Hearing on issues related to the implementation status and prospects of fiscal federalism

Summary

May 7, 2025 |The Parliamentary Budget Office (PBO) held a hearing today on issues related to the implementation status and prospects of fiscal federalism before the competent Parliamentary Commission. In the document presented by PBO Councilor Giampaolo Arachi, after a brief description of the main measures concerning territorial Entities' finances contained in the 2025 Budget Law, focus was placed primarily on the contribution to public finance required from these Entities. The presentation highlighted several critical issues emerging from its design and coexistence with cuts to resources for local investments. Secondly, the adequacy of resources compared to the expenditure needs for fundamental functions and Essential Service Levels (ESLs) was addressed, with particular reference to Municipalities. Finally, some general considerations were advanced on how a stable framework of rules should be designed for territorial Entities' contribution to public finance to ensure effectiveness and coherence with the new European governance, and how the fiscal federalism implementation path should coordinate with any progress in differentiated autonomy.

The contribution to public finance amounts to 7,780 million in the period 2025-29 and primarily burdens the Regions. The distribution of the burden among different local governments does not appear attributable either to different spending dynamics in recent years, or to the varying weight of compressible expenditure, but rather to the need to improve the Regions' budgetary results. Indeed, they register more substantial deficits compared to other local governments and have greater difficulties in reducing them over time.

A potential criticism stems from the fact that the Regions' deficit is essentially determined by the accumulation over the years of the Liquidity Advance Fund (LAF), which, in turn, derives from liquidity needs to address due healthcare commercial debts, **while each Entity's contribution** to public finance—which for those in deficit represents an additional repayment of the deficit—**is parameterized to extra-healthcare expenditure**.

Critical issues also emerge from the adoption of current expenditure as the criterion for distributing the contribution to public finance among Entities in individual sub-sectors. These derive from the composite nature of territorial Entities' current expenditure, strongly influenced by transfers between different government levels, **and from the need to ensure coherence between the burden imposed on Entities and the availability of adequate resources to finance standard expenditure needs related to fundamental functions, service objectives, and ESLs.** Regarding the first aspect, for containing these Entities' expenditure, it would likely have been simpler to intervene directly on State transfers, considering that both Regions and local Entities receive funding beyond healthcare and social spending (excluded from the reference current expenditure for contribution allocation) and that many municipal functions are performed in associated form (and, therefore, the current expenditure of lead Municipalities is affected by transfers received from associates). Concerning the protection of fundamental functions and ESL financing, it should be considered that their perimeter extends beyond healthcare and social matters. While for Ordinary Statute Regions (OSR) it is hoped that the process of defining standard expenditure needs related to ESL matters will soon be completed to delineate their respective resources, **for local Entities, the contribution allocation should occur consistently with the equalization criteria used for the Municipal Solidarity Fund (MSF) assignment, the equalization funds of OSR Provinces and Metropolitan cities, and the Special Fund for Service Equity Levels, to avoid one neutralizing the effects of the other at the expense of fundamental functions and ESL financing.**

The text shows, solely for OSR Municipalities, a possible inconsistency between the criteria used for the allocation of the contribution to public finance and the equalization criteria, using an expenditure indicator that exceeds the equalization perimeter and is therefore sustained to perform non-fundamental functions and/or service levels above the standards financed with fiscal effort. The exercise reveals that in many cases, the required contribution exceeds what would be consistent with MSF equalization objectives, and larger Municipalities would be advantaged, where higher revenues derived from autonomous fiscal effort normally concentrate and, consequently, residual expenditure—outside the equalization perimeter—is broader.

Finally, concerns emerge about the effective use of current provisions related to the contribution to public finance to make investment expenditures, which should partly counterbalance the concurrent cut to funding for investment programs for the period 2025-2034 arranged by the 2025 Budget Law. The territorial Entities concerned already register a significant available surplus, which for Municipalities is growing over the years (from 3,475 million in 2023 to 5,212 in 2024) instead of being used to finance investments. **There is therefore a risk that the constraints on current expenditure** will not promote investments in subsequent years but, rather, **translate into the accumulation of earmarked resources in local Entities' budgets, especially small Municipalities, with immediate benefits for the general government balances but at the expense of local communities.**

Regarding the adequacy of resources available to Municipalities, its evaluation is currently hindered by the absence of standard expenditure needs estimation in absolute value and the persistence of numerous direct transfers for financing fundamental functions and ESLs that do not fall within equalization mechanisms. Nevertheless, the relative static nature of equalized resources appears problematic due to substantially invariant tax bases over time and the lack of explicit mechanisms for periodic review of vertical transfers from the State budget. The 2025 Budget Law has arranged a gradual increase in the MSF which, however, is not intended for relatively less endowed Entities, but aims to ensure that Municipalities historically enjoying greater resources continue to receive them even if not justified by their current expenditure needs and fiscal capacity. **It is desirable that, considering public finance objectives, there is multi-year programming of expenditure needs such as to allow Entities to perform their activities, guaranteeing ESLs and other services within fundamental functions, while respecting budget balance constraint**. In this perspective, not only the relative distribution of current expenditure among Entities should be considered, but also its level, evolution over time, and composition. Among other factors, consideration must be given to additional costs connected with ESL definition, current expenditure margins necessary to operationalize new structures realized or to be completed within the National resilience and recovery plan (NRRP), exogenous factors determining the variation of expenditure needs (e.g., inflation), rigidity of certain expenditure items (such as personnel, passive interests, and loan repayments), costs deriving from personnel contract renewals, and those potentially connected with deficit repayment.

All this would require, first, an evolution of the municipal standard expenditure needs methodology that allows their definition in absolute value and, subsequently, from the resource side, **to consider not only fiscal capacity, but also the set of transfers flowing to Municipalities and to overcome their relative static nature.** The implementation of the delegated law for fiscal reform and the revision of rules contained in the accounting and public finance law and that relating to the implementation of budget balance could contribute to this overcoming.

In the future, assuming the maintenance of the budget balance objective for territorial Entities, the highlighted limitations could be overcome through better transfer programming. This should begin in the Structural Budget Plan, where, together with the net expenditure growth rate of the general government, the programmatic evolution of expenditure needs relating to local Entities' fundamental functions and ESLs compatible with it should be defined. Based on predictions of fiscal capacity dynamics, the State's contribution to equalized transfers to ensure financial needs coverage should then be determined. To this end, it is necessary to proceed with a rationalization of transfers not intended for special interventions provided by the fifth paragraph of Article 119 of the Constitution that still flow to local Entities outside equalization funds, and to complete the fiscal federalism implementation path with the reform of OSR financing, included as enabling in the NRRP and to be realized by the first quarter of 2026.

In the presence of realistic and sustainable estimates of expenditure needs and their evolution over time, medium-term programming of resource evolution would help local Entities respect budget constraints without renouncing planning capacity and could mitigate the resistances hindering equalization progress.

During the Structural Budget Plan validity, the programmatic transfer path may be modified to respond to changed evaluations on the evolution of expenditure needs or fiscal capacity. Even in the absence of such modifications, **it might nevertheless be**

necessary to provide in annual programming documents additional contributions charged to territorial Entities to prevent unforeseen and non-discretionary revenue increases from being used to increase disbursements, risking the achievement of primary net expenditure growth objectives. Unlike interventions on transfers in the programming phase, **such potential contributions should have a counter-cyclical nature and symmetrically engage both territorial Entities and the State**: the former should refrain from spending higher non-discretionary revenues in favourable cycle phases, the latter should integrate resources in adverse phases to avoid a pro-cyclical contraction of expenditure. **The new contribution on the territorial Entities introduced with the 2025 Budget Law could evolve in this direction. It should be noted that it does not necessarily determine a reduction in expenditure dynamics but only its postponement.** For Entities in surplus, the contribution reduces current expenditure space in the year it is applied but increases that related to capital expenditure in subsequent years. Entities in deficit are required to accelerate its repayment by anticipating savings otherwise due over a longer horizon.

Finally, **the completion of fiscal federalism must be coordinated with the potential implementation of differentiated autonomy** in relation to ESL determination and the management of revenue sharing for financing Regions requesting greater autonomy (RAD).

With Ruling 192/2024, **the Constitutional Court has, among other things, declared unconstitutional the provision of the delegated law on differentiated autonomy regarding the annual alignment mechanism of revenue destined to finance delegated functions to expenditure needs through modifications of revenue sharing rates on State taxes.** According to the Court, this would not only potentially determine a de-responsibilization effect for Regions, given that their inefficient management could have been substantially settled in full by the State, but would also have denaturalized the essence of revenue sharing, making them effectively analogous to earmarked State transfers, which Article 119 of the Constitution legitimizes only in specific cases.

However, a financing system for RADs based on revenue sharing rates fixed over time can generate a progressive divergence between revenue, which has dynamics linked to tax bases, **and standard expenditure needs,** which respond to variations in costs and needs, generating two types of problems, particularly for functions with defined ESLs. First, in cases where revenue exceeds standard expenditure needs, the potential de-responsibilization effect would re-emerge for Regions managing additional functions inefficiently, while in cases where revenue falls below standard expenditure needs, ESL financing would be endangered. Secondly, an asymmetry would be created between the financing of ESLs for functions already under regional competence and those related to functions attributed to RADs. For the former, Legislative Decree 68/2011 provides that revenue sharing and regional taxes be equalized with respect to standard expenditure needs, thus correcting, through variations in equalization transfers, any deviations.

These critical issues could find resolution in closer coordination between the two reforms. In particular, the possibility of including in the Equalization Fund provided by Legislative Decree 68/2011 the standard expenditure needs and revenue sharing associated with additional functions recognized to RADs should be evaluated.