

# Hearing on the state of local public finances and the development of fiscal federalism

## Summary

The Chair of the Parliamentary Budget Office (PBO), Lilia Cavallari, testified today before a hearing at the Parliamentary Committee for Fiscal Federalism. After discussing the extent and effects of the extraordinary measures taken to support local authorities in addressing the crisis engendered by the pandemic (section 2), the Chair focused on the following issues: new developments regarding fiscal federalism for provinces and metropolitan cities (section 3.1); the recent acceleration in the process of determining essential service levels (ESLs) (section 3.2); the possible effects on the current structure of local taxation of the proposed replacement of the municipal additional income tax with surtaxes (section 4); the degree of involvement of decentralised entities in the implementation of the National Recovery and Resilience Plan (NRRP) and current issues that could hinder the latter in narrowing the territorial and infrastructure gaps that characterise Italy (section 5); and the recent evolution of infrastructure equalisation (section 6).

In the last two years, a **series of extraordinary measures have been implemented to enable local authorities to address the economic and social consequences of the pandemic and to offset the reduction in local tax revenue**, which have temporarily altered the ordinary system of intergovernmental financial relations. Resources totalling €11.9 billion in 2020 and €2.8 billion in 2021 were transferred to local governments, of which €8.5 billion to municipalities, €1.1 billion to provinces and metropolitan cities and €5.1 billion to regions.

For municipalities and provinces, the definition of criteria and methods for allocating the resources to be devoted to food solidarity and those allocated to the Fund for the Basic Functions of Local Authorities (the "*Fondone*") played a central role. The criteria identified met the dual need to offset revenue losses and ensure funding for the programmes necessary to cope with the economic and social consequences of the health crisis. Food solidarity funds were distributed to municipalities in proportion to their resident population and on the basis of the gap between municipal per capita income and the national average. The criteria for allotting the *Fondone*, on the other hand, were mainly based on fiscal capacity, although in some cases the increased needs connected with the economic and social crisis were considered.

As regards the regions and autonomous provinces, the resources of the Fund for the exercise of the functions of these entities, equal to €4.3 billion in 2020, having been essentially intended to offset revenue losses, were distributed on the basis of this criterion. Furthermore, Legislative Decree 137/2020 made €250 million for 2020 and €110

million for 2021 available to the ordinary statute regions to support the categories subject to restrictions during the various phases of the health crisis.

This substantial volume of resources was allocated with measures adopted on an emergency basis and within an uncertain and incomplete regulatory framework governing the procedures for central government's contribution to financing the basic functions of local authorities in adverse economic conditions. Article 11 of Law 243/2012, which governs the procedures for central government's contribution to financing essential service levels and basic functions in adverse phases of the cycle or in response to exceptional events, which was revised in 2016 and later declared unconstitutional, remains unimplemented today.

The gaps in the regulatory framework may have accentuated certain problems with the emergency measures of 2020 and 2021. One of the first of these was determining the precise purpose of the support measures: the measures were intended in part to offset the reduction in local government revenue and in part to meet the increased funding requirements of those entities. However, the resources for one and the other purpose were not always clearly distinguished, especially as regards the resources delivered through the *Fondone*. A second aspect to consider is the need to define the scope of the expenditure that can actually be financed by local authorities with emergency support. Specifically, the problem is to uniquely identify expenditure related to basic government functions. Finally, it could be difficult to determine which increased needs of local authorities are strictly attributable to the effects of the emergency and not more generally related to the initial economic and social situation of the various territories. Emergency support measures should not perform an equalisation function among local authorities.

The distributive outcome of the emergency support measures must also be assessed in the light of these considerations. In this regard, if we look at the per capita distribution of food solidarity resources by region -- based in part on an income criterion - higher values are observed for the southern regions. For the *Fondone*, however, the overall average amounts allocated in both 2020 and in 2021 were generally higher for local authorities in the central-northern regions, at least when the main allocation criteria were based on the loss of revenue. The situation was reversed when increased needs were given greater weight in allocation procedures.

Overall, the use of these emergency programmes would benefit from the completion of the regulatory framework. If the attempt of Article 11 of Law 243/2012 to specify automatic mechanisms for transferring resources corresponding to local government's share of the cyclical component of the deficit to the local level were to be abandoned in favour of discretionary arrangement determined on a case-by-case basis between central government and local authorities, the certification and monitoring of the transferred resources would play a key role. These activities make it possible to ensure the *ex-post* correspondence between the amount disbursed by central government and the actual needs of local authorities even in the absence of automatic rules.

In the same period, **permanent measures were taken that have already facilitated** and, in the future, **will further facilitate the implementation of fiscal federalism**. This regards in particular the acceleration of the determination of ESLs, the lack of which have represented one of the main obstacles to the creation of the equalisation systems on which such federalism is based. In recent years, a number of essential service levels and objectives have been established, structural resources have been found to cover the costs, and coordination and programming activities have been planned.

The 2022 Budget Act sought to impose order on the matter by referring to the legislation that had already established ESLs and introducing further provisions, the implementation of which will, however, require a series of subsequent steps. The overall framework remains fragmented and heterogeneous. Its completion will have to be accompanied in the next few years by additional measures to better coordinate the provisions for determining ESLs and rationalising the various sources of funding. While the expansion of the concept of essential service levels served to begin the progressive construction of a system of uniform local social services integrated with health services and labour policies and achieve consensus among the various levels of government and all the actors involved, it also entailed certain difficulties in specifying its substance, which is not always translatable into a service to be provided to the public. The multitude of funding sources for ESLs in the social arena makes it difficult to assess their overall adequacy. Despite the increase in the Municipal Solidarity Fund, the extension of essential service levels may require new sources of funding, in particular for the non-self-sufficient, the dedicated fund for which is only partially increased and is slated for reform under the NRRP. As for nursery schools, the decision to include private-sector services among those that contribute to achieving compliance with the associated ESL remains questionable. Looking forward, the full implementation of fiscal federalism in accordance with the design envisaged under Law 42/2009 would require pooling the financing for the ESLs provided by local authorities in a single fund that would ensure equalisation based on standard requirements, which are in turn founded on the ESLs. To facilitate this and implement a general reorganisation, it would be helpful for the measures intended to determine the ESLs to be coordinated through a framework law and brought together in a single measure.

**In the last two years, the progress achieved**, however partial, **in establishing the ESLs has accompanied the evolution of the implementation of fiscal federalism**, at least as regards the municipal sector and that comprising provinces and metropolitan cities, while the process for regions is still at a standstill.

As already noted at the previous hearing,<sup>1</sup> the equalisation system for **municipalities** has been revised, establishing that from 2030 (the end of the transition period) the Municipal Solidarity Fund shall be based entirely on the difference between standard requirements

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<sup>1</sup> Hearing of PBO Board member Alberto Zanardi on the state of implementation and outlook for fiscal federalism in the light of the National Recovery and Resilience Plan before the Parliamentary Committee for Fiscal Federalism of 20 October 2021 (Summary in English. Full text in Italian).

and standard fiscal capacity, thus eliminating the 50 per cent ceiling on the fiscal capacity eligible for equalisation and abandoning any reference to historical levels. Beginning with nursery schools and social services, the process of revising the methodology for determining standard requirements was initiated with the goal of eliminating references to the quantitative levels of services historically provided by individual municipalities and linking them instead to standardised service levels valid for the entire country. Additional resources have been appropriated for nursery schools, social services and the transport of students with disabilities, which will enable municipalities with insufficient service levels to expand the services they offer without however penalising those that have already achieved a high level of performance, with the clear intention of fostering convergence. Finally, a mechanism for monitoring and verifying the actual increase in services delivered has been envisaged.

As regards **provinces and metropolitan cities**, after the deceleration caused by the sovereign debt crisis and the unsuccessful attempt at constitutional reform, the 2021 and 2022 Budget Acts have lent impetus to the reorganisation of the regulations governing these entities with the aim of defining, from 2022, new financing methods consistent with the design of fiscal federalism.

Recall that following the economic and financial crisis of 2010-2011, central government closely involved this sector in the rebalancing and consolidation of the public accounts. This led to progressive cuts in the resources devolved to them, as well as a tightening of the budgetary objectives of these entities, such that starting in 2014 the contribution of the provinces to the public finances was obtained through current expenditure savings, which were to be transferred to central government. Furthermore, the failed attempt in 2016 to reform Title V of the Constitution left open many questions concerning both the functions and the funding of these entities.

As a result, a need has emerged in recent years to reorganise the structure of these entities, making it consistent with the provisions of the enabling law on fiscal federalism. This review process began with the 2021 Budget Act, which established two separate funds starting from 2022 – one for each category of entity – into which all the grants and funds for current expenditure currently assigned to these bodies should be merged. The distribution of resources must be based on the standard requirements and fiscal capacities of the entities involved. The system delineated with this legislation was then supplemented by the 2022 Budget Act, which: 1) specified the methods for the allotment of the two funds for the purpose of equalisation; and 2) allocated additional funds to provinces and metropolitan cities for the performance of their basic functions.

The two central features of the reform were therefore the determination of the standard requirements and fiscal capacities of the provinces and metropolitan cities and their use in determining the methods for allocating the funds. For provinces and metropolitan cities in the ordinary statute regions, the standard requirement, equal to a total of €2,771.3 million, was estimated using the regression cost base approach. The calculation is based

on 2018 expenditure for each function, but the normalisation of the variables made it possible to move away from the historical expenditure criterion. The result of the calculation are standard requirements expressed in monetary terms, which directly enter into the distribution of the funds. The fiscal capacity of the entities, estimated at €3,060.8 million, was obtained by evaluating the revenue from their own taxes at a standard rate, i.e. excluding the fiscal effort.

The two funds established with the 2021 Budget Act include all grants and current expenditure funds relevant to these entities, equal to €1,333.8 million, and their overall contribution to the public finances, equal to €2,769 million. The difference between these two aggregates gives the net contribution to the public finances, amounting to €1,435.2 million in funds transferred to central government. The mechanism for the distribution of the two funds is based on estimates of standard requirements and fiscal capacity and is divided into two components. The first recalculates the net contribution to the public finances of an individual entity on the basis of the difference between its own requirements and its fiscal capacity. This mechanism accounts for 8 per cent of the distribution of the contribution to the public finances in 2022 (the remaining 92 per cent continues to be assigned on the basis of historical levels). However, the percentage will increase over time. The second component transfers the additional resources provided for in the 2022 Budget Act to these entities (€80 million in the first year, with the amount growing in subsequent years), which reduces the sector's net contribution to the public finances. Funds are allotted to each entity in proportion to their requirements. The inclusion of new resources during the process of equalisation implies that despite the significant rebalancing, no entity will see its resources reduced. In this way, the areas in which the entities can exercise their fiscal autonomy – which is completely absent today – will be gradually restored, the adequacy of which will also be assessed by taking account of future developments in requirements and the tax bases of their own taxes.

Looking ahead, the contribution to the public finances should be based more correctly on reserving a share of the revenue from the main taxes levied by provinces and metropolitan cities (IPT – provincial registration tax and RCA – automobile civil liability insurance tax) to central government. In this way the risk of a contraction in tax bases, which today is entirely borne by the provinces and metropolitan cities, would also be shared by central government and the equalisation funds, in a manner similar to the mechanism in place for municipalities, would act exclusively on fiscal capacity and additional central government resources to ensure that all entities are able to fund the performance of their basic functions.

**Decentralised public finance arrangements should also be involved in the future in the reform of the national tax system.** Among its various provisions, the enabling law under examination in Parliament envisages the replacement of municipal and regional additional income tax levies with surtaxes. For municipalities, unlike the regions, the version of the enabling law under discussion establishes that the scope for adjusting the tax rate will be set so as to ensure that municipalities as a whole shall receive revenue

equal to the revenue currently generated by the average municipal income tax rate, eliminating the residual fiscal leverage available to municipalities and making it impossible for a significant number of entities to generate the same revenue now produced through the fiscal effort exercised with the municipal additional income tax levy. At the hearing, we assessed the extent to which the proposed measures would preserve adequate scope for subnational entities to exercise their revenue-generating autonomy, a constitutive element of the reform of fiscal federalism.

Using the most recent data available, it can be estimated that by applying a surtax rate that would generate the same revenue as the municipal income tax rate would for all municipalities as a whole, only about 50 per cent of municipalities, with about one-third of the population, would be able to maintain their revenue at current levels. To enable all municipalities (in the ordinary and special statute regions) to maintain their fiscal autonomy, generating the same revenue potentially achievable today with the application of a 0.8 per cent rate of municipal income tax (approximately €6.2 billion), the surtax should be set at 3.78 per cent. At this rate, the percentage of municipalities that would not be able to raise the same revenue generated with the existing municipal income tax would decrease to about 29.3 per cent (with 28 per cent of the population). These entities are essentially those municipalities that currently levy a high average municipal income tax rate (greater than 0.6 per cent): among these, about 59.7 per cent of municipalities in ordinary statute regions and 81.3 per cent of those in special statute regions would find themselves pinched. Overall, the loss of revenue would amount to some €109 million (about 8.6 per cent of the municipal income tax previously raised), of which €92 million in the ordinary statute regions (8.3 per cent of revenue) and €17 million in the special statute regions (10.9 per cent of revenue).

In addition to entailing permanent changes in the levy for taxpayers (being more progressive than the municipal income tax), the transition to a surtax approach would produce changes in the revenue raised by individual entities (fiscal capacity) and therefore - in the short term - in equalisation transfers through the Municipal Solidarity Fund. In the transition phase, municipalities whose fiscal capacity would increase would in any case have greater resources available to them, as the offsetting of the expanded fiscal capacity is only partial. Overall, the fiscal capacity created with the surtax is greater than that of the additional income tax, especially in the Northwest of the country and, to a lesser extent, in the Centre (thanks to the key contribution of Rome), while it is lower in the South. From 2030, however, when the equalisation mechanism will be fully based on the difference between requirements and fiscal capacity, these variations in the revenue raised by each entity will be fully offset by transfers, and the transition to a surtax will have no impact on the resources available to the individual municipalities.

The changes in the equalisation fund would reduce the number of entities with revenue shortfalls even with the application of the 3.78 per cent rate. In 2023, the percentage of such entities would decline from the 29.3 per cent indicated earlier to 28.5 per cent (24.8 of the population), with a shortfall of around €64 million. When fully operational, with the

transition to total equalisation, entities with revenue shortfalls would decrease further (to 24.6 per cent of the total, or 20.8 per cent of the population) and the associated compensation requirement would fall to around €35 million overall.

Another key aspect is the impact that **the NRRP could have on the ability of local authorities to offer services to their citizens** – helping to strengthen the infrastructure endowments necessary for them to perform their functions – **and in bridging the differences between local government entities and territories as part of a gradual convergence process.**

As already noted on previous occasions, a significant portion of the lines of investment envisaged under the NRRP involves local authorities as the implementing entities, above all in the sectors of intervention involving areas for which such entities are responsible (health and social services, as well as green revolution and ecological transition programmes). It can be estimated that these authorities would be responsible for managing between €66 billion and €71 billion of the funds available through the Recovery and Resilience Facility (RRF), or between 34.7 and 36.9 per cent of the total resources earmarked for Italy for all NRRP missions.

Furthermore, at least 40 per cent of the resources of the NRRP and the Complementary Fund (CF) financed with national resources that can be associated with projects in a specific territory must be allocated to the South in order to meet one of the overarching objectives of the Plan, namely reducing territorial disparities, with a view to ensuring the delivery of adequate levels of services throughout the country. An initial analysis by the Department for Cohesion Policies of the Presidency of the Council of Ministers (DPCoe) – which is responsible for monitoring compliance with the territorial constraint – found that of the total resources taken into consideration (€222.1 billion, of which €191.5 through the RRF and €30.6 through the CF), €211.1 billion could be associated with a specific territory, of which €86 billion would be allocated to the South, satisfying – with an overall share of 40.8 per cent – the allocation restriction provided for in applicable legislation. However, this overall share masks different percentages for the entities responsible, of which more than half are around or above the 40 per cent constraint. In only two cases – the Ministry of Economic Development and the Ministry of Tourism – are the percentages of resources allocated to the South significantly lower than the 40 per cent constraint, with values of between about 25 and 30 per cent. This is attributable to various circumstances, including the fact that the primary legislation for part of these measures did not establish reserves in favour of the South, the presence of investments that must comply with the principles of economic and financial sustainability, to be assessed on the basis of market criteria, and the presence of an open call mechanism that makes it impossible to specify territorial constraints *ex ante*. Compliance with the overall constraint will in any case be constantly monitored, as for about one-third of the available resources the initial assessments of the DPCoe are based not only on preliminary estimates and information but also on indications of plans by the entities involved to comply with the allocation constraint.



Furthermore, an initial survey by the DPCoe of measures already activated through competitive procedures that have not yet led to the selection of the projects to be financed found clear indication that the choices made by the entities involved often do not comply with the express provisions of the Circular of the Minister for the South issued to ensure compliance with the territorial constraint. Three different situations appear to have emerged: i) unallocated resources are in any case allocated to the southern territories, thereby safeguarding the share earmarked for the South, but only for just over a third of the total resources analysed; ii) unallocated resources are allocated regardless of the territorial location of the projects; and iii) no explicit criterion is made for the territorial use of unallocated resources, which occurs for most of the resources.

**With regard to the actual achievement of the NRRP objectives**, three main problems have emerged: the ability of central government departments to use tenders and calls to steer the allocation of funds among entities in a manner consistent with the specific and general objectives of the Plan; the ability of the administrative and technical departments of the subnational levels of government to develop projects appropriate to the various lines of investment; and the amount of time it currently requires to implement projects, which reflects the different planning and management capacities of the regions and other local authorities.

With regard to the **first critical issue**, in order to verify the integration between the specific objectives of the measures and the territorial constraint, an analysis was conducted of the 36 calls published through May 2 for the allocation of NRRP resources to territorial entities with a total value of €24.3 billion, of which 43.3 per cent earmarked for the South. The analysis found a variety of different methods being used to structure the calls. These take the form of six different approaches to formulating the ranking of projects, each of which raises issues concerning possible differences between the final ranking of the selected projects and what would have occurred in the absence of the territorial constraint, to the detriment of both efficiency and the achievement of the primary objective of the projects. For calls with national rankings (both individual and broken down by theme), the problem arises when the project ranking produced using the criteria envisaged in the call does not comply with the territorial constraint. In this case, better projects from the point of view of the specific objectives of the measure would be shunted aside in order to enable the financing of less effective projects that, however, were located in the South. In the case of rankings by macro-areas with resource allocations determined on the basis of the territorial constraint, achievement of the investment objective could be partially hindered if the macro-areas with the greatest infrastructural deficiencies exhaust their resource allocation. In the case of regional rankings with resource allocation determined on the basis of the primary objective, it could occur that – as a result of the regional pre-allocation of funding – an entity whose primary objective has already been achieved receives financing anyway because entities in the same region with greater structural gaps decide not to participate in the tender, leaving available the resources allocated to them. Finally, for negotiated procedures, although designed to enable swift activation of expenditure by avoiding the use of



competitive procedures, it is not possible to evaluate *a priori* the adequacy of the criteria adopted and the relative efficiency of the allocation of funds given the way in which they are implemented (an initial selection of the general projects, followed by a second phase of negotiation of measures with the project proponents).

As regards the **second critical issue**, both the PBO and other observers have noted on multiple occasions that for many years government entities have seen a significant reduction in their staffing levels as a consequence of the turnover restrictions imposed with the corrective measures adopted since 2010 as part of the consolidation of the public accounts. This has impacted the composition by age and qualifications of personnel and led to the widespread practice of local authorities not directly performing functions such as the planning and technical and economic evaluation of investments, relying instead on the advice of private-sector professionals. In this general context, studies by other institutions have observed that the most problematic situation is faced by the South, which experienced a sharper contraction in personnel and which focused subsequent permanent recruitment on hiring persons previously engaged in community service, with an unfavourable impact on generational turnover and the hiring of employees with higher-level qualifications.

In order to remedy these problems and respond to the new needs connected with the implementation of the NRRP, the Government has deployed an array of measures on several levels. These include expanding authority to hire personnel and transfer of resources, simplifying and accelerating competitive hiring procedures and rolling out extensive training plans. Pending the completion of these activities, a technical assistance programme has been developed. However, the introduction of these tools does not guarantee an effective increase in the administrative capacity of local authorities, in particular those in the South. Any such improvement will depend on the ability of the entities themselves to effectively exploit the possibilities available to them in implementing the NRRP investments. Initial data seem to indicate certain difficulties in this regard. For example, with regard to a specific NRRP investment line concerning the improvement and mechanisation of the urban waste separation network, while the personnel requirement planned by Sicily appears to be consistent with the achievement of the targets for 2023, the other two worst-performing regions (Basilicata and Calabria) submitted personnel plans in line with the national average.

The **third critical issue** concerns the time currently required to carry out projects, which reflects the diverse planning and management skills of the regions and other local authorities. Data on tender procedures conducted between 2007 and 2021 indicate that in the South and Islands projects took average of 7 per cent longer to complete than in the Centre, 21 per cent longer than in the Northeast and 22 per cent longer than in the Northwest.

The results of the econometric analyses conducted by IRPET in collaboration with the PBO confirm that the changes already adopted to support the projects financed by the NRRP

and those provided for in the enabling law for the reform of public contracting (under discussion in Parliament) would help limit project implementation times and reduce the gap in the South. In particular, the estimates suggest that simplified and more flexible solutions, such as those to which the enabling legislation would give more room than provided for in the 2016 reform of the Procurement Code (negotiated procedures, direct award, maximum price reduction criterion, integrated procurement), accelerate the award and start-up of projects without adversely impacting the time necessary for their execution.

However, the need to balance the gains from simplification and flexibility with a reinforced focus on the quality of contract counterparties should not be underestimated. The results of the model clearly show that the experience accumulated by both the contracting authority and the companies involved (approximated by the number of works completed in the previous four years) can be associated with faster execution and shorter overall times. The measures adopted in recent years and the guidelines set out in the enabling legislation are steps in this direction, with renewed attention to the qualification system of contracting authorities and company ratings. It would be advisable to take swift action to make counterparty quality control operational and effective, especially considering the fact that in ten years' time national and European institutions and the media will no longer be focusing the considerable attention now being devoted to tender procedures for the projects under the NRRP and the new European programming cycle (2022-2027).

An effective assessment of contracting authorities and companies is also necessary to maximise the effects of two other measures contained in the enabling legislation: the first is the provisions encouraging the aggregation of municipal contracting authorities, which the results of the analyses associate with a lengthening of project implementation times when the entities involved share the same troubled starting conditions (as is often the case in the South); the second is the implementation of the Small Business Act, which, if applied too mechanically in all areas of the country, could lengthen project implementation and raise costs by reserving projects for SMEs and local businesses.

Finally, a final issue addressed in the hearing concerned **infrastructure equalisation**. It was emphasised that the recently-resumed survey of infrastructure to quantify needs is an essential prerequisite for assessing and reducing the territorial divide in existing infrastructure endowments and for using more efficiently the variety of resources available in the coming years. Accurate quantification of infrastructure disparities is crucial, not only to determine investment priorities and steer the related planning (by sector and macro-area), but also to move beyond historical expenditure levels as a criterion for allocating resources and adopt resource allocation approaches based exclusively on actual needs for territorial rebalancing. This would eliminate the need to reserve specific shares of funding for the South, which are often different and difficult to integrate. This would become automatic if the goal is to bridge the gaps in infrastructure endowments. The ongoing work to establish the allocation criteria for the Infrastructure

Equalisation Fund is also crucial as it could represent the start of a change of course in the allocation of resources and could also lay the foundations for greater coordination of both the various additional interventions during all phases (from the choice of the works to be carried out by territory and by sector to monitoring progress and commissioning) and of those additional interventions with ordinary central government capital expenditure, 34 per cent of which must be directed at the South under the provisions of Law 18/2017.