

Summary and Introduction

Why publish a Report on local government finance in Italy?

Over the past decade, the process of political decentralisation in Italy has been particularly intense. The transfer from central to territorial governments of administrative competences and revenues, together with the reduction in administrative controls foreseen by the so-called Bassanini Act, have considerably strengthened the local government role and autonomy (provinces and municipalities). In the same period, a slow and continuous reconstruction of the regional and local governments' financial autonomy has been going on. Indeed, the Constitutional Reform of 2001 and, partly, the legislative provisions central and local governments introduced in some sectors have further consolidated that dynamics. Admittedly, the reform process is still going on and it will be laborious: however, the ongoing constitutional reform is bound to further enhance the role of local government in Italy.

And yet, at the same time, the difficulties of the central government public finance have imposed limits and controls onto the local government revenues and expenditure in order to respect the Stability and Growth Pact at the European level. In turn, the smaller transfers from the central government and the introduction of constraints on the revenues and expenditure management made it necessary to review the priorities and modalities of local government service supply and to enlarge the range of its traditional financing instruments. The growing role of local governments went alongside with a budget squeeze, which created a contradiction which might have different effects and indeed deserves to be monitored. One may wonder whether this kind of situation leads local governments to adopt strategy-based budget policies or whether it may, eventually, reduce the local government functions and services which would have an impact on the citizens' welfare and on competitiveness. Thus, a correct evaluation of those outcomes, which are probably different in the various geographical areas and for different kind of bodies in the articulated landscape of Italian local governments, is of the utmost importance in terms of policy.

Indeed, it is worth remembering that the story of local public finance has always been intertwining with the story of the economic and social development of Italy. This happened in the past century with the first industrial development, as well as soon after World War II, with the South-North migration flows, till the creation of industrial districts and of a negotiated planning system for local development. The supply of basic infrastructural services, housing policies, the municipal welfare state, cultural interventions and the organisations of events, the promotion of economic activities have always been the reflection of this functional relation through time. Today, local governments' policies have to provide suitable and innovative answers to partially new phenomena such as the relative reduction of industry and the development of the service sector, the urban development, immigration from abroad and the population ageing, otherwise the fiscal system is no longer sustainable and the Italian competitiveness is gradually mined.

Against this framework, ISAE (Institute for Economic Studies and Analyses), IRPET (Regional Institute for the Economic Planning of Tuscany) and IRES *Piemonte* (Institute for Economic and Social Research in Piedmont) feel the need to jointly carry out continuous and consistent surveys on the local government public finance through the publication of an annual Report which, apart from describing the major financial trends in the Italian provinces and municipalities, could provide an assessment and an interpretation of the ongoing processes, by offering indications on the evolution of the whole public finance system. There are three basic considerations behind this joint effort.

Firstly, in the official documents available, the trend of the Italian local government finance is regularly monitored with an eye to the control of accounting and administrative procedures (Reports to Parliament of the Section on Autonomies of the Court of Auditors, initiatives of the Ministry on Internal Affairs and of the Observatory on Local Governments' Finance and Accounting), or with a prevailing attention onto the description of the dynamics of aggregate financial items (the Reports of the Ministry of Economics, of the Ministry on Internal Affairs and of the Bank of Italy). Other non-official initiatives are more scattered and are often connected with vested interests (sometimes, the analyses carried out by local category organisations). Admittedly, the national-level picture – which is reconstructed in the survey of **Appendix 1** of the

present Report - is rich but too aggregated to highlight the structural determinants and the dynamics of the Italian local government finance and, in particular, its deep internal diversification.

Secondly, the data on the local government finance show a limit due to the delay with which basic information (disaggregated by geographical area and by sector) is made available. This makes the task of those who wish to spell out the local governments' financial problems much more difficult. Indeed, the applied economic analyses show that, for a diagnosis to be made on the financial and economic health of local governments, account must be taken of the main differences within them (between bodies of different size, lying in urban or in non-urban areas, in different kinds of environment etc.). This is one of the most important profiles to consider in order to assess public policies towards local governments and to make significant comparisons between single bodies and their main typologies. Admittedly, there are some applied studies on the disaggregated data - even though they had the above-described time delays - but they have been carried out on the basis of autonomous initiatives, which means that no international comparison is feasible.

Finally, the absence of consistent comparative analyses on local government finance within the European Union emerges. Indeed, this kind of analyses provides useful indications if one wants to identify possible innovations in the Italian local finance. As a matter of fact, the process of European unification may be a thrust towards more convergence in the European local government systems.

One might wonder why the focus is on local and not on regional finance. The main reason lies in the fact that the still incomplete constitutional reform makes it difficult to have an overall idea of the regional and local government finance, even if it remains to be seen whether this is necessary in the next future. That is why the present Report strictly focuses on local government finance referred to provinces, municipalities and all the other bodies (i.e. local owned manufacturing firms, institutions, foundations, etc.) supplying them services of any kind. Obviously the same might hold for regions, particularly from the point of view of the principle of subsidiarity and of a larger transfer of administrative functions from central to local governments. It may also be useful in terms of the wide-encompassing re-thinking which is necessary to implement the reformed Title V of the Italian Constitution, as it is based on the analyses and

proposals stemming both from the activities which public and private research bodies have been carrying out over the past few years and on the work of the “High Commission for the study and the settlement of general principles of public finance and fiscal system”, which published its final Report at the end of September 2005.

The ambition of the present Report is contributing to fill the above described gaps of knowledge, by prompting a consistent and coherent discussion among economists. The Report will be published on an annual basis.

The first issue of the Report is divided into three parts:

- 1) Part I is devoted to the examination of the structural and evolutionary characteristics of the local government finance examined from different viewpoints, namely from an institutional, a geographical and a chronological point of view (in the short and in the long run);
- 2) Part II contains monographic surveys based on an overall and/or on sectoral viewpoints concerning the framework of financial measures ruling local government, the problems of fiscal revenues, the problems of specific investment-financing instruments, the analysis of the interventions in the social service sector, the management of economic services through public utilities.
- 3) Part III hinges on important aspects of the fiscal decentralisation process in the EU Member Countries. The first issue deals with local government company taxation.

The papers contained in the present Report – particularly in Part II - are aimed at promoting the transfer of knowledge between local administrations so as to favour the diffusion and comparison of techniques, experiences and methodologies which are considered innovative. In the present Report, wide room is left to the discussion of general problems, paying little attention to case studies and specific experiences, which will be provided by future Reports, which – as the first one - are going to be a sort of forum to analyse, exchange experiences and compare ideas with scientific rigour but having in mind a wider public. In particular, the Report is aimed at operators acting at different government levels (both central and local), who are the institutional counterparts of local governments, as well as at operators and administrators of local governments themselves and at entrepreneurs providing public services, who might draw useful indications from it.

To corroborate the analysis – particularly the one carried out in Part I of the Report – ISAE has implemented a data bank on the economic-financial flows managed by local governments (municipalities and provinces) which enabled to underpin the survey with robust quantitative information. The data bank contains revenue flows and budget payments deriving from the integration of two main sources, namely the surveys of the National Institute of Statistics (*Istituto Nazionale di Statistica* – ISTAT) on the budgets of municipal and provincial administrations and the surveys on quarterly cash flows made by the State General Accounting Department (*Ragioneria Generale dello Stato* – RGS). The ISTAT surveys provide detailed data not only by economic item, but also by function; the RGS surveys provide information only by economic category, but they are particularly updated. The integration between the two sources enabled to elaborate estimates up to the year 2004, which is one of the most original aspects of the present Report. In the meanwhile, our thank goes to ISTAT and to the RGS for making their micro-data available as well as for supporting ISAE during the integration of sources, which was a fundamental step in the data bank construction.

Contents

A greater fiscal autonomy and the implementation of the principle of correspondence and accountability, a better managing efficiency and larger commitment in infrastructural works and in investments in general are the main targets reached by the local government finance in the past decade. Conversely, the failure to reform the system of fiscal transfers and the emergence of great differences in terms of revenues-expenditure in different geographical areas are the critical elements. Indeed, the former may have sometimes favoured opportunistic behaviours while the latter deserves special attention to promote the necessary corrective measures.

Turning to the financial autonomy, the data used to carry out the analysis described in **the first three Chapters** of the present Report indicate that, in spite of the narrower gap of tax and tariff pressure between the North-Centre and the South, the figures of the North-Centre remain significantly high. That phenomenon may be affected both by the unfair distribution of tax bases and by the presence of different degrees of tax evasion in the different areas and, in the next future, local governments may be called to play a major role on this very point, even though the present operational capacity of their tax

departments may be questioned. With reference to expenditure, the recovery of capital payments, particularly for investments, was less intense in the Southern area, where the need remains to reduce the local governments' delay which has even widened.

The geographical differences in the *per capita* revenues and expenditure may depend on historical "objective" reasons (institutional differences and divergences in need and fiscal revenues), as well as on "subjective" reasons (preferences). By comparing local governments which are similar in "objective" terms, one may understand whether there are differences in preferences, namely "subjective" discrepancies.

Generally speaking, since 1970 Italy has been witnessing an alternation of diversification phases (1972-1978 for the reduction of financial accountability, and 1990-2002 for the recovery of fiscal autonomy) and of convergence phases (1978-1989, for equalisation policies). Thus, whenever the possibility to diversify emerges, Italian local governments tend to diverge because of the strong discrepancies in subjective and in objective factors.

As a matter of fact, starting from 1996, the gap in fiscal pressure and in *per capita* current expenditure between the North and the South of Italy has been narrowing: indeed, while in the first part of the period the gap had been widening, the subsequent fiscal pressure slowdown in the North of Italy and the ongoing recovery in the South reduced the gap (the Southern distance from the national *per capita* current expenditure goes from -18% to -13%). While in the North the lighter fiscal pressure has come together with a current expenditure reduction, the municipalities in the Centre seem to have decided to maintain a high pressure in order to defend the expenditure levels they reached. A similar trend was observed in the South, where Southern provinces have recovered part of the delay they had accumulated also thanks to the new taxes introduced in that period.

However, in 2004, there remain glaring geographical differences both in terms of fiscal revenues and (to a smaller extent) of current expenditure (transfers have a compensatory role even though they weight less than taxes). The North lies in-between the high-pressure, large-expenditure Centre and the low-pressure, small-expenditure South. The main discrepancies emerge between the Southern regions of Italy (excluding the two Islands), showing levels of fiscal pressure and current expenditure falling short of the national average by 20%, and the Northern special-statute regions, with a current

expenditure exceeding the national average by 30%, without further burden for citizens due to fiscal transfers.

The demographic structure of the municipalities also affects the regional gaps in current expenditure. Indeed, the municipalities of some regions – *Lazio*, for instance –, though registering an average expenditure above the Italian figure, would rank below the national average value if their demographic structures were considered.

Indeed, within the same administrative region, the different municipalities' dimensions cause different effects: usually large municipalities have a larger expenditure, but the revenues are not as large. Medium-sized municipalities have proportionally larger revenues than expenditure, hence have a wider margin of fiscal autonomy. However, this general rule shows important exceptions, especially in Central regions, where the average municipalities have larger expenditure levels than large municipalities, maybe because of their role in tourism-related activities.

The fiscal choices of municipalities and provinces are generally consistent among the regions, with few exceptions. Above-average levels of fiscal pressure emerge in some local administrations in *Toscana*, *Emilia* and *Lombardia*, while those in the South and in the Northern special-statute regions are below average. Please notice that the provinces' fiscal autonomy is larger than the municipalities' one - net of the personal income tax share - and also its variability among different regions is wider.

The strongly diversified weight of regional transfers highlights the differences between the expenditure levels of provincial administrations in different regions. Indeed, when dealing with provinces, there are strong differences in the institutional tasks, due in particular to the delegations of functions some regions have implemented to provinces in the transport sector. However, also net of delegations, the provinces in Central regions, but also in *Piemonte* and *Basilicata*, show above-average expenditure levels. Conversely, the provinces in *Lazio* and *Lombardia* rank rather low, maybe crowded out by the large municipalities lying in those regions.

The composition of the municipalities' expenditure mainly consists of basic services (service networks, social services, education and transport...), having a stable incidence, and of a portion of services mirroring the citizens' preferences (culture, sport...). And it is in this very sector that the enormous differences between the Southern regions of

Italy (75 euros *per capita* for sport, culture and social services) and the Northern special-statute regions (275 euros *per capita* for the same sectors) emerge.

The fiscal pressure growth of the Nineties, even though it happened in the presence of a symmetric reduction in central government transfers, favoured an improvement in the budgetary situation. In the first phase, that improvement was also due to a reduction in the investment component which afterwards, in the late - Nineties, expanded again till it reached the peaks in the past few years.

In terms of expenditure composition (percentage on the overall capital expenditure, that is of the most development-oriented component) local governments followed a positive path. In terms of financial sources, apart from the interruption of the process of growing fiscal autonomy which occurred in the past two years, the main problem seems to be the failure to reform the fiscal transfer system. The rules envisaging the gradual introduction of a fiscal equalisation system based on the principles of equity and efficiency (Decree Law n. 244/97) remained dead letter. Admittedly, the transfer of tasks and functions was accompanied by more fiscal and pseudo-fiscal autonomy, which marked the departure from the system of “derived finance” which, in the two previous decades, had contributed to creating considerable budget imbalances because of the discrepancy between spending power and revenue capacity. But when the final act towards the re-organisation of a federal system based on the principles of subsidiarity and efficiency was close, the process registered a slowdown and the local governments’ autonomy was reduced, particularly in fiscal terms.

The set of local taxes which were introduced in the past decade – as described in **Chapter 7** of the present Report – is quite strong in terms of percentage of local governments’ total revenues. There are however limits which may and must be overcome by introducing some innovations. In particular, also in view of the implementation of art.119 of the Italian Constitution, it is worth underlining that a sound fiscal autonomy is characterised not only by the tax base *potentiality* to produce tax revenues and by the tax rate *manoeuvrability*; but also by the tax base time *dynamics*. Admittedly, tax bases must be elastic to income and prices, otherwise the tax rate manoeuvrability and the revenue potentiality risk to be exclusively used to maintain the real value of tax revenues. And yet, tax bases particularly sensitive to the economic,

consumption and productive profiles cause difficulties because of the risks connected to the cyclical fluctuations.

However, an equilibrium must be found. In this sense, it seems reasonable to maintain and somehow enhance the personal income tax revenues, as well as taxation on rents and real estate. However, that should go alongside with the introduction of two innovations, namely the reform of the census and classification of the Italian Cadastre, with a larger involvement of municipalities, and the introduction of a diversified fiscal autonomy according to the municipalities' demographic dimensions.

The remarks made in **Chapter 7** suggest that, generally speaking, local fiscal system should focus on real estate taxation, on the one hand, and on taxation on the use of soil, on the other (occupation and use of urban and non-urban areas, services to non residents, tourists or commuters, etc.) with a uniform taxation on personal income able to maintain through time the real value of tax revenues, hence make all citizens contribute to the local government budget funding. Indeed, the thorough analysis of the experiences made in the EU Member Countries described in **Chapter 11**, suggests not to abandon the idea of a value added tax, income or product type, which is identified as the ideal tax base for a local taxation on productive activities.

The great (geographical and sectoral) variability in the revenue collection capability, in the reaction to reforms, in the propensity to spend, in a word in the observed behaviours characterising the Italian local governments, needs to be brought to some form of unity and must be monitored in aggregate terms. The behaviour of the macro-aggregate *local government finance* directly and significantly impacts on the overall public budget: note that in the three years 2002-2004 the net borrowing computed according to the Maastricht Treaty standards increased up to levels which had emerged in the Eighties, when the whole sector of local governments was worth 0.7% of GDP (0.4% of GDP considering only provinces and municipalities). This situation requires rules of governance guaranteeing the smooth co-existence of the various components – in particular those managed by the different levels of government – within a process of convergence towards balance. To this end, as other European countries, also Italy adopts the Domestic Stability Pact (DSP), which is thoroughly analysed in **Chapter 4** (from a general point of view) and in **Chapter 5** (from the point of view of local governments and with special reference to Tuscany).

The DSP rules for local governments have been often modified: at the beginning, the provisions made only reference to budget balances, then to the expenditure growth, sometimes including and sometimes excluding some specific categories. Between 1999 and 2004, Italy adopted a “golden rule” variant which excluded public investments and interest payments from the DSP deficit computation. Indeed, the flexibility allowed to local governments in honouring the standards foreseen by the European Stability and Growth Pact concerns in particular investments, which are a typical multi-annual expenditure, particularly “praiseworthy” for the whole community and fundamental for the economic development and for employment, which can be funded through deficit spending. This is in keeping with the wording of the new article 119 of the Italian Constitution, envisaging that all public administrations must obtain a budget balance net of investments. The aim of the rule was not to penalise the investment capacity of those government bodies which resort to capital expenditure and, thus, avoid any depressive impact on the economy. It was a way to create more room to local administrations, which often meet difficulties in financing the volatile and large expenditure for capital growth with their own revenues. However, the 2005 introduction of more or less strict ceilings to capital expenditure was an attempt to limit the expenditure evolution (even the most profitable one), in the meantime trying to avoid the risk of illegitimate allocations and computation of some expenditure items.

The analysis carried out in **Chapter 4** shows that one should be favourable to the golden rule accompanied by a maximum ceiling for the capital expenditure of all sub-national governments and, at the same time, one should foresee compensatory behaviours at the central level. Indeed, the plafond set to capital expenditure of local governments should impose some sort of priority ranking, which means a better project selection.

With reference to the fiscal discipline implementation, attention was paid to the illegitimate use of the word “Pact” to identify a whole set of rules which are *de facto* imposed by the central government and are neither agreed upon by the different government levels on an equal footing, nor based on a mutual consensus. As a matter of fact, local governments are in favour of a more cooperative approach, which is usually adopted in countries with a more advanced level of decentralisation. Besides, in a cooperative system too, the fiscal discipline attaches a determinant role to the central

government in the decision-making process and in coordination. And yet, the definition of procedures aimed at connecting the actions taken at the different government levels, particularly in the phase of financial planning, appears fundamental: the general targets set for the whole General Government should be shared between the various government levels, so as to make the central government action and the public finance provisions more transparent and reliable and, ultimately, obtain sound public finances.

This means that the complex system of monitoring foreseen by law should be strengthened thanks to the creation of a system of accounts providing detailed, comparative and timely information. Indeed, an integrated and not scattered system of accounts is the first and main guarantee for a correct representation of the financial status of the various government levels. In this sense, a rapid and wide-spread diffusion of the Information System on the Operations of Government Bodies (*Sistema Informativo sulle Operazioni degli Enti Pubblici – SIOPE*) is longed for, as it is a useful instrument to collect data on the ongoing situation, hence make a comparison between local governments and evaluate the different degrees of efficiency of the public action.

Chapter 5 examines the DSP rules announced in the Financial Law for 2006, making a simulation of the impact they could have on local governments in Tuscany. The simulation outcome, based on the incomplete data available in October 2005, has not the ambition to thoroughly compute the impact - which will mainly depend on the local governments' behaviours - but it shows the importance of data collection on local government finance to plan a public intervention at all government levels.

The simulation, which assumes the adoption of considerable financial cuts for local governments in Tuscany, gives rise to some general remarks.

Firstly, as for the investment ceiling, Chapter 5 – somehow running counter the approach of the previous Chapter – expresses a criticism of this choice, as it may be counterproductive and trigger a depressive effect on the whole economy. Besides, those effects might be more likely to emerge in a situation of economic recession as the present one, when the opposite solution – i.e. prompting both public and private investments – would be more useful.

Secondly, it is necessary to revise the criteria to distribute the necessary cuts to reduce the country's public debt between central and local governments. From a federalist viewpoint, regions and local governments should be asked sacrifices proportional not to

their expenditure level, but rather to their borrowing level, which means resuming the budget balance logics. This also means that a geographically dishomogeneous distribution of the efforts to reduce the deficit must be adopted, so that each local government is free to decide when and how to intervene on revenues, on expenditure or on both.

Thirdly, the fact that the DSP rules have often changed through time is one of the shortcomings of the whole mechanism, particularly when the rules become, as in this case, more rigid and restrictive. The need to have a stable point of reference, at least for some time, is a top priority for all local government bodies and this really requires an answer.

Indeed, the continuous change of the DSP rules through time, associated to the failure to reform the system of transfer distribution, caused considerable managing difficulties and continuous adjustment costs for local administrations. Local administrators report a sense of uncertainty and temporariness towards the amount of resources on which they can reckon in the long run to finance the interventions on their territory. This did not favour the diffusion of a culture of planning and accountability in local government operators. Recently, that kind of approach is partially emerging among local administrators also thanks to the reforms which led to the present version of the Consolidated Law (*Testo Unico*) on Local Government Autonomy.

Virtuous and efficient behaviours have characterised, for instance, the management of public utilities, which were favoured by the long reform process which has been taking place in this sector and which has deeply changed the organisation and market structure. That ongoing process - apart from increasing competition on the market and for the market - had a positive impact on local government finance. **Chapter 10** tries to assess the outcome of the reform of local public utilities. As already mentioned, the improvement in terms of efficiency and profitability were significant, and yet delays and contradictions emerge, particularly when analysing the territorial dispersion of the performances.

The reform of local public utilities had a considerable impact in the North and Centre of Italy, prompting the transformation of tens of municipal companies into joint stock companies, with more suitable structures in terms of organisation and dimension. Given that those kinds of companies were not so diffused in the South of Italy, also the reform

impact was weaker in the South and many municipalities continued to manage autonomously that service, thus contributing to the municipal “pulverisation” of the services supply.

At first, the reform projects were also envisaging tenders for service supply, so as to make the markets controllable and the local market monopoly temporary. However, crossed vetoes against this part of the reform eventually favoured the approval of an overall law enabling municipalities to depart from the principle of market competition. Given that some sector reforms had already introduced the principle of tenders for public service supply, it remains *de facto* operational in natural gas distribution, in electricity supply and in local transport.

Indeed, a continuous and diffused profitability improvement has been going on in local government services. This holds true in particular up to the beginning of the present decade, because an inverse of trend seems to have occurred in the past few years. The “threat” to make the market controllable may have contributed to the firms’ growth in dimension and efficiency. Also the State subsidy cuts had a role, whereas the recent worsening may be due to the legal uncertainties and to the final outcome of the reforms which seem unable to affect local monopolies.

While the reforms of local public utilities in the South seem to have been rather ineffective, in many Northern and Central municipalities the combined effect of partial privatisation and incomplete service liberalisation brought about a financially virtuous circle, which eventually bore fruits in terms of municipal revenues both through the sale of municipal companies and through the distribution of dividends, which has accompanied the investment growth. However, the financial benefits the municipality receives from its own company mark a conflict of interest with its function of regulator. Only full privatisation would enable the municipality to play the sole role of regulator, but it is difficult to believe that municipalities will sell all their companies and renounce to financial benefits. From a political point of view, the revenues stemming from local public utilities are costless, even though the high profits withdrawn by municipalities and by private share-holders are an implicit tax weighting on users. The revenues many municipalities receive from those sources risk to be mined from the reduction of profitability which has been characterising the past few years, at a time when the

Stability Pact constraints become more stringent and transfers to local governments are decreasing.

On the other hand, there is a very close link between the restrictions imposed by the DSP and by the cuts to State transfers and the attempts made by local governments to find new financing sources, particularly to support investments projects. From this viewpoint, the role of local governments has considerably grown in the past decade but, in this case too, there emerged remarkable geographical discrepancies. **Chapter 6** focuses on these aspects and provides a detailed analysis of the Southern area.

To finance their investments, local governments have to choose whether to continue acting in a “classic” way, waiting for traditional capital account transfers from the central government or from the POR funds (*Programma Operativo Regionale*, Regional Operative Programme) or, alternatively, to “organise” their financial management making it more dynamic and open to new solutions.

The rules and regulation which are increasingly oriented to decentralisation with cuts to State transfers; the privatisation of the *Cassa Depositi e Prestiti*; the introduction and regulation of Local Government bonds and project financing (the ruling of which in Italy dates back to 1998), brought about deep changes in local governments’ managing performances. Indeed, a new concept of the finance-administration relationship has been gaining ground, and local administrations are growingly similar to companies. However, only part of that new concept was really implemented and its impact on the development of new administrative roles was only partial.

The most blatant limits emerge in the *Mezzogiorno* of Italy, where there is a strong resort to traditional bank loans and the adoption of more innovative and complex financial instruments (Local Government bonds) is still limited. It is worth noting that, in the next fifteen years, the South will still benefit from the EU financial resources within the Community Support Framework for Objective 1. That led local governments to develop their planning function more than their financial ability, thus conveying resources onto feasibility studies on the creation of EU-funded infrastructures. However, steps forward were made by introducing mechanisms awarding local governments showing their ability to prompt private investments.

From the point of view of banking, a major reverse of trend took place following upon the gradual transformation and privatisation of the *Cassa Depositi e Prestiti* alongside

with the introduction of rules determining the opening of the market to other banking groups (cfr. Law n. 403/90).

Among the critical factors hampering an adequate diffusion of innovative financial instruments supporting the local governments' investments – particularly in the South – there is the lack of an integrated information system on the financial operations already started or bound to be implemented by local governments, namely a sort of observatory on financial instruments providing reliable and timely information. The available empirical evidence indicates that most local governments resort to traditional bank loans: in the North-Centre the percentage is worth 83-89%, while in the *Mezzogiorno* it is beyond 95%.

The use of Local Government bonds is rare in the *Mezzogiorno*, as it accounts for slightly more than 10% of the bonds issued by municipalities and provinces per volume, while it accounts for 48.9% in the Centre and for 40.9% in the North. There are also problems connected to the use of rating and somehow linked to those questions: indeed, out of 47 Italian local governments resorting to that financial instrument, only 4 provinces and 3 municipalities lie in the South. Indeed, the phenomenon whereby only bodies of a certain size resort to rating concerns the whole country.

The situation of project financing is more dynamic. Thanks to the enforcement of Law n. 415/98 and to the following creation of the Project Financing Unit (*Unità Tecnica di Finanza di Progetto* – UFP) of the Ministry of Economics and Finance, which has successfully followed some operations, that instrument has been gaining ground among local governments. A contribution also came from regions, which have played a major role of sensitisation and communication towards local governments (for instance the administrative region *Campania* created its own Project Financing Unit). Indeed, the inclusion in the Regional Operational Programmes (*Programmi Operativi Regionali* – POR) of specific awards for local governments including the project financing formula in their investment plans was of the utmost importance. And those initiatives were mirrored in the proliferation of calls for the search of promoters in the South, even though it remains to be checked how many of them become real infrastructures. The great number of calls indicates a good propensity of local governments to entrust private operators. However, for that instrument to be smoothly adopted, there are still unsolved

legal, administrative and financial problems (mainly connected to inadequate cash flows which small and very small initiatives generate, around 7.7 millions of euros).

Admittedly, the process of innovation of the financing formulas was started: for it to continue and grow, it is necessary to train the staff and bring about a larger diversification of competences within the existing structures, also through further investment in education and training. Indeed, specific professional figures should emerge not only able to manage traditional bank loans, but also to opt for innovative financial instruments, so that the best possible solutions are identified to guarantee the necessary investment resources and to maintain the budget balance of each local government.

Admittedly, as already recalled in the previous pages, many components affect the inter-regional variability of the local governments' spending behaviours: one of the most significant concerns the management of health care and social policy services, that is the local welfare state, which is dealt with in **Chapter 8**. The absence of a regulation in this sector, the service cost and other cultural and institutional elements led to wide gaps in the regional supply of those services. It is an out and out "diversified citizenship": the criteria and conditions to have access to those services deeply differ from one area to the other and, in some cases, local social services are almost absent. The new welfare law (Law n. 328) of December 2000 aimed at redefining and enhancing the general guidelines of some national social policies (through monetary transfers) and integrate them with local social policy services, reducing the existing disparities in the municipal supply of social services and start the process of welfare state regionalisation. However, its implementation was only partial and, for the time being, it is limited to local services and it is based on the State-region and on the region-local body co-financing of social policies.

Pending the re-organisation of the central welfare state, one would have thought that the service improvement was to be mirrored in larger local expenditure. The expected impact of Law n. 328 and of the National Fund for Social Policies consisted of a growth in the social policy expenditure of municipalities, particularly in those areas which historically offered scarce social services. Conversely, the data show that, since the enforcement of Law n. 328, the municipalities' expenditure has been growing, but with a not different dynamics compared to the previous years. Besides, expenditure has not

increased in areas with historical shortcomings, while it continued to grow in the North-Centre, where local governments had already experienced in the early-Nineties the supply of new services and interventions, thus maintaining – let alone widening – the already existing gap.

A fundamental instrument to fairly manage social services – mentioned in Law n. 328/00 – is the s.c. Equivalent Economic Status Index (*Indicatore di Situazione Economica Equivalente* – ISEE). **Chapter 9** thoroughly depicts the problems and the solutions which were faced in the long phase of creation and completion of that instrument. The Chapter focuses on the critical aspects and on its shortcomings, by analysing the initial choice of the measuring unit, namely the alternative between an income-based or a consumption-based parameter. The analysis deals with the problem of the way in which one's patrimony is considered among the ISEE-building variables and evaluates the pros and the cons of the final option to adopt one single ISEE scheme and not a diversified formula for each aim.

Decree Law n. 13/00 modified the ISEE by including a 20% patrimony share and by leaving to the Italian Social Security System (*Istituto Nazionale della Previdenza Sociale* - INPS) the managing of the centralised data bank aimed at collecting the Single Replacement Statements (*Dichiarazione Sostitutiva Unica* – DSU), which is the basis for all family benefit granting. However, some sort of flexibility was introduced by art. 3 of Decree n. 130 envisaging the possibility on the part of granting bodies to introduce “further criteria to select the recipients”. In other words, the single ISEE form, managed by INPS, was not successful. If, on the one side, its adoption is also diffused at local level, there are many cases in which it cannot be implemented and there are many alternative indicators. Generally speaking, the choice of instruments other than the ISEE is justified by its shortcomings, among which its reference to the gross rather than to the net income, its lack of flexibility, its definition of household and the scale of equivalence which is being adopted. Indeed, there was no general consensus on the computation of patrimony.

The “High Commission for the study and the settlement of general principles of public finance and fiscal system” suggests to amend the Decree Law n. 130/00, possibly resuming at least part of the flexibility foreseen in the previous Decree Law n. 109/98. Maybe in this area some sort of mutual scepticism between the decentralisation

advocates and the centralisation supporters - particularly between different administrations – must be overcome. One feels that the creation of a single data bank is fundamental to improve the transparency of the operations made through the welfare state and to minimise the number of self-declarations requested to citizens, but this option would be really justified if data on the real granting of allowances were available and if questions to the central government on the part of the granting bodies were feasible. This would mean monitoring the overall welfare state effects, which would mark a significant step forward in the knowledge of the distributive effects of public expenditure.

Problems and prospects

To try and submit some indications for the future, the analyses made in the Report should be set against the social-economic and geographical framework of reference, which has deeply changed over the past few years for at least three types of reasons:

- a) the growing role of services in the economy significantly changed the geography of economic activities, particularly in urban areas, thus promoting the development of different kinds of service activities (services to households and firms, large trade systems, etc.) which, together with the change in the social profile of the population, enhanced the quality of the demand for services to local governments;
- b) the demographic dynamics brought about a growing demand for local services. It is characterised by a gradual ageing of the native population which is pulverised in ever smaller households depending from external help, together with a rise in immigrant workers who become fundamental actors in the demand for housing, education, assistance;
- c) the economic competition finds new points of reference: indeed the continental level goes alongside with the local level, with the consequent demand for “territorial quality” and for (either material and immaterial) strategic infrastructures.

Finally, local governments must play a strategic role to guarantee the level of wellbeing and the creation of external economies for local economic systems. However, alongside with a growingly qualified demand for local interventions, local governments are often confronted with the impossibility to provide adequate answers, particularly because of the difficult situation of public finances in Italy. The present Report thoroughly spells

out the elements causing the discrepancy between expectations and operational opportunities, between the demand for welfare and local competition, on the one side, and financing difficulties, constraints and dimension-based diseconomies, on the other. Also looking at future prospects, there emerge considerable obstacles of political-institutional, economic and geographical nature.

The first obstacle is of political-institutional nature: indeed, a first fundamental factor is the opposition to decentralisation exerted by the central government which is subject to a pressure from above (EU) and, at the same time, from the bottom. Apparently the story of the creation of ordinary-statute regions accompanied by a process of fiscal centralisation is taking place again after more than thirty years. Today, the reform of Title V of the Italian Constitution is followed by the failure to implement it, by the reduction of the already limited margins of fiscal autonomy and by a growingly stringent enforcement of the DSP. This is accompanied by the ongoing precariousness of local autonomies and by the uncertain evolution of the constitutional reform process, in spite of a certain consolidation guaranteed by the Consolidated Law (*Testo Unico*) on Local Government Autonomy (Decree Law n. 267/00).

The second problem is of economic nature. Decentralisation, according to some authors, is a luxury for rich countries which Italy cannot afford in this period of stagnation, as it has such a historically large public debt. Maybe this conclusion is excessively dramatic and pessimistic, but the fact remains that gradual public expenditure restrictions induced by the European constraints and by low economic growth highlight the difficulties met both in introducing transfers of functions from one level of government to another, and in imposing local taxation without undermining the overall recovery. Furthermore, local taxation should be reviewed so as to ensure the income elasticity to the economic dynamics, which today is minimum, particularly in municipalities.

Finally, the diffusion of the decentralisation process is particularly problematic in Italy given the wide development gaps (among the widest in Europe) characterising its different areas. In this situation, autonomy risks to be seen more as a source for unfairness than as the demonstration of different preferences, even if it is easy to realise that decades of centralisation have not narrowed the gaps in service supply among the different areas of the country. The analysis of the long-term expenditure and fiscal pressure trends provided in the Report shows that there is a spontaneous diversification

of behaviours whenever the margins for autonomy are larger, but also that preferences in favour of government intervention are not diversified according to the North-South logics. Regions with strong municipal and provincial role coexist with low fiscal pressure areas with a large presence of private operators. The differences in behaviour due to the recent constraints imposed by the Financial Law narrowed again in the past few years, but the basic problem remains of structural gaps in preferences, in costs and in revenue capability which the enforcement of art. 119 of the Italian Constitution and the consequent tax and transfer reform has to deal with.