

Fiscal Decentralization in Italy: Some Lessons

Stefano Piperno
Ministry of Finance

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1. Introduction

Italy offers interesting insights into the risks and pitfalls that may be encountered when a decentralization process is not well managed. Once a highly centralized country, it has experienced a slow and contradictory shift towards political decentralization since the Constitution of 1948, though this process has only accelerated significantly in the last years.

This paper is divided into three parts.

The first section spells out the main institutional features of the present Italian system of territorial government and recent changes that have been made to it.

The second illustrates some of the important features of the process of decentralization which has taken place in Italy, with special reference to some of the problems that are currently being faced in Indonesia. In particular, I deal with four main topics:

- a. the fair sequencing of devolution: meaning, first competences, then revenues, and the perverse effects of the reverse;
- b. the crucial issue of local accountability and local fiscal autonomy;
- c. the key role of self-generated revenues in designing a viable general grants system for local authorities;
- d. the importance of building consensus by involving the regional and local authorities through institutional mechanisms such as intergovernmental committees.

The last section draws general conclusions about the main issues raised in this seminar.

2. The present system.

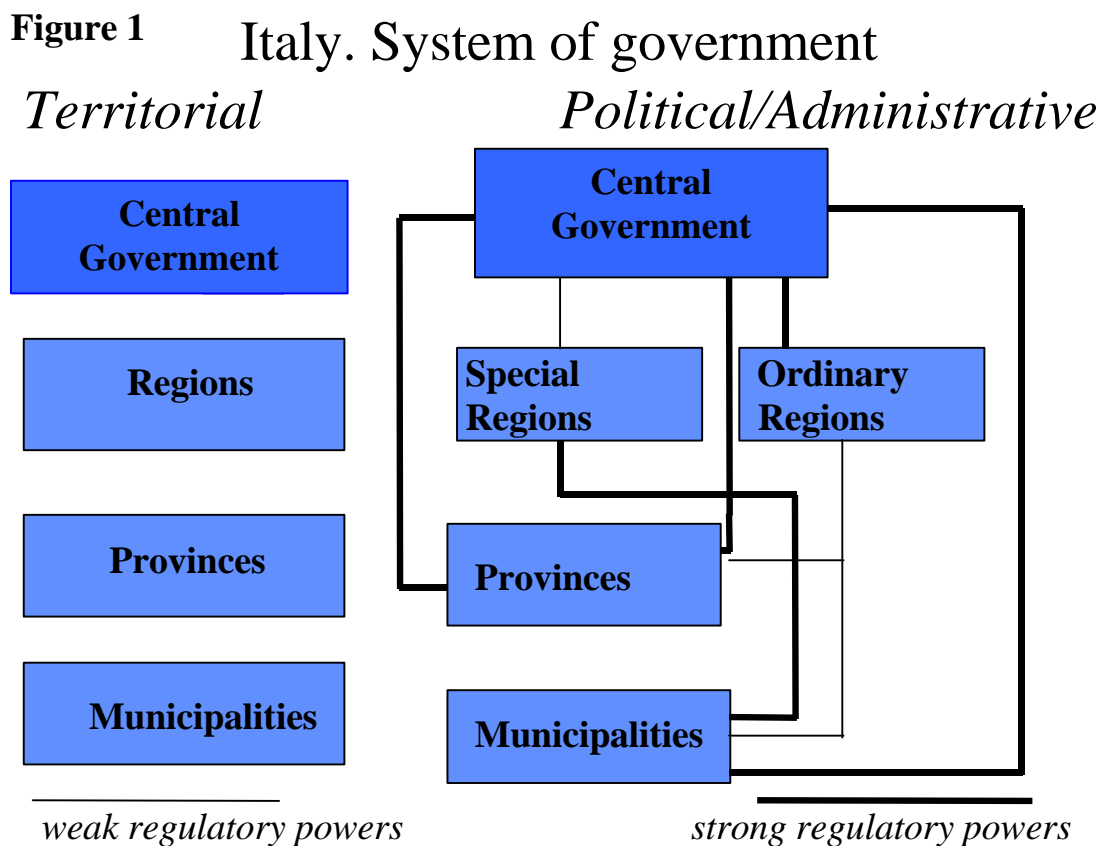
Institutional framework

Territorial government in Italy breaks down into four layers. Sub-national governments comprise 20 Regions, 103 Provinces and 8,100 Municipalities. This territorial structure - shown in figure 1 - is typical of the early stages of regional systems.

While Provinces and Municipalities have been established since the country came into being, Regional governments are a relatively new entity, as Regions were established only under the 1948 Constitution. Regions are provided with legislative and administrative powers, particularly relevant in the fields of agriculture, commerce, public health, tourism, public works and long-distance public transport. Five Regions - the large islands (Sicily and Sardinia) and areas close to national borders (like Trentino Alto Adige, divided into the two Autonomous Provinces of Trento and Bolzano, and Valle d'Aosta) with sizable non-Italian-speaking populations - are called 'Special Statute' Regions. Four of them were established in 1949 (the

fifth, Friuli Venezia Giulia, was established in 1964) to reduce the threat of separatist movements and ethnic tension. They have far wider competences - for instance in education and the promotion of industrial activities - than those of the other 15 Ordinary Statute Regions, which became operational only in 1970.

The central government still retains a strong regulatory power mainly on ordinary regional governments which it exercises through the various central institutions. For example, for every field of responsibility assigned to regional legislatures, the national parliament determines the principles that regional laws have to follow. On the other hand, the national executive can veto a regional law when it considers that national principles have been overpassed. Conflicts of competence between the central government and the regions brought to the Constitutional Court have been consistently decided in favor of the central government, which appoints all constitutional judges.



Until 1998, Ordinary Regions had practically no tax autonomy and were financed by central government transfers. Health care expenditure represents the main portion of their expenditure. Moreover, in health care provision regions act mainly as agents of the central government, which still dictates general policy orientations in this field. Besides, health services are not provided directly by Regions but by special purpose autonomous bodies, the Local Health Units.

Provinces, modeled on the French Départements, have very limited responsibilities and - at least until 1998 - no tax autonomy. Their role is practically negligible in metropolitan areas, where they are dominated by

large Municipalities. Nonetheless, they still play a recognizable role outside metropolitan areas, especially in rural and mountain areas, where the Province's main goal is to coordinate small Municipalities.

Municipal governments are still at the heart of the Italian decentralized system of government. As in most other countries, they are responsible for typical urban policies, such as town planning and zoning, transport, traffic control, water provision, street lighting and cleaning, garbage collection and disposal and a growing number of social, cultural and leisure services. Their role has recently been strengthened by two major reforms: a) the direct election of mayors and b) the re-introduction of a substantial amount of tax autonomy.

One of the alleged main weaknesses of the present municipal system of government is undoubtedly its high fragmentation. As mentioned before, there are more than 8,100 *Comuni*, or Municipalities. Small-sized municipalities are particularly frequent in the northern regions and have higher provision costs and offer a narrower range of services than large ones. However, mergers and other structural reform policies are strongly resisted, and only recently have Municipalities experimented new ways of providing services based on association, cooperation and contracting out.

The central government also retains a firm grip on provincial and municipal governments through bureaucratic control and the distribution of centrally controlled resources, such as the allocation of general purpose grants to Municipalities, the location of new government agencies, extraordinary spending programs and the financing of large infrastructural projects. Italy has not developed a *cumul de mandats* system along the lines of the French one, where national political figures involve themselves in local politics, running for mayorships, regional presidencies or other local, important positions. As is well known, the French *cumul* produces two effects. The first is to blur the borderline between national and local politics; the second is to induce national political figures to compete among themselves to channel national resources to their own local constituencies. In Italy, new mayors are more powerful figures than before because, as we shall see, they are now directly elected. True, Italian mayors have political connections with the center but, contrary to their French colleagues, they are still mostly local political figures, even if mayors of big cities now have nationwide public recognition.

Summing up, the present Italian Constitution is typical of a unitary state, despite the presence of regional governments. The central government is still at the center of the stage and local governments have so far been protected and guaranteed from regional interventions by central government legislation. Local electoral mechanisms, taxing powers, ordinary grants, local functions and organizations fall within the strict domain of national legislation. Regional legislation cannot interfere in the main matters of local government life, apart from those specific legislative powers that are assigned to the Regions

This situation may change radically in the near future, due to the recent start of a process of devolution of centrally-owned administrative functions to regional and local governments. This process was spurred by the increased demand for decentralized government and federalism, largely from the richest northern Regions, and has taken place within the framework of the present constitution due to the failure of any attempt to change it. This strong demand for decentralization has been interpreted as implying a substantial strengthening of present regional governments according to classical federal models. In fact, the framework law (L.59/97), the s.c. Bassanini Act, after the name of the Minister who drove it through, provides¹ for a mechanism of devolution of powers in many relevant areas hitherto carried out by the State to the Regions and from the Regions to Provinces and municipalities over a three-year period. It must be stressed that, for the purpose of implementing the devolution reform, the government has been given discretionary powers (delegation), meaning that it is free to issue decrees without formal approval by Parliament (but it needs the consensus of the new intergovernmental consultative bodies: see the second section). The decrees are only bound to respect a set of principles established in the law:

- subsidiarity;
- wholeness, efficiency and economy;
- cooperation among different levels of government;
- responsibility and uniqueness of administration;
- asymmetry (to take into account the huge differences in size and assets of local authorities - mainly Municipalities - which can influence their ability to carry out the new functions);
- autonomy of local governments in terms of self-organizing powers;
- fairness in the devolution of human, technical and financial resources;
- adequacy, e.g. administrative capability of the receiving governments.

In particular, the principle of cooperation has been set to grant the respect of Italy's EMU public debt and inflation rate commitments, sharing the relative responsibilities in terms of macroeconomic stability with the local governments. According to the principle of subsidiarity, only the functions explicitly stated in the law are excluded from the power transfer². In particular, the central government will retain administrative jurisdiction over some strategic areas, such as foreign affairs, relations with the European Union, justice, defense, monetary and fiscal policies, universities and other sectors that have to be dealt with nationwide.

The new responsibilities to be transferred to regions and local authorities include the allocation of industrial incentives, the cadastre (property registry), public works, roads (except highways and national routes) and regional railways, education, the cultural heritage, mining concessions and environmental protection. This

¹ Law 59/97 provides guidelines for three strictly intertwined reforms: the decentralization of central government functions, the reform of central public administration and the simplification of administrative procedures.

² This marks a striking change from the previous devolution processes of 1972 and 1978 where the State waived only some specified functions not following the wholeness principle.

process encompasses both regulatory powers and financial and personnel resources along the lines of the German model of 'administrative federalism'.

If continued, this process of devolution could radically alter the existing system of regional/local relations by opening more room for regional interventions in local affairs. In other words, the new scheme of regional-local relations is coming closer to the traditional federal model, in which local governments are strictly dependent on 'regional' legislation, decisions and controls. There is no strictly necessary reason for this to be so. The full implementation of the law is presently resisted by central bureaucrats.³ It is also far from granted that regional governments will rapidly strip themselves of their newly acquired responsibilities in favor of their local governments.

Financial resources

The distribution of expenditure and revenue (Table 1) among levels of government offers a condensed view of the intensity of decentralization. In 1997 the central government accounted, together with Social Security Agencies, for 72 percent of total expenditure. Since 1980 the local government share (including non-territorial government: see the note to Table 1) has been maintained constant at about 27 per cent. Fluctuations are mainly due to the capital component of local expenditures. In the Eighties and in the early Nineties central government expenditure has been inflated by interest payments, due to primary deficits and the growth of debt. Limiting our analysis to primary spending (total outlays minus interest payments) the role of local administrations would account for 30 per cent, slightly superior to the State's (29 per cent, and 41 per cent for Social Security Agencies). Moreover, its share is supposed to increase significantly in the next few years as a result of the process of devolution outlined by the Bassanini Act.

Historically, regional and local governments in Italy have been characterized by a huge "vertical fiscal imbalance" because until recently they have been denied access to broad-based taxes. In 1980 sub-national governments accounted for about 6 percent of total revenue, but this share had risen to about 11 per cent of total revenue in 1997. Their performance has thus been quite remarkable. It should be even more so in the future, starting from 1998, as we shall see in the next section.

Yet, recent reforms have consistently increased the degree of decentralization of the present system, and will do so all the more, if the central government keeps all its promises in the near future. On the revenue side, the tax autonomy of subnational governments has been expanded since the early Nineties, but will be completed only in the early 2000s. What follows is a series of further details about Regions and Municipalities⁴.

³ The Ministry for Culture and the Artistic Heritage, whose record is far from brilliant, is among the fiercest opponents, claiming that the Regions are basically incapable of maintaining intact both their physical and artistic environment.

⁴ I leave out Provinces which gained relevant fiscal autonomy as well.

Table 1. Italy: Share of different levels of government on total public sector revenue and expenditure^o

Years	Central Government		Local Government ^{oo}		Social Security Agencies	
	Revenues	Expenditures	Revenues	Expenditures	Revenues	Expenditures
1980	59.1	42.6	6.1	27.1	34.7	30.1
1981	59.7	42.9	6.8	30.4	33.4	26.5
1990	61.6	47.4	7.7	27.6	30.6	24.9
1991	61.7	47.0	7.9	27.7	30.3	25.1
1993	61.6	50.1	9.3	24.5	29.0	25.3
1994	60.2	47.7	10.7	25.6	29.0	26.5
1995	59.5	48.6	12.3	24.6	28.1	26.7
1997	56.9	40.6	10.7	26.7	32.3	32.5

^oConsolidated data; transfers from one level of government to others are included in the expenditure of the beneficiaries.

^{oo} Includes Regions, Provinces, Municipalities, Local Health Units, Other local administrations.

Source: our calculations from Central statistical Institute (ISTAT), National Accounts, 1999, Rome.

The process was started in 1993 with the introduction of the ‘Municipal property tax’, a close relation of the tax on real estate administered by local governments all over the world. The tax is levied by municipalities, which have the power to fix the tax rates between relatively wide brackets determined by the central government. The property tax presently forms the bulk of local tax revenues, together with a special tax for refuse collection, which is scheduled to be transformed into a charge over the next few years. Taxes and fees presently account for about 50 percent of total municipal revenue. This percentage accords with the majority of international practice. According to a recent central government decision (July 1998), Municipalities are allowed to tax personal incomes at a flat rate, initially set at a bare 0.20 percent, which may be increased, in no fewer than three years, to a maximum of 0.5 percent. Moreover, Municipalities will be allowed to share a surtax on income at a flat rate that will be determined by both the Ministry of Finance and the Home Affairs Ministry in order to finance the transfer of functions established by the Bassanini Act.

The building of regional tax autonomy has taken longer. The major step was only made in the 1997 financial law, which introduced a direct-type value-added tax (IRAP, Regional tax on business activities) to be levied on all business activities as of 1998⁵. The new tax has a broad, potentially very productive tax base: value added, net of depreciation, but including interest payments. Regional governments have been constrained to levy a centrally-set uniform tax rate of 4.25 per cent for 1998. Agriculture (1.9 per cent in 1998, the standard rate being reached gradually by 2004) and banking and the insurance sector (5.4 per cent in 1998 the standard rate being achieved in 2003) are entitled to special arrangements. According to the law, however, the regional governments should be free - starting from the year 2001 - to raise or lower their tax rate by a

⁵ IRAP replaces employers’ compulsory health contributions, the local income tax on profits (actually a central tax), the local tax on business activities and the tax on companies’ net wealth.

maximum of 1 per cent and to apply varying rates to different sectors and categories of taxpayers. Initially, however, 90 per cent of revenue from IRAP- like the whole revenue from the basic surtax on income- will be earmarked to finance the National Health Service, which accounts for the bulk of regional expenditures. This partially limits the fiscal autonomy and accountability of the Regions. IRAP should about double the share of subnational revenue on national total.

The same law laid the foundations for a tax-base sharing process whereby personal income tax is shared with the federal government. More precisely, in 1998 regional governments were allowed to tax personal incomes at a flat rate, initially set at a bare 0.5 per cent (offset by a corresponding reduction in the state tax rate), which may be doubled to 1.0 per cent, starting from the year 2000. As in the case of Municipalities, these rates are admittedly extremely low. They do, however, make a start in what is, potentially, an extremely rich field of taxation, whose intergovernmental sharing is typical of most advanced federations and regional systems (examples of the latter systems are Spain and the United Kingdom, with reference to Scotland only). Finally, regional governments have been allowed to enter the field of gasoline taxation, which they will share - up to a third of the present tax rate - with the central government. In 1999, Law n.133 completed the new system of regional finance. It established a regional sharing of the proceeds of VAT (only for the Ordinary Statute Regions) and an increase in the basic regional surtax on personal income from 0.5 to 0.9 per cent, consequently raising the ceiling to 1.4 per cent, capable together of drastically cutting the transfer receipts from the central government. Virtually, these changes should allow the wealthiest regions of the North and the Center to cover all their present spending responsibilities with own and shared taxes, hence consistently reducing the present vertical fiscal imbalance. In fact, according to the latest calculations these new sources of income can grant the financial self-sufficiency for at least seven out of the 15 Ordinary Statute Regions.

The aim of the residual transfers, based on the shared proceeds of VAT, from central government will be fiscal equalization among regional governments according to a new mechanism that will start to be implemented in the year 2001 and that- as I write- is still under the scrutiny of Parliament. In the following section, I briefly outline its main characteristics.

The effects of the last reforms are relevant. The share of local governments on total public sector revenue rose to about 15 per cent in 1998, owing mainly to the introduction of IRAP.

Limiting the analysis to tax revenues (Table 2) the dimension of fiscal autonomy appears more evident. The share of Regions and the other territorial governments rises from about 9 per cent in 1995 to more than 16 per cent in 1998. It will raise to 19 per cent with the full implementation of the new regional and local surtaxes on personal income⁶.

⁶ The revenue sharing of VAT is only notionally based on a derivation base. It uses a set of criteria which imply a redistribution of resources among the Regions themselves, with an explicit equalization aim. Actually, it is like a general equalization transfer whose amount is fixed in legislation and cannot be modified without consent of sub-national governments

**Table 2. Distribution of tax revenues among different levels of governments
(billions of lire)**

	1995	%	1998	%
Central Government	447381	90.1	519481	83.2
Social Security Agencies	3245	0.7	1162	0.2
Regions	16241	3.3	70664	11.3
Health Authorities	0	0.0	0	0.0
Municipalities and Provinces	28576	5.8	31720	5.1
Other local administrations	1140	0.2	1638	0.3
Total	496583	100	624665	100

Source: Ministry of the Budget and the Treasury, General Report on the Economic Condition of the Country, 1998,1999

These changes are going to strongly affect the functioning of Italian subnational governments in many ways, from purely financial behavior to the broader institutional and political context of intergovernmental relations.

3. The present system: the main features with regard to the Indonesian devolution process

The dynamics of intergovernmental relations in Italy over the last 50 years show that some aspects are crucial for the success of a decentralization process. The course followed has, de facto, slowed down the process, besides jeopardizing the country's macroeconomic and political equilibria. Such problems offer food for thought for other countries, such as Indonesia, which are now embarking upon a process of decentralization.

At least four points can be stressed.

- 1) The sequencing of transfers of competences and resources to subcentral bodies. In the case of Special Statute Regions, resources were transferred before competences, many of which have been effectively performed by the Regions. In the case of Ordinary Statute Regions, the process has been suitably adjusted, but has led to an underestimate of the cost of the functions transferred.
- 2) The fiscal autonomy of subcentral bodies (Regions, Provinces and *Comuni*, or Municipalities); the lack of such autonomy has triggered an overgrowth in local government spending. Only with the introduction of considerable fiscal autonomy for local bodies (for regional authorities only over the last two years) has this spending trend been checked, ensuring among other things compliance with the parameter envisaged by the EU Treaty of Maastricht.
- 3) The difficulty of designing a general transfer system without fiscal autonomy: in such circumstances, the system inevitably becomes gap-filling.
- 4) The need to develop a process of decentralization with the participation of the system of autonomies, both through associations of local bodies and through intergovernmental committees.

Matching expenditure and revenue assignments

A) Special Statute Regions

Correct sequencing in expenditure and revenue assignments is a crucial issue. If you assign revenue to regional authorities before transferring functions, the risk is that you will allow them to overspend in their current activities without performing their newly devolved state functions. This is precisely the case of the Italian Special Statute Regions. As I outlined above, these Regions have broader expenditure assignments than the ordinary ones. Their revenues are based on a system of tax sharing, which varies from Region to Region, but generally leaves high shares of the main locally collected taxes (such as income and consumption taxes) on a derivation basis. This was defined as ‘the original mistake’ during the debate in the Constituent Assembly. As an eminent public finance scholar of the time and a member of the Assembly remarked, ‘First, we do not know anything about the cost of the functions to be transferred to regions... If we do not have a criterion at our disposal to establish the amount of expenditure assignments, we cannot have a criterion for the sharing of revenues either’ (Einaudi, Const. Ass., pp. 4072-73, 1948).

The Special Statute Regions were theoretically entitled to a greater amount of resources to balance their more extensive range of competences. In fact, some of them - Sicily, for example - under the terms of the constitutional laws that approved their statutes, may be likened to members states of a federation.

So what actually happened? The Special Statute Regions have continuously used their extra resources to overspend in the sectors common to the Ordinary Statute Regions, leaving the Central Government to perform the additional functions that had given them the special status.

There is evidence of this outcome⁷. First, we can compare (Table 3) the differences between actual per capita expenditures in the sectors assigned to both Ordinary and Special Statute Regions. As we can see, inexplicable differences exist, mainly in capital expenditures. Final balance figures in 1992 on per capita spending per sector always show a spending differential in favor of the Special Statute Regions, especially in terms of spending on capital account. Such Regions, in fact, spend more than five times as much as Ordinary Statute Regions, whereas in current terms the differential is the equivalent of about 70 per cent. Glaring differences exist in the spending sectors common to both types of Region, such as those associated with personal services. For the right to study Special Statute Regions spend about 7.6 times more per inhabitant than Ordinary Statute Regions, three times more for vocational training, about 16 times more for cultural organization, 10 times more for sport and six times more for social welfare. Not randomly, given the national health fund system, based on quotas per capita and bound allocations, spending on health care is only slightly higher (1,592,000 lire against 1,526,000 lire).

⁷ See Ministry of Finance, Fondazione Agnelli, 1994

Table 3. Per -capita expenditures of Special and Ordinary Statute Regions**(1992, 000 lire)**

<i>Expenditure sectors</i>	<i>Ordinary Statute Regions</i>		<i>Special Statute Regions</i>	
	<i>Current</i>	<i>Capital</i>	<i>Current</i>	<i>Capital</i>
General Administration	91.83	10.86	402.83	18.84
Job creation	1.55	1.45	53.30	30.80
Police, fire protection	0.06	0.15	15.24	8.10
Education entitlement	11.06	3.51	95.37	31.00
Vocational training	31.57	1.16	102.59	5.66
Culture	3.84	11.53	66.05	27.04
Welfare	24.37	5.76	144.01	37.83
Health	1526.74	23.96	1592.41	67.60
Sport, leisure	0.41	0.79	9.20	23.21
Agriculture	15.47	63.79	61.79	272.71
Forestry	1.37	7.56	7.67	57.65
Mountain area development	0.84	2.83	15.18	6.04
Quarries, mineral water	0.01	0.08	7.99	15.60
Hunting and fishing	1.66	0.40	29.21	7.12
Public works	0.78	35.37	1.96	171.58
Aqueducts, sewage	5.94	39.65	26.01	113.87
Roads	0.22	7.14	5.63	64.04
Other public work	112.37	6.36	87.84	14.53
Railways transport	3.84	0.41	0.02	0.28
Sea Transport	0.97	1.57	2.64	8.64
Air transport	0.06	0.06	0.12	5.31
Other transports	0.07	0.40	0.41	3.63
Crafts	1.53	11.04	10.33	58.73
Tourism	6.36	9.12	32.36	74.50
Commerce	0.39	0.92	6.04	40.50
Housing	2.39	24.57	0.91	178.57
Town planning	0.22	1.24	9.94	23.39
Industry, natural resources	1.21	8.40	8.04	160.26
Environment protection	1.64	5.58	8.59	21.44
Scientific research	0.98	0.58	2.48	2.39
Debt service	17.41	0.67	13.85	0.00
Not classified	11.24	13.75	70.90	191.90
General transfers to local governments	0.79	0.01	235.26	107.89
Social security	0.00	0.00	6.32	0.00
Total	1879.17	300.65	3132.47	1850.66

Source: Istat, Regional Budgets, 1995.

A second aspect has to be taken into account. The decentralization of functions to Special Regions ought to have implied a cut in Central Government intervention due to the substitution effect generated by the transfer of competences.

In reality (Table 4), this effect has not been achieved in that we see a non-marginal central government presence in some sectors of regional competence, such as welfare, transport, agriculture, industry and tourism (that is, the aggregate denominated F2), while spending on other functions, such as general administration, defense, justice etc (aggregate F1), is consistent with the assignment of competences. It is surprising to see central government spending of about 18,000 billion lire in sectors to some degree comparable to those of regional competence against regional government spending of about 44,000 billion

lire. Nor does the comparison with some Ordinary Statute Regions display the differences we might have come to expect. Summing together Central Government payments, transfers to Regions and the autonomous revenues of Regions we obtain an indicator of the total endowment of public resources. The differences in the Central Government per capita payments fail to compensate for the differences in transfers between the two types of Region. Ultimately, the endowment of resources per capita is always much higher in Special Statute Regions. The comparison between the Valle d'Aosta, Trento and Molise, three regions with similar territorial and demographic characteristics, is particularly striking (10-11 million per capita in the Special Statute Regions against 4.3 in Molise).

Only since 1990 has the central State started to address the problem. To do so it has used two tools:

- cutting specific purpose transfers to Special Statute Regions, on the assumption that they already had sufficient resources for functions still performed at the central level (the reduction of the National Health Fund, for example);
- transferring spending competences (for state road management, for example) without any corresponding transfer of new revenues.

Table 4. Central government payments for different functions in some Italian Regions (net of special expenditures for the southern Italy, interests and other non spatially attributable expenditures). Per capita values of own regional taxes and central grants to Regions
Per capita values in thousands of lire (1992, actual payments and revenues)

<i>Regions</i>	<i>Population</i>	(a) <i>Expend. F1</i>	(b) <i>Expend. F2</i>	(c) <i>Regional own tax revenues</i>	(d) <i>Transfers to regions</i>	<i>a+b+c+d Consolidated expenditures</i>
Molise (Ord.)	331494	42	2281	42	1872	4237
Campania (Ord.)	5668895	851	2429	61	1786	5127
Abruzzi (Ord.)	1255549	794	2281	76	1731	4882
Umbria (Ord.)	814796	683	2496	98	1874	5152
Emilia Romagna (Ord.)	3920223	725	1961	92	1899	4677
Lombardia (Ord.)	8882408	633	1665	62	1784	4145
Valle d'Aosta (Spec.)	117204	832	860	1874	9554	13120
Bolzano (Spec.)	444243	853	815	147	6693	8508
Trento (Spec.)	452479	915	1210	234	8663	11022
Friuli Venezia-Giulia (Spec.)	1195055	1179	1976	80	2736	5971
Sicilia (Spec.)	4997705	764	2080	223	3022	6090
Sardegna (Spec.)	1651902	183	2312	148	3473	6116

Source: Our calculations on data from Istat and Ministry of the Budget

F1: include central expenditures on general administration, defense, justice, public safety, employment and pensions (net of transfers to Regions);

F2: include central expenditures (net of transfers to Regions) on education, housing, welfare, health (net of National Health Fund), transportation, agriculture, industry, trade, crafts, other economic interventions, civil protection, grants to local governments

Ord.: Ordinary Statute Regions

Spec. : Special Statute Regions

This, however, has entailed sizable transaction costs due to conflict which, in some cases, have required the intervention of the Constitutional court.

It is evident how a fair sequencing of expenditure and revenue assignments could have avoided all these negative consequences.

B) Ordinary Statute Regions.

The transfer of competences from State to Ordinary Statute Regions followed a different course and triggered different problems. To date, the process has taken place in three periods - in 1972, in 1978 and in 1998 - and is still in progress.

Unlike in the case of Special Statute Regions, the central government first quantified the cost of the function to be transferred and, on the basis of its calculations, determined the amount of funds to be allocated to finance the Ordinary Statute Regions. In 1972 and 1978, the procedures followed for the calculation of functions were inadequate and allowed for an effective transfer of competences lower than that envisaged by law. The consequences were negative on two counts:

- a) the failure to assign fiscal powers to Ordinary Statute Regions created a lack of accountability, with the regions feeling entitled to spend more because they were penalized by limited initial State transfers, giving origin to more or less hidden deficits;
- b) the central State could not elude this thrust. In an attempt to control it and maintain decision-making power over allocations, it embarked on the path of sectoral funding. As a result, until the early 1990s, regional balance sheets were the sum-total of sectoral funding. The main ones were thus targeted at the financing of the national health and public transport systems. It would be wrong also to forget the role played by numerous sectoral funding established by the special laws promoted by the various Ministries (for instance in agriculture and in housing). This set into motion a mechanism which has, de facto, converted the various regional departments into a sort of new deconcentrated field administration for central administrations. Veritable interest coalitions have been created between central and regional bureaucracies and economic interest groups (in agriculture and crafts, for example), thus seriously hampering the definition of general regional development policies. At the same time, the central administration has failed to control the effects of sectoral funding.

In particular, the experience of the two main sectoral funds (Health and Transport) demonstrates how no equilibrium has been found between the centre's governance of the system (through the fixing of guidelines and uniform standards, the formulation of criteria for the interregional distribution of funds and checks on their use) and the autonomy of the Regions in the planning and management of health structures and local public transportation.

This is why recent reforms have eliminated or envisaged the elimination of all sectoral constraints on spending. Only through total allocation of fiscal responsibility will it be possible to avoid the continuous emergence of hidden deficits.

Likewise, the Bassanini Act, based precisely on the negative experience of the other two phases of regional decentralization, envisages the absence of sectoral constraints on the new regional functions. Once the cost of the functions to be transferred has been identified, the Regions will be acknowledged a participation in the revenue from taxes on the income which covers it. The participation of Regions and local autonomies in the process of identification and transfer of the State's financial and technical resources is nonetheless guaranteed (see fourth point).

The fiscal autonomy of Regions and local governments.

This is, arguably, the most important lesson to be learnt from the Italian experience of what a decentralization process ought not to be. Among the major industrialized countries none has experienced a so high degree of vertical fiscal imbalance. This is true both for Regions and Municipalities. Until 1993 the Regions' tax revenues were mainly shared taxes for Special Statute Regions (with no discretion neither for base nor for rates) and some minor low- yielding own taxes for Ordinary Statute Regions (Table 5). Since the fiscal reform of 1972, Municipalities based their financing mainly on central grants (Table 6) and only in 1993 were new own taxes assigned to them (property tax).

Table 5. Distribution of budgeted current and capital revenues (net of loans) of Special and Ordinary Statute Regions

	1981	%	1985	%	1990	%	1996	%	1998	%
<i>Special Statute Regions</i>										
Own taxes	2854	34.42	8627	41.8	17282	52.2	26787	63.3	35885	77.9
°of which shared	n.a	n.a	n.a	n.a	n.a	n.a	26527	62.7	28902	62.7
Transfers	5168	62.33	11296	54.7	13572	41.0	14084	33.3	8701	18.9
Non tax revenues	270	3.26	723	3.5	2223	6.7	1454	3.4	1507	3.3
Total	8292	100	20646	100	33077	100	42325	100	46093	100
<i>Ordinary Statute Regions</i>										
Own taxes	348	1.2	557	1.1	1535	1.9	16902	15.4	64341	52.0
°of which shared	n.a	n.a	n.a	n.a	n.a	n.a	9726	8.9	9326	7.5
Transfers	27743	97.6	48360	98.2	78396	97.4	91150	83.2	57580	46.6
Non tax revenues	334	1.2	348	0.7	559	0.7	1487	1.4	1697	1.4
Total	28425	100	49265	100	80490	100	109539	100	123618	100

Source: CNR- Institute for study of Regions, Regional Budgets, various years.

The tax reform of the early Seventies was carried forward with an explicit centralist philosophy. Hence central government had to be assigned the full 'fiscal lever', or almost, while local bodies were left with very meager possibilities of raising taxes. Two basic types of justification were offered for this. On the one hand, economic policies demanded that the center have a strong capacity to steer and control the economy; on the other, resources had to be redistributed between the wealthier and poorer areas of the country, avoiding inequalities due to the variability of the distribution of local tax bases.

Table 6. Distribution of current revenues of municipalities 1970-1996

	1970	1979	1990	1996
Own tax revenues	58.8	11.2	19.1	39.0
Non tax revenues	18.1	9.6	15.5	19.2
of which: fees	12.4	4.9	9.8	11.9
Transfers	23.0	79.1	65.2	41.7
Total	100	100	100	100

Source: Central Statistical Office (ISTAT)

In so far as it favored the interests of the two main parties concerned, the reform met with little opposition. Central government increased the amount of resources it could maneuver - remember that in that period it seemed that regionalization might radically transform the centralist arrangement of the State and reduce the role of Ministries - while local administrations no longer had the weighty responsibility of having to tax local populations without losing their competence over spending (the opportunity to promise services without the burden of having to finance them is probably the secret dream of any local administrator). As a result, the local political class was able to shirk its responsibilities to such an extent that - declarations of principle apart - the return of the fiscal lever at local level was, in some cases, perceived more as a constraint than a resource and an opportunity to bring administrators and electors closer together.

Especially until the late Eighties, the system was forced to pay a high price in terms of efficiency. Dependence on transfers from the center has allowed local administrators to shirk their responsibilities and made taxpayers lose perception of the cost of local public services. Hence overspending as a result of the provision of non-requested or inefficient services. It was the negative assessment of these outcomes that underpinned the 1992 reform. It would be wrong, however, to underestimate the fact that any reform of the local tax system is invariably a politically controversial process likely to trigger major conflict vis-à-vis distribution. It is no coincidence that, in Italy, the reform was approved only in September 1992, when the dramatic economic situation and the explosion of the public debt forced a heavy devaluation of the lira.

The grants system.

From 1970 until 1994, the system of intergovernmental fiscal relations was marked by a huge vertical fiscal imbalance for both Ordinary Statute Regions and other local authorities. However, this imbalance was financed in one way for the Regions, and in another for Municipalities and Provinces. In the first case, recourse was made to sectoral funds, concentrated in the Health and Transport sectors, in the second - almost exclusively - to general grants.

The Ordinary Statute Regions.

Originally, the Ordinary Statute Regions were supposed to receive their main revenues from two general funds, the Common Fund and the Regional Development Programs Fund. The first was determined according to varying percentages of certain excise taxes, while the second was discretionary. With the

introductions of a variety of modes of use, they gradually lost their general character, and were abolished to be replaced by the new system outlined above (surtax on income, sharing of VAT). Thus, for the scope of the paper, the interesting thing to note is that the vertical imbalance for Regions has been addressed mainly with special purpose funds. Until 1998, such funds accounted for a large share of total expenditure, mainly in the Transport and Health sectors (table 7). Conditional grants will be drastically reduced on account of acquired awareness of the sundry flaws of the mechanism:

- Excessive bargaining procedures with huge delays in the determination of their total amount, inefficient budgeting process, regional overspending, growth of deficits;
- Incapacity of central government to set clear standards in the various sectors (mainly Health and Transport);
- Incapacity of central government to control the use of funds;
- Allocation between beneficiaries based on previous years' expenditures, rewarding overspending and inefficiency;
- Increasing influence of line Ministries, hence weakening of macroeconomic control;
- Reduction of political autonomy of regional governments.

Table 7. Distribution of specific transfers by sectors

Sectors	1981			1990			1998		
	Total expenditures (a)	Specific transfers (b)	% (b)/(a)	Total expenditures	Specific transfers	% (b)/(a)	Total expenditures	Specific transfers (*)	% (b)/(a)
General administration	1113	0	0.0	3773	1.5	0.0	5440	3	0.1
Education culture	905	315	34.8	1066	39	3.7	1652	65	3.9
Vocational training	669	370	55.3	1843	962	52.2	3424	1707	49.9
Welfare	661	288	43.6	1192	75	6.3	1892	62	3.3
Health	19628	19422	99.0	60065	56149	93.5	92941	91003	97.9
Agriculture, hunting	2183	1130	51.8	5271	2231	42.3	8734	2512	28.8
Industry, Craft, Commerce	274		0.0	1030	116	11.3	2056	468	22.8
Tourism	196		0.0	956	93	9.7	1198	15	1.3
Transport	854	49	5.7	6268	4619	73.7	8491	961	11.3
Public works	1096	526	48.0	5067	1434	28.3	5238	1111	21.2
Housing	1729	1362	78.8	1711	988	57.7	4217	3329	78.9
Not attributable (**)	9286	308	3.3	61264	4527	7.4	21778	3074	14.1
Total	38594	23770	61.6	149506	71234	47.6	157061	104310	66.4

(*) for Health in 1998 included 90% of IRAP (45000 billions)

(**) Mainly repayments of debts

Source: CNR- Institute for study of Regions, Regional Budgets, various years.

As I mentioned above, this year a new system will be introduced designed to drastically reduce the sectoral funds within three years. Since 2001, nearly all the specific purpose transfers from State to Ordinary Statute Regions will be abolished⁸ and substituted with sharing of VAT, gasoline tax and personal income tax. While gasoline tax and personal income tax will be shared on a derivation base, the mechanism established for VAT is complicated making it closer to a general transfer. As we can see in Table 8 the value of the abolished transfers is offset by the three new revenue sources (39,720 billion lire). VAT (35,958 billion lire,

⁸ The law states that the State can maintain specific transfers only when there is a national interest. In economic terms this would mean that there must be relevant spillovers and/or redistributive and merit goods concerns in the provision of local services.

equal to a share of 25,7% of total collections) will initially be distributed according to the previous transfer starting from the year 2001. These allocations⁹ will gradually be replaced by a new formula based equalization mechanism reflecting both expenditure needs and fiscal capacity (for details see the Appendix).

Table 8 The new revenue arrangements for Ordinary Statute Regions

	National Health Fund	Other specific Funds	Total	VAT sharing			
				Income surtax 0,4%	Gasoline tax 8 ITL per liter	"historical expenditure"	Total
Piemonte	2591	293	2884	400	17	2467	2884
Lombardia	1064	202	1266	951	33	282	1266
Veneto	2419	112	2531	387	19	2125	2531
Liguria	1840	233	2073	134	6	1933	2073
Emilia-Romagna	2066	179	2245	395	18	1832	2245
Toscana	2802	211	3013	285	16	2712	3013
Marche	1091	133	1224	100	6	1118	1224
Umbria	933	130	1063	54	3	1006	1063
Lazio	2417	619	3036	354	21	2661	3036
Abruzzo	1439	242	1681	67	5	1609	1681
Molise	406	153	559	13	1	545	559
Campania	7058	1118	8176	204	13	7959	8176
Basilicata	677	292	969	23	1	945	969
Puglia	4748	756	5504	161	11	5332	5504
Calabria	2615	881	3496	59	6	3431	3496
Total	34166	5554	39720	3587	176	35957	39720

Source: Ministry of Treasury, 2000. Billions of lire.

A central monitoring system is set up to enforce a minimum standard for the health sector. This means that Regions have to introduce reporting procedures aimed to enforce nationally uniform levels of health care. Regions not complying with these standards will have part of their equalization transfer and shared taxes converted into specific grants for health services.

Municipal and Provincial Governments

A) 1977-1993

Initially, (1972-1982) Municipalities and Provinces were financed by the State with mere gap-filling transfers, assigned to finance "historical spending". Subsequently and until 1993, an increasingly large quota of transfers was allocated on the basis of equalizing criteria (table 9), though the latter - used to allocate a given quota of total transfers - varied in the course of time. The three main criteria were:

- evening out differences in per capita expenditure of Municipalities with similar size;
- larger per-capita transfers were given to small and large Municipalities. The assumption was that unit costs of local governments were U shaped;
- Municipalities situated in poorer than average provinces received higher per-capita transfers.

⁹ The allocation ("historical component") obtained in the year 2001, will be gradually reduced by 5 per cent a year for the next two years and by 9 per cent a year in the next 10 years until 2013, when it will be canceled.

Table 9. Distribution of grants to municipalities according various criteria. 1982-1993

a)Current grants									
Distributing criteria	82	83	84	88	89	90	91	92	93
<i>Historical expenditure 82-77</i>	95.8	93.1	82.0	58.1	53.0	45.6	46.6	46.0	46.9
<i>Specific grants</i>	-	-	2.1	6.6	6.4	16.0	14.2	14.1	13.7
<i>Equalization grants</i>	4.2	6.9	15.9	35.4	40.5	38.4	39.2	39.8	39.4
Total	100	100	100	100	100	100	100	100	100
<i>Absolute value of current grants (billions of lire)</i>	13775	14172	16037	21148	20715	24113	24753	24981	25700
b)Equalization grants									
Distributing criteria	82	83	84	88	89	90	91	92	93
Equalization of per capita expenditures	100	100	45.6	16.9	13.5	12.3	12.3	11.9	12.3
Weighted population with discrete weighting factors			35.2	20.2	16.1	14.6	14.6	14.2	14.7
Weighted population with continuous weighting factors				41.4	49.3	52.1	52.1	52.9	52.1
Inverse of the per-capita GDP at provincial level			19.2	21.4	21.1	21.0	21.0	21.0	21.0
Total	100	100	100	100	100	100	100	100	100
<i>Absolute value of equalization grants (billions of lire)</i>	578	918	2548	7478	8398	9254	9700	9954	10121

Source: Ministry of Treasury, 1997

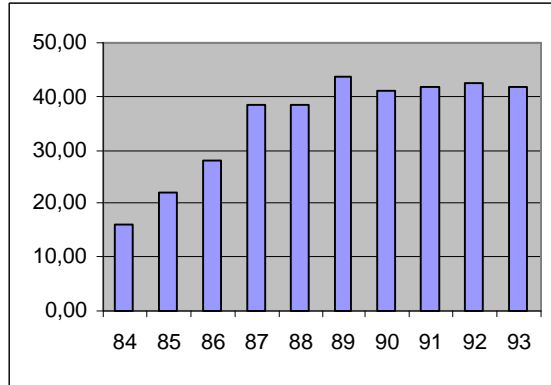
Between 1984 - the first year in which the equalizing component assumes a significant dimension - and 1989, the weight of the equalizing contribution thus rose from 6 to 40 per cent, settling at this latter value until 1993 (Fig. 2).

The Home Affairs Ministry considered the results of this policy a success, since it reduced to a considerable extent the variance of per capita spending of Municipalities with similar size. However, municipalities with the same population may have very different production costs due to orography, climate, density of population, commuting, etc. In fact the outcome of this policy was relatively ineffective, in terms of both efficiency and equity. Actually, an equalization scheme ignoring revenue capacities and based loosely on expenditures needs can hardly give fair incentives to efficient management and is bound to become a gap-filling approach in view of the huge responsibilities of central government in addressing the vertical fiscal imbalance.

B) 1993-1999

Law n.142/90 introduced new equalization criteria based mostly on expenditure needs and revenue capacity, but only in 1992 were the implementing regulations approved. Besides, the introduction of the local property tax allowed to consider the revenue side in equalization formulas for the first time.

Fig.2 Percentage of equalization grants to Municipalities 1984-93



Source: Home Affairs Ministry

The system is based on three distinct funds:¹⁰

Recurrent Fund

Equalization Fund

Conditional Fund

Leave out for the moment the Conditional Fund targeted for specific expenditures mandate by the Central Government (youth employment, etc.), and let us concentrate on the other two Funds.

The Recurrent Fund should finance basic services, representing a minimum and uniform amount of services all over the country, while increased local fiscal autonomy will take care of higher level services. This set of basic services was determined by the Home Affairs Ministry after consulting the State - Cities and Local Autonomies Conference (see below). Initially the Fund was allocated on the basis of previous transfers net of property tax collections with the standard rate. It should be gradually replaced by the new system based on expenditure needs.

The Fund was to be fixed in nominal terms, while its increases, in line with the inflation, ought to have been added to the Equalization Fund. This Fund had to be distributed in such a way as to gradually equalize per capita tax revenues of each local unit by bringing them close to the average calculated for all units comprising the same population bracket. One of the main problems in implementing this mechanism is that, since information of effective tax bases was missing, the Ministry had to use the actual collection as a proxy of revenue capacity. This gives an incentive to lower tax effort¹¹.

There is no point in describing the mechanism because it worked only in 1994 and 1995 and is now under review. In 1998, the Equalization Fund accounted for only 7 per cent (Table 10). As far as we can know, the

¹⁰ Two funds exist to finance investment, but their role is very limited at present. In practice, they serve to pay the cost of the financing local investments undertaken in the Eighties. The problem of allocating general funds to finance investment has never been properly addressed in Italy.

¹¹ This was one of the reasons that drove the Ministry of Finance to the decision to implement the Bassanini Act to the management of the Cadastre (property registry) to decentralize to Provinces and Municipalities.

new mechanism is supposed to rely more on fiscal effort and revenue potential and to determine the expenditure needs in a fairer way.

Table 10 The grants system after the introduction of local fiscal autonomy (billions of lire)

	1994	%	1998	%
Recurrent Fund	13577	51.7	13245	54.0
Equalization Fund	742	2.8	1834	7.4
Conditional fund	3625	13.8	3523	14.3
Investment Fund	8073	30.7	5797	23.6
Specific Investment Fund	246	0.9	108	0.4
Total	26263	100	24507	100

Source: Home Affairs Ministry

Two main conclusions can be drawn from the experience of the transfer system in Italy:

- a. A viable grants system requires the fiscal autonomy of local governments.
- b. It is necessary to avoid changing the rules of the system of general and sectorial transfer to Regions, Provinces and Municipalities too often. If it is true that the transfer system has to guarantee a certain temporal flexibility and allow periodic reviews (the Australian experience of the Commonwealth Grants Commission is exemplary in this respect), this cannot translate into impossibility of local administrations to formulate long-term budget policies.
- c. Without adequate fiscal autonomy, to expect to control the evolution of local spending with both sectoral funds (Regions) and general funds (Provinces and Municipalities) is an illusion.

The participation of local authorities.

The last 20 years have seen growing awareness of the fact that, to be effective, political decentralization requires adequate institutional mechanisms. Without a federal arrangement (which normally envisages the representation of member States), over the last few years we have seen the number of intergovernmental bodies increase and their role in Italy grow. This is, arguably, one of the most interesting - albeit least analyzed aspects - of the reforms carried out in the meantime. Intergovernmental bodies perform numerous functions. The growth in shared policies has made it increasingly necessary to define decision-making forums in which the different institutions participate simultaneously. Numerous national laws envisage the participation of the Regions through various forms of agreement and accord, besides more generic consultation in the different sectors of intervention. In its jurisprudence, the Constitutional Court has deliberately elaborated the principle of the need for 'fair collaboration' between Central Government and Regions. One highly important body set up precisely for this purpose is the State Regions Conference, created in 1988 by specific legislation following a trial period.¹² It is based at the Prime Minister's Office, and is made up of the Presidents of the Regions and chaired by the Prime Minister or by a Minister delegated by him. Depending to the points on the agenda, it may be attended by other Ministers or representatives of administrations of the State or of public bodies. The Conference has advisory functions and also

¹² The full name of the body is Permanent Conference for relations between the State, Regions and Autonomous Provinces.

'co-manages' policies, in the sense that it helps, through agreements, to elaborate activities to steer and coordinate numerous sectors of the State (especially in the fields of health and environmental protection). More recently, the Conference has also received autonomous power to steer and implement given laws.

Intergovernmental bodies are not confined to the State-Regions Conference. After a long debate, the State-Cities and Local Autonomies Conference was set up in 1996 with analogous functions. It is chaired by the Government Premier and made up of six Presidents of Provinces and fourteen Majors, of which five from the biggest cities, the Presidents of the main Associations of Local Authorities and some Ministers. Indeed, for given duties the two Conferences can join together in the so-called Unified Conference. The latter plays a crucial role in solving intergovernmental conflicts for the assignment of competences and resources to enact the 'Bassanini package'.

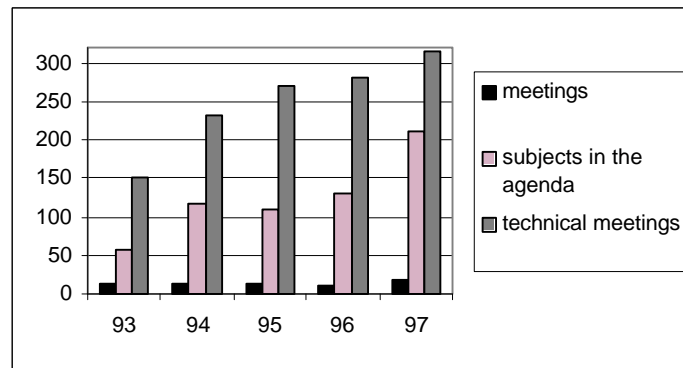
The activity of these bodies is rapidly intensifying (Fig. 3). Between 1993 and 1997, the number of official meetings of the State-Regions Conference increased from 12 to 19 (plus, in 1997, the seven meetings of the Unified Conference) and, overall, the subjects addressed increased from 56 to 211. In parallel, the technical activity of central and regional functionaries also burgeoned, with meetings preparatory to the sessions of Conferences increasing from 150 to 314 in the same period.

A similar trend was recorded at regional level. Different Regions thus set up Regions- Local Body Conferences which, for the moment, are largely organic advisory instruments for local bodies, though, for some, they ought to constitute a sort of second regional chamber with the guarantee functions typical of federal systems (the Region as a federation of local bodies). At the end of 1997, 12 regions had set up such bodies, albeit following different procedures.

To explain this, it is necessary to mention, first and foremost, the growth of the political clout of medium-large cities, thanks both to electoral reform and renewed commitment to local development policies. The dynamism of such cities has been evident in the initiatives of their mayors, of the National Association of Italian Municipalities (ANCI) and of the Union of Italian Provinces (UPI). These two organizations are powerful national lobbies which have fostered the creation of the new intergovernmental decision-making and advisory body, the State-City-Autonomies Conference, alongside the pre-existing State-Regions Conference.

When the Government reaches an agreement with the various Conferences, it is very unlikely that Parliament will vote against their proposals. Members of Parliament are strictly tied to local politics and are aware of the risks of non-re-election if they fail to support local initiatives. Consequently, some define these Conferences as a sort of third 'hidden' House of Parliament.

Fig. 3 Growth of the activity of the State -Regions Conference



Source: Public Affairs Department

3. Conclusions.

Italy has a regional system of territorial government which is presently undergoing a number of transformations. Some, possibly far-reaching, changes have already been introduced into this system and the role of sub-national governments has been strengthened. Regional and local tax autonomy, for example, has been strongly increased. A process of constitutional review has been attempted and this could lead to the transformation of the present system into a federal system. A joint parliamentary committee (Commissione Bicamerale) was set up in 1997 and has since produced the draft for a new Italian constitution. Constitutional review, however, came to an abrupt halt in 1998¹³, since the strong pressure for change, namely for federalization, failed to attract general support across all areas of the country (especially in the South, the least developed part of Italy).

Moreover, the constitutional debate on federalization is permeated by strong institutional rivalries among sub-national governments. While regional governments are ardently pressurizing for a classical two-layer federation, whose actors would be the Central government and the Regions, local governments - notably the Municipalities - are demanding three-layer (or “three-star” in modern-day political jargon) federalism, where both regional and local governments would operate on a play-level field. Nevertheless, the so called “administrative federalism” is underway and is giving new momentum to the process of political decentralization.

Finally, to date the recent devolution of taxing powers to Regions and other local governments has gone hand-in-hand with a reallocation of spending responsibilities. In this way, devolution has so far allowed all levels of government to maintain their budget steering capacity, implementing strict new reporting systems to ensure effective control over general government spending.

¹³ The stoppage in Italy was due to the withdrawal of opposition parties from the special parliamentary joint-committee (‘Commissione Bicamerale’).

What lessons can be drawn from all this?

I believe there are five in particular.

First lesson: Devolution takes time. Looking back, anyone is struck by the fact that fiscal decentralization in Italy, has been almost permanently “in the making”. Only on the eve of the new millennium does it seem to have reached a more stable arrangement. This is bound to be true in the future too. For example, according to the most recent proposal, the new mechanism of regional revenue sharing of VAT and equalization will be fully implemented only in 2013.

Second lesson: Sequencing is a crucial issue. The financing of the Special Statute Regions is a glaring example of the perverse effects of the wrong sequencing of devolution, whereas the financing of Ordinary Statute Regions is an excellent example of the risks of “special-purpose grants inflation” due to the lack of regional fiscal autonomy and an initial unfair costing of the functions to be transferred.

Third lesson: Sub-national government must have the power to tax: only with substantial fiscal autonomy can the decentralization process be compatible with the maintaining of control over general government spending.

Fourth lesson: Fiscal equalization through a viable grants system has to be clearly and fairly designed to get the support of all the areas of a country, bringing together accountability and solidarity, and it cannot perform well without relevant own local taxation.

Fifth lesson: Sub-national governments have to be deeply involved in the devolution process: the achievement of fiscal discipline can be facilitated through formal arrangements, such as Intergovernmental Committees, between central and local governments.

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APPENDIX: The new revenue sharing of VAT for Ordinary Statute Regions.

Law n.133/99 established a new revenue sharing arrangement for Ordinary Statute Regions, based on personal income tax, gasoline tax and VAT. While the first two taxes are shared on a derivation basis, the distribution of VAT is tied to a particular equalization mechanism. A recent decree has set out the criteria for the distribution of VAT among Regions.

The first step is the distribution among Regions based on private consumption used as a proxy for the regional VAT tax base.

The second step is the calculation of the quotas (s.c. “historical component”) which would produce a balanced budget for every Region after the cancellation of the previous central transfers. They represent the initial distribution in 2001. From 2002 they will be reduced gradually (5 per cent a year for the first two years, 9 per cent a year for the further ten years) to make room for equalization. The distribution of this (growing) share of the historical component will be made according the following formula:

$$\text{Comp}_{\text{VAT}}^{\text{it}} = \frac{P^{\text{it}}}{\sum_i P^{\text{it}}} + \frac{P^{\text{it}} \beta \sum_j \tau_j^{\text{t}} (x_j^{\text{t}} - x_j^{\text{it}})}{\text{VAT}^{\text{t}}} + \frac{P^{\text{it}} (s^{\text{it}} - s^{\text{t}})}{\text{VAT}^{\text{t}}} + \frac{P^{\text{it}} \gamma^{\text{t}} (e^{\text{it}} - e^{\text{t}})}{\text{VAT}^{\text{t}}}$$

where:

i= Regions (i=1,2,...15)

t= year (t=2001,2002,...2013)

$\text{Comp}_{\text{VAT}}^{\text{it}}$ = share of VAT for Region i in the year t, with $0 \leq \text{Comp}_{\text{VAT}}^{\text{it}} \leq 1$

P^{it} = population of region i in the year t

$\beta = 0.9$, indicates the so called “solidarity coefficient” for the equalization of fiscal capacity;

j= own and shared taxes which define the regional fiscal capacity

τ_j^{t} = national average tax rate of revenue source j in the year t

$x_j^{\text{t}} = (\sum_i P^{\text{it}} x_j^{\text{it}}) / (\sum_i P^{\text{it}})$ = average per- capita national tax base

x_j^{it} = per capita tax base of region i

s^{it} = per- capita health expenditure needs of region i

$s^{\text{t}} = (\sum_i P^{\text{it}} s^{\text{it}}) / (\sum_i P^{\text{it}})$ = national average per capita health expenditure needs

$\gamma^{\text{t}} = 0.7$, indicates the level of equalization that must be obtained with this criterion

e^{it} = standardized per capita non-health expenditure of region i, calculated through a statistical regression model¹⁴ which assesses the extra costs due to the small dimensions of regions

e^{t} = national average standardized per capita non-health expenditure

VAT^{t} = total VAT shared among Regions in the year t.

The first term of the formula determines an equal per capita distribution. This is corrected to take into account the differences in tax bases and the differences in health and aggregate non- health expenditure needs.

The second term defines a regional per-capita fiscal capacity measure and relates it to an equalization yardstick represented by the national average per-capita fiscal capacity. The Regions whose fiscal capacity exceeds the yardstick

¹⁴ Based on a loglinear relation: $e^{\text{it}} = a + b * \log(P^{\text{it}})$.

will have the 90 per cent of their difference reduced and the other way round for the Regions whose fiscal capacity fall short of the yardstick.

The third term is based on the difference between the health expenditure needs of each Region and the national average determined by the Health Ministry using economic and demographic indicators. Basically, it attributes different weights to the various age groups of the population with reference to distinct services, such preventive care, hospitals, etc.

Finally, the fourth term seeks to compensate for the absence of scale economies with reference to the aggregate non-health expenditures in the smallest Regions. In fact, consolidation of Regions does not appear as feasible in the present political context. Yet, to avoid excessive incentives to inefficiency this equalization component is reduced to 70 per cent with the parameter γ^1 .

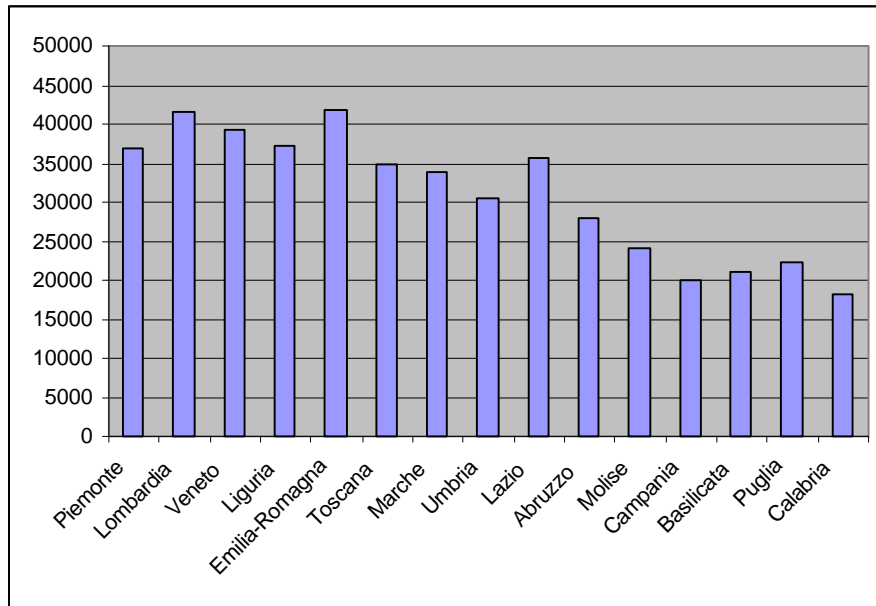
In Table A1 we see the first simulations of the new mechanism outcome. The first column shows the distribution based on consumption, the second the “historical component”, and the third the distribution made according to the formula. A clear pattern emerges in favor of the less developed regions located in the southern area of Italy (Figure A1).

Table A1. The new revenue sharing of VAT for Ordinary Statute Regions: criteria of distribution

	Private		Historical		Equalized distribution Comp ^{it} _{VAT}	%	Criteria of equalization			
	Consumption	%	Expenditure	%			f=b + c+ d + e	Population (b)	Health expendit. needs (c)	Non-health exp. needs (d)
Piemonte	3335	9,3	2467	6,9	2593	7,21	8,82	1,11	-0,07	-2,65
Lombardia	7543	21,0	281	0,8	805	2,24	18,57	-0,19	-2,18	-13,96
Veneto	3669	10,2	2125	5,9	2075	5,77	9,23	-0,11	-0,15	-3,2
Liguria	1420	3,9	1935	5,4	1978	5,5	3,36	1,14	0,54	0,46
Emilia- Romagna	3513	9,8	1833	5,1	1845	5,13	8,14	1,5	0,05	-4,56
Toscana	2803	7,8	2711	7,5	2751	7,65	7,26	1,21	0,19	-1,01
Marche	1179	3,3	1118	3,1	1410	3,92	2,99	0,24	0,55	0,14
Umbria	603	1,7	1005	2,8	1025	2,85	1,71	0,27	0,48	0,39
Lazio	3858	10,7	2661	7,4	2478	6,89	10,81	-0,7	-0,47	-2,75
Abruzzo	867	2,4	1609	4,5	1640	4,56	2,63	0,08	0,54	1,31
Molise	192	0,5	544	1,5	561	1,56	0,68	0,06	0,3	0,52
Campania	3106	8,6	7959	22,1	7386	20,54	11,91	-2,36	-0,72	11,71
Basilicata	312	0,9	944	2,6	949	2,64	1,25	-0,08	0,42	1,05
Puglia	2373	6,6	5332	14,8	5358	14,9	8,4	-1,62	0,01	8,11
Calabria	1183	3,3	3432	9,5	3107	8,64	4,25	-0,56	0,51	4,44
Total	35958	100	35958	100	35958	100	100	100	100	100

Source: Ministry of Treasury, 2000

**Figure A1. Per capita regional income of Ordinary Statute Regions
1996**



Source: Central Statistical Office (ISTAT), 1999