# To What Extent do Central Governments Erode Subnational Jurisdiction using Fiscal Arrangements?

## Perspectives from India and Italy

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## 1. Introduction

At present, nearly 40 per cent of the world's population lives in one or another form of federal system. Federation is not a static and rigid concept; it has evolved into different forms in different countries. These structures of government have evolved over time depending upon historical, political, cultural, geographical, and economic factors.

The aim of this paper is to describe the path toward federalism and its fiscal arrangements in two very different countries: one – India – a State whose Constitution introduces a federal system as the basic structure of government for the country, with more than a billion inhabitants and with huge territorial differences and disparities; the other – Italy – a bit older and with less than 60 million inhabitants and some territorial differences, and traditionally a strong unitary State only recently introducing some federal elements.

India became a federal State after its independence; however, its degree of federalism is a debatable issue due to certain unitary features of the Indian Constitution. The Indian Constitution, in its Seventh Schedule (Article 246), defines the powers and functions of the centre (national government) and the states (subnational government). The Schedule specifies the exclusive powers of the centre in the Union List; exclusive powers of the states in the State List; and those falling under the joint jurisdiction are placed in the Concurrent List. All residuary powers are assigned to the centre. The nature of the assignments is fairly typical of federal nations. The functions of the central government are those required to maintain macroeconomic stability, international relations, trade, and those having implications for more than one state. But in practice does this really happen? Or is there a need to rethink this question of assignment?

Italy since its unification has been a highly centralized State and has in the last decade undertaken several steps toward decentralization of political and fiscal powers. Title V of the Italian Constitution has been revised redefining the assignment of competences between all levels of governments, granting in particular new accrued power to regions that now enjoy powers comparable to those of a state in a federation. As a result, the role of subnational entities should have grown. But has it? Or is the subnational jurisdiction being gradually eroded by the central government?

The particular form of fiscal arrangements in a country are not a rigid scheme applicable to all federations, rather it reflects the peculiar and different forces of nation making. In this process, member jurisdictions may retain certain fiscal prerogatives while surrendering others, thus affecting the resulting fiscal structures. Apart from these political and historical factors, there are also good economic reasons why certain fiscal functions should be operated on a more centralized level, while others should be decentralized. Richard Musgrave in his classic, *The Theory of Public Finance*,[1] formulated a three-branch division of the fiscal functions of a

[1] Richard A. Musgrave and Peggy B. Musgrave, *Public Finance in Theory and Practice*, McGraw-Hill International Editions, 1989.

government—resource allocation, redistribution, and stabilization. In federations, these fiscal functions are assigned to different levels of governments on the basis of comparative advantage.

## 2. Indian Fiscal Federalism

### 2.1 *Constitutional Provisions*

The Indian Constitution assigns the exclusive, concurrent, and residuary powers and functions of the centre and the states. The major subjects assigned to the states comprise public order, public health, agriculture, irrigation, land rights, fisheries, industries, and minor minerals. The states also assume a significant role for subjects in the Concurrent List like education and transportation, social security and social insurance. The assignment of functions and powers, particularly tax powers, has certain anomalies which gives more financial strength to central government in comparison to state governments. There are, however, constitutional and statutory provisions to neutralize or minimize these anomalies.

The assignment of tax powers in India is based on a principle of separation, i.e. tax categories are exclusively assigned either to the centre or to the states. Most broad-based taxes have been assigned to the centre, including taxes on income and wealth from non-agricultural sources, corporation tax, taxes on production (excluding those on alcoholic beverages), and customs duty. A long list of taxes is assigned to the states. However, only the tax on the sale and purchase of goods now in form of VAT has been significant for state revenues. The centre has also been assigned all residual powers, which implies that the taxes not mentioned in any of the lists automatically fall into its domain. This tax assignment system has some notable anomalies. The separation of income tax powers between the centre and states based on whether the source of income is agriculture or non-agriculture has opened up avenues for both avoidance and evasion of personal income tax. Second, even though from a legal perspective taxes on production (central manufacturing excises) and sale (state sales taxes/VAT) are separate, they tax the same base, causing an overlap and leaving less tax room to

the latter. Finally, the states are allowed to levy taxes on the sale and purchase of goods, but not services. This, besides providing avenues for tax evasion and avoidance, has also posed problems in the levy of a comprehensive value added tax. However, on the tax reform front, after VAT, the next logical step should be a unified Goods and Services Tax (GST), which combines the central and state VATs. One anomaly in this transition has been the status of taxes on services. The original Constitution implicitly assigned service taxes to the centre, through its residual powers over taxes. In 2004, the central government chose to add service taxes explicitly to the Union List, via a constitutional amendment.

### 2.2 *Indian Fiscal Federalism in Practice*

The result of the assignments of tax and expenditure authority, as well as their implementation in practice, has been a substantial vertical fiscal imbalance. In 2002-3, the states on average raised about 38 per cent of government revenues, but incurred about 58 per cent of expenditures (the figures focus on current expenditures and revenues). Transfers from the centre made up the balance. In fact, the ability of the states to finance their current expenditures from their own sources of revenue has seen a long-run decline, from 69 per cent in 1955-6 to 52 per cent in 2002-3. While the expenditure shares of central and state governments suggest a fairly high degree of decentralization, states' control over expenditure policies is less than the figures indicate since about 15 per cent of states' expenditures were part of centrally sponsored schemes involving specific purpose transfers administered by various central ministries.

On account of diverse socio-economic factors, there is an imbalance between revenue capacity and expenditure need of the states, and it varies across different states depending upon the size of their tax base, the size and composition of population, and other factors affecting the cost of providing public services. The richer states, due to their high capacity, can provide better standards of public services than their poorer counterparts.

As a mechanism to take care of vertical and horizontal imbalances, there are three channels of current transfers from the centre

to the states. First, the Finance Commission decides on tax shares and makes statutory grants. Second, the Planning Commission makes grants and loans for implementing development plans (which are discretionary transfers). Third, there are the central sector and centrally sponsored schemes, in which various ministries give grants to their counterparts in the states for specified projects either wholly funded by the centre (discretionary transfers through *central sector projects*) or requiring the states to share a proportion of the cost (discretionary transfers through *centrally sponsored schemes*).

### 2.2.1 *Fiscal Transfers*

*The Finance Commission.* The Finance Commission is constituted in accordance with Article 280 of the Constitution of India. The existence of an independent Finance Commission renewed every five years is a unique feature of the Indian fiscal federalism. The Finance Commission gives its recommendations on devolution of taxes to the states, prepares forecasts of the revenue receipts and expenditures of the state governments and recommends grants against financial gaps of those states which have a deficit even after devolution of central taxes.

The Commission also recommends grants for upgrading various facets of administration such as police, jail, education, road maintenance, as well as for specific problems like natural calamities and devolution to local bodies. The Finance Commission attempts to achieve the maximum possible balance between competing demands of the states and the requirements of the centre in discharging their respective duties and responsibilities. There are three major aspects of the Finance Commission recommendations so far:

(i) The Finance Commission has steadily raised vertical transfers in the divisible pool of central taxes.
(ii) All the Commissions until the Eighth Finance Commission (1984) followed what is known as the "gap-filling" approach, i.e. the gap between revenue receipts and expenditures, and recommending non-plan deficit grants to fill the financing gaps arrived at on this basis. This encouraged the states to increase their non-plan revenue

expenditure, incurring deficits, as they anticipated the financing of such gaps by grants from the Finance Commission. The Ninth and Tenth Commissions, however, followed a normative approach in this regard.

(iii) In the formula devised for redistribution of the divisible pool of central taxes among the states, the Finance Commissions have relied heavily on backwardness criteria, measured in terms of per capita income. The absence of any weight for a state's tax effort in the formula for redistribution of devolution until the Tenth Finance Commission has provided little incentive for the states to maximize their resource mobilization effort.

So far, twelve Finance Commissions have made recommendations and, barring a few exceptions, these have been accepted by the central government. However, the working of these Commissions, their design of the transfer system, and the approach and methodology adopted by them has come in for criticism. In particular, terms of reference of last two Finance Commissions (Eleventh and Twelfth) marked a greater divergence from the constitutional mandate and further pushed state governments along the path of economic reform.

Through the Presidential Order of 28 April 2000, an attempt was made to alter the constitutional mandate of the Eleventh Finance Commission, which was asked "to draw a monitorable fiscal reform programme aimed at reducing revenue deficit of the states and recommend the manner in which the grants to the states to cover the assessed deficit on their non-plan revenue account may be linked to progress in implementing the programme". This had two far reaching implications—one, that "fiscal reform" was constitutionally legitimate; and two, it sought for the centre the right to use assistance to cover non-plan revenue deficits as an instrument to enforce compliance.

The terms of reference of the Twelfth Finance Commission included suggesting "a plan by which the (state) governments, collectively and severally, may bring about a restructuring of the public finances, restoring budgetary balance, achieving macro-

economic stability and debt reduction along with equitable growth". The implications for states are clear: access to resources would depend on the states' compliance in raising user charges for its public services, privatization of state-owned public enterprises, and becoming more self-sufficient in resources.

The balance of power has perceptibly shifted in favour of the centre in the past decade. The acute fiscal crisis which states face, characterized by bankruptcy, rising debt, and debt servicing expenditure, is confirmed by the Reserve Bank of India (the central bank) in its Report on State Finances of the last few years. The increase in revenue and fiscal deficit has accompanied falling real government spending on development, and though the extent of this is higher in backward states, it is a far more generalized phenomenon across states.

Normally, states are blamed by the centre for this fiscal crisis on account of their fiscal profligacy, or no serious effort being made for revenue mobilization through tax effort and user charges, etc. But when looking at this aspect empirically, it is the centre rather than the states that has been derelict in resource mobilization and tax effort. Due to several fiscal measures, such as the reduction in tax rates and tax concessions, initiated by centre, there is a decline of tax-to-GDP ratio from 10-11 per cent in the early 1990s to 8-9 per cent after the late 1990s. One quarter of this was offloaded to state governments and mandatory transfers fell from 3 to between 2.5 and 2.75 per cent of GDP during the ten years beginning in 1993-4. As a consequence of the fall in the central tax-to-GDP ratio, the ratio of fiscal transfers from the centre to the states as proportion of GDP has declined from 5 per cent (Eighth Finance Commission), 4.9 per cent (Ninth Finance Commission) to 4 per cent (Tenth and Eleventh Finance Commissions). Non-Finance Commission transfers have also declined by 4 per cent of GDP. The Twelfth Finance Commission noted that an increase in the share of the states in central tax revenues from 29.5 to 30.5 per cent and the overall ceiling on transfers by 0.5 per cent to 38 are unlikely to offset the potential shortfall on account of the decline in the central tax-to-GDP ratio.

The centre has tried to keep more and more resources outside the divisible pool resulting in greater centralization. The share of

those sources of revenues that are outside the divisible pool, from which states receive finances (such as special surcharges) has grown, with a negative impact on the states. Within the divisible pool, there is a tendency on part of the centre to make devolution conditional. The Twelfth Commission has deliberately created a framework to push fiscal restructuring, by banning increases in grants and tightening borrowings. Nine of the ten grants are tied—all of them except the non-plan revenue deficit grant. Norm-guided grants that cover the deficits of the states are only 40 per cent of all grants, while 60 per cent of these special-purpose grants are discretionary without a transparent criterion. The first two Finance Commissions, however, argued that statutory grants through the Finance Commissions should be "residuary and should be mostly automatic and unconditional", directed at best to particular purposes. The Twelfth Finance Commission has deviated from this and suggested minute implementational and institutional details.

Until the late seventies, most of the states had either no deficit on their revenue account or only a marginal one. For a number of reasons, states' debt burden increased during the 1980s and 1990s. In the name of stabilization during the 1990s, the interest rate on loans from the centre remained very high even if the rates of interest on market and other non-government loans declined. This resulted in larger interest payments, and states having to incur additional debt on this account, leading finally to them being caught in a vicious and self-perpetuating debt trap. Thus, a centrally-controlled high interest rate regime resulted in a spiraling debt burden for states. In response, the Twelfth Commission has introduced a package for debt reduction with two main components:

(i) The consolidation of all state debt outstanding to the centre on 31 March 31 2004, at an interest rate of 7 per cent, to be repaid over 20 years.
(ii) The second, and much more problematic, proposal is a new debt relief scheme linked to the reduction in the revenue deficits of states.

Under this scheme, the repayments due on central loans from the year 2004-5 to 2009-10 (after consolidation) will be eligible

for write-off, but the amount of the write-off will be linked to the absolute amount by which the revenue deficit is reduced in each successive year over the entire period. A precondition for eligibility for this scheme is the enactment of the fiscal responsibility legislation.

Not content with requiring that states enact fiscal responsibility legislation as a precondition for obtaining the debt relief, the Twelfth Commission has also specified what such legislation should meet as a target.

This includes the following features:

(i) Eliminating the revenue deficit by 2008-9;
(ii) Reducing the fiscal deficit to 3 per cent of Gross State Domestic Product (GSDP) or its equivalent defined as a ratio of interest payments to revenue receipts; and
(iii) Bringing out annual reduction targets for revenue and fiscal deficits.

In addition, the Commission recommends that "states should follow a recruitment and wage policy, in a manner such that the total salary bill relative to revenue expenditure net of interest payments and pensions does not exceed 35 per cent". The Commission even demands withdrawal or reduction of the public sector: "In the period of restructuring, that is 2005-10, state governments should draw up a programme that includes closure of almost all loss making State Level Public Enterprises (SLPEs)."

So, it can be seen that in recent years the Twelfth Finance Commission, which is a constitutional body meant for recommending fiscal transfers, is being used to undermine state fiscal jurisdiction.

*Planning Commission.* The Planning Commission, the apex body for approval of the Five Year and the Annual Plans of the states is another major source of resources from the centre to the states, in addition to the statutory tax-devolution and grants-in-aid recommended by the Finance Commission. Plan grants and loans to the states for financing their development programmes under the Five Year Plan and Annual Plans were initially project-based,

but later according to an agreed formula known as the Gadgil Formula.

Central Plan Assistance to state plans can be broadly classified into two categories: Central Assistance (Domestic) and Additional Central Assistance for Externally Aided Projects (EAPs). Central Assistance (Domestic) includes not only the Normal Central Assistance (NCA), but also other additional central assistance to states for other programmes, such as Basic Minimum Services (BMS), Slum Development Area Programmes (SDAP), Accelerated Irrigation Benefit Programmes (AIBP), and other central support for state plan.

*Special* vs. *Non Special Category States*. For the allocation of Plan Assistance, states are classified broadly into two groups, Special Category and Non-Special Category states. The Special Category states are those states which are in a strategic location on the border with neighbouring countries, hilly terrain, inadequate economic and social infrastructure, predominantly larger tribal population, or a limited resource base compared to development needs.

For Special Category states 90 per cent of the NCA is given as grants and 10 per cent as loans. In the case of Non-Special Category states, however, only 30 per cent of NCA is given as grants and 70 per cent as loans. Irrespective of the original terms and conditions of the external aid, when such aid is passed on to the state, it is provided on the same terms and conditions as NCA. In respect of other components of central assistance to states, as mentioned above, there are specific guidelines relating to each special and other programme.

For implementation of schemes approved by the National Development Council (NDC)[2] and monitored by the Planning Commission, the loan component of resources is important. Now, when the centre is forcing states to rely on the market for these loans, less developed states are going to suffer on the implementation of plan-projects.

[2] The highest economic decision-making body, comprising the Prime Minister, Deputy Chairman of Planning Commission, all Chief Ministers, and other key central ministers such as finance, commerce, etc.

*Centrally Sponsored Schemes*. There are also large numbers of development programmes known as Centrally Sponsored Schemes (CSS), which are initiated by the centre and implemented by the states in various sectors. These schemes are largely financed through assistance from the centre, with some share from the states, which may vary from scheme to scheme. They cover a variety of development-oriented schemes ranging from poverty alleviation, family planning, and employment programmes in the rural areas to a large number of small schemes in sectors like agriculture, education, and health – areas which fall squarely within the states' purview. Many of these schemes have a large staffing component with the posts in a number of cases continued across several planning periods, the cost either being met fully or partly by the centre.

This has become an important channel for fiscal transfer to states. The centre imposes its development objectives on the states through these schemes, which may not match with the developmental priorities of the states. But poorer states have no choice but to accept the terms and conditions imposed by the centre.

## 2.3 *Some Future Challenges from the Indian Perspective*

Looking at the structure and practice of Indian fiscal federalism, it can be said that it is well planned and designed for a country like India with diverse social, political, economic, and cultural dimensions. In practice, there still exist vertical and horizontal imbalances within the system. In recent years, particularly in the period after 1991,[3] there have been efforts to push a reform agenda through the states using constitutional and statutory bodies such as the Finance Commission and Planning Commission, and other mechanisms like the Centrally Sponsored Schemes. Now, most of the recommendations for fiscal transfers include conditionality which

[3] In 1991 India adopted New Economic Policy (NEP) under which its economic policies were liberalized and economy was opened-up. Economic reform under the broader framework of NEP is still going on.

undermines the fiscal authority of the states. Arbitrary limits to revenue and fiscal deficits can prevent important and socially necessary public expenditure, which is required to improve current welfare and future growth prospects. There is no reason to keep capital expenditure within some predetermined limit, since even debt sustainability depends upon the relation between the interest rate and anticipated return from public investment. Apart from this, there is the issue of social returns, which appear to be completely ignored by the recommending bodies.

Such conditionality will affect states in a number of ways. The revenue raising capacity of the states is limited, even more so since the centre has taken upon itself all powers to tax service sector incomes. In this situation, if revenue deficits are to be progressively reduced and brought down to zero, this necessarily means that revenue expenditures will have to be cut. In most of the states, by far the largest item of expenditure on the revenue account is salaries. It is false to see these as unnecessary or unproductive expenditures, since these are for those who are to provide the important public services that everyone acknowledges to be essential. Since state governments are responsible for almost all of the expenditures that affect the quality of life of ordinary citizens on the ground, from infrastructure and sanitation to health and education, preventing expenditure on wages and salaries for those who would perform these functions is an impossible proposition.

## 3. Italian Fiscal Federalism

### 3.1 *The Origins of Decentralization in Italy*

In Italy, a decentralization process from the central to regional and local governments is taking place. Yet this process only began in recent years: from the unification in 1861 until the 1970s, Italy was *de facto* organized as a centralized state. After the fascist dictatorship Italy became a republic with the new Constitution of 1948 which provided for some elements of federalism. Article 5, for instance, acknowledged local autonomies; Title V provided for the creation of Regions (Article 131) and defined their legislative powers

in some areas and recognized special autonomy to certain regions located in disadvantaged areas and because of cultural and linguistic differences.

Despite all that, the creation of regions was only implemented many years later; only the Special Statute Regions (Trentino-Alto Adige, Friuli-Venezia Giulia,[4] Valle d'Aosta, Sicily, and Sardinia) were established immediately after the coming into force of the Basic Law, with extensive expenditure autonomy and central funding which cannot be changed by ordinary law.

The remaining 15 "ordinary" regions were only created in the 1970s as an intermediate level between local levels (provinces and communities). For many years the regions served mainly as administrative tool of the central government, betraying the original formulation of the Constitution.

According to the original formulation of Title V (especially of Article 117) of the Constitution, ordinary regions had the authority to formulate legislative initiatives complementary to or within the framework of national legislation. Therefore, they could not legislate independently from the state. Within these limits, they had legislative powers in many fields, including local police, health assistance, and also had the obligation to act as an administrative branch for the central government (Article 118).

In the 1990s, economic and political crisis pushed citizens to demand more accountability at the political level: it was exactly in those years that new steps towards decentralization began. With Act 142 of June 1990, municipalities and provinces were given the right to adopt their own status and define their organization while Law 158/1990 changed the mechanisms of financing regions. In the following years many laws were passed in order to reform local (and regional) finances, instituting new taxes like ICI (property tax) and IRAP (professional tax) and changing the grants mechanisms and the system of transfers from the centre to the subnational entities. Another important step was Act 59/97 and 127/97, the so-called Bassanini Laws, which started a deep administrative reform of the state that is still under way. In the same

[4] Friuli-Venezia Giulia's status was only approved in 1962.

year another important law was passed, Law 281/97, introducing an intergovernmental forum. Furthermore, during the 1990s a series of other acts were approved, always with the aim of modernizing the inefficient public administration and to fulfil the requirements on public finances established by the Maastricht Treaty. In order to harden the budget constraint of subnational entities, by 1998 an Internal Stability Pact was passed, Law 448/98, defining a system of punishments to control aggregated public finance.

These legislative initiatives, however, did not change the relative weight of subnational entities in the aggregated finances as these acts did not change the actual distribution of functions between the entities. As result, these initiatives were not considered far-reaching enough and some regions began requesting further reform along federal lines. Also in consequence of the electoral success of the Northern League party in the 1990s, the federalism issue entered in the Italian public debate.

### 3.2 *The Reform of the Constitution in 2001*

The reform of the Title V of the Basic Law, which modified Articles 114 to 133, took place on 8 November 2001, after being approved by the Parliament and confirmed by a referendum (Constitutional law number three of 2001). As for Articles 117 and 118, important changes were introduced, particularly a dramatic increase in the number of concurrent competencies shared by the national and regional governments. Regions were accorded legislative powers in areas of their exclusive competences in both spending and taxing areas. However, this reform also presents problematic and unresolved aspects, as power-sharing in the areas of overlapping competences was not clear, giving rise to numerous conflicts of interpretation.

The new Constitution establishes as exclusive competences of the central state foreign policy, immigration, religious affairs, currency, the national tributary system, national bookkeeping, fiscal equalization, electoral systems, public order and security, citizenship, definition of minimum standards in public services provision, general framework on education, on welfare, on environmental

protection, and on cultural and artistic goods. All other functions are regional competences, except for those defined concurrent among which international trade, education, scientific research, professions, and health care.

This reform changes the nature of the Italian state toward a federal state but gives no indication on how fiscal relations between the different levels of governments should be designed, leaving to ordinary laws the task of redesigning the resource and expenditure interaction between the centre and the periphery.

Between 2001 and 2006, several follow-up constitutional reform proposals were proposed by the government in charge known as *devolution laws*: re-specifying health, education, and administrative police as areas of exclusive regional competence; the creation of a second chamber as a federal senate; as well as a substantial modification of the powers of President of the Republic and the strengthening of the power of the Prime Minister. Eventually this reform did not change much in the fiscal relations between the different levels of governments. The law known as law 268/2005 did not pass the popular referendum test in 2006, and so the 2001 reform with its imperfections continues to be in force and to pose questions about allocations of responsibilities between the various levels of government, and more problematically still, the need to find solutions through ordinary law.

The constitutional reform process is not finished yet, as the new articles are difficult to interpret and leave many contentious issues, and are full of deficiencies that make their translation into ordinary law very difficult. The general picture is that the Constitution calls for a rather high degree of federalism, but its implementation has been non-linear because of political disagreements.

### 3.3 *Fiscal Arrangements between the Centre and the Regions*

Fiscal arrangements between the central government and the subnational entities have seen devolution of competencies over the last 15 years.

The devolution reforms in the 1990s increased the share of subnational government spending, rising from nearly 15 per cent in 1990 to nearly 30 per cent in 2005, as well as the resources to finance these expenses. Fiscal federalism has evolved, aiming at improving the efficiency of public services and to better meet the desire of citizens to decide and control their own destiny. However, the results are still far from being satisfactory.

By now subnational spending is financed by a mix of own revenues, shared taxes, state transfers, and debt. New tax assignments have kept pace with new spending responsibilities but the devolution of tax and spending powers remains highly disproportionate: subnational tax revenues cover less than half of their current expenses, leaving a substantial role to state transfers. This reflects a vertical financing gap that, while contrary to the intent of the new Constitution, is nevertheless reinforced at the practical level.

Generally, three different types of fiscal arrangements among different levels of governments can be identified: (i) tax base and revenue sharing mechanisms, (ii) intergovernmental transfers, and (iii) institutional arrangements, including independent grant commission, intergovernmental forum and intergovernmental cum civil society forum.

The actual resources of regions consist of the IRAP professional tax, the tax surcharge on personal income tax, fuel tax, and a share of VAT, but these resources are not sufficient to cover the expenditures derived from the provision of goods and services as established by the new Constitution. Until now, this imbalance has been covered by ad hoc transfers from the central government.

In order to give regions fiscal autonomy, tax bases and revenue shares should be better designed, and a higher degree of coordination between the centre and the periphery is needed. Furthermore, as discussed below, the decree Law 56/2000 should be revised.

A different approach to promote a more intense cooperation between the central and local governments is by setting up institutions where macroeconomic objectives, budgetary programmes, and the related enforcement mechanisms (such as the Domestic Stability Pact) are established through a negotiation process invol-

ving different tiers of government. The complexities inherent in intergovernmental fiscal relations strongly suggests, following the examples of Germany and Australia, that some decision-making powers should be assigned to an independent fiscal council, where all levels of governments are adequately represented. The fiscal council provides the forum where a number of delicate issues can find resolution: the decision about overall deficit target allocation across different levels of government, the monitoring of compliance of such limits; the definition of budgeting rules effective for both central and local governments; the setting up of uniform standards and financing responsibilities in the case of concurrent functions among central and regional governments; and the determination of equalizing criteria underpinning the system of interregional transfers.

### 3.3.1 *Art 119 of the Constitution*

The general framework for fiscal arrangements between the central and subnational entities is established by Article 119 of the new Constitution. Article 119 gives complete revenue autonomy to lower levels to finance their normal activities, with the introduction of an equalization fund designed to have a marginal role in poorer regions. The separation of powers in terms of precise revenue sources was left vague and dependent on ordinary law. The Article identifies different means of financing: own taxes, and tax sharing supported by an equalization fund (general purpose grants) without assignments for entities with lower fiscal capacity. The Article establishes that these three types of resources should allow subnational entities to be fully financed. Finally, it is established that regions and local entities can issue debt only to finance public investments.

### 3.3.2 *Decree Law 56/2000*

Already before the reform of the Constitution, the government passed a decree law known as 56/2000, where intergovernmental fiscal relations were redesigned with the aim of redefining interregional equalization and developing greater local fiscal autonomy. The decree law regionalized health expenditure and introduced new instruments to finance subnational governments, among them

tax sharing arrangements on personal income tax, on fuel tax and the new equalization method. In particular, this decree law abolished central government transfers and replaced them with a rules-based system of regional sharing and horizontal equalization based on a portion of national VAT receipts. The sharing of the national VAT revenue would become the highest source of regional revenue. According to this law, the sharing formula allocates 38.55 per cent of national annual VAT revenues to the regional level and then divides this amount by each region's share in national consumption. 40 per cent of this amount would constitute the basis of the national equalization fund where rich and poor regions benefit according to their historical spending, resident population and deviation from national average tax capacity. The setting of the tax sharing formula would be established with the collaboration of subnational levels via the State-Regions Conference with periodic modifications if necessary.

In the end, this decree was never completely implemented as some mistakes were made in the calculation of transfers and other parts of the constitutional reform remained to be implemented. At the end of 2004 the government suspended the validity of the equalization systems (decree 314/2004) and since 2002 no agreements on equalization funds have been achieved and for matters related to health financing, monthly transfers are used, while the financing of the administrative decentralization is done through.

Nevertheless, this decree remains relevant and the model of fiscal relations presented seems consistent with new Article 119 and its insistence on eliminating ordinary central government transfers through financial self-sufficiency in the regions. In 2005, the High Commission on Fiscal Federalism (ACOFF) proposed a revision of the decree law modifying the taxes assigned to regions and instituting a vertical equalization system in which each region is guaranteed 95 per cent of their fiscal requirements through own taxes and tax sharing.

Seven years after the decree law 56/2000, a new proposal on the application of fiscal federalism appeared in the summer 2007, approved by the national government but not by the Unified Conference (State-Regional, Provincial-Local). Unfortunately, the

new proposal renders the political acceptance of fiscal federalism even more difficult. For example, Article 6 establishes that equalization for municipalities under a certain population threshold is done by the region and establishes the shift to an equalization fund mechanism based on production standard costs for the provision of certain social services and no longer on a historical expenses basis. The transitional phase to its full implementation is similar to that of Decree 56/2000—fixed for 5-10 years—and hence a long transitional period that will end in 2013 or even later.

### 3.3.3 *Grants and Equalization*

According to the new Constitution, regions should be fiscally autonomous and the central government is responsible for an equalization fund for those entities with lower per-capita fiscal capacity. Until to now, the discussion around how to structure this fund has been very prolonged and, aside from decree law 56/2000, there has been no other serious attempt to define the new equalization system. Agreements on how to redistribute resources among regions have until now been made on a year-by-year basis and have shown several design weaknesses:, the difficulty of establishing the fiscal need of a region (at the moment based on historical expenses); the strong dependence of regional resources on the tax base (hence on economic cycles of the regions); and the possible increase of dualism with the consequent need to compensate for these disparities with an ever-larger equalization fund.

The new Constitution establishes that all regions should treat identical persons identically in the provision of public services. In order to ensure this, all regions, depending of their fiscal capacity, would receive a transfer to meet the needs of the population. The definition of these minimum standards has also encountered several problems.

This raises the critical question of how to the design of the fiscal equalization through local assignment of the tax system. This poses the question about how to optimally design an equalizing system that guarantees the necessary yield of autonomous tax effort by local authorities and at the same time provide for right incentives for poorer jurisdictions without discouraging richer ones.

### 3.4 *Some Future Challenges from Italian Perspective*

Building on this general framework, the main suggestions offered by the recent Italian experience can be summarized as follows. It is generally recognized that the strengthening of (marginal) tax autonomy at subnational level is needed to improve subnational government accountability. However, this contrasts with the difficulty of relying on taxing powers consistent with the fundamental features required by the literature on fiscal federalism. In this sense, a possible solution consists of recognizing and allowing subnational governments' significant room for manoeuvre in setting surcharge rates on taxes shared with the central government. Attempts should be made to define a more transparent separation of the assignment of public expenditure responsibilities between central and local governments, in terms of designing, implementing, and financing public programmes.

The system of intergovernmental fiscal relations in Italy has moved in cycles with varying degrees of decentralization. As measured by the ratio of local-to-total public spending, the degree of decentralization has steadily increased following the increased activity of regional governments. The functions assigned to regional and local bodies have progressively increased over time as a result.

The system of fiscal federalism designed by the new Constitution, however, is far from being satisfactory. On the expenditure side, the sharing of responsibilities between national and regional government is marred by the overlap of legislative competences on a variety of crucial public activities. Inadequacy is even greater on the financing model, as the new Constitution does not state clearly the fundamental choices on the degree of interregional diversity that the new system is expected to generate in the provision of public goods. Great emphasis is laid on own taxes (which differ greatly in per capita terms in different regions due to long-standing differences in per capita incomes), but no indication is provided on the extent to which fiscal capacity should be equalized.

To fulfil the reform in the direction of federalism there is an urgent need to implement Article 119 defining new regional and

local tax assignments. This should be correlated with spending functions, allowing regions to participate in determining a defined and flexible VAT sharing mechanism, and defining a new redistribution mechanism with a hard lower level budget constraint in order to avoid the common pool problem that has a long tradition among certain subnational governments in Italy.

## 4. Conclusion

The two case studies described show how fiscal relations among different levels of government are a sensitive topic and that different historical, social, and economic factors may lead to different pathways. In the case of Italy, steps toward federalism are seen as a way to reduce national/central interference in the lives of citizens. Until now, a significant advance toward decentralization and regionalism has been reached. Further developments are difficult to foresee, however, because of the reluctance of the central government to implement the necessary laws. Also in the case of India, where the federation has existed for around 50 years, the central government tends to prevail over its constituent units, dictating unilateral arrangements to maintain the national unity among the very heterogeneous subnational entities.

In a world of growing integration and economic interdependence, fiscal arrangements are necessary either to maintain national cohesion (through an adequate perequation system) and to face international pressure more effectively (negative and positive externalities do not stop at national borders). Fiscal arrangements should be flexible enough to allow single jurisdictions to perform the policies asked for by their citizens and to maintain a sound fiscal system and the cohesion of the federation.

A high level of vertical earmarked grants suggests an inclination towards interfering in subnational entities from the central government, but is also a way to overcome certain gaps in the provision of services (guaranteeing a minimum standard level across the country). Even if specific-purpose grants are used extensively to minimize the risk of suboptimal spending in domains characterized by significant positive spillover effects, or to secure minimum

standards for specific services throughout the country, unconditional grants increase the discretionary power of local governments as to how to organize local provision in the most effective way.

Other arrangements like internal stability pacts are useful to guarantee the sustainability of public expenditures and avoid free-riding and bailing-out opportunities. But at the same time, they can hinder the dynamism and growth of an area that would need more flexible public policies at a given moment to foster economic developments.

What is really essential in designing such fiscal arrangements is the active involvement of all parties, who should agree on certain issues and cooperate to fulfil them, as well as the existence of open forums in which variations and updates to fiscal arrangements are periodically discussed. This is essential to keep the precarious balance between the (often diverging) requirements of the different constituent units of a federation.