Inter-American Development Bank
Banco Interamericano de Desarrollo
Latin American Research Network
Red de Centros de Investigación
Research network Working paper #R-398

Problems of Soft Budget Constraints in Intergovernmental Relationships: The Case of Italy

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November 2000

Cataloging-in-Publication data provided by the
Inter-American Development Bank
Felipe Herrera Library

Bordignon, Massimo.
Problems of soft budget constraints in intergovernmental relationships : the case of Italy / by Massimo Bordignon.

p. cm. (Research Network working paper ; R-398)
Includes bibliographical references.

1. Intergovernmental fiscal relations--Italy. 2. Budget--Italy. 3. Finance, Public--Italy.
I. Inter-American Development Bank. Research Dept. II. Latin American Research Network. III. Title. IV. Series.

336 B844--dc21

Inter-American Development Bank
1300 New York Avenue, N.W.
Washington, D.C. 20577

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Abstract[*]

Problems of "soft budget" constraints in intergovernmental relationships are currently at the frontier of research in local public economics. This paper reviews the Italian experience in the field, starting from themid-1970s up to the present period, compares it with that of other countries, and uses it to comment upon the state of arts of the literature. The paper argues that the soft budget constraint problem has been a rampant one in the Italian local public finance, generating efficiency losses, lack of political accountability and undermining the soundness of public finances. The paper inquires into the causes and possible solutions to the problem, and in particular describes and comments upon the decentralization process of the 1990s. Finally, the Italian debate on fiscal federalism of the 1990s is also reviewed, arguing that some of the suggestions of this debate may be of interest more generally.

Key words: Soft budget constraints, intergovernmental grants, fiscal federalism, pressure groups

JEL: H77.

Acknowledgments

This paper is a revised version of a previous draft prepared for a ZEI workshop on Comparative Fiscal Federalism held in Bonn on 21-22 May 1999. I benefited greatly from the comments of the participants. In particular, by my discussant, and by Juergen von Hagen and Jorn Rattso, the organisers of the meeting. I am also grateful to Flavia Ambrosanio, Floriana Cerniglia, Nicoletta Emiliani, Piero Giarda and Mina Vaccari, who read the manuscript and helped me correcting several mistakes. Nicoletta Emiliani also helped me in gathering meaningful data on Italian local governments, always a problem in Italy. The responsibility for all views and remaining errors rests on the author only.

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1. Introduction

Problems of bailouts and their economic implications have traditionally been studied with reference to episodes of governmental intervention in the industrial and banking system (i.e., Dewatripont and Maskin 1995 and the literature quoted therein). Because of size, economic relevance, or simply political connections, some firms are deemed too important to be allowed to fail; in the event of economic difficulties, governments feel forced to step in and rescue them financially. In turn, expectations of this behavior on the part of the government may make the perceived budget constraint of the firms "soft" (e.g., Kornai, 1986), leading them to behave suboptimally, say, by taking too much risk or allocating resources inefficiently. On policy grounds, this then raises the issue of which instruments, institutions or policies can be used to cope with this problem, allowing or forcing governments to credibly commit not to interfere with the functioning of the economic system.

Although less widely studied, it is important to realize that exactly the same kind of problems may characterize the relationship between central and local governments.[1] Undoubtedly, most local governments are for reasons of size and economic or political relevance too important to be allowed to fail; indeed, in many countries it is not altogether clear that a local government can actually "fail." Furthermore, local governments are often a very important piece of the total government; financial difficulties at the local level may then bring about difficulties at a higher level, undermining the equilibrium of the central government's budget. Again, this raises the question of which policies can be introduced to eliminate or reduce the bailout problem. In the present context, this basically means inquiring into issues such as the optimal assignment of functions and resources to the different levels of governments, the structure and the level of the intergovernmental transfer system, the legal constraints concerning the availability of debt to local governments, the political rules determining the relationship between local and central parties and politicians, and so on.

[1] Although the problem has always been known, it has raised considerable interest only recently, in particular in the writings of policy-oriented economists working on developing economies such as Bird *et al*. (1995), Prud'homme (1995) and Tanzi (1996). Theory seems to have lagged behind, however, not least because "soft budget constraint" problems could not even arise in the standard approach to fiscal federalism (i.e., Oates, 1972) where central government is supposed to have unlimited commitment powers. For recent attempts which somewhat link the design of intergovernmental relationships with problems of soft budget constraint, see Wildasin (1997) and Qian and Roland (1998). The political economy literature has made some steps further, stressing in particular the "common pool" problem—induced by the separation between spending and financing decisions at local level—as one of the causes of soft budget constraint; see, for instance, Tabellini and Persson (1994, 1999).

In this paper, we pursue two tasks. First, we briefly review the Italian experience in local public finance from the mid-1970s to the present period. We argue that the bailout problem and the connected problem of a perceived "soft budget" constraint at the local level have been rampant in Italian local finance for the last twenty years. This has caused severe efficiency losses in the provision of local public good and services, induced a lack of responsiveness and accountability of local politicians to local preferences, undermined political participation at both local and central levels, and generated severe problems for the equilibrium of central government finances. Second, we build on the Italian experience to comment upon the current state of research on this issue in economics and to suggest an agenda for further work.

In particular, concerning the Italian situation, we argue that several connected reasons were, and still are, responsible for soft budget constraint problems at the local level. First and foremost is the *mismatch between own resources and functions at the local level*, resulting in a large vertical imbalance between local tax revenues and expenditures.[2] The ultimate root of this mismatch can be traced back to the 1948 Constitution, which mandated expenditure assignments to local governments, while being less specific on the means and on the level of the government which would be in charge of financing these expenditures. This constitutional ambiguity allowed the central government in the 1970s—when a massive tax reform was introduced and some new local governments (ordinary regions) were established—to centralize tax revenues while decentralizing public expenditures. This reduced the perceived cost of public expenditures at the local level, thus stimulating an increase in local public expenditures and local deficits, which the central government felt forced to accommodate ex post through increased transfers (e.g., Brosio *et al*., 1980). The central government's subsequent attempt to regain control of local finances by controlling local expenditures more directly (say, by imposing ceilings on the rate of growth of local expenditure and introducing conditional grants) was only partially successful.

A second factor was the large *overlap of functions* among the different levels of government, which reduced the accountability of local politicians and induced local governments to free-ride on each other. A third cause of budgetary problems was the *inability of the central government to commit* to a precise policy concerning local finances, defining functions, own resources and grants to local governments in a coherent framework, and an inability to maintain

[2] On these grounds, Italy is certainly not unique. The empirical research of Stein (1999) on Latin America countries, for instance, also offers considerable support for the existence of a systematic link between bailing out by central government and vertical imbalance at the local level.

that framework consistently. In turn, this lack of a committing technology on the part of the central government can be largely traced back to the features of the Italian political system itself, a parliamentary regime with electoral rules based on proportional representation, which typically resulted in weak, very short-lived coalition governments.[3] As a result, it was fairly typical for central governments to renege on the local public finance policy decided by their predecessors.[4] A fourth aggravating factor was *the lack of transparency* in accounting procedures at the local level and in the formulas for intergovernmental transfers. The former made it more difficult to identify waste in local expenditures, while the latter allowed for the lots of hidden political exchange taking place in the setting of the intergovernmental transfers. Finally, the *lack of an adequate system of political representation at the local level* often resulted in the selection of local politicians who were hardly responsive to local preferences.

Most of the recent history of Italian local public finance can be read as an attempt to come to terms with these problems. Since the beginning of the 1990s, several reforms have been passed which have attempted to: 1) progressively "harden" budget constraints on local governments, through an increase in their financial autonomy and a reduction in the transfers paid by the central government; 2) increase the responsiveness of local politicians by passing new electoral laws at the local level and by introducing a clearer separation between the functions assigned to the different levels of government; 3) keep local public expenditures under even stricter controls, by introducing cash controls on them. These attempts have only been partially successfully so far. They succeeded in keeping at bay the rate of growth of local public expenditures in the short term but did not remove entirely the incentives to misbehave. We review these policies, arguing that the failure of the attempt to introduce a constitutional reform in 1997, committing the political system to the decentralization process, can be considered as the main cause for the limited effectiveness of these policies. Indeed, in spite of the ongoing debate on fiscal federalism in Italy, there are worrying signs of the political system's reverting to a re-centralization of local policies.

[3] To be more precise, in 1993, under the pressure of a national referendum, a reform was passed which to some extent transformed the electoral rule to a plurality. However, in the main chamber 25% of MPs are still elected with the proportional rule.

[4] The effect of different political institutions on central government ability to commit and its consequence on expenditure and budget deficits has been studied empirically by Roubini and Sachs (1989). For an application to local government expenditures, see Borge and Rattso (1999).

A lively debate on decentralisation took place in Italy in the mid-1990s in anticipation of the attempted constitutional reform. Although never fully applied, some of the ideas generated in that debate were somewhat original even in an international context. This is particularly true for the “soft budget constraint” problem in intergovernmental relationships. For this reason, in the following we will also pay some attention to the Italian debate on fiscal federalism, reviewing some of the most original ideas.

The rest of the paper is organized as follows. Section 2 provides the reader with some background information on the structure of the local governments in Italy. Sections 3 to 5 briefly illustrate the development of local public finances in Italy. More specificially, Section 3 illustrates the development of local public finances from mid-1970s to the beginning of the 1980s, focusing on the financial crises of the municipalities and the subsequent bailout by the central government. Section 4 discusses the period from 1980 to the beginning of the 1990s, mainly focusing on ordinary regions and health financing. Section 5 reviews the period from 1990 on, commenting on the reforms. Section 6 briefly reviews the Italian debate on fiscal federalism of the mid-1990s. Section 7 sums up by discussing what can be learned from the Italian experience and by suggesting avenues for further research.

Before beginning, a word of caution is in order. In what follows, we will not attempt to review in detail all the developments in Italian local public finance in the last 25 years. This would be too space and time-consuming, in addition to being overly boring to both the writer and the reader. Rather, we will focus only on some relevant episodes that illustrate the main theme of this paper, relegating all the remaining developments of the period to the background. At this point, I would like to refer the interested reader to other sources for more extensive coverage. Unfortunately, literature in English on the Italian local system of government is rare and often out of date. A good recent discussion is in Emiliani *et al*. (1997), who cover some of the features of the Italian local public finance not discussed here and present a richer set of data; Levaggi (1996) discusses in some more detail the transfer systems among municipalities. Although a bit out of date, the works of Fraschini and Osculati (1991) on municipalities and Buglione and France (1983) on regions also offer useful introductions to the Italian system of local government.

2. Italian Local Government: Background Information

There are four levels of government in Italy: central, regional, provincial and municipal. Local governments consist of 20 regions, around 100 provinces, and more than 8,300 municipalities. In theory, higher levels of governments have a role in supervising and coordinating the behavior of lower level of governments in the same territory. In practice, though, there is no hierarchical relationship between these different levels of government. Each local government is basically autonomous in pursuing its policies and, in particular, there are very few financial links between the different levels of sub-national governments.[5] On the contrary, each local government has a direct financial link with the central government, which at least partly finances current and capital expenditures with grants.[6] Among the subnational governments, municipalities and provinces have been a part of the structure of the Italian state since its unification in the nineteenth century.[7] Regions, on the other hand, were introduced only with the 1948 Constitution. Furthermore, 15 of these, called the Ordinary Statute Regions, were formally established in 1970 and became fully operative only in 1978, when the National Health System was established and regions were given responsibility for health care, as set forth in the 1948 Constitution (see below).

Municipalities and provinces are *administrative* bodies. Municipalities, by far the most important of the two, are in charge of managing services such as local police, public hygiene, social welfare, solid waste collection, street cleaning, urban planning, urban public transportation, street maintenance, zoning and regulation of trade, supply of gas and electricity, parks and sports facilities, and the provision and maintenance of buildings for primary and secondary education. Provinces have residual responsibilities for non-solid waste collection, maintenance of provincial highways, mountain transportation and air and water pollution

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[5] These are mainly due to some functions which have been transferred by regions to municipalities in the past (such as, for example, labor training and housing) and which are still financed with grants coming from the regional budget. In the near future these regional grants to municipalities and provinces should to some extent increase as an effect of the 1997 tax reform and the 1997 "decentralization laws." See below.

[6] This is not true only for some "special" regions that directly finance all their functions, with no extra money coming from the central government budget. See below.

[7] The main functions of municipalities and provinces were established in a comprehensive law in 1934; subsequent important revisions occurred in 1977,1990, and in 1998 with the approval of the implementing laws relative to the two "decentralization laws" of 1997 (the so-called Bassanini laws).

control.[8] Municipalities and provinces differ greatly in terms of both the size of the population and of the territory. Municipalities, in particular, range from very small towns of a few hundreds of inhabitants to big cities with millions of citizens. Despite this, they are all attributed the same functions by law. A well known result is that most municipalities are too small in size to capture the increasing returns to scale in the provision of local public goods and services, resulting in per-capita public spending which on average is considerably larger than those of larger municipalities.[9] In spite of a long history of urbanization, it is worth recalling that approximately 50% of the Italian population lives in towns with less than 30,000 inhabitants, so that the loss of efficiency induced by suboptimal size is likely to be considerable. The present borders of cities derive mainly from historical considerations; in spite of some attempts of fostering mergers of smaller towns by the central government, the number of municipalities in Italy has actually slightly increased since the second world war, contrary to the common tendency in most developed countries (e.g., Bailey, 1997).

Italian regions belong to two different groups: *special (statute) regions* and *ordinary (statute) regions.* Special regions were established immediately after the war.[10] Their statutes, which in some cases (e.g., Sicily) were issued even before the same 1948 Constitution, have the rank of constitutional laws. Each special region is a world apart from the other special regions. Each has a different assignment of resources and functions, depending on its statute and the approved implementing laws (Cerea *et al*., 1989), but there are some common features. First, they have generally been attributed more functions than ordinary regions.[11] Second, their primary source of revenue is *shared national taxes*. Which national taxes are shared, and to what extent, depends on the statute of each special region. The five special regions are either large islands (Sicily and Sardinia) or small regions close to the national borders with a high percentage of foreign population (Valle d'Aosta, Trentino Alto Adige, Friuli Venezia Giulia). The larger

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[8] This list is only partial, indicating the main functions attributed to the two levels of government. Again, it should be noted that because of the two 1997 decentralization laws these functions might be considerably augmented in the near future.

[9] Empirical estimates of per capita expenditures as a function of population size usually show a U-shape, with per capita public expenditure being higher at the two extremes, and the least cost size being in the range between 50,000 to 100,000 inhabitants (see for instance, Ambrosanio et *al*., 1999). Of course, these simple estimations do not consider the fact that big cities also carry the weight of providing services to commuters.

[10] Except Friuli-Venezia Giulia, which was established in 1964.

[11] For instance, four special regions of the total of five are directly in charge of paying transfers to municipalities; two directly finance primary and secondary education, two finance disability pensions, and so on. Furthermore, since 1996 Trentino alto Adige, Val d'Aosta and Friuli Venezia Giulia are completely in charge of financing their health sectors.

autonomy and resources given to these regions were mainly meant to prevent the threat of separatist movements and ethnic conflicts. A common judgement in Italy is that because of their financing system, which directly links special regions' resources to central government tax revenue,[12] citizens in the special regions have been treated overly generously by the Italian state, receiving more resources than necessary to finance their extra functions (Maggi and Piperno, 1992).[13] Notice that special regions are *legislative bodies*; in the range of their competencies, they can issue laws regulating their own territories and decide which functions to implement.

Ordinary regions are also *legislative bodies;* however, they can issue laws only in the framework of what is established by national laws. The delay in establishing these regions, more than twenty years after the Constitution was drafted, was probably due to political reasons. The ruling party of post-War Italy (the Christian Democrats) was afraid to lose power by delegating resources to local governments which could be more easily controlled by the opposition party (i.e., the Communist Party). Indeed, regions were established only in the seventies, after the electoral success of the opposing parties, and made operative only in the period when the Communist Party was giving external support to the government coalition. The political willingness to keep regions under strict central control may partly explain the decision taken concerning the financing of these regions, as will be discussed below.

The functions of ordinary regions were laid out in the Constitution and implemented by regional laws.[14] Ordinary regions are responsible—whether directly or indirectly through local production units such as the Local Health Units (since 1993, Local Health Firms)—for most expenditures on health, transportation, welfare, agriculture, environment, tourism, public housing and vocational training. The Constitution was less precise in defining the resources to be given to

[12] It is maybe worth recalling that tax revenue in Italy, as a percentage of GDP, rose from 26% in 1980 to 43% in 1992. As a result, special regions saw in the period a huge increase in their resources without bearing any political responsibility for that increase and with a limited increase in their functions. See next note.

[13] Just to give an idea, Trentino Alto Adige receives 90% of all state revenue collected in its territory and Sicily the totality. As a result, in 1994, citizens in Val d'Aosta, received 12 million lire per capita and citizens in Trentino Alto Adige 9 million per capita, whereas citizens in ordinary regions on average received less than 2 million lira. Even taking into account that these regions perform extra functions, and computing the relative extra costs, this seems to be an overly generous treatment by any account (see Cerea *et al*., 1989 for some estimations of the extra costs incurred by the special regions). It should also be noted that for a long time the Italian state also gave to these regions grants for financing expenditure in selected sectors, such as the health sector. These have been eliminated only recently for some of them. In the Italian debate on fiscal federalis, changing the financing system of special regions has often been proposed, making it more like the financing of ordinary regions. The problem is that the financing system of special regions is defined in their statute and this statute has Constitutional value. Indeed, it is commonly acknowledged that it is more difficult to change these statutes than the Constitution itself, as there are no defined procedures for doing so.

these regions, addressing generally of shared national taxes, own taxes and grants from the central government. As a result, as discussed below, the central government chose for a long period to finance these local governments almost exclusively through conditional and unconditional grants.

Ordinary regions vary greatly in terms of population and territory. The largest region, Lombardia, with almost 9 millions inhabitants, is in terms of size a state of its own, larger than Austria. The smallest region, Molise, with slightly more than 300,000 inhabitants, is smaller than many Italian cities. Irrespective of size, all ordinary regions are assigned the same tasks by law. Again, as for municipalities, this implies that many Italian regions are clearly below the optimal size, whatever that may be.[15]

Italian regions do not differ only in size, however. The most important distinction is in terms of the part of the country in which they are located. As is well known, the Center-North of Italy is, by all standards, much more developed than the South. This reflects itself not only in higher resources being available for the Northern regions[16] but also in a better social climate and in a tradition of better administrative government. This partly explains why, with approximately the same resources, ordinary regions of the Center-North have generally been able to offer better services to their citizens. It also explains the great emphasis put by Italian politicians on the redistributive role of the public sector on the territories. We will see shortly how important this element was in determining local government financing in Italy.

We discuss expenditure and revenue assignments to the most important local governments, municipalities and ordinary regions in more detail in the next sections. A few quantitative indicators may, however, be useful in setting the stage for the discussion. Table 1 reports total revenues and expenditures for all levels of governments in selected years. It shows that subnational governments are responsible for more than 25% of all total expenditures (including Social Security), and their expenditures are around a third of central government

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[14] They are also under redesign because of the decentralization laws.

[15] Bordignon and Emiliani (1997), for instance, estimate the per capita administrative cost of regions as a function of population. Upon controlling for other variables, it turns out that elasticity of these costs with respect of population is -44%, implying that increasing the population of ordinary regions by one million inhabitants on average reduces administrative cost per capita by 45,000 (1996) lira

[16] To quote only one figure, GDP per capita in the richest region, Lombardia, is more than twice that of the poorest region, Calabria. Worse than that, the gap between Northern and Southern regions, remarkably stable in the 1980s, has been on the rise in recent times. Furthermore GDP per capita may not be a good measure of the different resources potentially available to the North and South. As we discuss below (see Section 6), the tax base of the newly introduced regional tax (IRAP) is distributed even more unevenly than GDP on the national territory.

spending (excluding Social Security). Netting out intergovernmental transfers (the figures in brackets), subnational governments spend approximately half as much as the central government—the latter figure includes interest payments, so that in terms of primary spending this ratio is even higher. They are, therefore, a very important part of the total government. Local expenditures were[17] on average around 14% of GDP, a figure which rather closely matches the corresponding figures for other developed countries (see Bailey, 1997). However, local government own revenues (the figures in brackets) were on average below 3% of GDP, a number by far lower than the corresponding figures in other countries. This is clear evidence of the mismatch between own revenue and expenditure referred to in the introduction. Indeed, in terms of tax revenues, in the 1980s Italy was probably one of the most centralized countries in the world.

Table 1. Revenue and Expenditure by Different Levels of Government (% of GDP)

	General Gov.[1]		**Central Gov.**		**Sub-national Gov.**	
	Revenues	*Expenditures*	*Revenues[2]*	*Expenditures[2]*	*Revenues[2]*	*Expenditures[2]*
1980	33.6	42.2	23.5 (20.3)	30.8 (18.2)	11.7 (1.9)	12.8 (11.3)
1985	38.6	51.2	28.8 (24.0)	41.4 (24.0)	14.0 (2.3)	14.1 (14.0)
1990	42.5	53.4	31.0 (26.5)	40.9 (25.4)	13.2 (2.9)	14.6 (14.5)
1993	45.0	57.6	43.1 (29.9)	43.1 (29.0)	13.6 (4.2)	14.1 (14.0)

Source: ISTAT 1) Including social security contributions and payments. 2) In brackets the figures net of transfers from or to the other levels of governments; without brackets, the same figures gross of transfers.

Table 2 distinguishes total expenditures and revenues for the different types of local governments for the most recent year for which I could find comparable data for all local governments. The table illustrates the relative importance of the different types of government. Ordinary regions spend approximately half of all local governments put together, while provinces cover a much smaller part of public expenditures. The table also illustrates the mismatch between own revenues and expenditures for each type of local government. Clearly, the vertical imbalance was much more pronounced for both ordinary and special regions than for other levels of government. Indeed, in 1992, own revenues of regions covered only 3% of their

[17]And it is still. The decentralization laws of 1997 have not yet been implemented, so it is not clear what will be the increase in the expenditure allocated to sub-national governments. Preliminary estimates (Zanardi and Arachi, 1998) quantify these new functions in a range between 20,000 to 30,000 billion lira, that is between 1-2% of GDP.

total current revenue. We will see how things changed in the 1990s. We now discuss the story behind these figures.

Table 2. Local Government Revenues and Expenditures (% of GDP, 1992)

	Ordinary Regions	*Special Regions*	*Provinces*	*Municipalities*
Total revenues	6.9	2.4	0.6	5.5
Current revenues	6.1	2.2	0.6	4.4
Of which Transfers	5.9	2.2	0.4	2.6
Total Expenditures	7.0	2.9	0.7	5.7
Current expenditures	6.0	1.8	0.5	4.0

Source: Italian Ministry of Budget

3. The Tax Reform of the 1970s and the Financial Crisis of Municipalities

A useful starting point for discussing the evolution of local public finances in Italy is the tax reform of the 1970s. In 1972-73, a massive tax reform was introduced with the aim of rationalizing and modernizing the tax system, which was unanimously considered to be inefficient, inequitable, and, in comparison to those of the other European countries, unable to generate enough revenue to finance highly needed expenditures, especially on capital goods and infrastructure. Several taxes, mostly real taxes and indirect specific taxes inherited from the past, were repealed and new ad-valorem and personal taxes were introduced. These included Irpef, the tax on personal incomes, Irpeg, the tax on corporate income, and Iva, the new VAT required by the EEC. Tax administration and enforcement, previously partly attributed to local governments, were totally centralized, and a new system of enforcement, based on automatic accounting procedures, was introduced (see Bordignon and Zanardi, 1997).

Concerning municipalities, old local taxes, such as the family tax and some sales taxes, for which municipalities had previously had the right to choose the tax rate and define the tax base, were eliminated. Others, such as IGE, where municipalities shared revenues, were substituted by IVA, which did not allow for any revenue sharing at the local level. The reform also introduced some new local taxes (Invim, Tarsu, Tosap, etc.)—basically taxes on the capital gains on housing assets (Invim), on waste collection (Tarsu) and on the use of urban territory

(Tosap)—but these proved immediately to be highly inelastic to income, and their real revenue easily eroded by inflation. The reform also introduced a new tax on all incomes other than dependent labor income, Ilor, (literally, the Local Tax on Incomes) which was supposed to serve the double role of inducing some qualitative income discrimination in the fiscal system, and of financing local governments. However, this tax never served its role; first, half of its base was eliminated by a ruling of the Constitutional Court, which removed self-employed income from its tax base, revenue subsequently claimed in its entirety by the central government.

The effects of these choices on the fiscal autonomy of municipalities were devastating. Until 1972, own tax revenues covered about 50 percent of the total current revenues of municipalities; by 1978 this figure had dropped to less than 10 percent. Correspondingly, grants from the central government rose from less than 30 percent of total current revenues in 1972 to almost 80 percent in 1978 (see Fraschini, 1980).[18]

As is apparent from the documents of the period, the elimination of all municipal fiscal autonomy was a deliberate political choice at the time. To understand why, it must be recalled that, in the mid-1970s, Italy was going through severe social and economic crises. Because of the oil shock of 1973, economic growth had halved and inflation was soaring (it remained at two digits for more than a decade). Social unrest, including terrorism, was widespread. In this situation, which also led the ruling parties to bring the Communist party closer to the government, centralizing all tax revenues was thought to be an avenue for keeping social cohesion in the country. The program was as follows. Local taxes would be substituted by a system of transfers aimed at equalizing the expenditure capacity of all municipalities, thus eliminating differences in local public expenditures due to different resource endowments. This was thought to be highly desirable, especially given the enormous differences between the North and the South. Grants and transfers to local governments would be based on a vast array of "objective" parameters, eliminating any possible inequity in the distribution of resources. Furthermore, financing local governments only through transfers would give the center better control over both the growth and the composition of local expenditures, thus achieving sound

[18] One may wonder why local governments did not oppose to such a dramatic cut in their revenue-raising activities. According to Fraschini and Osculati (1991, p. 224) "[The reform]...was favourably received: mainly because it lightened the administrative and political responsibilities of the local authority regarding the management of the old taxes. Moreover, the new system was only supposed to be temporary and, in addition, appeared to guarantee for the immediate future a growth in real terms in revenue, and therefore in spending capacity." On the latter point, as explained below in the text , local governments turned out to be dramatically wrong.

public finances and stimulating expenditures in those sectors where it was thought necessary to do so. The residual autonomy of municipalities, if any, would be in selecting public expenditures for that part not determined by the central policy maker.

To use a euphemism, the results of the centralization of the mid-1970s did not live up to expectations. As discussed in a number of empirical and theoretical studies centered on the financial crisis of Italian local governments of the 1970s (for instance, Brosio *et al*., 1980; Rizzo, 1985; Brosio, 1985), by eliminating all fiscal autonomy at the local level, the center also eliminated all perceptions of the costs of increasing expenditures at the local level, thus enticing local politicians to increase, or at least to accommodate, demands for higher services and higher salaries. As a result, current terms expenditures of municipalities rose by an average 20 percent each year between 1970 and 1977 (around six percent in real terms).[19] Current revenues, composed of quickly falling own tax revenues and increasing transfers, did not rise fast enough to keep pace with the soaring expenditures. In percentage of GDP, while cities' current expenditures remained roughly constant during the period, current revenues actually dropped by more than 20%. As a result, current deficits soared, moving from less than 765 billion lira in 1970 to 4,200 billion lira in 1977. Debt service and interests payments also soared, increasing by more than six percent in real terms each year from 1970 to 1976.

Confronted with increasing current expenditures and falling revenues, local governments reacted by cutting capital spending (investment in public works dropped by more than 30 percent of GDP during the period) and by financing the current deficit through borrowing from commercial banks. This was possible under Italian legislation that, prior to 1975, did not impose any restrictions on borrowing by local governments. By the end of 1977, the total stock of external debt of municipalities had reached 13,000 billion lira, more than three times as much as at the beginning of the period.[20] Coupled with nominal interest rates above 20%, many municipalities quickly found themselves unable to finance interest and debt service. For many cities, bankruptcy was imminent.

In this situation, the central government had no choice than to step in and rescue them. In 1977, emergency measures (the two "Stammati decrees") were passed, imposing ceilings on the rate of growth of local expenditures, restrictions on borrowing, and increasing transfers. In 1978,

[19] The figures quoted in this page are taken by Fraschini (1980).

[20] The situation was not different for provinces, which had followed the same destiny of municipalities. See the account in Fraschini (1980).

when the two decrees became law, the central government assumed direct responsibility for the debt accumulated by the municipalities prior to 1977, including interest and principal. At the same time, central government transfers to local governments were increased by almost 300 percent from 3,700 billion lira in 1977 to 9,400 billion lira in 1978. As a result, the financial situation of the municipalities was quickly reversed. From a current deficit of 4,200 billions of lira in 1977, municipalities moved to a current surplus of almost 840 billion lira in 1978. Furthermore, because the central government was now paying the interest for most of the debt accumulated thus far, interest payment and debt service of municipalities were cut in half. In exchange for the financial help, the central government imposed strict limits on the rate of growth of local public expenditures (for instance, by not allowing new hiring in the local governments) and made borrowings for local governments more difficult. After 1978, borrowing to finance current expenditures was strictly prohibited (except for temporary liquidity shortages) and a balanced budget requirement, including grants, was imposed. These measures proved to be effective. The growth of municipal expenditures was kept under control in the subsequent years and the debt[21] incurred by local governments remained approximately constant at about 10 percent of GDP during the 1980s.

Thus, the financial crisis of municipalities of the 1970s was quickly overcome. Its effects, however, were long-lasting. On the one hand, municipalities had learned that the central government would step in and rescue them in case of an imminent failure. The resulting moral hazard problem reduced fiscal responsibility at the local level. In order to keep local expenditures and deficits at bay, the central government had to impose ceilings and other mandatory measures on local expenditures in all the subsequent years. Fiscal irresponsibility was aggravated, though, by reduced fiscal autonomy. The ratio of own revenues to total revenues of municipalities remained below 30 percent during the 1980s and started to rise again only after the reforms of the 1990s (see below). On the other hand, the policies of strict central control over local public expenditures did not harden the budget constraint; they simply moved the problem from the bailout of debts and deficits to the determination of grants. In order to “save” them financially, the central government had simply increased the transfer to each municipality so as

[21] This is mainly the debt with the Deposit and Loan Fund, a public agency from which municipalities can draw resources to finance capital expenditure.

to approximately balance their budget. But, by doing so, it had implicitly given a premium to municipalities that had been less fiscally responsible.

To understand the seriousness of this problem, the next table (again drawn from Fraschini, 1980) reports the municipal debts for current and capital expenditures and by territorial areas. Two elements are of interest. First, the debt was much higher in absolute value in the South than in the North. This reflects the fact that municipalities in the South are much poorer than in the North, and that the financial crisis of the 1970s hit them much more severely than cities in the North. Second, the composition of the debt was very different in the North than in the South. Even in the middle of the financial crisis, in 1975, municipalities in Northwest Italy used almost 80 percent of their borrowing to finance public investments. In the South, 90 percent of the funds borrowed went to finance current expenditures. This in itself, of course, does not prove that municipalities in the South were less fiscally responsible than municipalities of the North. It could be that cities in the South, being poorer, simply had to use all their borrowing just to finance current expenditures, sacrificing all public investment. It does prove, however, that indiscriminate financing of local government deficits through increased grants made the central government cover up a lot of waste and reward the more inefficient municipalities.

Table 3. Debt for Current and Capital Expenditure and for Territorial Areas, (per capita) lira

	Debt for current expenditures (1)	*(1)/(3) %*	*Debt for capital expenditures (2)*	*(2)/(3) %*	*Total (3)*
North-west Italy					
1970	19,206	16.2	99,730	83.9	118,930
1975	48,441	21.7	174,550	78.3	222,950
North-east and central Italy					
1970	84,541	53.7	72,890	46.3	157,430
1975	213,055	62.9	125,480	37.1	338,530
South Italy and Islands					
1970	134,058	84.0	25,630	16.1	159,690
1975	321,655	89.3	38,360	10.7	359,640

Source: Fraschini (1980)

Since 1978, the central government has attempted to change the grant system several times by gradually moving from a system which mainly finances past expenditures of municipalities to a more rational one based on “objective” parameters capturing differences in needs and costs across municipalities. It never succeeded in doing so. According to Emiliani (1997), more than 50 percent of the transfers paid to local governments in 1993 still depended on the debt accumulated in the 1970s. There were two basic reasons for this. First, accounting and budget procedures of local governments in Italy are not developed enough to allow for a serious analysis of costs and expenditures at the local level, and little is known about the true tax base for a number of local taxes. Thus, estimating reliable demand and cost functions turns out to be particularly difficult. Attempts to do that made, e.g., by a government commission in 1993 and 1995 (Ambrosanio *et. al.*, 1999) were far from satisfactory, and this was known by all participants, including the municipalities.[22]

Second, and more importantly, the central government lacked the political will to impose a change in the transfer system. For example, a new law was passed in 1994 which was supposed to progressively reduce (over 16 years!) the role of past expenditures in the determination of transfers in favor of "objective" parameters computed by the commission mentioned above. However, the new model was applied only in 1994, to be abandoned in 1995. In 1996, a new law was passed proposing a new model of determination of transfers; this law was never applied.

This lack of commitment on the part of the central government can be attributed to two factors: the characteristics of the Italian political system on the one hand, and, especially in the 1990s, the public finance emergency on the other hand. As explained in the introduction, the Italian political system produces ever-changing central governments, which typically do not feel bound by decisions taken by previous governments.[23] As a result, governments have been reluctant to write long-term contracts with local governments and have too often been willing to renege on contracts once they had been signed.

As a result of all these failures, transfers to municipalities (and, in general, to all local governments) in Italy are still decided annually on the basis of a bargaining process between representatives of the municipalities and the central government. Basically, each government receives what it received the previous year plus (or minus) an amount that depends on the general situation of public finances and the relative bargaining strength of the two parts.

[22] One can always try, however, as it is difficult to image the results to be worse than those of the current system. The present author, together with Flavia Ambrosanio and Umberto Galmarini, computed standard costs and expenditures for municipalities in Lombardia (Ambrosanio *et al.*, 1999). One of the two provinces of Trentino Alto Adige, which is in charge of financing its own municipalities, also has developed a model to estimate standard costs and expenditures for its municipalities.

"Objective" indicators for implementing transfers to local governments are manipulated so as to fit with the result of the bargaining. Clearly, the political affiliation and the political importance of the participants (say, the mayor of a big city) may also affect the result of the bargaining.

It might be useful to note at this point that this way of setting the grants, in addition to being clearly inefficient and inequitable, has two other negative consequences, which have always been more serious for ordinary regions than for municipalities, as the ratio of transfers in their revenues has always been higher (see next section). First, this approach introduces uncertainty into local government budgeting. As transfers are decided annually, no local government really knows at the time of setting its budget how much money it will receive from the central government that year, let alone in years to come. This makes budget management and planning difficult, and it reduces the ability of local politicians to run their administrations efficiently.

Second, the political strength of a mayor or a president of a region does not stem from the ability to govern efficiently. Rather, it stems from having good relationships with central government politicians and public officials, as these relationships may result in receiving more grants. Thus the Italian grant system induces a distortion in local government, diverting scarce resources from managerial effort to lobbying. By the same token, it also tends to produce a political class that is better at lobbying than management.[24]

We end this section by noting another characteristic of the Italian system of local government that works against efficient management at the local level. This is the large overlap of functions between different levels of government, which reduces the accountability of local politicians and induces local governments to free-ride on each other. As explained in the next section, this problem is rampant, especially in health management. For municipalities and provinces, a simple example illustrates the point. In the education sector, the central government is in charge of financing teachers' salaries and equipment and local authorities finance outlays for building maintenance. Financing of the support staff is divided between the municipalities which pay the salaries of the nonteaching personnel in kindergartens and scientific high schools,

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[23] The average life of an Italian government in post-war Italy was about 10 months. Following the electoral reform of 1993, however, the average life has slightly increased.

[24] On these grounds, the Italian experience certainly offers support to the political economy literature which, in the presence of centralized revenue and decentralized expenditure (the "common pool" problem), argue in favor of modelling local governments as "pressure groups": see for instance Persson and Tabellini (1994). See Section 7 for further comments.

the provinces which are in charge of the nonteaching personnel in technical high schools, and the central government which finances the salaries of the nonteaching personnel in classical and professional high schools. Finally, the administrative staff in kindergartens and scientific high schools is paid by the central government, which also pays the staff in the junior schools.

No one really knows or recalls any longer why the assignments to the different levels of governments were chosen in this way. The result, however, is an administrative nightmare, inefficient management of the work force and a loss of accountability of the governments involved in the sector.[25]

4. The 1980s and the Financial Problems in Ordinary Regions

We now turn to the other main actor in the Italian local government system: the ordinary regions.[26] Introduced in the 1970s, they became an important part of the Italian system of government only in the 1980s, when they assumed their full responsibilities. Much of what we have already said for the municipalities could be repeated for ordinary regions, except that, especially in the 1980s, their situation was decidedly worse than that of municipalities. Lack of fiscal autonomy, fiscal irresponsibility, lack of accountability and transparency, overlapping competencies and the perception of soft budget constraints affected this level of government in a way that was unknown to the other local authorities. Bailouts by the central government, rather than being relegated to a single episode as in the case of municipalities, were a common practice in financing for this level of government.

We begin by describing the assignment of expenditures and resources to these regions.[27]. In 1992, the year before the first reform of the 1990s, ordinary regions spent 71.1 percent of their total resources on health services, 6.1 percent on transportation, 10.4 percent on economic services (mainly agriculture), 3.1 percent on education and culture, 1.3 percent on housing and

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[25] Some of the consequences of this state of affairs may be almost comical. For instance, in the research mentioned above, Ambrosanio *et al*. (1999) found no correlation whatsoever between the amount of expenditure and the number of staff employed in the education sector by municipalities and other indicators such as the number of schools or the number of students. Whether this was due to slack, mistakes in the accounting procedural of municipalities, or failures in the data set is not known.

[26] As discussed above, the situation of special regions was totally different. Because of the relative abundance of resources, however, they had in general a better life, and, especially in the case of the three small regions of the North, they are generally regarded as local governments with a tradition of high efficiency in the supply of services. Islands, though, are in a much worse state and, especially in the case of Sicily, a terrifying story of inefficiency and criminality could be told. However, this story will have to wait for another occasion.

[27] The source of the following data is the Ministry of the Budget.

4.5 percent on general services. Interest payments were only 0.5 percent of total expenditures, all of which were used to finance capital expenditure.[28] On the revenue side, 2.7 percent came from own taxes, largely surcharges on small central government excises on consumption and production,[29] and 96.8 percent from grants and transfers (96 percent from the central government alone). Of the transfers from the central government, less than four percent came as *unconditional* grants[30] and the rest as *conditional* grants. Among the latter, the most important were the National Health Fund, a fund earmarked for health expenditures, and the National Transportation Fund, earmarked for transportation. In addition, there were dozens of smaller earmarked funds, most of them designated for financing agriculture, forestry and other economic services.

As in the case of municipalities, a deliberate choice had been made by the central government to keep the fiscal autonomy of the ordinary regions at the lowest possible level. The constitutional ambiguity regarding the financing of these regions was used to inflate the role of grants relative to own taxes and shared revenues. Conditional grants predetermined not only the type of expenditure, but also many other details, as regions were often given very strict guidelines by the central government on how to spend the money, leaving them very little room to express their legislative powers. For example, in the case of health services,[31] the Ministry of Health determined in minute detail how resources from the National Health Fund (NHF) should be employed (for instance, the share of current and capital expenditure, the amount going to finance hospitals rather than paying general practitioners, etc.), and the parameters determining the supply of services in the regions (e.g., the number of hospital beds or of general practitioners for 1,000 inhabitants). Furthermore, most of the elements affecting health expenditures were directly determined by the central government itself (say, ticket rates on drugs, wages and

[28] Regions can borrow only to finance capital expenditure, and there are strict rules (basically sound finances) concerning both the size (no more than 25% of current surplus) and the conditions under which debt can be raised.

[29] According to the Italian accounting definition of own taxes, a local government is said to have an own tax as long as it has at least some latitude in modifying the tax rate.

[30] They were the Common Fund and the Regional Development Projects Fund. Both of them were distributed following a strongly distributive rule. For instance Calabria, the poorest region, typically received from the funds 2.5 times as much as Lombardia, the richest region. In theory, the Common Fund should have been financed with a given percentage of the revenue from excise taxation (the mineral oil tax) to enact the Constitutional principle of sharing tax revenue. In practice, as any other transfers to local government, its size was determined yearly as the result of a bargaining between the central government and the regions; see below in the text.

[31] In Italy, health services are mainly provided by the public sector either directly through public hospitals or indirectly, by financing with public money, approved private hospitals and suppliers. The private health sector is

salaries of health workers, rates for private suppliers, etc.). According to some estimates (Bordignon and Volpi, 1995), the share of the total budget that was really left at the disposal of the regional authorities was less than four percent.

Regional politicians and managers were, therefore, not accountable to the citizens of their regions; basically, they had no choices to make except those of following central government rules. However, in a sense, they were not accountable to the central government, either. They could be held accountable only if they failed to comply with the formal rules defining the allocation of grants. But there were no substantial controls, if only because poor accounting procedures in the public sector made such controls extremely difficult. Similarly, on the revenue side, regional taxes, being mostly surcharges on state taxes, were difficult to manipulate and were totally invisible to the taxpayer.

Two arguments were used to support this extreme centralization of powers, which was certainly in conflict with the spirit if not the letter of the 1948 Constitution. First, the central determination of expenditures was thought to facilitate control over the growth and distribution of regional public expenditures. This also explains the decision, taken in 1982, to avoid any automatic determination of grants.[32] The size of the conditional and unconditional funds—together with all grants and transfers made to all the other local governments—were to be determined yearly by the central government at the time of presenting the budget law, depending on available resources and on the policies pursued by the central policymaker.

Second, entrusting all resources to the centre and financing local governments via grants, was thought to enable the central government to reach higher levels of redistribution across the country. In the case of ordinary regions, this was (and still is) felt particularly necessary as health services are concerned. A sentence in the Constitution was read as implying that access to the same health services was a constitutionally guaranteed right of all Italian citizens. As health services are assigned to the regions by the Constitution, the perceived implication was that each region should provide exactly the same services in exactly the same way, imposing the same prices and charges to all citizens. As costs and needs differ across the country, the constitutional rule might well have been regarded as compatible with different resources being assigned to

rather small. The Italian National Health System (SSN) was introduced in 1978, basically copying the characteristics of the British NHS. See France (1996) for a recent account of the SSN and a comparison with the NHS.

[32] From 1978 to 1981, grants to the National Health Fund were based according to a National Health Plan set up by the Ministry of Health.

different ordinary regions. In practice, however, estimating local cost functions and the quality of services was difficult due to the lack of reliable data and accounting procedures. Therefore, the pursuit of uniformity in the provision of health services became a pursuit of uniformity in per capita health expenditures.

In this respect at least, the central government was indeed successful. In spite of the large differences in own resources among Italian regions, (ordinary) regional per capita expenditures were (and still are) basically the same in all Italian regions. By far less successful was the central government's effort to equalize the supply of services and to control the growth of regional expenditures. To explain why, I will focus on health services. Much the same could be said for the other sectors, in particular transportation (see, for instance, Emiliani *et al*., 1997).

First, in terms of the quality of services, Northern regions have performed consistently better than their Southern counterparts. In spite of equalized resources per capita, the supply of public health care facilities is considerably lower in the South than in the North. As a result, the part of household demand for health care met by private suppliers and partly paid by the citizens themselves has been consistently higher in the South than in the North.

Second, and more important for the aims of the present paper, the overlapping of competencies in the health sector between the central government and the regions induced a large degree of fiscal irresponsibility at the local level, resulting in consistent waste of resources and in regional expenditure growth above the desired level. In a sense, the separation of functions between the center's financing the services and setting rules and guidelines and the regions' managing the services turned out to be the worst of all possible worlds. All attempts made by the central government in the 1980s and the beginning of the 1990s to control the growth of health expenditures by setting strict budget rules were ineffective, with actual expenditures running consistently above planned expenditures. Regions refused to accept any blame for this, always claiming that they were just applying state rules and not having enough managerial room to promote resource saving in the sector. According to the regions, the blame lay with the central government itself, which was consistently underfunding the National Health Fund, forcing the Local Health Units (LHUs), the regional bodies in charge of producing and managing the health services, to borrow to meet their financial needs. Irresponsibility at the regional level was reinforced by the lack of credible penalties, such as bankruptcy procedures, for regions. The result was a continuous bailout of LHU debts by the central government and a loss of the central government's ability to program and control health expenditures—exactly the opposite of what was hoped at the time the system was set up. In turn, health being an important part of total government expenditures, this inability to control expenditures at the regional level resulted in higher public deficits and debt accumulation at the central level.

The following table (taken from Degni and Emiliani, 1995) illustrates the development of the National Health Fund in the period 1989-1993.

Table 4. National Health Fund: Budgetary Appropriation and Deficits in Ordinary Region (*in billions of lira)*

	1989	*1990*	*1991*	*1992*	*1993*
Budget appropriation (1)	49,443	55,350	67,384	71,044	70,311
Deficit (2)	6,235	13,688	9,880	5,316	5,545
Central Government loan (3)	4,784	9,859	8,795	5,316	------
(2)/(1)	12.6	24.7	14.7	7.5	7.8
(3)/(1)	76.7	72.2	59,0	100,0	----

Source: Degni and Emiliani (1995).

The first line illustrates the budget appropriation to NHF for each year; the second line, the deficit incurred in the health sector each year, that is, the difference between actual expenditures and the resources assigned to the NHF. At the beginning of the period, effective expenditures were 13 to 15 percent larger than planned. In 1990, effective expenditures were 25 percent larger than planned. The third line reports the short term loans from the central government to the regions to meet the increased expenditures. Notice also that the situation seems to be improving at the end of the period, when the reforms of the 1990s began to take hold (see the next section).

But how was it possible that, for more than a decade, the central government consistently underestimated health expenditures to such an extent? To answer this question we have to examine in greater detail the process of setting up the NHF and the behavior of the actors involved. The figures shown in the table are the result of a game being played between the regions and the central government, a game whose rules were perfectly known to everybody, except maybe to public opinion and to some representatives of international organizations. Every year, at the time of setting the budget law, the central government determined both the size of the

NHF and its distribution across the regions. The NHF was partially funded by the revenues from two earmarked taxes, a payroll tax on dependent workers and a health income tax on self-employed workers.[33] . The central government decided how much additional money to put into the NHF, thus effectively programming health expenditures for the next year. Both the size and the distribution of the NHF across regions were the result of a bargaining between the regions and the central government. The appropriation rules were more or less set so as to equalize per capita health expenditures in each region, with some adjustments to account for health mobility across regions,[34] needs indicators and the (political) bargaining power of the players involved. In deciding the size of the NHF, the central government deliberately underfunded the NHF, making it just slightly larger than the (planned) size of the previous year. The regions accepted this underfunding because it was obvious to everybody that the budget thus set for health expenditures was going to be "soft." Underfunding provided a short-term but substantial (political) advantage to the central government, allowing it to present a better-looking national budget, thus reducing the need for hardly popular reduction in public expenditures or increases in the tax pressures. It did have, of course, longer-term disadvantages; but, because of the peculiar characteristics of the Italian political system, the government taking the decision would most probably not be there to take the blame when this happened.

Faced with insufficient resources to finance health expenditures, regions could not borrow to meet their financial needs because of strict legal regulations on regions' borrowing (see note 28). However, the Local Health Units (LHU),[35], the regional bodies actually in charge of producing and financing the health services, could borrow, and they did, through arrears to suppliers and by borrowing from banks. In doing so, the LHU's never faced any credit constraints, despite their deteriorating financial situation, because it was again obvious to banks and suppliers that sooner or later the central government would step in and take care of debts and interest. As the process took time, however, private suppliers to LHU's, expecting delayed payment, generally overpriced their services. Eventually, and generally with one or two years'

[33] On average, the revenue from these health taxes never covered more then 50% of the total outlays in the sector. Both taxes have been repealed by the 1997 reform and substituted with the Irap tax; see the next section.
[34] Because of the lower quality and quantity of public health services available in the South, Italy is characterized by high health mobility, with citizens of the South emigrating to the North to consume health services.
[35] LHUs also charge user fees; however, the income generated by these fees never exceeded 3% of their total expenditure.

delay, the central government did step in, clearing debts and interests of the LHU's by issuing government bonds.

It should be noted that this immediately increased the stock of central government debt in the year in which the bailout took place, yet without affecting the central government deficit in that year. The effect on the national budget appeared only in subsequent years, when interest on the increased debt was allocated to the national budget.

Thus, everybody was happy playing this game:[36] the central government, because it could present better-looking, although slightly falsified, budget numbers; the regions and the LHU's, because they could offer health services without really having to make any efforts to reduce waste and because they could blame the central government for the poor quality of services due to a lack of resources; and the private suppliers of the LHU's, because they could overprice them. At least up to 1992, even the citizens seemed to be happy, too, because in exchange for poor services and ever-increasing tax pressure and public debt, they could invest their savings in public bonds paying high nominal and real interests rates.[37] Paradoxically, at the end of the 1980s, the high interests rates on public bonds resulting from the mismanagement of public finance by the central government had in fact become one of the governing coalitions' primary means of maintaining political consensus. It was only with the financial crisis of 1992 and the political earthquake produced by the "clean hands" judges that it became clear that the game described above, and similar games being played throughout Italian society, could not go on.

5. The Reforms of the 1990s: Attempts at Decentralization

The turning point in the Italian story of public finance occurred in 1992 (Monorchio, 1996), an exceptional year in Italian history for two reasons. First, the country's financial crisis culminated in Italy's falling out of the European Monetary System and the devaluation of the lira. Subsequent accounts by the members of the ruling executive (Barucci, 1996) clearly show that the Italian government of the time feared the financial bankruptcy of the country, resulting from a refusal by private households and banks to hold government bonds. Repudiation of public debt was a serious possibility. To avoid a financial crisis, the most ferocious fiscal contraction in post-

[36] The game is still going on, although to a less extent. Estimations of the actual total debt of the LHUs (now, Local Health Firms) are at around 30,000 billion lira, and the actual government is preparing to cover it up in the next budget law.

war Italy was introduced. In 1992 alone, the fiscal contraction amounted to more than five percent of GDP, resulting from increased taxes and cuts in public expenditures. Furthermore, long-needed "structural reforms" were introduced to reform the health system, the pension system and local government financing.[38] The reversal of the financial situation begun in 1992 was indeed successful; since 1993, the central government primary budget has presented large and increasing surpluses. In 1997, the primary surplus was as large as six percent of GDP, and the budget deficit dropped below three percent of GDP,[39] allowing Italy to meet the Maastricht criteria and be admitted to the EMU in 1999.

Second, the disclosures by the "clean hands" judges in 1992, emphasized by the media, quickly eroded the consensus of the parties which had continuously ruled the country since the end of the Second World War.[40] At one point in 1993, more than 100 Italian MP's were under scrutiny for corruption by the judicial system. As a result, the Italian Parliament, which had traditionally been very responsive to the pressures of well organized groups and very good in blocking or delaying reforms which could jeopardize the power or the economic performance of these groups, had no strength nor legitimacy left to oppose the decisions taken by the executive. Together with the financial emergency, this explains why in 1992, in only three months, important reforms that had been discussed in parliament for more than a decade were quickly approved. These included important reforms of local government financing. In particular, the central government's attitude regarding local public finances changed dramatically. Rather than attempting to control local expenditures by the center, responsibility at the local level was increased by reducing the role of transfers and by increasing the revenue and expenditure autonomy of the local governments.[41]

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[37] It is worth recalling that in 1992 interest payments on public debt amounted to 12% of GDP and real interest rates were around 6-7%.

[38] It was also decided to freeze public and private wages, with a trilateral agreement reached in 1993 between the central government, the trade unions and employers' representatives. This probably saved the country as it prevented the strong currency devaluation of the subsequent years from affecting the inflation rate.

[39] It was over 10% of GDP in 1992.

[40] Mainly the Christian Democratic Party and the Socialist Party. Both parties would have been completely wiped out by the political stage in the subsequent 1994 elections.

[41] Not extraneous, naturally, to the central government's changed attitude towards local governments was naturally not extraneous the electoral success in the North of the country of the Lega, a territorial party which asked for more decentralization in revenue and expenditure ("fiscal federalism," in their interpretation of the word). For a brief period, from 1994 to 1996, the Lega was also a member of the governmental coalition which ruled Italy. Subsequently, however, it committed political suicide by isolating itself by the rest of the Parliament and by radicalizing its political program (e.g., advocating secession of "Padania," a fictitious region in the North of Italy made up of some of the wealthiest Italian regions, such as Lombardia, Veneto, Piemonte, and part of Emilia-

For what concerns us here, the main reforms were as follows. In 1993, following the reform of the health system, the two earmarked health taxes were attributed to the ordinary (and special) regions. Furthermore, the central government reduced its responsibility for the financing of health services to "guaranteed, nationally uniform" levels of health care services. Regions were to "bear the financial consequences of supplying health care above this guaranteed uniform level, of setting up health units and beds above the set standards, and for the deficit of Local Health Units." To help regions meet these requirements, extra resources and more fiscal autonomy were given to them. In particular, regions were allowed to increase the rates of the earmarked taxes to up to six percent, and actually were supposed to be under obligation to do so if the Local Health Units were in deficit.[42] New unearmarked resources were given to the regions in 1993, while transfers were cut by the same amount.

In 1995, the decentralization process took another important step forward. In that year, *all* conditional and unconditional grants to ordinary regions, except those to the NHF, were abolished by the central government. In exchange, the regions obtained a share of the revenue from the national tax on gasoline consumed in their territory, and the right to increase, up to 30 lira per liter, the gasoline tax rate. To match the difference between the abolished grants and the revenue from shared taxes, a new unconditional Redistribution Fund was established.[43] It was supposed to disappear as soon as the new resources coming from the shared tax on gasoline had reached the size of the abolished grants.[44] As the resources coming from the gasoline tax were not earmarked, the regions saw a consistent increase in their free resources.

In 1997, another massive tax reform took place (see Bordignon *et al.*, 1998). The two earmarked health taxes were abolished together with Ilor, Iciap (a small municipality own tax introduced in the 1980s) and a number of other taxes on corporation and local consumption, and

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Romagna). The lack of a serious political force at the national level supporting decentralization has much to do with the current difficulties in pursuing the decentralization programme initiated in 1992. See below.

[42] The financing of the health care units, both private and public, was also changed by moving from a "retrospective" (cost-plus) system to a "prospective" (fixed price) one. In particular, public and private hospitals are now financed according to the American DRG system. Furthermore, Local Health Units—renamed Local Health Firms—and the main public hospitals were transformed to firms by adopting private sector accounting rules. In particular, they can now run profits, and these profits can be used to increase remuneration of employees. In copying with the logic of a decentralized system, the determination of the DRG tariffs was attributed to the regions themselves. For further details, see France (1996).

[43] The name of the Fund derives from the way it was computed. Basically, the percentage of sharing of the national gasoline tax was determined so as to guarantee exactly the same amount of resources of the abolished grants to the richest region, Lombardia, which was therefore in equilibrium All other regions received transfers from the Fund, in a percentage depending on the amount of the transfers abolished for those regions.

replaced by a new "regional tax on all productive activities," the Irap. Because of its very large tax base (approximately half of the national GDP), the Irap is a massive tax.[45] In 1998, the first year of its application, and with an average tax rate around 4.2 percent, its revenue was around 50,000 billion lira. Eventually, all Irap revenues should go to regions; currently, however, the central government receives a part of it in compensation for some of the national taxes repealed by the reform. 90 percent of the revenue from the Irap is earmarked for health; the rest is allocated freely to the regions (net of a quota to be given to municipalities; see below). Starting in 2000, the regions have some autonomy over the tax rate of Irap, allowing them to raise (reduce) the rate in their territory by one percent. Furthermore, regions are also given a share in the tax base of Irpef (the personal income tax); half a percent of the tax base of the income tax is allocated to regions and earmarked to health. Again, as of 2000, regions have the opportunity to increase their share in Irpef by increasing it by one percent.

Finally, in 1997 the two decentralization framework taxes (known as "the Bassanini laws") were passed. These laws eliminated a number of formal controls by the central government on regional behavior, and made an attempt to assign the regions and other local authorities all those administrative functions that the Constitution does not explicitly assign to the central government. The implementing laws were approved in 1998; but today it is still unclear which specific functions will be attributed to the regions and what resources they will have for them. It is also unclear how this devolution of resources will be financed—quite likely by increasing the regions' share of the tax base of Irpef and the gasoline tax and, maybe, by giving the regions a share in the revenues from Iva collected in their territories.

Concerning municipalities and provinces, a main framework tax was passed in 1990, which reduced the role of the central government in the direct financing of local governments to a residual one limited to central functions attributed to municipalities. In 1993, Invim was abolished and a new tax on housing wealth, Ici, was introduced. Municipalities were allowed to choose the Ici tax rate in a given interval (between 0.4 to 0.7 percent). Progressively they have been given more autonomy in determining tax deductions from Ici and in monitoring their Ici tax base. Transfers to municipalities were reduced in 1993 by the same amount of the Ici revenue at

[44] Not the southern regions, however, which were going to receive the same resources in real terms forever.

[45] Basically, the theoretical tax base of Irap is a measure of value added, net GDP at the cost of factors; i.e., the sum of all wages, profits and rents (including interest payments) net of depreciation. In practice, a variety of special

the minimum 4 percent rate, (net of Invim's revenue in 1992). In 1997, in exchange for the abolished Iciap, they received a sharing quota in the regional Irap. In 1999, municipalities received 0.5 percent of the tax base of the income tax in their territory to finance the new functions delegated by the central government with the Bassanini laws, with the possibility of increasing this quota further up to 1%. Similar decisions were taken for provinces.

In order to increase accountability of local governments and to make them more responsive to local preferences, new electoral laws were introduced for municipalities (1993) and ordinary regions (1994), which replaced the old, simple proportional rules. Under the new rules, the role of the president of a region or a province and of the mayor of a major city has been strengthened. In cities above 15,000 inhabitants, mayors are now elected through a two-ballot mechanism, similar to the French general election mechanism. If no candidate receives more than 50% of the votes under the first ballot, the two candidates receiving the greatest number of votes go to the second ballot, where the candidate receiving more than 50% of the votes is elected. Once elected, the list supporting the winner receives a majority premium assuring at least 60% of the seats in the municipal council. A mayor cannot be substituted by her majority or overthrown by the council; if she falls, new elections must be held. Similar majority premiums have been introduced for regions, although, differently from the mayor, a president can be substituted by her council.

The new electoral rules have been effective in giving more powers especially to the mayor, who cannot be betrayed or blackmailed by her majority any longer. They have also increased the visibility of the mayor in the public. Indeed, at least in the large cities, the new electoral rules created a new local political class largely independent of the national parties.[46] Casual evidence suggests that the new electoral rule, coupled with more budget autonomy and larger flexibility in the use of resources, has been instrumental in reducing slack in the municipal administration.

Summing up, quite a massive change in local public finance occurred in Italy in the 1990s. The change is best witnessed by the new ratio of transfers and own resources for all levels of government. Thanks to Ici, average municipalities now finance more than 50 percent of their

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provisions (mainly in agriculture and in the banking sector) reduces this tax base somewhat. Irap tax payments are furthermore not deductible from other local or national taxes.

total expenditures with own resources. This ratio stands at 65-70 percent for municipalities in the North (Ambrosanio *et al*., 1999). There are, however, cities in the South where own resources cover no more than 20-30 percent of total expenditures. After the reforms, ordinary regions receive conditional transfers from the central government only to finance health expenditures (in 1998, approximately half of NHF was directly financed by regions through Irap; the rest came from the central government); for the rest they are either self-financed or receive unconditional money from sharing of national taxes or from the Redistribution Fund. Furthermore, the decentralization laws have eliminated many formal controls which effectively reduced the legislative autonomy of regions in several sectors.

Does this mean that the 1990s reforms solved the problems of local public finance in Italy, providing correct incentives to local governments and eliminating the soft budget distortions of the past ? Not quite. Large distortions at the local level are still present, and there is a very serious risk that a reversal of the decentralization process, both on the expenditure and revenue side, might occur. Regarding municipalities, the situation has largely improved on the revenue side, because of the new local taxes. However, the problems of overlapping of competencies and suboptimal size indicated above still prevail at this level of government. Waste and the lack of accountability still affect municipalities. Worse than that, the grants to municipalities (and provinces) that remain in effect are still decided in the old ad hoc and discretionary way based on past expenditures. As cities are more financially autonomous, lobbying at the central level for higher grants is less important than it was in the past; however, it still takes place. The resulting irrational system of transfers is even less tolerable today than in the past, since increasing autonomy at the local level has also increased inequity in the distribution of resources across the country. A more rational system of grant allocation is badly needed for reasons of both for efficiency and equity.

Regarding the regions, the overlapping of functions illustrated above still largely affects health expenditures. The problem is that, at the moment, ordinary regions do not do much other than finance and regulate health expenditures; if anything, the ratio of health expenditure to the total regional expenditure has increased further since 1992, reaching approximately 80% in 1997

[46] Indeed, in the 1999 European elections, a new Party (the “Democrats”), largely made up of the mayors of the main Italian cities, ran for the seats in the European parliament, in competition with the original parties of which the mayors had been members.

(Bordignon and Emiliani, 1997).[47] Thus, distortions in health expenditures which result from overlapping competencies and bailouts are likely to affect deeply the behavior of regions in other sectors as well. On these grounds, it must be noted that the 1993 health reform did not succeed in inducing fiscal responsibility at the regional level. Draconian measures in the health sector[48] passed by the central government at the beginning of the 1990s managed to keep the growth of health expenditure under control in those years. However, health expenditures started increasing immediately afterwards, resulting again in deficits in the current accounts of the LHUs (now called Local Health Firms, LHF). In spite of the 1993 law, regions have refused to use their increased fiscal autonomy to finance these deficits; despite the law, the room given to them to increase the earmarked health tax rate has never been used. Quite clearly, the implied threat in the 1993 health reform law was not credible; regions knew that by not raising their tax rates they would eventually force the central government to give in and finance the deficits.[49] As a result, LHF deficits were, and still are, financed ex post by the central government (see note 36). To some extent, the game described in the previous section is still going on.

To put it differently, the overlapping competencies in the health sector produce a "double moral hazard effect" (Bosi and Tabellini, 1996). Although provided with extra resources, regions prefer to spend this extra money in sectors other than health services, leaving central government with the obligation to cover the deficit in the health sector. The reasons are twofold. On the one hand, because of the large overlapping of competencies, the perceived budget constraint is certainly softer in the health sector than in other regional sectors. Regions are more certain that the central government will eventually foot the bill for health spending rather than, say, spending for agriculture or tourism. On the other hand, spending extra money in other sectors is politically more rewarding for regional governments, because their citizens perceive these sectors as being more directly under the control of the regions than health. Quite obviously, no regional government feels like increasing the tax rate on its own constituency to provide better health

[47] Pending the effects of the decentralization laws, of course.

[48] Mainly, a large increase in the rate of copayments by consumers to health services and a forced reduction in the prices of pharmacological drugs.

[49] This also suggests, in contrast with what is argued in some recent literature (i.e., Eichengreen and Von Hagen, 1996), that a reduction in the fiscal imbalance *per se* is not enough to make the budget of a local government "hard." As long as the expectations of bailing out are not erased by the system, the local government will simply refuse to use its increased autonomy to cover its extra expenditure. See the concluding section for more comments on this issue.

services, when another level of government might be credited for these. The net result is a stimulus to increase deficits and expenditures in both the health sector *and* in the other sectors.

Unfortunately, this situation seems to be irresolvable. On the one hand, the central government (or at least the current ruling majority) does not seem to be willing for political reasons to resolve the conflict of competencies by giving more autonomy to regions. On the other hand, the Constitution does not allow the central government to entirely bypass the regions in health management.[50]

The situation has been further complicated by the central government's choices regarding the new resources allocated to the ordinary regions. In a country so economically divided as Italy, the decision to base the new fiscal autonomy of regions on taxes on value added (Irap) and income (the regional share to Irpef) was bound to be problematic. Income and value added are much more inequitably distributed across the country than other potential regional tax bases such as regional consumption. In 1998, the first year in which the new tax law was in force, per capita revenues from Irap were equal to 1,364,800 lira in Lombardia, the richest region, compared to only 383,300 lira in Calabria, the poorest region. For the "private" part of Irap,[51] the part for which the regions have tax rate autonomy, the difference is even more remarkable: 1,208,700 lira in Lombardia versus 180,400 lira in Calabria. With such differences, no further decentralization of financial powers to the regions is possible or desirable without a decent and rational redistribution system across Italian regions. This also explains why most of the Italian debate on fiscal federalism focuses on the normative characteristics of such a system (see next section).

Not least because of the figures just illustrated, the decentralization process of the early 1990s seems to have stopped, and there are worrying signs of a reversal. The 1997 decentralization laws are taking much more time to be implemented than expected and might eventually result in less devolution of functions than desired. A new health reform, just proposed by the Ministry of Health, attempts to recentralize this sector. Furthermore, the pressing central government finance situation of the late 1990s made the central government introduce new

[50] A recent decree, to be made law in 2000, foresees the removal of the central conditional grants to the health sector, and their substitution with (unconditional) resources stemming from regional sharing of national taxes. However, the Ministry of Health is strongly opposed to this solution, as it fears that the removal of a direct channel of funding by the central state to regions may also undermine its authority over regional behavior. This fear may be justified: see Banting (1997) for a discussion of a similar conflict occurring in Canada, between the Federal Government and the Provinces, as a result of the progressive reduction of the share of Health financing by the Federal Government. As to how things will evolve in Italy in the future, it is hard to say at the moment.

[51] The private part of Irap is value added in the private sector; the public part is basically the public employee wages.

restrictions on local public expenditures. In 1995, regions and local governments were responsible for pushing up the central government deficit by an unexpected 10,000-15,000 billion lira. The central government reacted by imposing cash controls on the funds regional and local authorities can withdraw from their cash accounts with the Treasury. In 1998, the Maastricht Stability Pact was decentralized in the sense that local governments will have to pay (in the form of reduced transfers and reduction in shared taxes) a portion, depending on their own deficits, of any penalty imposed on Italy for violating the deficit limit of three percent of GDP. Clearly, these policies reflect the difficulty of continuing the process of decentralization in times of fiscal emergency and tight aggregate budget constraints.

A good opportunity for Italy to commit to the decentralization process was lost with the failure of the Bicameral Commission in 1997, a political two-chambers body made of representatives of all Italian parties, which was set up in 1996 to propose amendments to the Italian Constitution in a large set of areas. The Bicameral Commission was the most serious attempt made to change the Constitution in Italy in recent years,[52] all the leaders of the main Italian parties were part of this Commission. Surprisingly enough, the Commission did not fail on "fiscal federalism" but on the reform of the electoral laws. At the end, the Italian political parties had found a good compromise to transform Italy in a federal state (see next section).

6. **The Italian Debate on Fiscal Federalism**

In anticipation of the constitutional reform, a lively academic and political debate took place in Italy in the mid-1990s. Because of the central role played by the "soft budget constraint" in local public finance, most of the proposals focused on ways to eliminate or reduce this problem. The main idea was to introduce a clearer *separation* between the central and local levels of government by reducing the overlap of spending competencies and by increasing the role of own resources in the finances of local governments.[53] Furthermore, to increase accountability of local governments, it was suggested that the resources assigned to local governments should be unearmarked. As we saw above, to some extent at least these ideas were implemented in the 1990s.

[52] Other attempts were made in 1989 and in 1993; they all failed.
[53] Most of the discussion was in terms of which own tax bases to assign to regions, and in terms of which state tax bases to share with regions. The introduction of Irap has somewhat settled this issue.

However, this was certainly not enough to avoid entirely the risk of ex post intervention and bailouts by the central government. Most writers were convinced that more radical policies were necessary. Forbidding the central government to bail out local governments by law had already proved to be unfeasible; thus, other ways had to be found to make such an intervention more difficult or almost impossible.

According to Giarda (1995), Northern and Southern regions had to be treated separately given their different economic endowments of resources. Northern regions should become entirely independent from the center. They should set the rates for their own taxes and receive a fixed share of national taxes to guarantee complete coverage of their expenditures[54] other than those for exceptional reasons (such as natural catastrophes and war). Any further central government intervention should be prohibited by law, or even better, the Constitution. In this way, regional expenditures would be determined entirely by regional own resources, and regions would have enough flexibility on the revenue side to express their autonomy. In contrast, the much poorer Southern regions should at least partially be financed by the central government through vertical transfers.

Bordignon *et al*. (1996), Bosi and Tabellini (1995), Brosio *et al*. (1994), and others have advocated a more radical version of the same idea. All regions, Northern and Southern, would be made completely independent from the central government, giving them enough resources to finance entirely their regional expenditures. A number of tax bases should be given exclusively to regions, allowing them to freely determine tax rules, tax rates, and tax enforcement. Vertical transfers should be abolished and replaced by *horizontal transfers*, which would be computed by using a pre-established formula (written in the Constitution). The parameters of this formula would be estimated periodically by a commission consisting of representatives of all regions and the central government.[55] Horizontal financing, similar to the arrangement in Germany, would harden the budget constraint of the regions. Direct transfers from the North to the South would also be more transparent than the hidden transfers that currently go through the central government budget. As a result, bailouts would be more difficult.

[54] "Standard" expenditure and with reasonable assignments for health expenditure. In passing, it should be noted that Piero Giarda, an eminent academic public economist who had played the political role of vice-minister in the Ministry of Treasure since 1995, has been the key character behind most of the decentralization which occurred in Italy during the period.

[55] In the case of Constitutional reform, this Commission should have been under the control of the second chamber or regional Senate.

In the end, the first proposal won the day. The text approved by the Bicameral Constitution implicitly contained this idea. Southern regions—and their representatives in the national parliament—saw stronger safeguards in a proposal that maintained a key role of the central government in territorial redistribution. The first proposal also had the advantage of allowing for a "two-speed" devolution process. According to this approach, Italian regions would be assigned a set of available functions by the Constitution; and in any given period each region would have chosen from this set which functions to administer from that period on. The central government would then give to all regions the resources necessary to finance their new functions. Critics to this solution (including the present writer) pointed out that this would turn into an administrative nightmare, with different overlaps of competencies in different parts of the country, and with the possibility that the transition to a federal state would never end. In fairness, however, it must be recognized that the Bicameral proposal was probably the only one that could have been adopted in Italy at the time; the resistance of the South to a more extensive decentralization would otherwise probably have stopped the process altogether.[56]

7. Conclusions

The Italian history of local public finance provides a good example of what should *not* be done to avoid bailouts and fiscal irresponsibility. Some of the problems we illustrated above are country-specific and cannot be easily generalized. However, in our view, some general lessons emerge from our account.

First, the Italian experience certainly supports the theoretical (Eichengreen and von Hagen, 1996) and empirical (Stein, 1999) literature suggesting that a coherent assignment of own resources and functions to local governments is essential to avoid the soft-budget constraint phenomenon. When grants by the central government cover more than 80 percent of the resources of local governments, as has happened in Italy, there is simply no hope of enforcing sound public finances at the local level. Since the cost of raising local expenditures is largely borne by non-residents, local governments have a clear tendency to free-ride against each other. In principle, a "strong" central government, able to internalize the negative externalities across

[56] Two other positive features in the Bicameral Proposal should be recalled. First, as is the case in most federalist countries, the residual financing of municipalities and provinces through grants was to be assigned to regions and jointly decided by regions and local authorities representatives in the second national chamber. Second, each region would have been allowed to choose freely its own electoral system.

local autonomies, may counteract these pressures (i.e., Borge and Rattso, 1999). However, when the central government is also as "weak" as in Italy, the incentives to accommodate pressures for high expenditures at local level become simply irresistible.

The Italian experience also suggests that the mere removal of vertical fiscal imbalance alone is not enough to eliminate the incentives to overspend at local level. Larger fiscal autonomy at the regional level in the health sector and even a law explicitly prohibiting the central government from eventually footing local bills were not enough to enforce a hard budget at the regional level. The problem here lies in the attribution of political responsibility across different levels of government. As long as it is not clear which level of government is accountable for a given service, expectations of bailouts by the central government tend to be self-fulfilling. In Italy, the central government cannot allow a region to go bankrupt in the health sector for the simple reason that it would itself be blamed for this failure. This is why the Italian debate on fiscal federalism insisted so much on a better separation of functions and competencies between different level of governments.

Second, the Italian experience also has something to say on the theory of bailouts in intergovernmental relationships (i.e., Wildasin, 1997; Qian and Roland, 1998). This theory suggests that two elements are important in determining the probability of a bailout: the size of the localities and the magnitude of the externalities across jurisdictions. The larger the externalities associated with local expenditures, the stronger is the motivation for the central government to intervene. The larger the local government, the more difficult it is for the central government to commit not to bail out that locality. The first prediction is somewhat supported by the Italian experience;[57] the second is not. Although the issue deserves more serious empirical research, *prima facie* evidence in the Italian context suggests that, on the contrary, larger local governments are more fiscally responsible than smaller governments. One explanation is the fact that the incentive to free-ride may be smaller for large localities, as a larger part of their expenditures is supported by residents through the central government budget. For instance, it seems unlikely that the richest Italian region, Lombardia, which alone produces more than 30% of the total revenue of the country,[58] would not consider that in the case of a bail-out, a large part of the extra burden would be carried by its own citizens. On theoretical grounds, this suggests

[57] Indeed, health services can be thought of as a case where externalities are very large.
[58] The city of Milan alone, with slightly more than 1,000,000 inhabitants, generates more than 10% of all national revenue from the highly progressive personal income tax.

considering in more detail the characteristics of the revenue system (e.g., the degree of progressivity of the personal income tax) when assessing the relationship between the size of a local government and the likelihood of a bailout.

The Italian experience also suggests paying more attention to the characteristics of local government financing when modelling local government behavior. The very large share of grant financing in Italy distorts the behavior of local politicians towards lobbying with the central government rather than an efficient provision of local public goods. Generalizing, this suggests that in cases where grant financing at the local level is substantial, it may be more useful to view the relationships between the different level of governments as a lobbying process (Persson and Tabellini, 1994).

Third, the Italian experience shows that institutions, and particularly constitutional rules, matter even in the context of intergovernmental relationships. As we argued above, at the root of the centralization undertaken by Italian governments in the 1970s, which generated the subsequent problems of soft budget constraints, is a constitutional problem. The 1948 Constitution did not set precise rules for financing at the local governments, allowing the central government to centralize all revenues in the mid-1970s. Also, most of the problems regarding the overlap of competencies among different levels of government derive from a constitutional failure. There is little hope of enforcing a change in the local governments behaviour without a constitutional change separating the functions and the resources of the different levels of government and allowing the country to commit credibly to a decentralization process.

Finally, the Italian experience suggests that decentralization and redistribution, particularly geographical redistribution, do not go well together. Judging by the Italian experience,[59] one can have high levels of territorial redistribution or one can have efficient local governments; having both is likely to be a chimera. Attempting to enforce a uniform provision of local public goods with very different endowments of resources at the local level ends up by increasing the role of transfers in local government financing and by strongly constraining the behavior of local governments. Fiscal irresponsibility at the local level is likely to result, stimulating problems of soft budget constraints.

[59] And by the German one. See Seitz (2000) for an account of the German intergovernmental redistribution system after unification.

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