only on land and buildings different from the main residence; 2) TARI, a service tax to finance garbage collection, 3) TASI, a service tax to finance all the other indivisible services provided by the municipality. As regards to IMU, nothing changes with respect to its 2013 version. TARI substitutes previous charges (called TARSU, TIA 1, TIA 2 and finally TARES) to fully cover the cost of garbage collection and disposal. Its amount depends jointly on the size of the building and on the number of residents. Finally, TASI is a true new tax. The tax base is the same as of IMU, but it is comprehensive of main residence. The basic tax rate is 0.1%, which could be reduced or even cancelled by mayors on the different types of buildings. There is also a maximum threshold, fixed on 0.25% for 2014 (plus an additional requirement that the sum of the IMU tax rate plus the TASI tax rate cannot be greater than 1.06%). Municipalities could also introduce tax allowances for main residence. A share of the tax is paid by the owner of the building and a share (up to 30%) is paid by the tenant, if any. In 2011, municipalities were also granted a "tourist tax". This tax was discretionary, could vary from 1 to 5 euro per person per night and could only be introduced in touristic cities, as nationally defined.

As regards to regions, the tax rate of compulsory part of the surcharge on IRPEF was raised from 0.9% to 1.23% in 2012.

4.2 Transfer mechanisms

The reform of local taxation carried along the need to reform the transfer mechanism too. The main novelty on these grounds is the introduction of *standard costs and needs* to compute municipal grants. Following the 2001 Constitutional reform, in 2009 the Italian parliament delegated government to approve new norms on fiscal federalism (framework law L. 42/2009)[27]. The framework law contemplated the possibility of transferring funds to local government according to two criteria: *standard costs*, to finance "fundamental" activities, and fiscal capacity, to finance all other activities. On the basis of a 2011 decree implementing the law, in order to compute standard costs, very detailed questionnaires on the characteristics of the supply of all main services were sent to all municipalities. This information, coupled with budget data and other data on the territory and local prices, allowed to compute minimal and average standard costs for the provision of services. Features of the population were instead used to compute standard needs[28].

The process of gathering and processing information lasted three years; and standard costs/needs have just been made public (June 2014)[29]. In principle, these standards could also be used to compute the *total size of grants* to be given to municipalities (the sum over all municipalities of how much more money in excess of standardized local taxation each municipality needs to cover standard needs when offering services at standard costs); in practice, and as long as public finances will be at risk, they will be used *to allocate savings* across municipalities, revising Internal Stability Pacts and grants accordingly. A similar approach is used to determine standard costs and

[27] See Ambrosanio and Balduzzi (2011).
[28] All computations were carried forward by Sose, a Treasury fully owned private firm specialized in empirical analysis.
[29] In principle, the process should be repeated every three years.

needs for health expenditures (and consequently transfers) for regions, though here the law is even clearer in stating that the total amount of resources will not be determined as the sum of regional needs, but by the overall constraints of the national budget.

The reform of the transfer mechanism was combined with several changes of the Internal Stability Pact. First, since 2013 all Municipalities over 1,000 became subject to the Pact. Second, concerning targets: in 2008, a new concept of *"mixed accrual basis" balance* to define target was introduced. With this definition, the final balance is given by the sum of an *accrual* current balance and of a *cash* capital balance, net of some exceptions. This definition is more consistent with European constraints, which do not allow for a *golden rule*, and make window dressing operations for municipalities (re-labelling some items of current expenditure as capital ones to escape the Pact) more difficult. Nonetheless, as we saw in the previous section, this new comprehensive budget rule introduced a very strong incentive to reduce public investments for municipalities, adding to the usual advantage in cutting capital expenditure during a crisis. Going back to targets, they are calculated as a percentage of the average current expenditures recorded three year earlier[30]. Percentages may vary according to the size and "virtuosity" of each municipality (see below), whereas reference years vary with time. Third, along with sanctions a new system of *premia* was introduced[31]. However it was only applied in 2012 as it soon became obvious the many difficulties in applying it.

An additional reform concerns the so-called *Tesoreria Unica* (literally, Unique Treasury), first issued in 1984, then abolished in 1997 and finally re-introduced in 2012, in the midst of the financial crisis. According to the *Tesoreria Unica* regime, local authorities are no longer able to deposit the revenues they collect at their own treasurer's office (that is, in commercial banks) but are obliged to do so in a specific interest-bearing account created by the Bank of Italy. Interests are then paid back to the central government. Local governments can manage payments and deposits but cannot manage cash otherwise. In other words, local governments were subtracted the possibility to bear and cash interests, which were attributed to the central government.

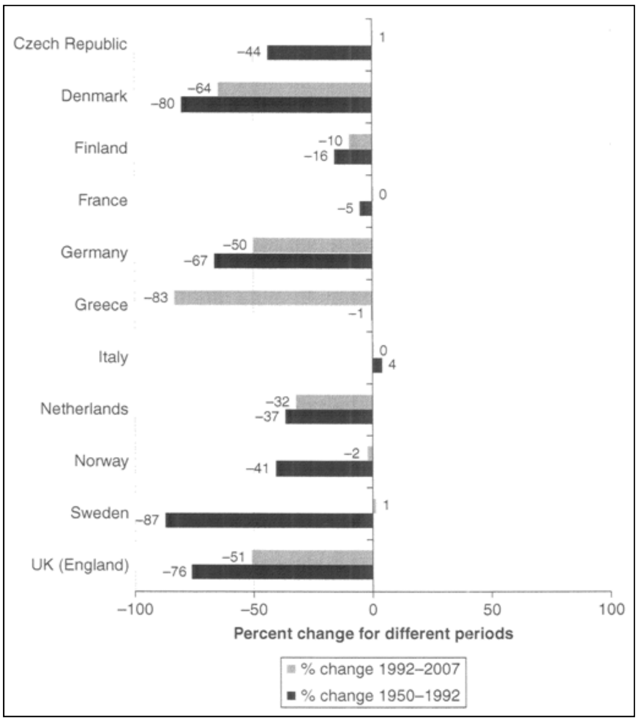
4.3 The number of governments

A well-known problem of the Italian system of government is the excessive number of local governments, too many regions and too many municipalities, many of a size too small to achieve efficiency in the production of services. For instance, 75% of all municipalities (about 8,100) have less than 5,000 inhabitants; and although less than 17% of the Italian population live in these towns, mayors and councillors representing these small towns constitute more than 55% of the total municipal politicians. Plus, there are also too many levels of government, with the 21 regions, the 104 provinces and the 8,100 municipalities and other aggregations insisting on the same territory, often with overlapping responsibilities[32]. The problem has been obvious for decades, but political resistance have always managed to abort any attempt of reform. On the contrary, as

[30] That is, the Internal Stability Pact imposes on each municipality in year *t-1* in preparing the budget for year *t* an improvement on the mixed budget balance in some percentage of the average expenditure registered over a period of three years, two years ahead, from *t-2* to *t-5*. The time distance is due to data availability.
[31] Municipalities were divided in four classes considering financial autonomy, current balance, and revenue collecting ability. The best local authorities then obtained the status of "virtuous", gaining a "discount" on the year's target. This discount had to be financed by a non-virtuous authorities. Almost 150 Municipalities were selected in 2012.
[32] One of the main reason why large public works in Italy take so much time and cost so much is certainly due to this excessive fragmentation. It takes a lot of time to get the agreement of all these bodies, and at the end one needs to compensate all of them for a proposal to be accepted and implemented. The other reason is the excessive delays in administrative justice that magnifies the veto power of each of these bodies.

shown in Graph 6 below for municipalities (but the same could be said for provinces), Italy is unique among European countries in having witnessed up to the crisis an *increase* in the number of local authorities, as splitting one territory in more governments has usually been a sure way to attract more central money and to increase the number of elected positions available for the local political class.

Graph 6
Variation in the number of municipalities in 11 European countries: 1950-1992 and 1992-2007*



Source: Baldersheim and Rose (2010, Figure 1.2)*

The economic crisis and the pressure of public opinion finally allowed to make some progress on these grounds. After several unsuccessful attempts, in 2014 a law was passed to reshape local authorities, with the specific aim to introduce and regulate "Città metropolitane" (Metropolitan cities), redefine and reorganize the role of provinces (in the wait for a Constitutional reform finally abolishing them; see section 5), and to provide new regulations for municipality unions and merger.

The new government landscape that is emerging is still largely unsatisfactory, but with some undeniable progress built in. First, the level intermediate between regions and municipalities, province, has been definitively abolished as an autonomous level of government. Provinces are still there[33] –with reduced powers—but the provincial government is no longer directly elected by citizens and it is composed by representatives of the mayors of the cities belonging to the same province. Small municipalities are also still there; but below some threshold (10,000 inhabitants),

[33] As Provinces are explicitly mentioned in the Constitution, they cannot be truly abolished without changing the latter.

they are now forced to join forces in the provision of *all* services in “unions”, new political bodies whose mechanism of representation and governance are similar to that of the new provinces. A straightforward merger for small municipalities would have been largely preferable, but unions are likely to be an intermediate step in this direction[34].

Finally, the law also introduces the new ”Città metropolitane”, another important step in the direction of rationalizing the structure of government that has been under discussion for ages (Città metropolitane are even mentioned in the current Constitution, although none of them existed so far). In spite of the proliferation of local governments, Italy always missed an administrative/political body that could relate to the reality of its great urban agglomerates. Municipalities are usually too small[35], and provinces did not have the right competences.

A rational reform would have used this opportunity to also discuss size and funding of the new Città metropolitane, but that would have been probably wishing too much. Thus, the new Città metropolitane inherited both the territory and the funding of the old province they substituted[36], plus a number of extra-powers, basically related to all networks (telecommunication, transport, utilities, etc.) serving the Metropolitan city. The Metropolitan mayor is the mayor of the main City and the Metropolitan Council is again made up by representatives of the mayors of all cities and towns belonging to Metropolitan area. Not surprisingly, while only 5 o 6 areas surrounding the main cities could qualify themselves as Metropolis on the grounds of standard economic and social indicators (Iommi, 2014), 10 new Metropolitan cities (9 plus “Roma Capitale”), were in fact introduced, a compromise needed in order to reach enough political consensus to pass the law.

4.4. Bankrupt procedurals

Additional reforms passed during the crisis concerned the legislation concerning municipalities’ financial distress. This a condition under which a municipality can no longer provide its essential functions and services or when it is unable to pay back its own debts. Usually, financial distress is due to one (or more) of the following causes: bad accounting practices; liquidity crisis; excessive and out-of-control use to off-budget debts; low and bad budget monitoring procedures, and so on. The legislation provides explicit support for municipalities who declares themselves of being in distress, but a distress usually also calls for a suspension of the city autonomy. The mayor and the council need to resign, a central government commissioner takes all powers, debt and interests are frozen, assets are liquidated, tariffs and taxes are increased up to the maximum level etc.

Tables 13 and 14 below summarize all distress episodes in the last 25 years, selected by region and by size of the municipalities. Notably, they are relatively few, are mostly concentrated in small towns and in the poorer south, and did not increase that much during the crisis, contrary to what one might have expected.

[34] As a matter of fact, central government tried several times to enforce merging among small towns, even by providing monetary incentives, but with very little success. Since 2014, only 57 villages decided to merge, and this process, carried out through consultative referenda, gave birth to 24 new and bigger municipalities.

[35] For instance, Milan is a relatively small city, slightly more than 1 million inhabitants, with approximately 600,000 people commuting each day in and out the city. But around Milan live other 5 millions of people, all somewhat related economically to the main city.

[36] Thus, the Provincia di Milano just became the Città Metropolitana di Milano and similarly for all the other 9 metropolitan cities.

However, this should not be taken as an indicator of good financial health for Italian municipalities or at least not for all of them. First, a side effect of the reforms tightening national budget rules (up to the introduction of the European fiscal compact in the Italian Constitution) passed during the crisis is that central government is no longer allowed to help distressed cities with extra money. Thus, municipalities have now an incentive to engage in more window dressing of the budget[37], in order to try to avoid or postpone the default as much as possible. Second, exactly to counteract this incentive and avoid the financial situation to degenerate even further, a 2011 law allowed the Italian Corte dei Conti (the judicial body in charge of revising all public budgets) to declare directly the financial distress of a municipality (*guided distress*), while before only the municipality itself could do it.

Table 13
Financially distressed Municipalities, by Regions, 1989-2013*

	1989-2000	2001-2008	2009-2013	1989-2013
Piemonte	5	0	1	6
Lombardia	14	0	1	15
Liguria	3	0	1	4
Veneto	3	0	0	3
Emilia Romagna	8	0	0	8
Toscana	4	0	1	5
Umbria	4	0	0	4
Marche	5	1	0	6
Lazio	34	4	7	45
Abruzzo	17	0	4	21
Molise	12	0	3	15
Campania	104	6	18	128
Puglia	34	1	2	37
Basilicata	19	0	0	19
Calabria	121	6	18	145
Sicilia	21	3	7	31
Sardegna	2	1	0	3
Total	406	19	88	495

*Source: Corte dei Conti, Sezione delle autonomie,
Relazione sulla gestione finanziaria degli enti locali, 2011 - 2012

But somewhat paradoxically, to avoid the just introduced *guided distress* and so to have to openly acknowledge the fact that several Italian cities might be on the verge of bankruptcy, since 2012 (with some further adjustments in 2014) the central government has provided municipalities with the possibility of an *early distress* (or multiannual financial rebalance), where the rebalance procedure is still managed by the political bodies of the municipality. In this case, the municipality has to prepare a plan according to the following steps: a) a precise determination of the distress causes and evaluation of the municipality budget balance; b) a plan of actions and deadlines to solve financial problems within ten years; c) clear definition of resourced to realize the plan (own revenues, debt). More recently (decree 16/2014) the terms for financial rebalance have been further extended, provided the rebalance is significantly conditioned by the reduction of public services' costs and the re-organization of municipalities' owned private companies that offer public services.

[37] The most common practice is to play around with "active residuals", sums that the municipality has not cashed in the past but that it declares to expect to cash in the next budget (for instance, due payments for fines or tariffs) so allowing it to "close" this budget in equilibrium. When future comes, the game is played again. The abnormal size of these residuals is one of the indicator used by the Corte dei Conti to indicate the presence of a financial distress.

The upmost of these schizophrenic procedurals is that several small and large cities, especially in the south, are still on the verge of bankruptcy. It will have to be seen if these multiannual financial rebalance work or if they will just be a way for a city to seat and wait for central government's support without having to declare a financial distress and pay the consequent costs[38],[39].

Table 14
Financially distressed Municipalities, by population, 1989-2013

	1-9.999	10.000-59.999	Above 60.000	Total
Piemonte	5	0	1	6
Lombardia	15	0	0	15
Liguria	4	0	0	4
Veneto	0	3	0	3
Emilia Romagna	8	0	0	8
Toscana	4	1	0	5
Umbria	3	1	0	4
Marche	6	0	0	6
Lazio	33	11	1	45
Abruzzo	19	1	0	20
Molise	15	0	0	15
Campania	89	35	4	128
Puglia	33	3	1	37
Basilicata	17	1	1	19
Calabria	134	11	0	145
Sicilia	20	11	0	31
Sardegna	2	1	0	3
Total	408	79	8	495

*Source: Corte dei Conti, Sezione delle autonomie,
Relazione sulla gestione finanziaria degli enti locali, 2011 - 2012

4.5 Off budget debts and arrears

Another way to look at the financial health of Italian local governments is to consider off budget debts and public arrears. In the Italian legal framework, off budget debts are defined as debts originated by practices not in compliance with accounting rules. Thus, these debts are not recorded and undermine budget truthfulness and transparency; in addition, part of these debts are not formally recognized. According to Corte dei Conti's estimates, this problem concerns about a quarter of Italian municipalities; and in the time period between 2010 and 2012, off budget debts of municipalities have increased to about 1.265 euro millions (Table 15).

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[38] Despite the law, for instance, at the beginning of 2014 the Central government transferred 400 million Euro to Rome, in order to avoid an almost certain bankruptcy of the city.
[39] This might be too harsh. One positive effect of the new rules and in particular the implicit treat by the Corte dei Conti is that it forced several municipalities to clean the budgets, reducing many bad accounting practices (see note 37). It should also be noticed that as a consequence of the European rules a reform was also passed concerning the *harmonization of accounting rules and procedures for all public entities*. The accounting reform has only be applied so far experimentally to a sample of cities but it should be applied universally starting with 2015. One important request of the new accounting procedural is the introduction of a *consolidated account* for local authorities, including all owned private companies. This will certainly improve accountability as the Internal Stability Pact stimulated municipalities to transfer debts and workforce to private societies they owned, as the latter are no subject to fiscal rules. The central government is currently trying to force municipalities to sell or shut down many of these companies (according to some estimations, Italian municipalities own completely or have the majoritarian share in almost 14,000 private companies).

Table 15
Off budget debts of Municipalities 2010-2012 (euro millions)

Year	N. of Municipalities	Recognised	To be recognised	Total
2010	2006	628,763	353,055	981,818
2011	1930	551,079	264,953	816,032
2012	1951	576,548	688,646	1.265,194

*Source: Corte dei Conti, Sezione delle autonomie, *Relazione sulla gestione finanziaria degli enti locali*, *2011 - 2012*

Concerning public arrears, these differ from off budget debts because in this case debts are originated by practices in compliance with accounting rules but with shortage of coverage funds. There are no available official and certain data about the exact amount of arrears. The Bank of Italy[40] in 2013 estimated them in about 90 euro billions, half of which originating in the health care sector (arrears of Health Care Units). Notice that at least for municipalities some of these arrears were a result of the working of the Internal Fiscal Pact itself, which, since 2011, asked municipalities to reach the targets on budget on both accrual and cash bases. Hence, a municipality might have had the money to pay private suppliers, but was unable to spend it as it had already met its cash limit.

Table 16
Arrears payments (euro billions, on 28 march)*

	Resources assignment	Resources available	Payments
Total amount	27.2	24.9	23.5
Total amount as % of assignment		92%	86%
Central Administration	3.0	3.0	3.0
Regions - Autonomous Provinces	15.8	13.8	13.7
Provinces and Municipalities	8.4	8.2	7.0

*Source: Ministry for the Economy and Finance, "*Sblocca debiti", stato di attuazione*, 2014

In 2012 and 2013 the central Government approved two decrees, in order to pay off a big chunk of these arrears[41], 40 euro billions between 2013 and 2014 or about 2,5% of GDP. In particular, 23.5 euro billions of arrears were repaid by March 2014, 13.7 billion of which concerning arrears owed to suppliers of health-care services (Table 16).

To understand the rationale for these policies, one should note that payment of arrears for current expenditure increases public debt *but not public deficit* of the general government, because the national institute of statistics (ISTAT), following European rules, computes such expenditures on an accruals basis. Therefore, they are already budgeted in the deficits of previous years. On the contrary, payments made in order to extinguish commercial debts for capital expenditure also *increase* the *deficit* because ISTAT calculates this expenditure on a cash basis.

[40] Bank of Italy, Economic Bulletin, n. 68/ 2013 and n.2/2014; the Bank of Italy makes a yearly estimate of commercial debts on the basis of sample surveys of firms and supervisory reports.
[41] Payments concern debts that were assessed as "certain, liquid and collectable" at the end of 2012; a debt is certain when its existence is not challenged (i.e. it is not the subject of disputes or contested in some other way); it is liquid when its amount has been determined or can easily be determined; and it is collectable when the deadline for payment has expired.

Repayment of the commercial debts in 2013-14 represented perhaps the only counter cyclical fiscal measure that Italy could adopt since the beginning of the crisis while still complying with European rules[42]. It is hard to estimate the impact of these payments on growth. The Bank of Italy (2013) estimates fiscal multipliers which depend on how firms use the amount they receive (close to unity in the case of investment in machinery and working capital, and close to zero for the amounts that firms hold for precautionary purposes); in particular the effects of the measures to unblock general government commercial debts (totalling €47 billion in the two years 2013-14) on GDP is estimated to be a little over half a percentage point in the three years 2013-15.

Repayment of commercial debts by local units was therefore probably a good policy to follow for the national government. Still, it has to be acknowledged that it worsened the soft budget constraint problem at local level, that as we discussed above it is still rampant in the Italian structure of governments. The necessary financial resources have been disbursed by the central government trough cash advances to regions and municipalities; they should be reimbursed in the future, but of course it will have to be seen if this really happens.

5. The Italian version of the fiscal compact and the new Constitution

5.1 The new art 81 and the "legge rinforzata".

In 2014, the Italian version of the European treaty known as Fiscal Compact, entered in force, via a constitutional amendment (rewriting art.81) and an implementing law (*legge rinforzata*; literally enhanced law) voted with supermajority. As well known, the new fiscal rule does not allow for debt to finance investment, but only to account for economic cycle. The "legge rinforzata" specifies this requirement further by clarifying that the country will be assumed to be in a budget equilibrium if it reaches its *medium term objective*, as defined at the European level. For Italy, the medium term objective is to have (starting with 2015) a balanced structural budget. The rule applies to general government. For the central government application of the law means an overall (structural) budget in equilibrium, including transfers to local governments and social security's entities.

For the local governments, the law specifies something different. Overall budget equilibrium must be reached (each year) at the *regional level* for all local governments belonging to that region, including the regional government itself, but there are no specific constraints for each single local government. This means that, say, a single municipality can still debt finance an investment *provided* that this new debt is matched by a corresponding surplus of another municipality located in the same region, or by a surplus at regional government level[43]. Thus, this constitutional provision replicates what already implied by ordinary laws, through the *vertical* (the region pays) or the *horizontal* pact (the other municipalities pay), with the difference that now national horizontal pact seems to be excluded, as the overall budget equilibrium must be reached at the level of each region.

[42] The European Commission took the view that they were not problematic as they referred to past behavior. Plus, as noticed into the text, by and large, these payments did not affect the deficit rule but only public debt. And the European rule on debt reduction only applies from 2015 onwards.

[43] This pooling of municipalities' surplus and deficits at the regional level, exploiting the lumpy nature of investment at local level, makes sense for large regions such as Lombardia, with 10 million of inhabitants and more than 1,600 municipalities. It makes by far less sense for smaller regions such as Calabria or Molise.

The problem with this provision is that, as seen above, these pacts do not seem to be working; only the vertical pact worked so far and only in those regions where the regional government had some extra money to spare (basically only in the north). And it is not obvious why the horizontal pacts should work in the future. As discussed above, one of the reason why they did not work is that in a situation of economic difficulty and uncertainty concerning both future grants and future regulations, municipalities with a surplus did not trust lending their money to some other municipalities. To make it works, there should be a more explicit guarantee that this money will come back and also more flexible rules (mimicking a true market mechanism) that allowed to remunerate the lending.

One way to proceed would be to strengthen the role of regional government with respect their own municipalities, giving regions *the control of local finance*, currently under the control of the national government; that is, allowing grants and grant allocation to municipalities to be decided at the regional government. The central government could simply transfer to each region the money it now uses to finance the municipalities of that region[44], letting the region decides how to allocate these resources. And the fact that regions control present and future grants would allow them to guarantee that the money a municipality gives up today (letting others use its surplus) comes back tomorrow (with some interest). In other words, the regional government would then have the powers to guarantee that all local governments insisting in the same region, including the regional government itself, would respect the overall balanced budget rule, even allowing for a break of the rule at the single municipality level.

Unfortunately, although this enhanced role of regions versus their municipalities is perfectly compatible with the current constitution, it was never applied[45]. Municipalities, that in Italy have traditionally a stronger role than regions, in particular big cities, resent region “centralism” and always resisted such a move, preferring to maintain a direct financial link with the central government. Worse, as we discuss below, this enhanced role of regions is *less compatible* with the new proposed constitution that undoubtedly weakens the institutional and political role of regions.

The conclusion is that the new fiscal rules might turn out to be too strict to allow for debt financing of even economically meaningful public investments, forcing each local government to be continuously in a budget balanced equilibrium. This can dampen growth in a country where a) local investments are traditionally very important (approximately 2/3 of public investment are usually carried out at the local level); b) they are the only ones that work[46] c) they have already been dramatically reduced during the crisis, as we saw above.

5.2 Local governments in the new proposed Constitution

The process leading to a constitutional reform has just started and will require time to be approved (if ever) as it needs two passages in both houses with a minimum time span of three months between each passage and possibly, a confirmative referendum. But the new government is very determined to bring it to a conclusion and the amended text has the support of main parties represented in the Parliament. As already stated, the main aim of the constitutional reform is to eliminate the Italian perfect bicameralism, transforming the upper house in a Senate of local

[44] It should not necessarily be a transfer. For example, the central government could just raise the regional tax share on VAT or the regional surcharge tax on IRPEF, reducing suitably its own tax rates.
[45] Only the three small Special regions in the north have full control of the financing of their municipalities.
[46] See note 31 for a discussion of why large public works in Italy are difficult to decide and to execute.

authorities whose support is no longer needed for the central government to rule. But the constitution also implies deep changes for the structure of local governments. Provinces are definitely abolished; region's functions are drastically reduced, in particular the category of shared functions is abolished; and a *supremacy clause* is introduced[47], so that in case of a conflict central government legislation is now much more likely to dominate regional one[48].

Regions exclusive functions are still enumerate in the constitution[49], but this is hardly a protection for region's autonomy as the supremacy clause will presumably allow the central government to have an upper hand in these matters too. The role of regions also change. They gain a role in the Senate, as out of 100 senators, 74 will be representatives of the regional councils (elected by the regional councillors among themselves to become senators)[50]. But they share this role with the mayors of the main cities, as 21 senators (one for each region) are mayor[51]. The role of the new Senate is basically only advisory, except for constitutional changes, international treaties and the election of the President of Republic, where it has the same status as the lower chamber, as a potential guarantee against a too powerful national government.

More specifically, the new Senate may ask to examine all legislation, but the lower chamber has no obligation to take into account Senate's suggestions. More protection is offered on laws referring to the articles of the constitution that directly impact on local government functions; the new article 117, where the main regional functions are indicated. Here, an exam by the Senate of proposed legislature is compulsory. But the lower chamber is still the final decision maker, as it can always overcome Senate amendments by absolute majority (50%+1 of votes among all MPs)[52]. And legislative initiative is in the hands of the lower house. Even the wages of the President of region and the regional councillors will be from now on decided by the central government as it happens for municipalities and at same level of the mayor of the main municipalities. Interestingly, while there is still a debate in Parliament about the nature of senators (if directly or indirectly elected), no one has raised any objections about the reduced role of regions, an indication of the low level of consensus that regions presently enjoy among citizens.

The art.119 on fiscal federalism (never really applied) remains basically unchanged, although it makes even less sense in the new structure. This is a problem, because as it has already happened, in order to conciliate this article with reality the legislator will have to introduce several unnecessary complications in local finance[53]. Furthermore, number and identity of regions remain

[47] Central government can invoke reasons of "national interest" to bypass regional legislature.
[48] In case of a conflict, it is always up to the Constitutional Court to decide.
[49] The new constitution enumerates all exclusive functions of central government, where now many of the previous shared functions are allocated. For example, all previous shared functions on energy, infrastructures, banking system, labor, trade, etc. return to the exclusive competence of the national government. All other functions are in theory exclusive functions of regions, subjected to the supremacy clause. But the new art.117 is more specific on some of the functions that remain to regions. They mostly coincide with the main ones currently attributed to regions. Health care provision, vocational training, local transport and environment.
[50] Seats will be allocated to regions according to population, but as there is minimum number of senators for each region and the number of regional senators is limited, representation will only weakly follow population.
[51] The remaining five senators are directly appointed by the President of the Republic.
[52] In the hope of the constitutional lawmaker, the fact that regions are already involved, through their representatives in the Senate, in the definition of the legislature concerning their (reduced) functions, should reduce *ex ante* the reasons for conflict with the national government, while the supremacy clause should reduce it *ex post*, by making it less likely that a region will appeal to the Constitutional Court (being less likely that it can now win).
[53] Recall that according to art.119 transfers can only be redistributive and without string attached. This has meant, in applying the 2009 Framework Law, having to "invent" a lot of *fake tax shares* to be able to provide local governments with the same grants they received before.

unchanged, although this would have been the right opportunity to merge together at least the smaller ones.

Summing up, while the current constitution has in the regional level of government the fundamental agent for decentralization, in the future, if the new constitution is approved, many functions will be the facto or de jure re-centralized, and regions will basically have the same rank of municipalities. Future Italy will then be composed only by the central government and by municipalities, quasi-municipalities (the regions) and union of municipalities (these are also the new Metropolitan cities). The question is whether this will work.

6. Concluding remarks

The economic crisis that started in 2008 and deepened in 2011 deeply affected the fiscal relationships between levels of government in Italy. The crisis was not a direct result of mismanagement of local finances, although the poor quality of several institutions concerning regional and local government had a role in explaining the dismay performance of the economy both before and during the crisis. As a consequence of the crisis, the Italian system of government clearly moved in the direction of a re-centralization of policies. Likely, this new equilibrium will also find a new constitutional basis. It will have to be seen that this new equilibrium will be able to offer a more efficient and responsive system of governments at local level. Some steps, detailed in the paper, clearly point in this direction; others do not.

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