ASSESSING REGIONAL AND LOCAL GOVERNMENT EXPENDITURE NEEDS IN ITALY. SMALL ACHIEVEMENTS AND BIG PROSPECTIVE ISSUES.

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Introduction

Subnational finance in Italy has been dominated since the 1990s by the reintroduction of tax autonomy. Own revenues have to a substantial extent replaced intergovernmental

grants. These grants are allocated basically according to the historical criterion, rewarding low income and wealth conditions and small size of local units. In other words, the Italian grant system is geared to protect poor and small (in terms of their population) subnational governments.

As in every historically-based transfer system, inefficiency and inequity have accumulated over the years. The system has been subject to frequent changes, but not to overall reform. Attempts to introduce objective need factors failed and the allocation of grants has been increasingly geared to equalize revenue in a period where disparities of per capita own revenues have hugely increased as a consequence of the reinvention of local tax autonomy.

Surely, lack of reform is also due to weak central government guidance, huge fragmentation, large disparities between the various areas and institutional and political infighting.

A new legal framework for the intergovernmental transfer system is provided by the new constitution of 2001 that introduces the concept of minimum standards of service provision for basic public services, such as health and social protection, and mandates equalization for the other functions based on fiscal capacity only and without consideration of expenditure needs factors for these functions.

The paper is divided into two parts. The first part illustrates the present system and its evolution over the two last decades. The attention is focused on the attempts that have been made to introduce components based on needs. The second part presents the perspectives and the issues underlying the new constitutional discipline.

PART I. THE PRESENT SYSTEM OF INTERGOVERNMENTAL GRANTS IN ITALY

Background

The system of subnational government in Italy changed substantially over the last twenty years. The steady devolution of taxation powers to local governments has gone hand-in-hand with the reallocation of spending responsibilities.

In l990, sub-national governments accounted for only approximately 8 percent of total revenue, while their share on total central and local government expenditure was 38 per cent. The latest data (2006) shows that local government's share has climbed to 23 per cent of general government revenues (Table A2 in the Appendix). To date, municipal and provincial governments make up about 20 percent of total public expenditure. The regions, together with the health authorities (which are offshoots of the regions), account for another 26 per cent of total public expenditure (Table A3 in the Appendix). Thus, regional and local governments are responsible for 46 per cent of government spending, net of social security and interests on debt.

Table 1. Structure of revenue of local governments

	Provinces		Communes		Regions	
Revenues	1990	2005	1990	2005	1990	2005
Own taxes	8,5	59,2	19,4	52,5	1,6	39,9
Fees and user charges	0,5	0,9	9,8	11,9	0,1	0,1
Grants	85,5	33,3	65,1	26,0	97,7	59,3
Non tax revenues (*)	5,5	6,6	5,7	9,6	0,6	0,7
Total	100	100	100	100	100	100

Source: Ministry of Economy, Country General Economic Report, various years. Accrual revenues.
(*) Net of borrowing.

Central transfers constitute more than fifty per cent of regional revenues. They represent one third of provincial revenues and one fourth of municipal revenues (Table 1). Flows of intergovernmental grants in Italy are represented in Table 2. From 1990 to 2006, transfers from the central to the local governments decreased from 51 per cent to 22 per cent of local governments' expenditure. At the same time the importance of transfers from regions to local governments in terms of their expenditure increased from 11% to 17% .

Table 2. Share of transfers from State and Regions against total expenditures by Provinces and Communes 1990-2006

Transfers from:	1990	1995	2006
State	50,91	34,47	22,43
Regions	10,69	10,22	16,69

Source: Ministry of Economy, Country General Economic Report, various years.

Main features of intergovernmental grants

There have been traditionally two distinct general transfer systems in Italy, one for the regions, and one for the local governments (municipalities and provinces). As we will see later, the new Constitution tries to make the system uniform by introducing the same equalization grants principles for all level of governments.

Ordinary regions

Initially (1970), two general funds, the Common Fund and the Regional Development Programs Fund were introduced to finance regional expenditures. The allocation of the first fund was determined according to varying percentages of a number of excise taxes, while the allocation of the second was discretionary. These funds gradually lost their unconditional character and were replaced by sectoral funds, concentrated in the health and transportation sectors. The experience of the two main sectoral funds (health and transportation) showed that an equilibrium could be hardly found between central governance of the system (through guidelines and uniform standards, criteria for the interregional distribution of funds and checks on their use) and the autonomy of regions in the planning and management of health structures and local public transportation.

In the late nineties a new system for financing regions was devised.

First and foremost, they were assigned important sources of own taxation. Notably, a regional tax on business activities (IRAP) and a regional surtax on personal income. The former is a direct-type value-added tax to be levied on all business activities as of 1998.The standard tax rate was set at the uniform level of 4.25 per cent, but regions are entitled to raise or lower their tax rate by a maximum of 1 per cent and to apply varying rates to different sectors and categories of taxpayers The new tax has a broad, potentially very productive tax base: value added, net of depreciation, but including interest payments. It has become the major regional tax.

Table 3. Revenue arrangements for ordinary regions, 2001

	National Health Fund	Other specific Funds	Total	Income surtax 0,4%	Petrol tax 8 ITL per liter	VAT sharing "historical expenditure"	Total
Piemonte	2591	293	2884	400	17	2467	2884
Lombardia	1064	202	1266	951	33	282	1266
Veneto	2419	112	2531	387	19	2125	2531
Liguria	1840	233	2073	134	6	1933	2073
Emilia-Romagna	2066	179	2245	395	18	1832	2245
Toscana	2802	211	3013	285	16	2712	3013

Marche	1091	133	1224	100	6	1118	1224
Umbria	933	130	1063	54	3	1006	1063
Lazio	2417	619	3036	354	21	2661	3036
Abruzzo	1439	242	1681	67	5	1609	1681
Molise	406	153	559	13	1	545	559
Campania	7058	1118	8176	204	13	7959	8176
Basilicata	677	292	969	23	1	945	969
Puglia	4748	756	5504	161	11	5332	5504
Calabria	2615	881	3496	59	6	3431	3496
Total	34166	5554	39720	3587	176	35957	39720

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

Secondly, the main special purpose funds were abolished. and replaced by tax sharing and equalization grants. Table 3 shows how the total amount of the abolished transfers was offset by the shared taxes: the personal income surtax **at a standard flat rate, the** petrol tax and VAT. Shared taxes – when added to their own taxes - allowed the wealthiest regions of the North and the Center to cover all their spending responsibilities . While the petrol tax and the personal income surtax were shared on strict derivation, the VAT was notionally shared according to regional consumption and then reassigned according to equalizing criteria. The initial allocations ("historical expenditure", Table 3) of VAT were enough to cover the existing expenditure levels. After transition VAT had to be allocated among regions according to fiscal capacity and expenditure needs.[1] This grant system distinguished between two main sectors of expenditure reflecting : a) health needs and, b) non-health needs. Health expenditures represented 72 per cent of regions' total expenditures.

a) Health needs. These needs were introduced separately because of the central government mandate to introduce essential levels of health care.

Assessment of health needs distinguished between six categories of essential services (LEA). The age structure of the population was used as the crucial indicator of need. (Table 4). The basic formula is summarized as follows:

$R_{ia} = P_{ij}.U^{*}_{aj}.S^{*}_{a}$. ($^{3}\sqrt{B}$i only for hospitals)

With:

i= 1-15 (Ordinary Statute Regions)

a= 1-6 (categories of Essential levels of Health Care – LEAs)

j = age groups, and

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[1] For details see the Appendix.

where R_{ia} indicates the share of the total allocation fund assigned to region i for the LEA a, U^{*}_{aj} indices of health consumption by age for the different LEA (assumed to be equal in all regions), S^{*}_{a} the average per capita expenditure for the LEA a at the national level, and Bi is the standardized mortality rate in region i.

The use of the age structure of the population is standard in the literature on health care and in actual government practice. This method aims at transforming the effective population of every region into a "virtual" population, taking into account the differences in demand for the health care services within different demographic

Table 4. Essentials levels of health care (LEAs). Relative weight and need indicators for 2006

| Essential levels of Health Care (LEAs)	Amount of the Fund (%)	Indicators of health needs
Public health promotion and prevention programmes	5	population
Outpatient care	51	
° Pharmaceuticals	13	population weighted by age group
° Ambulatory services	13	population weighted by age group
° Other outpatient health services	18,1	population
° General practitioners	6,9	population
Inpatient care (Hospitals)	44	population weighted by age group

Source, Ministry of Health 2006.

groups. For instance, the weights used in Italy with regard to the hospital LEAs are the coefficients of 2.539, 0.254 and 3.025 applied to the individuals pertaining to the age groups of less than one year , 5-14 years and older than 75 years, respectively. In this way, we can define the equivalent expenditure per capita as the total health care expenditure divided by the weighted population, rather than by the effective population.[2]

b) The detail of non- health expenditure needs calculation is given in the Appendix. Needs were estimated with the help of a regression model, which assessed the extra costs due to

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[2] In the recent years, however, the formula for assessing the relative health expenditure needs among the regions has been simplified. The latest version (2006) is based for 66 per cent on weighted capitation shares and for the rest on simple capitation shares.

the small dimensions of regions. This effort to introduce a system based on needs was frustrated by the opposition of some less developed Southern regions, once they realized at the moment the system had to start to be implemented that they were going to loose from it. Thus, the new allocations have never been made and the system continues to be based, for non-health expenditures, on the previously existing pattern, which is based on negotiations and is therefore totally obscure and non transparent.

Figure 1. Per capita GDP and per capita expenditures of Ordinary statute regions. 2005
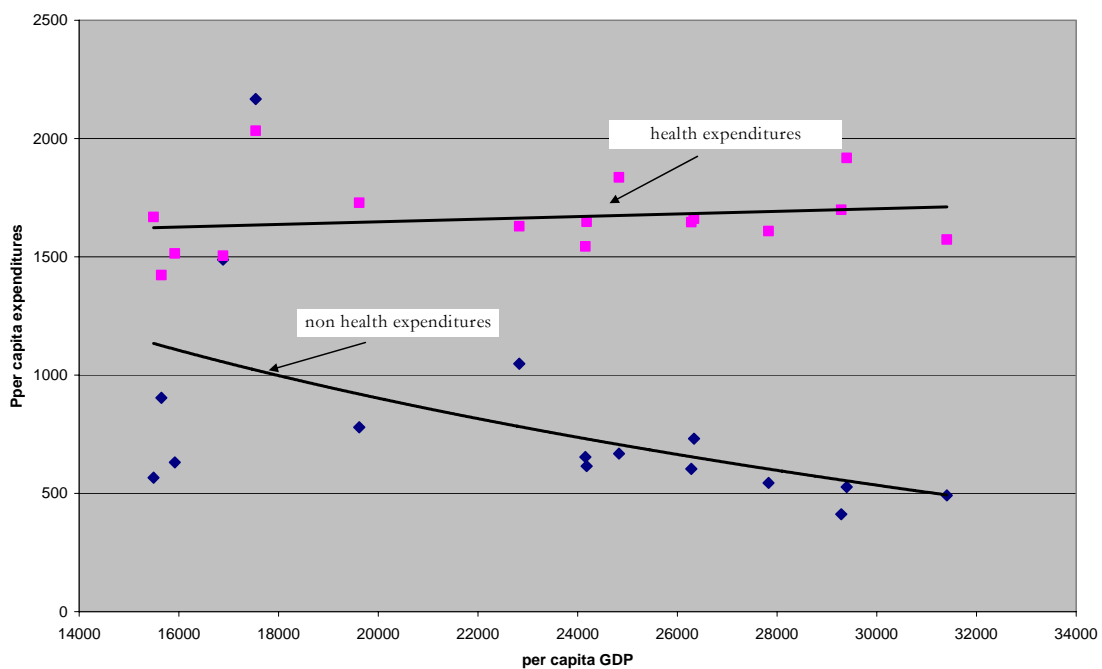
Health care expenditure is dominant and the system of essential levels ensures uniformity of per capita resources to all regions, while sector transfers (Giarda, 2005), mainly capital and tied to EU regional structural funds, ensure that in total the poorest regions have per capita expenditure levels higher than the richest regions (Figure. 1).

In fact, allocation of grants to regions seems to be dominated more by motives of convergence of regional development than by motives of equalization of levels of service delivery. The latter would require at most equal per capita levels of expenditure and not a negative correlation of these levels with GDP (table A4 and A5 in the appendix).

Municipal and Provincial Governments

The system for allocation of general grants to local government is and has been, as in the case of regions, rather obfuscated. Its complexity challenges a clear and concise description. It has been subjected over the years to frequent changes that have not altered its fundamental characteristics. The system of allocation favors the small-sized local government units and of the big ones and has no clear equalizing impact.

Until 1993 a large quota of transfers was targeted to equalization, though the criteria used varied in the course of time. The main objectives were:

- evening out differences in per capita expenditure of municipalities with similar size;
- larger per-capita transfers were given to small and large municipalities. The assumptions was that unit costs of local governments were U shaped;
- municipalities which were poor and/or situated in poor areas received higher per-capita transfers.

This policy was considered by the Ministry of the Interior, that was in charge of it, as a success, since it reduced to a considerable extent the variance of per capita spending of municipalities of similar size. In the reality the policy was ineffective, in terms of both efficiency and equity. This is because municipalities with the same population have actually different production costs and needs due to the physical setting, climate, density of population, commuting, etc..

The Law n.142/90 reforming the local government introduced a new system of grants for municipalities based largely on expenditure needs and revenue capacity, which was implemented in 1992. The new system was necessitated, among other things, by the introduction of the local property tax. This tax is levied by municipalities, which have the power to fix the tax rates between relatively wide centrally determined brackets. At the end of the nineties local governments were assigned also a local surcharge on personal income tax.

The new system had three distinct funds for recurrent expenditure:

a) the Recurrent Fund

b) the Equalization Fund, and

c) the Conditional Fund

Table 5. Method for assessing expenditure needs in 1994-95

Basic services	*Need/cost factor measurement unit*	*population groups*
General administration and justice (*)	Population	0-499 inhabitants
Local police	Population	500-999
Garbage collection and disposal	weighted urban area plus non urban area in km²	1000-1999
Primary education	share of population between 6 and 10 years	2000-2999
Secondary education	share of population between 11 and 13 years	3000-4999
Cemeteries	population weighted with life expectancy	5000-9999
Streets and public lighting	weighted urban area plus non urban area in km²	10000-19999
Water	urban area in km²	20000-59999
Sewage	urban area in km²	60000-99999
		100000-249999
		250000-499999
		beyond 500000

Expenditure needs of each municipality is assessed multiplying average expenditure per measurement unit in each population class by its actual measurement unit for each service. This value was adjusted with a deprivation indicator and with a weighting factor tied to the presence of militaries.
(*) includes five individual services.

Formally the measurement unit cost for each basic service is:

$$PMO^1_j = \sum_{i=1}^{n} S_i / \sum_{i=1}^{n} UD_{ji}$$

With:

S_i = current expenditure of Commune i in population class 1 for the basic service j

UD_{ji} = measurement unit cost for the service j of Commune i

Expenditure needs for the service j in the individual Commune i of class 1 is given by:

$$FABB_{ij} = PMO^1_j * UD_{ji}$$

While the sum of the expenditure needs for all basic services in population class 1 is given by:

$$\sum_{j=1}^{14} FABB_{ij} = \sum_{j=1}^{14} PMO^1_j * UD_{ji}$$

The total of expenditure needs of all Communes will be given by:

$$\sum_{i=1}^{n} \sum_{j=1}^{14} \sum_{z=1}^{12} FABB^z_{ij}$$

These funds were supplemented by two additional funds for capital expenditure, based mostly on sector legislation, such as that for school building and urban infrastructure.

The *Recurrent Fund* was aimed at financing, a minimum and uniform level of basic services. This set of basic services was determined by the Ministry of the Interior after consulting the State - Cities and Local Autonomies Conference.

It used for its allocation a number of indicators specific to the distinct municipalities - such as the population and its age structure, the size of urban and extra-urban area, population density and access of population to services. Some other indicators were referred to the

socio-economic conditions of the province where municipalities were located. Table 7 summarizes this method. As reported, the main determinant was population. The basic assumption behind its use was again that unit costs of local governments are U shaped and that any transfers system had to replicate this distribution. To this aim, municipalities were and still are distributed in twelve different classes of population. For each class, the grant per capita was calculated with reference to the uniform level of service provision. Then, this amount was adjusted by using specific municipal and provincial indicators.

The total amount of the *Recurrent Fund* was to be fixed in nominal terms, while its increases, in line with the inflation, ought to have been added to the *Equalization Fund*. This Fund had to be distributed in such a way as to gradually equalize per capita tax revenues of each local unit by bringing them close to the average calculated for all units included in the same population bracket. One of the main problems in implementing this mechanism was that, since information of effective tax bases was basically inadequate, actual collections were used as a proxy of revenue capacity, giving an incentive to lower tax effort.

The working of this system (Ministero dell'Interno, 1995) has been frozen after 1995, due to strong disagreement among municipalities, and individual allocations have been adjusted annually in a

Table 6. Components of the grants system for the municipalities

	1994	%	2006	%
Recurrent Fund	13577	76	9021	81
Equalization Fund	742	4	773	7
Conditional fund	3625	20	1300	12
Total	17944	100	11094	100

Source: Home Affairs Ministry. 1994, billions of lire; 2006 millions of euro.

totally non-transparent way, that defies efforts of researchers, but seems to please most of local government units, since no request for reform has been loudly advanced.

Table 9 shows the U shaped curve of per capita municipal expenditure, to which the policy of size-differentiated transfers has contributed in a fundamental way.

Individual grants continue de facto to be based on their historical patterns.

Table 7. Per capita recurrent expenditure of Italian municipalities by population size. 2001 and 2005

	Per capita recurrent	Index. Smallest Class = 100	Per capita recurrent	Index. Smallest Class

Population classes	expenditure (000 of lires) 2001		expenditure (000 of lires) 2005	= 100
Less than 500	1.055,6	100	1214,8	100
500-999	993,0	86	1.158,9	96
1000-1999	735,2	64	878,8	73
2000-2999	676,7	59	741,4	61
3000-4999	737,4	64	694,7	57
5000-9999	647,7	56	642,7	53
10.000-19,999	680.9	59	678,9	56
20,000-59,999	737,5	64	723,5	60
60,000-99,999	759.1	66	831,8	69
100,000-249,999	891,8	77	844,6	70
250,000-499,999	1.104,4	96	914,2	76
More than 500,000	1.232,9	107	1256,2	104

Source: Ministry of Economy, Country General Economic Report, various years

Main weaknesses of the system

A) Regions.

Health needs

- The assessment of needs tied to LEAs is mainly based on population. As a consequence, per capita expenditure in health services is virtually equalized across regions. Despite equal levels of expenditure, huge disparities prevail in effective outcomes, as proven by the uninterrupted interregional migration of patients from the Southern regions to the Central and Northern regions in "search of quality".

- To assess properly health expenditure needs, indicators of health risk should be taken into account in addition to population indicators. This is because the age structure of the population represents only partially the health care requirements of distinct regions. Other variables (environmental, cultural and socio-economic factors) are relevant in the determination of the effective regional healthcare requirements .

- The central government practice of bailing out the deficits of the Health authorities originated by spending overshoots has muted the essence of the whole mechanism. In practice, health expenditure needs are redetermined annually (*ex post*) with painstaking negotiations between the regions and the central government.

Non health needs:

- Taking account only of the size legitimizes existing scale diseconomies. This implies and maintains a redistribution of resources from the biggest to the smallest Regions.

B) Provinces and municipalities

- Size in terms of population has always been the dominant factor in assessing the expenditure needs with regards to "basic services" that- according to official estimates (Ministero dell'Interno, 2002)- represent about 57 per cent of communes' expenditures and 67 per cent of provincial expenditures.
- However, the "cost of fragmentation" is relatively small. Today in Italy more than half (57 per cent) of communes have less than 5000 inhabitants, but their share of total municipal expenditures is only 16 per cent.
- The issue of specific needs of largest municipalities (metropolitan areas) has never been addressed.

PART II. TOWARDS A NEW SYSTEM

The new discipline of grants

With the review of 2001 transfers to sub-national government have received constitutional discipline. The constitution introduces three different types of transfers. The first one is implicitly introduced via the constitutional provision that mandates the central government to determine minimum standards of service provision applying to expenditure responsibilities meant to be essential, such as health and social assistance and to ensure their provision via appropriate financing. This requires a system of transfers based on minimum expenditure needs. Recent national legislation has extended the domain of essential expenditure responsibilities by including into them a still undefined set of municipal and provincial functions[3].

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[3] We might assume that they comprise the former "basic services".

The second set of equalization transfer refers to the remaining regional and local expenditure functions. Here, regional and local government units with a fiscal capacity below the national average will be entitled to equalizing grants based on the fiscal capacity only.

The third set of grants includes grants from EU programs and the corresponding Italian co-financing transfers. It includes also specific grants from the central government targeted at filling regional disparities in growth. It has to be noted that there is no constitutional provision allowing the use of specific/sectoral grants. For example, existing grants for kindergardens should be discontinued, although they have been preserved through an extensive interpretation of the new constitutional text by the Constitutional Court.

The stakeholders

The municipalities

There are more than 8,000 municipalities in Italy. Their size, in terms of population, varies from less than 50 to more than 3 million inhabitants. The size distribution of Italian municipalities still reflects the one that was prevailing in the pre-unitary States (that is, the situation preceding the creation of the country). While in the Northern regions a huge fragmentation prevails, the municipalities located in the Southern regions have a much larger size. A typical Sicilian rural municipality has from 30,000 to 50,000 inhabitants. This amount corresponds more or less to the size of the small provincial capital cities in the North. Obviously, there is a huge diversity between the two samples of municipalities in the urban functions their perform, despite the similarity in their population. Variance of income and wealth conditions is also considerable. The average per capita tax base of the municipalities of Calabria - the poorest region - is barely one third of that of the richest one, namely Lombardy. Also climatic conditions are extremely different, due to the diversity of latitude and altitude and of their combination.

The overwhelming majority of municipalities (meaning their political appointees and their administration officials) is at best lukewarm towards the reform of the grant system. In fact, this system gives them certainty of revenue and looks more attractive than the prospect of a reform where, considering the present climate of fiscal restructuring, losses could outweigh gains. In other words, officials and politicians show a risk averse behavior.

Comparisons with what other municipalities get do not seem to play a great role. The system has been in place for a pretty long time and has acquired a kind of legitimacy.

Over the years a common front against the central government has been created that prevails against idiosyncratic differences. In other words, Italian municipalities show a rather common platform towards the issue of their grant system and its reform - a main component of this platform being a preference towards steady yearly increases of the present allocations over an overhaul of the system. Growing local tax autonomy makes most local units lukewarm towards a need based reform. The rich units benefit from expansion of local tax autonomy, while the poorest ones are mostly interested in revenue equalization.

Their association

Municipalities are represented by the National Association of Municipalities (ANCI), that is subdivided into regional branches. The chairman of ANCI is traditionally elected among the representatives of small and medium sized municipalities, mainly because of their large number. As a consequence, the association has a clear small-medium sized municipality orientation. Big municipalities have mainly a veto power inside ANCI and have direct access to the central government. Party cleavages do not seem to play a fundamental role within the association, both because of the bipartisan tradition of Italian politics, where government and opposition parties were often associated in financial decisions, and because of the increasingly higher variance of electoral fortunes of political parties at the municipal level.

The reform of the grant system does not rank high among ANCI priorities. Considering the huge disparities between distinct municipalities, assembling a large enough and united front far the reform would be a quite cumbersome and risky task. ANCI prefers by large to support individual requests for marginal changes to the present system and to negotiate every year with the central government a substantial increase on the previous total allocation. Most of ANCI's activity concerning municipal finances on a day to day basis and is concentrated on asking compensation far every central decision that impacts negatively on the finances of municipalities.

The central government

There are two main actors playing at the central level, namely Ministry of Interior (MoI) and Ministry of Finance (MoF). MoI is the traditional tutor of Italian municipalities. In the former centralized system, its main functions consisted, in addition to finance, in monitoring and control.

MoI has elaborated the system for the allocation of general grants and the Ministry is still responsible for its implementation, although MoF makes the actual disbursements. Monitoring and control have been replaced by sponsoring. In other words, MoI represents the interests of municipalities at the central. government level (included the Parliament). Over the years a close working relationship has been forged between MoI and ANCI. The latter prepares the requests, which are then brought by MoI to the attention of the competent Ministry, or are translated into parliament bills, when the need arises.

As in most countries, MoF is keen of replacing MoI in every aspect of the intergovernmental transfers policy. Intergovernmental grants being a considerable item in the central budget, MoF would like to play an active role, hoping that a more efficient system of allocation would bring savings in their total amount. Moreover, MoF rightly believes that controlling the grant lever could ease the present difficulties of implementing the domestic Stability Pact.

The regional governments

These governments are far from presenting a common front. The main divide line is drawn by income and wealth disparities. Northern and Central regions, being much wealthier than the Southern ones, are rather cold towards intense redistribution of resources through the grant system. Different political orientations play a smaller role, while there is substantial animosity between ordinary and special statute regions, these latter ones being hugely privileged in the distribution of resources.

Regional governments, especially those situated into North and Central Italy, have increasingly asked to be made responsible of allocating grants to municipalities (given, of course, the provision of the corresponding finance by the central government). However, those pleas made very little inroad in the minds of municipal officials. As is usually observed across the world, municipalities prefer to interact with a more distant payer, that

is, with the central government, rather than with the regions - partly because the former is considered financially more viable and politically fair. The recent government draft law implementing the constitution of 2001 has partially accepted the regional requests by making regions responsible for allocating general grants to the small municipalities.

Intergovernmental consultative bodies

As mentioned in the introduction Italy has developed two intergovernmental coordinating bodies. They are the *Conferenza Stato-Regioni* and the *Conferenza Stato-Regioni Città*[4].

All central government decisions and laws impacting on subnational government have to be presented for evaluation to these bodies. Both conferences have also to agree at unanimity on the yearly allocation of grants to each level of government. Due to the incremental nature of the system of allocation, both conferences usually reach easily an agreement. The *Conferenza Stato-Regioni* had also reached, after long lasting debates about the intensity of equalization and the timing of the reform, an agreement on the reform of the transfer system for regions (Decree N. 56, 2000). However, as already mentioned, when in the year 2002 the new system was supposed to be started some Southern regions opposed its introduction, after realising that they were not (in their view) sufficiently guaranteed by the system of allocation.[5]

Conclusions

Regions and local governments prefer a long standing system of negotiated and discretional transfers over to a formula driven one. The reintroduction of local tax autonomy has made equalization of resources more impellent than adjustment to expenditure needs.

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[4] The former is made of representatives of the central government and of the Governors of all regions (who can appoint substitutes with reference to the issues dealt in meeting). The second conference is constituted by representatives of the central government, by the chairmen of the municipal and provincial government and Mountaineous Communities associations, by 15 mayors (of which 5 are from metropolitan cities) and by 6 presidents of provincial governments.

[5] It is worth noting that the absolute negative impact for the less favored region (Campania, the biggest southern region) amounted to a mere .5 per cent of its total revenues. A new agreement reached in 2005 postponed the end of the phasing out period from 2013 to 2067 but to date has not yet been implemented.

The new constitutional framework calls for assessment of expenditure needs only for socially strategic sectors, where essential levels of service delivery have been mandated. Essential levels are currently interpreted as implying strong uniformity in the provision of these services across the country.

The new constitutional provisions also open the way for protracted bargaining on the range of services to be considered where essential levels have to be applied. New conflicts between the rich and the poor regions and between regions and local governments over this range are to be expected.

Decreasing attention to need factors is partly justified by the increase in own revenue that expands the necessity of revenue equalization. However, new methods and procedures for assessing needs related to the "essential level of services" mandated by the new Constitution will have to be devised.

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APPENDIX

Criteria for revenue sharing of VAT for Ordinary Statute Regions: 2001

As mentioned in the text, Decree N.56/2000 established a new revenue sharing arrangement for ordinary regions, based on the personal income tax, the petrol tax and VAT. While the first two taxes were to be shared on a derivation basis, the distribution of VAT was tied to a distinct equalization mechanism, which is illustrated as following.

The first step is the distribution of VAT among Regions according to shares of private consumption.

The second step is the calculation of the regional allocations (s.c. "historical component") which would allow each Region to balance its budget after the elimination of the previous transfers. These allocations represented the initial distribution in 2001. From 2002 they were to be reduced gradually (5 per cent a year for the first two years, 9 per cent a year for the further ten years) to make room for equalization. The allocation of this (growing) share is made according the following formula:

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

where:
i= Regions (i=1,2,..15)
t= year (t=2001,2002,…2013)
Comp^{it}_{VAT} = share of VAT for Region i in the year t, with $0 <= \text{Comp}^{it}_{VAT} <= 1$
P^{it} =population of region i in the year t
β= 0.9, indicates the so called "solidarity coefficient" for the equalization of fiscal capacity;
j= own and shared taxes which define the regional fiscal capacity
τ^t_j = national average tax rate of revenue source j in the year t
$x^t_j = (\sum_i P^{it} x^{it}_j) / (\sum_i P^{it})$ = average per- capita national tax base
x^{it}_j = per capita tax base of region i
s^{it} = per- capita health expenditure needs of region i
$s^t = (\sum_i P^{it} s^{it}) / (\sum_i P^{it})$ = national average per capita health expenditure needs
$\gamma^t = 0.7$, indicates the level of equalization that must be obtained with this criterion
e^{it} = standardized per capita non-health expenditure of region i, calculated through a statistical regression model[6] which assesses the extra costs due to the small dimensions of regions
e^t = national average standardized per capita non-health expenditure
VAT^t = total VAT shared among Regions in the year t.

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

The second term defines a regional per-capita fiscal capacity measure and relates it to an equalization yardstick represented by the national average per-capita fiscal capacity. The Regions whose fiscal capacity exceeds the yardstick will have the 90 per cent of their difference reduced and the other way round for the Regions whose fiscal capacity fall short of the yardstick.

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

The third term is based on the difference between the health expenditure needs of each Region and the national average determined by the Health Ministry using economic and demographic indicators. Basically, it attributes different weights to the various age groups of the population with reference to distinct services, such preventive care, hospitals, etc. (see table 4 in the text).

Finally, the fourth term seeks to compensate for the absence of scale economies with reference to the aggregate non- health expenditures in the smallest Regions. In fact, consolidation of Regions does not appear as feasible in the present political context.

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

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

Source: Ministry of Treasury

Yet, to avoid excessive incentives to inefficiency this equalization component is reduced to 70 per cent with the parameter γ^{t}.

Table A1 reports the resulting allocations. The first column shows the distribution based on consumption, the second the "historical component", and the third the distribution made according to the formula. A clear pattern emerges in favor of the less developed (Figure A1).

Figure A1. Per capita regional income of Ordinary Statute Regions
2005
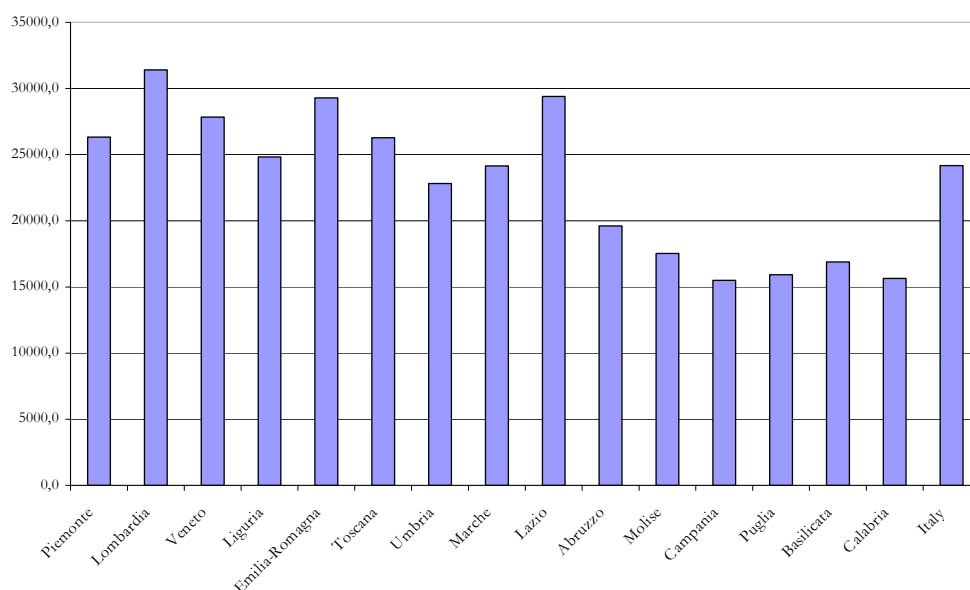
Source: Central Statistical Office (ISTAT), 2007

Table A2 Share of own revenues at the different levels of government

	1990	1995	2006
State	92	88	77
Regions	2	3	13
Health authorities (*)	1	1	1
Provinces & Communes	5	8	9
Total	100	100	100

Source: Ministry of Economy, Country General Economic Report, various years; cash revenues net of transfers. Revenues of Social Security Funds are not included.(*) In Italy health services are provided by special purpose autonomous bodies, the Local Health Authorities (*Aziende Sanitarie Locali*), financed by the Regions and not dependent on local governments.

Table A3 Share of expenditures at the different levels of government°

	1990	1995	2006
State	63	60	54
Regions	7	7	9
Health authorities	16	16	17
Provinces & Communes	14	17	20
Total	100	100	100

Source: Ministry of Economy, Country General Economic Report, various years.
°Consolidated data: transfers from one level of government to the others are included in the expenditure of the recipients. Cash expenditures net of interests paid by the state. Expenditures of Social Security Funds are not included.

Table A4. Simple correlation between per capita GDP e and Regions' per capita expenditure.
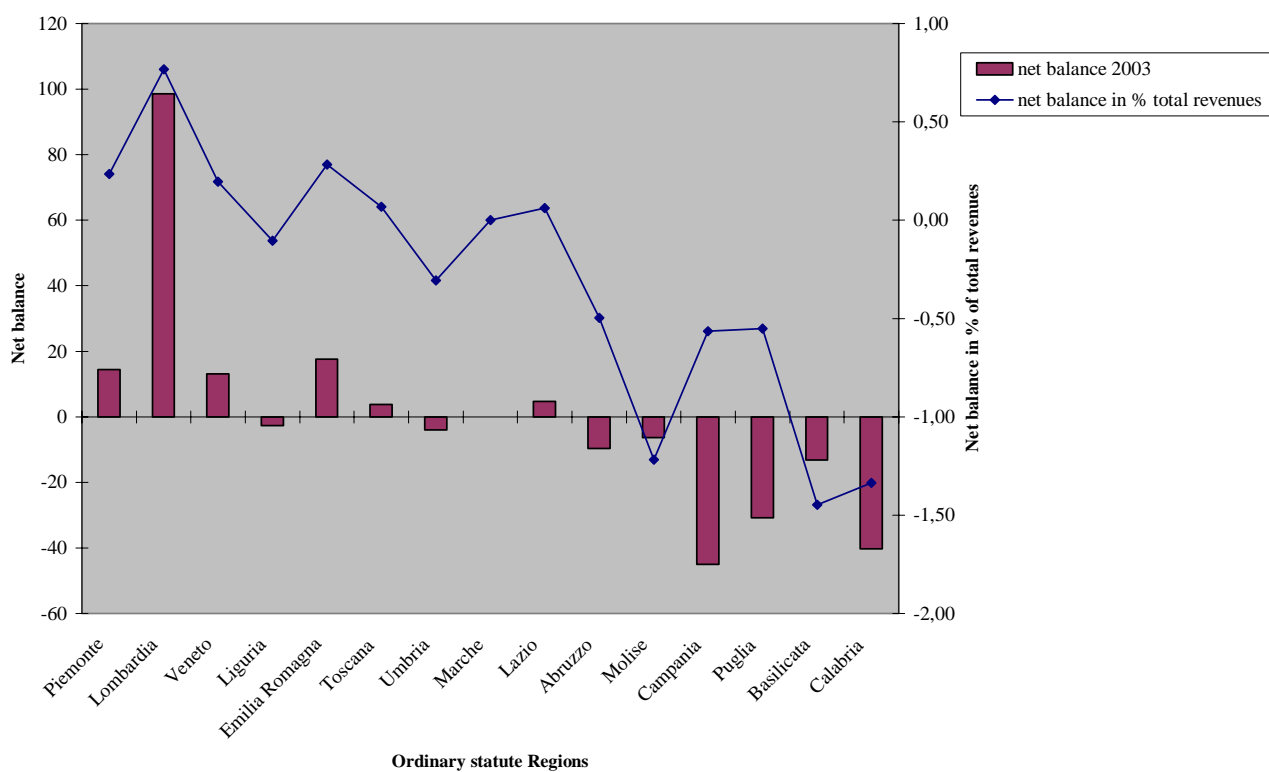**2005**

expenditures	per capita GDP

recurrent expenditure	0,369767625
capital expenditure	-0,489654792
total expenditure	-0,390389736
health expenditure	0,191705961
total net of health	-0,521283994

Table A5. Per capita GDP and per capita expenditures of Ordinary statute regions.
2005

Regions	Population Census 2001	per capita GDP	recurrent expenditure	capital expenditure	total expenditure	health expenditure	total net of health
Piemonte	4214677	26333	2054	338	2392	1661	731
Lombardia	9032554	31406	1828	236	2064	1573	491
Veneto	4527694	27831	1866	287	2153	1609	544
Liguria	1571783	24831	2208	296	2504	1836	668
Emilia-Romagna	3983346	29289	1886	225	2111	1699	412
Toscana	3497806	26280	1962	288	2250	1647	603
Umbria	825826	22830	2097	580	2677	1629	1048
Marche	1470581	24154	1827	371	2198	1544	654
Lazio	5112413	29398	2003	442	2445	1918	527
Abruzzo	1262392	19621	1851	657	2508	1729	779
Molise	320601	17542	1920	2280	4200	2033	2167
Campania	5701931	15492	1717	518	2235	1669	566
Puglia	4020707	15919	1798	347	2145	1514	631
Basilicata	597768	16885	1885	1108	2993	1505	1488
Calabria	2011466	15649	1824	503	2327	1423	904
Italy	48.151.545	24182	1887	376	2263	1648	615

Source: Audit Commission (Corte dei Conti), 2007, budget appropriations.

Fig. A2 The impact of the new equalization system for the regions after two years (2002- 2003)

Source: Audit Commission (Corte dei Conti)