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Fiscal federalism and equalization design under the growing public finance constraint: a case of Italian municipalities

Carmela Brugnanoⁱ, Giuseppe Ferrainaⁱⁱ, Francesca Loiⁱⁱⁱ, Larysa Minzyuk^{iv} and Marianna Nitti^v

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Abstract

Recently, the issue of federalism has turned at the centre of the political debate in Italy. It is basically due to the growing demand of rich northern regions who in 2018 laid down the requests to exercise additional functions retaining a more significant part of revenues that the central government collects in their territories. Another reason for attention to this issue is that the long period of public finance consolidation in Italy (2011-15) put the implementation of fiscal federalism to a standstill. There is a growing demand to ascertain the measure to which this implementation has been biased or remained undone. This paper focuses on this second issue investigating to which extent the design of fiscal federalism reform has been applied to the Italian municipalities with a special focus on the equalization system. The paper first proposes a review on the evolution of public finance setting in Italy before the crisis (2008-09), considering the decentralization process in the 1990s and the Constitutional reform of 2001 followed by the enabling law 42 in 2009. Then it looks at the period of fiscal consolidation after the financial crisis in 2011 focusing on the burden of adjustment measures imposed to Italian municipalities. Finally, it tries to summarize the contradictions that the overlapping of two contrasting political agendas – the centralization of public finance under fiscal consolidation and the ongoing fiscal federalism reform – created for the equalization system of municipalities.

classification: H50, H60, H70

Keywords: Fiscal federalism, Public finance consolidation, Equalization system, Italian municipalities

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Abstract

Nei mesi scorsi la questione del federalismo fiscale è tornata al centro del dibattito politico italiano, a seguito del rinnovato interesse verso questo tema da parte di alcune Regioni settentrionali, che hanno manifestato la volontà di esercitare direttamente una serie di funzioni fin qui amministrare dall'Amministrazione centrale, finanziando questo *surplus* di attività tramite quota parte di entrate che lo Stato attualmente preleva sui rispettivi territori di riferimento. Sul piano più strettamente scientifico, invece, la necessità di riportare la questione del federalismo fiscale al centro dell'analisi è dovuta al fatto che il lungo periodo di consolidamento delle finanze pubbliche italiane (2011-2015), determinatosi in ragione della crisi economica e finanziaria attraversata dal Paese, ha portato la riforma federalista ad un punto di sostanziale stasi. Per tale motivo è cresciuto l'interesse nel verificare se l'applicazione del federalismo fiscale sia stata parziale o abbia comunque preso forme differenti rispetto al disegno originario. L'analisi condotta in questo articolo muove da questo secondo aspetto, esaminando in particolare se e in qual misura il disegno della legge delega n. 42 del 2009 sia stato disatteso nei confronti dei Comuni Italiani con riferimento al sistema perequativo fin qui implementato. Il presente lavoro propone, nella prima parte, una revisione dell'evoluzione dell'assetto della finanza pubblica italiana prima della crisi (2008-09), considerando il processo di decentralizzazione degli anni '90 e la riforma costituzionale del 2001, successivamente seguita dalla legge delega n. 42 del 2009. In seguito, si considera il periodo di consolidamento fiscale intervenuto dopo la crisi finanziaria del 2011, concentrandosi sul peso della manovra a carico del comparto comunale. Infine, si cerca di fare una sintesi delle contraddizioni che le due agende politiche contrastanti – la centralizzazione della finanza pubblica a seguito della manovra e il procedere in contemporanea dell'implementazione della riforma federalista – hanno prodotto per il sistema perequativo comunale.

classification: H50, H60, H70

Keywords: Federalismo fiscale, Consolidamento finanze pubbliche, Sistema perequativo, Comuni italiani

Introduction

Federalism is a complex phenomenon. The models of federalism adopted internationally differ, in some cases significantly, in function of institutional, political and historical context. The Italian federalism design develops in the polycentric institutional system in which aside the regions there are present local authorities – municipalities, provinces and metropolitan cities – whose position, structure and core functions are safeguarded by the constitutional provisions. The distribution of authority and functions between different levels government is built on the principle of subsidiarity, differentiation and adequacy.

Besides the delicate polycentric institutional setting the recent history of public finance has also contributed to determine the design of Italian federalism. In order to understand it, it can be useful to give an overview on recent developments in the organization of public finance in Italy. Its essential steps consist in:

- almost total centralization of the fiscal authority in the early 1970s
- decentralization 1997-2000
- constitutional reform in favour of federalism 2001 and enabling law 42/2009
- centralization of public finance under fiscal adjustment 2011-15.

The period between 1971 and 1977 is characterized by almost total centralization of public finance in Italy by means of the Tax Reform Act of 1971⁶ and of the so-called Decrees Stammati (1976 and 1977). Under the centralized scheme, almost all local taxes were replaced with transfers from the centre to the periphery. The system with centralized tax collection and decentralized expenditure aimed, on one hand, to reduce the gap between the North and the South of the country in provision of local services and, on the other hand, to keep under control public spending.

The centralization resulted in the system of relations between the national and territorial governments, characterized by asymmetry between power to tax and spend, in which the centre, collecting taxes, was considered always ‘guilty’. Furthermore, during the 1980s, the Italian government lost control over public finances, both at national and territorial level, which resulted in an increase of the public debt over 100% of the debt/GDP ratio. In 1992, Italy experienced a strong currency devaluation leaving the European Exchange Rate Mechanism. Both the resulted financial

⁶ Legislative Delegation to the Government of the Republic for Tax Reform.

crisis and lately the need to meet the Maastricht requirements to join the common currency in 1997 called for the strong fiscal consolidation.

Between 1997-2001 there was observed a strong movement versus decentralization, believed useful to increase financial responsibility of territorial governments (Ambrosanio and Bordignon, 2007; Ambrosanio et.al, 2010). It was preceded with the introduction of municipal tax on real estate property ICI in 1992. By means of the Bassanini laws, the vast administrative functions and skills were transferred from the centre to the periphery. In short run, the decentralization contributed to further increase the system of transfers since the new peripheric functions were financed with additional resources coming from the centre (Rodean, 2012).

In 2001, there were adopted changes to the Title V of the Constitution to move the country versus federalist model. Coherently with the international trend, it was believed that fiscal federalism can be a remedy for the growing public debt. Providing territorial governments with power to tax and spend it was believed to enhance their accountability to local communities and to stabilize the growing public debt.

The constitutional reform called for a significant change in the existing relations between the centre and the regions. According to the art.117 of the new Title V, the state (the national parliament and, in the cases explicitly provided by law, the national government) retained the power to exclusively legislate on a limited subset of functions (defence, justice, public order, currency, international treaties, setting uniform standards and levels for the provision of fundamental/essential public services by regions and local authorities etc.), while all other functions were either reserved to regional legislation (exclusive regional legislation) or to be shared between the state and the regions (concurrent legislation) for which the first one should limitedly fix priorities/principles allowing the regions to legislate on details.

The new art. 119 of the Constitution describes the new fiscal relations between different levels of government. It establishes that regional and local authorities' functions should be financed totally with their own revenues, tax shares and with equalization transfers. The equalization system, to be instituted by the state, should benefit the territories with weaker fiscal capacity.

In 2009, there was approved the enabling law n. 42 which laid down the principles and criteria for implementation of the constitutional reform, providing the government with special legislative delegation to proceed with the implementation.

The new set of economic and financial relations between the centre and the territorial autonomies (regions, provinces, municipalities and metropolitan cities) aims to overcome the derived finance system (*finanza derivata*), in which the distribution of resources occurred according to the

historical levels of expenditure (*spesa storica*), by providing them with high levels of autonomy in taxing and spending safeguarding the principles of solidarity and social cohesion.

The resources for local governments (municipalities) according the law should come from their own taxes, tax shares and equalization transfers. Standard expenditure needs (*fabbisogni standard*) are to be considered as a benchmark for financing local governments through equalization system. To this end, the law distinguishes between local fundamental functions, for which it specifies full financing of standard expenditure needs, and the remaining local functions, for which it provides for partial equalization in fiscal capacity only. For the fundamental functions relating to civil and social rights, the state defines the essential levels of benefits (*livelli essenziali di prestazioni*) to guarantee throughout the national territory.

The law 42/2009 further mandates to set mechanisms of rewarding efficient local governments meeting targets and of sanctioning otherwise. The targets are to be established in terms of balanced budgets, provision of essential levels of benefits, low levels of fiscal pressure and increased employment.

The implementation of the law 42/2009 should be consistent with the financial commitments of Italy under the European Stability and Growth Pact. It should avoid duplication of functions and costs between different levels of government, safeguard the principle of progressivity in taxation and not increase overall tax burden.

The economic crisis between 2008-09 and lately the financial crisis (2011-12) hit severely the Italian economy and called into question the sustainability of its public debt. To regain confidence of financial markets, the central government in 2011 launched a massive fiscal adjustment program. In 2012, the Parliament voted to insert the budget balance principle in the Italian Constitution though it was not strictly required for the implementation of the Fiscal compact and Six Pack. Probably the ruling political coalition wanted in this way to bring to the attention of people the importance of balanced public budget and to take a strong commitment not to further increase public debt.

The measures of public consolidation in the period 2011-15, involved all levels of government, especially the local ones versus whom the central government undertook actions that some call as justifiable only «[...] by a perceived situation of extreme risk for the country, analogous to an international conflict» (Ambrosanio et. al, 2016). Among the principal measures introduced there were cuts in transfers, forced saving by means of the *Internal stability pact* (ISP), limitations of expenditure and borrowing, block of turnover etc.

In the same period there was registered a significant increase in tax autonomy of the municipalities. The increased autonomy, realized through extending municipal taxation of real estate,

was however a result of using local taxation to collect additional resources for national budget rather than an outcome of the fiscal federalism reform.

The centralization of public finance 2011-15 put *de facto* the fiscal federalism in standstill situation in which the reforms were nominally going on but without moving institutional setting versus federalist paradigm. In 2015 there was taken an attempt to consolidate *de jure* the new centralized setting with a proposal of the constitutional reform under the Renzi's government. This reform was rejected by the referendum in 2016 and now it is observed an opposite movement: a growing demand of regions to run autonomously additional functions and an increasing demand of local authorities (municipalities, provinces and metropolitan cities) to overcome the negative consequences of restrictive policies, to revise the chaotic implementation process of fiscal federalism reconciling its principles with the rules of coordination of public finance deriving from the balanced budget rule.

The rest of the paper is organized as follows. The first section reviews the main measures applied to municipalities under the fiscal consolidation 2010-15. The second section considers their effects on municipalities finance. The third section analyses how the restrictive policies contributed to shape the equalization program for municipalities in deviation from the original design in the law 42/2009. The fourth part concludes offering some policy indications.

The analysis and data in this paper does not consider the municipalities from the regions Val d'Aosta, Friuli Venezia Giulia and Trentino Alto Adige as they are not subject to the direct control of the central government authorities. The part of the paper that regards the equalization program adopted to Italian municipalities does not also consider the municipalities of Sicily and Sardinia to which is not applied

1. Municipal federalism under fiscal consolidation

The implementation of fiscal federalism after the enabling law 42/2009 coincides with the period during which Italy suffers recession following the economic (2008-09) and the financial crisis in 2011. The negative impact of these two shocks on real economy is dramatic: the Italian GDP contraction is -5.9% in 2009 and -2.6% in 2013.

The central government, given the huge public debt, did not adopt countercyclical fiscal policy (Ambrosanio and Balduzzi, 2013). In contrast, to regain the trust of financial markets versus Italian public debt, the government launched the fiscal consolidation program, mostly concentrated in 2011-13, which measures consisted in almost 56 euro billions of additional fiscal revenues, 46 euro billions

of current expenditure reduction⁷ and 20 euro billions of capital expenditures cut⁸. In 2012, the reform of the public pension system was adopted. It was expected to produce significant adjustments for public finance in medium-long period.

The fiscal consolidation involved all levels of government. For the municipalities, the bulk of burden consisted in reductions of transfers, introduction of new fiscal rules with heavy sanctions in case of their breaking (ISP and *balanced budget*), borrowing and expenditure limits and in block of turnover.

In the period 2011-15, the cuts of the central government transfers to municipalities amounted to about 8,5 euro billions (Table 1) given that the total local current spending was equal to 51 euro billions in 2010. The transfers reductions were provided through different normative acts (see Transfer cuts, Table 1) and realized using different criteria. Furthermore, there were differences in transfers cuts timing depending on the municipalities' population.

Table 1 Annual and cumulative financial effects of fiscal consolidation program for municipalities. Transfers cuts and ISP/budget balance constrains to spending, 2011-18 (euro millions)

	2011	2012	2013	2014	2015	2016	2017	2018	Cumulative 2011-2018
Total effects of fiscal consolidation program	3095	4100	3416	158	1003	-539	802	408	12443
of which ISP and new accounting rules	1509	1522	1261	-448	-637	-621	712	408	3706
of which transfer cuts	1586	2578	2154	606	1640	82	90	0	8737
<i>"Costi della politica" Law n.244/2007</i>	86	32	0	0	0	0	0	0	118
<i>D.L. 78/2010</i>	1500	1000	0	0	0	0	0	0	2500
<i>D.L. 201/2011</i>		1450	0	0	0	0	0	0	1450
<i>D.L. 95/2012</i>		96	2154	250	100	0	0	0	2600
<i>D.L.179/2012</i>			0	120	0	0	0	0	120
<i>IMU-Tasi*</i>				-139	152	82	90	0	185
<i>D.L. 66/2014</i>				376	188	0	0	0	563
<i>Budget Law 2015</i>					1200	0	0	0	1200

*With the introduction of TASI and the exclusion of main residence from IMU some local governments were losing tax proceeds (about 485euro millions). To compensate them, the specific compensation transfer was introduced to respect the invariance of resources. In 2014 it was about 624euro billions and was gradually declining to the level of 300euro millions in 2018. In the Table *IMU-TASI* indicates the difference between the estimate and the compensation transfer in contrast with the principle of the invariance of revenues.

Source: Elaborations based on the local spending and transfers 2011-18, Ministero dell'Interno.

The Internal stability pact was introduced for municipalities, as for regions and provinces, in 1999 following the commitments of Italy under the European Stability and Growth Pact. The budget bill 2016-18 substituted it from 2016 with the balanced budget rules. Though the new rules represent an important pass to overcome the restrictive budget stance under the ISP, partially relaxed in 2014-15, they continue to limit strongly the spending capacity of local governments even in the after-crisis

⁷ The expenditure constraint under the *Internal Stability Pact* are considered as a reduction in current expenditures.

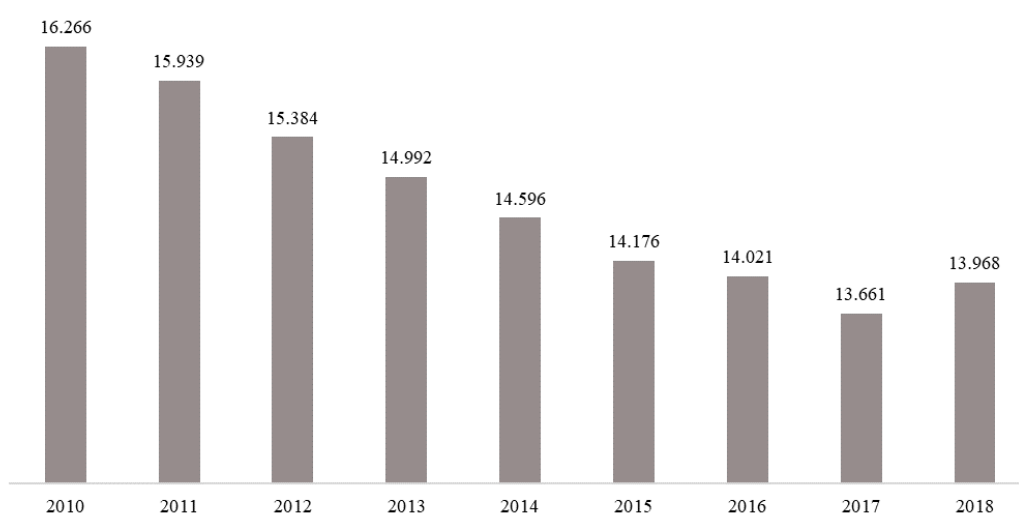
⁸ COPAFF First Report 2014, "Condivisione tra i livelli di governo dei dati sull' entità e la ripartizione delle misure di consolidamento della finanza pubblica. Available on <http://www.mef.gov.it/ministero/commissioni/copaff/>

period by blocking portions of the accrual resources to the provisions for bad debts (see ISP and new accounting rules 2017-18 in Table 1) .

The ISP rules originally were intended as an instrument to ensure financial responsibility of local governments, but during the fiscal consolidation they were used to constrain local governments to accumulate resources (surplus) to benefit the national budget. In the period 2011-15, the municipalities, limiting their expenditure, have cumulatively produced about 3207euro millions of surplus (ISP and new accounting rules 2011-15 Table 1). Furthermore, the rules of the Pact, including targets, sanctions, monitoring procedures and incentives, being at the core of continuous political bargaining, changed almost every year contributing to uncertainty under which local government had to operate.

Starting in 2007, public authority offices were severely limited to hire workers on a permanent contractual regime under the so-called block of turnover. Due to these limitations, between 2010-17, municipalities lost about 60.000 of employees⁹ decreasing their employment expenditure by 16% (Figure 1). The slight increase in the employment expenditure in 2018 is associated with extra spending to finance general revising of public employment contract occurred in 2018. It is important to consider that the block of turnover hit local governments in the period when the important reforms (budget harmonization and new procurement procedures) were in course requiring high level of expertise and numerous activities to comply with the law. Furthermore, during the crisis and in the post-crisis period there was an increasing demand for socio-economic services of municipalities (Pedaci et al., 2020).

Figure 1 - Employment expenditure of municipalities 2010-18 (accrual, euro millions)



Source: Elaborations based on the data from the municipalities' budgets 2010-18, Ministero dell'Interno

⁹ The data is based on elaborations of the data from the Conto annuale della RGS Ragioneria generale dello Stato.

Several reforms were adopted between 2011-13, seemingly a part of the fiscal federalism implementation, which aimed at making municipalities able to collect additional resources for the national budget. They mainly regarded local taxation and transfers.

In 2011, as a part of the implementation of the law 42/2009, the government passed the decree (D.lgs 23/2011) to introduce from 2014 a new real estate local tax, called IMU in substitution of the previous real estate tax ICI¹⁰. The IMU could not be levied on main residence of taxpayers. Its legal tax rate was fixed at 0.76% with the possibility to vary it between 0.46% and 1.06%. Local governments could deliberate to introduce tax allowances for some cadastral categories of buildings.

The decree (D.lgs 23/2011) provided for *fiscalizzazione* of the central government fiscal transfers to municipalities. This term means that the transfers, permanent and not earmarked to financing special projects/programs, were to be abolished and substituted with the transfers coming from the newly established state fund, *fondo sperimentale di riequilibrio* (FSR), of the equal amount¹¹. Though the decree specified different criteria for the fund distribution, including standard expenditure needs, in 2011 its distribution ensured local authorities the resources equal to the abolished transfers.

The reform designed by the D.lgs 23/2011 regarding municipal taxation never took place. In 2012 the government, to counter the negative consequences of the financial crisis in Europe, anticipated the introduction of IMU and substantially changed it (D.L. 201/2012): the IMU tax base was almost doubled by revaluating in linear way cadastral values; the tax base included main residence of taxpayers at the legal tax rate fixed at 0.4% with the possibility to vary it 0.2%¹². For all other buildings, the legal tax rate was 0.76%.

Being the tax base extended and the cadastral values increased, in 2012 the proceeds from IMU were much higher compared to ICI. The netting of this extra income was realized first through gaining by the state of the proceeds from all types of buildings at the rate of 0.38% except those from the main residence that remained fully of local competence, and secondly, through the reduction of resources distributed with the FSR. The distribution of the fund in 2012 was done to ensure the invariance of resources in transition from ICI to IMU.

In 2013, the rules changed again. All proceeds from IMU have become competence of the municipalities except those from the buildings of industrial and commercial destination¹³ whose

¹⁰ The municipal tax on real estate property ICI was introduced in 1992. Its tax base is computed on the cadastre values. In 2008, ICI was reformed by excluding main residence from tax base.

¹¹ The fund resources were netted however for the transfer cuts imposed by the central government in 2011 (see transfer cuts in Table 1).

¹² There was introduced a fiscal deduction of 200 euro on the main residence tax (plus an additional 50 euro for any conniving child younger than 26 years old up to a maximum number of eight children).

¹³ Building of industrial and commercial destination included in cadastral category D.

proceeds at the legal tax rate (0.76%) went to the state and whose extra tax levy revenues went to the municipalities.

In the same year, the FSR was abolished and substituted with a temporary fund, *fondo di solidarietà comunale* (FSC). Apparently, nothing changed for municipalities as all variations were implemented under the invariance of resources principle, which however were decreasing annually by means of transfer cuts (see transfer cuts in 2013 Table 1). The new fund functioning was, however, very different if compared to the FSR. In the new fund, for each municipality there were determined the standard capacity of IMU, equal to this tax proceeds at the legal rate (0.76%) and the fund standard resources, equal to the sum of revenues from the abolished ICI tax and FSR transfers¹⁴. While the FSR was fully vertical fund, filled with the central government resources, the FSC was designed to redistribute income coming from local IMU in order to insure the invariance of fund resources in the transition from ICI to IMU.¹⁵

In particular, for the functioning of FSC, local governments were preliminary subtracted the 38.23%¹⁶ of their IMU standard revenues to feed the fund (*quota di alimentazione*). Each municipality's FSC transfer was calculated as follows:

$$FSC_{it} = 0.3823IMUstd_{it} + Rstd_{it} - IMUstd_{it}$$

where $Rstd_{i,t}$ is the fund standard resources and $IMUstd_{it}$ is the standard revenue of IMU. The FSC in 2013 was partially horizontal fund, filled with the state resources (about 2807euro billions) and the local IMU revenues at the standard tax rate (4717euro billions). Its distribution mechanism consisted in the refund of 38.23% of $IMUstd_{it}$ 'corrected' for the gap between $Rstd_{i,t}$ and $IMUstd_{it}$. With decreasing of the fund resources ($Rstd_{i,t}$) by means of the transfer cuts (Table 1), the fund in 2015 became fully horizontal with about 300euro millions of local IMU revenues outsourced to the national budget.

The transition of the state's share in IMU from the revenues on all buildings at 0.38% rate to the revenues from buildings of industrial and commercial destination increased the tax base under levy of local governments compared to 2013. The extra resources, calculated at legal/standard rate, were outsourced to the central budget by respectively decreasing the fund resources of the FSC.

In 2013, the parliament voted another reform. Starting in 2014 there would be instituted 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 waste collection service, 3) TASI, a service

¹⁴ The FSR transfers were equal to the state transfers *fiscalizzati* under D.lgs 23/2011, diminished to account for the transfer cuts meanwhile applied.

¹⁵ From 2013-14, the FSC included a part of the State resources (vertical component) which however was erased under the transfer cuts applied to the fund resources.

¹⁶ From 2016 this percentage has been set at 22,43%.

tax to finance all the other indivisible services provided by the municipality with tax base is the same as of IMU, but comprehensive of main residence¹⁷. Within the same reform, the main residence was excluded from the tax base of IMU and included in the tax base of TASI, which is the same of IMU. The municipalities promptly responded to the TASI introduction by extracting from it the revenues that they had lost on IMU. This kind of tax manipulation could hardly respond to any reason different from the political consensus seeking. In 2016, main residence of taxpayers was excluded from the tax base of TASI as well. The respective revenues were substituted with the transfer from the FSC, equally increased. On the same time, municipalities were blocked the possibility to raise rates on all local taxes, excluded TARI which revenues are earmarked to financing fully the local waste management service.

Furthermore, the reform provided that from 2014 the FSC was becoming a permanent fund. Starting in 2015 until nowadays, the FSC transfers have been calculated considering in part local standard expenditure needs and fiscal capacities with explicit reference to the application of the fiscal federalism according to the law 42/2009.

The system of equalizations transfers developed within FSC is quite different from the equalization design described in the enabling law. The next sections provide more details on the deviations of the current equalization system for the municipalities from the original design provided in the enabling law 42/2009.

2. Effect of the fiscal consolidation on finance of local governments

The measures of fiscal consolidation were not ending in themselves and produced the effects on municipalities economy and finance. In the period there was observed, mainly due to the limitations and accounting rules of the ISP, a dramatic contraction in the local investments (Ambrosanio, Balduzzi and Bordignon, 2014). The total local current spending in contrast has increased (Table 2)¹⁸. The levels of expenditure for almost all principal local functions in 2017 compared to the 2010 are lower except for the local transport and viability and urban territory governing and waste management¹⁹. It is important to consider that between 2017-18 the local current expenditure retakes

¹⁷ The basic tax rate is 0.1%, which could be reduced or even cancelled by local authorities on the different types of buildings. There is also a maximum threshold, fixed on 0.25% and an additional requirement that the sum of the IMU tax rate plus the TASI tax rate cannot be greater than 1.06%.

¹⁸ The variations in Table 2 are calculated in nominal terms. The inflation rate in the same period was over 8% annual.

¹⁹ The positive dynamic was, at least in part, due to exogenous to fiscal consolidation factors. First, in the same period there were introduced new accounting rules which constrained local governments to consolidate budgets by including off-budget expenditures mainly regarding these two functions. Second, spending for waste management was growing due to the law requirements to increase

to grow mostly due to the central government financing local welfare programs and to addition spending to finance revising of employment contracts (in 2018).

Table 2 – Current expenditure of local governments, 2010-18 % dynamic. Index 2010=100

	2010	2011	2012	2013	2014	2015	2016	2017	2018
Administration services	100	99	97	102	96	94	93	91	93
Social services	100	96	93	93	93	92	91	91	95
Education	100	99	98	98	94	92	89	89	90
Governing urban territory and waste management	100	109	115	128	130	136	128	128	129
Local Transport and viability	100	103	110	111	115	113	105	102	102
Current expenditure	100	101	101	105	103	103	101	100	102
Current expenditure net of waste management and Local Transport Service	100	98	97	99	95	94	93	92	95

Source: IFEL (2019)

The fact that local current spending remained relatively stable despite decreasing transfers can be explained considering that, in the same period, there was observed a significant growth in the revenues from local taxation. While the central government transfers, including those from FSR and lately from FSC, between 2010-17 have decreased by 10.7 euro billions²⁰ (Table 3), the income from main local revenues (IMU-TASI, surcharge on IRPEF and tourist tax in 2017 compared to ICI, surcharge on electricity consumption, surcharge on IRPEF in 2010) has increased by almost 7.7 euro billions²¹.

Table 3 – Local resource, transfers and tax revenues under public consolidation, 2010-18 (euro millions)

		2010	2018	2010-18
Resources	(a) = (b) + (c)	29096	26047	-3238
Central government transfers*	(b)	16011	5087	-10765
Local tax revenues	(c) = (d) +(e) + (f) + (g)	13084	20771	7717
<i>surcharge electricity consumption</i>	(d)	694	0	-694
<i>surcharge IRPEF</i>	(e)	3109	4717	1553
<i>ICI-IMU-TASI</i>	(f)	9281	15576	3729
<i>tourist tax</i>	(g)	0	479	360

* From the central government transfers, only those from the Ministero dell'Interno, are subtracted the part of IMU revenues that serve to fill the FSC fund and which is refund to the municipalities with the FSC distribution (*quota di alimentazione*). In the municipalities' budgets (*Rendiconto consuntivo*) the local proceeds from IMU are

recycling. Not considering the expenditure on local transport and waste management, the total local current expenses decreased in the period 2010-17 (see Table 2).

²⁰ The negative variation of transfers 2010-17 in Table 3 considers transfer cuts as in the specified Table 1, the decreasing of transfers due to assigning to municipals of additional tax base in transition from ICI to IMU and variations in the state transfers not considered under fiscalizzazione (D.lgs 23/2011).

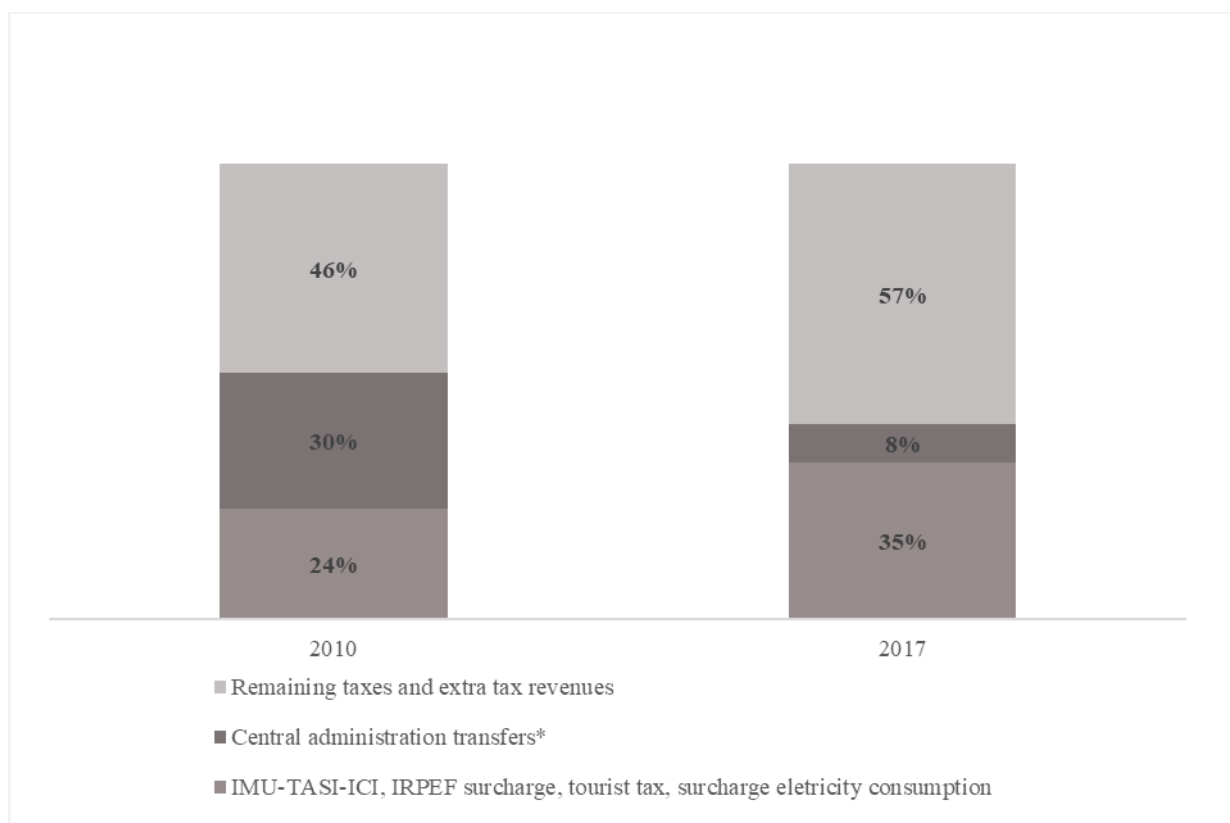
²¹ The local tax revenues in Table 3 do not comprise the proceeds from the residual local taxes: the revenues from COSAP and TOSAP were equal to 913euro millions, from ICDPA to 454euro millions, and from TARI to 8.883euro million. The municipalities budgets 2017, Ministero dell'Interno.

diminished for this part of IMU which is then accounted in the transfers from the state. Since this income is a part of the local IMU tax revenues, in the Table 3 it is considered in *ICI-IMU-TASI flow*.

Source: IFEL (2019)

The growth in local tax revenues combined with decreasing transfers contributed to increase significantly tax autonomy of municipalities. The weight of transfers in total revenues²² decreased from 30% in 2010 to 9% in 2017²³, while the weight of local tax revenues grew from 24% to 36% (Figure 2). The remaining local revenues, including the proceeds from the residual taxes (different from IMU-TASI, IRPEF surcharge and tourist tax), tariffs, fees and extra tax income, has grown as well. The driving force underpinning this positive trend was the growing income from TARI tax, which revenues are earmarked to financing the local waste management service.

Figure 2 – Local revenues . 2010-18 (% composition)



*Central administration transfers consider only the transfers from Ministero dell'Interno.

Source: Elaborations based on the data from the municipalities' budgets 2010-17, Ministero dell'Interno

²² Total revenues are equal the sum of the first three titles of current revenues in municipalities budgets (*Rendiconto consuntivo*): tax revenues, transfers, tax revenues.

²³ The decrease in the share of transfers in total local current revenues would be higher, if the situation in 2010 was compared with 2015. From 2016, the main residence of taxpayers was excluded from the tax base of TASI and the lost tax revenues were substituted with transfers from the FSC, equally increased. Thus, from 2016 the state transfers increase by about 3.6euro billions.

The local tax revenues were increasing due to two reasons. The first one was the application of new local taxes as IMU, whose tax base is much higher compared to ICI, and tourist tax. The second reason relates to the fact that the local governments responded to transfers cuts by moving their tax rates to the highest levels. By the end of 2015, the tax rate range under the autonomy of local governments has been mainly exploited for the taxes as IMU-TASI and with some residual space for the surcharge on IRPEF (Monteduro, 2019). In 2015 the last year before the local governments were banned to move their tax rates in 2016, the percentage of municipalities having the residual tax levy less than 10% of its maximum possible value was about 52% for IMU-TASI and 30% for the surcharge on IRPEF (Table 4).

Table 4 - Residual tax levy for IMU-TASI and IRPEF surcharge, 2015

Intervals residual tax levy	IRPEF surcharge		IMU-TASI	
	N. municipalities	%	N. municipalities	%
[0,10%)	2292	29.83%	3953	51.44%
[10%, 20%)	786	10.23%	1961	25.52%
[20%, 30%)	985	12.82%	1317	17.14%
[30%, 40%)	1011	13.16%	356	4.63%
[40%, 50%)	314	4.09%	59	0.77%
[50%, 60%)	698	9.08%	31	0.40%
[60%, 70%)	242	3.15%	7	0.09%
[70%, 80%)	314	4.09%		
[80%, 90%)	57	0.74%		
[90%, 100%]	985	12.82%		

Source: Elaborations of the Ministero dell'Economia e Finanza (2015)

The Table 5 shows the share of transfers, lost between 2010-18, that the local governments managed to substitute with local revenues (IMU-TASI, surcharge on IRPEF tax and tourist tax) distinguishing for size category of municipalities and their area of location. The mean value of such “substitution” is about 72% but the degree to which municipalities were able to re-gain transfer cuts varies significantly at micro level. It can be seen in the Table 5 that if for the big cities in the North and Centre of Italy the positive variation of revenues from the local taxes (2010-18) actually exceeds the negative variation in transfers, the cities in the South in the same period have lost a considerable part of resources, their mean “substitution” indicator is almost 30 % percent less than the national value.

Table 5 – The share of transfer cuts regained through tax levy on the local taxes (IMU-TASI, surcharge on IRPEF tax and tourist tax), 2010-18

Size category of municipalities (population)	North	Central	South	Total
<=1.000	68%	56%	32%	56%
1.001 - 5.000	75%	76%	45%	65%

5.001 - 10.000	75%	69%	50%	65%
10.001 - 20.000	77%	72%	58%	69%
20.001 - 60.000	76%	72%	55%	66%
60.001 - 100.000	70%	69%	45%	59%
100.001 - 250.000	88%	69%	44%	68%
>250.000	109%	102%	33%	89%
Total	85%	84%	47%	72%

Source: Elaborations based on the data from the municipalities' budgets 2010-18, Ministero dell'Interno

The decreasing of resources for the municipalities in southern Italy was not because they have not used fiscal levy but because their tax bases were not rich enough to raise revenues comparable to the decreasing transfers. As we see in the Table 6, the municipalities located in the South first have the residual tax levy lower than the national mean value for both IMU-TASI and IRPEF surcharge and, second, their actual revenues from IMU-TASI and IRPEF surcharge are lower than the national mean values as well.

Table 6 – Local revenues and residual tax levy, 2017 (euro per capite and % maximum potential level of taxes revenues)

Size category of municipalities (population)	Revenues on IRPEF surcharge (euro per capite)	Residual tax levy on IRPEF surcharge %	Revenues on IMU-TASI (euro per capite)	Residual tax levy on IMU-TASI %
<=1.000	45,6	46%	339,0	12%
1.001 - 5.000	58,3	32%	237,3	12%
5.001 - 10.000	70,7	22%	228,5	11%
10.001 - 20.000	73,6	19%	226,7	10%
20.001 - 60.000	74,3	16%	233,1	7%
60.001 - 100.000	80,7	17%	245,0	6%
100.001 - 250.000	92,0	16%	274,3	4%
>250.000	115,3	10%	397,1	2%
Location area				
North	93,5	21%	299,7	7%
Centre	92,7	14%	314,6	3%
South	54,4	17%	224,1	4%
Total	79,4	18%	264,0	7%

Source: Elaborations based on the data from F24 available 15/01/2018

Summing up, it seems that under the strict fiscal constraint Italian municipalities, having power to tax and spend, and thus accountable to their citizenship, preferred to maintain current spending and historical levels of local services through high taxation.

If the levels of local services remained almost unchanged, the main source of their financing changed significantly. If in 2010 the state transfers were an important part of resources to support the

provision of local services, in 2017 they were largely substituted with the local income at the tax rates driven to the maximum levels. It is important to consider that starting from 2016 the municipalities were banned to raise tax rates on all municipal taxes except TARI. This limitation has been relaxed only in 2019.

Not all municipalities were able to raise enough tax resources in order to substitute transfers. The cities in the South of Italy, thought having the residual tax levy lower than the mean national value, managed to re-gain cumulatively only about 42% of transfer cuts compared to 72% of the average national level. Small municipalities comparatively raised less resources in substitutions of transfer cuts as well. They, however, conserve on average higher levels of the residual tax levy. After relaxing local tax rates in 2019, it would be interesting to observe the dynamic of their revenues.

In this section the focus is made on current local spending and revenues because these are the inputs for determining the criteria for the equalization program that is analyzed in the following section.

3. Evolving of equalization program of municipalities under fiscal consolidation

In multilevel public finance fiscal equalization consists in transferring fiscal resources across different levels of government, or between jurisdictions of the same level, in order to offset differences in revenue raising capacity and/or in needs/cost of public service provision.

Fiscal equalization aims at equity and efficiency, but it may be useful as a mechanism to stabilize public finance (Blöchliger et. al, 2007). By imposing horizontal equity across local jurisdictions, all households or firms are ensured to obtain comparable public services subject to comparable tax burden, independently from residence. Fiscal equalization can be in this way useful to correct for inefficiencies arising when households or firms choose their location based on fiscal benefit rather than productivity. Finally, fiscal equalization may support macroeconomic stabilization and insure local jurisdictions against asymmetric shocks that they may not be able to overcome alone.

Equalization programs, existing both in federal and unitarian states, differ significantly across countries depending on institutional, political and economic setting. The main criteria to distinguish between a variety of programs are the direction of equalization transfers (vertical transfers from centre to sub-central governments and horizontal ones between sub-central governments of the same level), the equalization gap, the target and the approach to definition of expenditure needs/cost.

The equalization gap can be calculated considering differences in revenue raising capacity or in expenditure needs of local service provision. Some programs use both criteria to define the gap.

The target indicates the degree to which the equalization gap is filled by means of transfers. Finally, if the equalization gap is calculated considering expenditure needs/costs, there can be two different methods for their definition: the top-down approach in which total of expenditure needs/costs is given *a priori* and distributed between local governments according to some indicator of bigger/less level of needs/costs, and bottom up approach in which there is no predetermined ceiling to the resources and where, to impose budget constraint, there are determined essential or standard or minimum levels of services to provide (in terms of quantity e/o quality).

The enabling law 42/2009 in the case of municipalities provides for two types of equalization programs. For non-fundamental local functions, the law indicates the horizontal equalization program through the fund filled with municipalities' tax resources to partially equalize fiscal capacities (tax revenue raising capacity at standard tax rate). With reference to fundamental local functions the law provides for full equalization of standard expenditure needs (full target). To this end there should be established a vertical fund filled with the state resources to cover possible gap between total of standard expenditure needs and total of standard fiscal capacities: the equalization gap is the difference between expenditure needs and fiscal capacity.

Regarding the approach to the definition of standard expenditure needs, the enabling law is very ambiguous. First, it specifies that standard expenditure needs should be determined considering the essential levels of benefits and standard costs, associated with the provision of local services. Thus, it implies that the approach to adopt should be the bottom up definition of standard needs/costs. At the same time, the enabling laws specifies that total municipalities' fiscal transfers should not exceed the «historical» level of the central government's transfers to the municipalities and the equalization should produce no additional costs for the national budget, which seems to indicate that the approach to adopt should be of top down type. The ambiguousness of the enabling law 42/2009 regarding the standard expenditure needs is probably the main reason why the equalization program shaped under the fiscal consolidation (2010-15) and applied to the municipalities between 2015-19 is completely horizontal, not ensuring total equalization of standard expenditure needs. The essential levels of benefits, which can be useful to overcome this ambiguousness, have not been meanwhile defined.

In 2011, the decree (D.lgs 216/2011), in implementation of the enabling law, has defined the set of fundamental functions of municipalities including administration services, local police, urban services such as street cleaning and waste management, maintaining of school premises and auxiliary services to education, social services, local viability and transport. The decree further lays down guiding criteria to carry forward into the definition of standard needs such as: periodic collection of data from local governments through questionnaires, development of economic models suited to

better describe and predict costs of local services provision on which base to determine expenditure needs, periodical updating of data and methodology.

The decree remains ambiguous as to the definition of essential levels of benefits. It first states that standard needs should be considered a benchmark for financing fundamental functions and essential levels of benefits implying that there might be fundamental functions to which no essential levels of benefits correspond and *vice versa*. The decree then proceeds indicating that until the definition of essential levels, the existing standards, provided by the state laws, should be considered as essential to guarantee though standard expenditure needs. This provision opened the room for defining standard needs in the absence of essential levels of benefits consolidating the top-down approach. Besides it, where standards, provided by the state law, were missing, given the precedent, the benchmark levels to guarantee through standard expenditure needs have become historical levels of local service provision.

In 2012, the first questionnaires were sent to municipalities to collect data on local services provision which together with budget data and information about local costs and prices should constitute the basis for the determination of standard needs²⁴. The process of gathering the data and elaborating the methodological approach lasted almost three years and the first standard expenditure needs have been approved in 2014²⁵.

The methodology adopted for expenditure needs of municipalities is the regression cost base approach (RCA)²⁶. It consists in the regression analysis of the municipalities' current spending using a big variety of variables in order to specify models which better describe spending or cost patten of local services provision. There are serious concerns related to this approach as it involves a big amount of technical discretion. The value of coefficients of cost drivers and, consequently, standard needs depend crucially on the specification of economic model, on the choice of estimator and of sample for regression (Brosio, 2019). All these decisions are technical and subtracted from political debate which renders the whole process not transparent.

The analysis in this section does not, however, aim to discuss the critical issues related to the methodology of standard needs but to shed light on how the fiscal consolidation (2010-15) contributed to shape some of their traits and render equalization program targeting fundamental functions totally horizontal.

²⁴ The D.lgs 216/2010 invested Sose, the company fully participated by Treasury and Bank of Italy, with collaboration of IFEL, the Institute affiliated to the association of Italian municipalities, to compute standard need and costs.

²⁵The D.lgs 216/2010 provides that standard needs and costs to be updated regularly.

²⁶ For the review on the *Regression cost-based approach* see OECD (1981), Dafflon and Mishler (2007), Reschovsky (2007).

The first standard expenditure needs were derived through regression analysis from the distribution of local spending in 2009-10 and equal to about 38euro billions²⁷.

By the time of completing the elaborations, the state transfers to municipalities have declined by about 8,5euro billions through the transfer cuts (see Table 1). According to the laws providing for the transfers cuts, they regarded not only the transfers of the FSR/FSC but the equalization transfers as well. Thus, even before the equalization fund was actually instituted, its transfers had been already reduced by 8,5euro billions.

In 2014, the vertical component of the FSC, i.e. the difference between the total fund resources and the total standard income IMU-TASI, was scarcely equal to 1.09euro billions and there were intentions to further reduce it given that in the end of the year the Budget law for 2015 provided for another transfer cut of 1.2euro billions.

Furthermore, in 2014, even if standard fiscal capacities had not been yet determined, it was clear that the revenue raising capacity of municipalities (netted for the tax levy) would not be enough to cover the expenditure needs (38euro billions). As it was observed in the previous sections, the transfer cuts were partially substituted with tax levy. In fact, when in 2015 the fiscal capacities were finally approved (Decreto del Ministro dell'Economia e delle Finanze n. 11/2015), they equalled 28euro billions.

Given the mandate of the enabling law 42/2009 that the equalization program should not result in additional costs for the national budget, considered the fact that the historical level of local service provision has been mainly maintained (incorporated in standard expenditure needs) at cost of high level of tax levy (not incorporated in fiscal capacities) and finally taking in consideration that the essential levels of benefits have not been determined to constrain the expenditure needs, the latter ones have been transformed from monetary values into indicators of distribution (*coefficienti di riparto*). Such indicators of distribution could apply to whatever quantity of resources.

It exactly what happened in 2015, when a part of the FSC transfers was calculated to equalize the gap between new standard resources and fiscal capacities²⁸ where the new standard resources were calculated applying the indicators of distribution of needs to the total of fiscal standard capacities.

²⁷ It is important to consider that the fundamental functions include waste management service which total spending and expenditure needs amount to about 8euro billions and which are not be considered for equalization.

²⁸ For more detailed information of the equalization program within FSC starting from 2015 see IFEL (2016), Brugnano et al. (2017), UPB (2017).

The Budget law for 2015 (Legge di stabilità n.190/2014) providing for the equalization program in the FSC explicitly associated it with the implementation of enabling law 42/2009 despite many contradictions. The first refer to the fact that in the new system the standard expenditure needs lost their key role of benchmark for financing fundamental functions of municipalities becoming mere indicators of distribution, while such role was assigned to the fiscal capacities whose total sum determines the quantity of resources. The second group of contradictions regard missing essential levels of benefits whose definition would necessarily shed light on what to be considered as standard level of local service provision. The difference between the standard expenditure needs and fiscal capacity, if both netted for the waste management service, becomes very similar to the quantity of resources that municipalities managed to regain substituting transfer with fiscal levy (see Table 3 Local tax revenues 2010-17). The levels of services provided through autonomous fiscal levy cannot serve as benchmark for equalization: or the state provides additional resources to render them standard or calibrate standards to the levels that can be sustained with local standard tax levy.

Conclusions

With the equalization program for municipalities in course between 2015-19, many contradictions emerged. Seemingly nobody is fully satisfied with the equalization program on which so many expectations were put. The municipalities losing from the program complain about losing too much considered the transfer cuts that they have already had, those who benefit argue that they do not benefit enough to recover after a long period of fiscal consolidation. Independent institution as UPB argued (Nota n.1/2017) the equalization program, underpinned with the current methodology for standard needs and fiscal capacities, contributes to maintain status quo and the existing gaps in the provision of local services.

Given the contrasts between different stakeholders, the Budget law 2019 (law n.145/2018) blocked for a year the gradual transition to full application of the equalization fund advocating for an inquire on the equalization program correspondence to the mandate of the enabling law 42/2009 and on the reasons why the essential levels of benefits have not been determined yet.

The mandate to produce the report on the implementation of the law 42/2009 was given to the technical authority as the Commission for the elaboration of standard needs (*Commissione tecnica per i fabbisogni standard*). Though the report has not been produced yet, it appears evident that

solutions cannot be worked out through adjustments to the existing methodology of expenditure needs and fiscal capacities, but should consist in revising of the chaotic implementation of fiscal federalism: The original design should be reconciled with the current setting of public finance and political agenda. The definitions of essential levels of benefits, involving all political forces and local governments, might be an opportunity in this sense.

The fact that the essential levels of benefit have never been defined after the enabling law was approved in 2009 does not seem accidental. Since the municipalities have reduced the current expenditure less compared with the transfer cuts and raised the resources through tax levy, what is being defined as standard according to the current expenditure needs in monetary terms cannot be considered standard. To recognize that the average of historical level of local service provision cannot be considered any more standard may be very costly in terms of political consensus. The ambiguousness of the enabling law 42/2009 and the unwillingness to assume political responsibility in order to resolve the problem seem to be among the main reasons why the equalization program makes ‘unhappy’ all stakeholders.

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