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Italian regions' autonomy plans weigh on the fiscal framework's predictability

The financing system of Italy's regions is characterised by sizeable redistributive fiscal flows coupled with stringent fiscal discipline. These have cushioned against significant regional economic disparities and prevented budget and debt imbalances. Decentralisation is already uneven but could widen further following plans by three wealthy northern regions for greater devolution. If the plans are implemented, they will weigh on the predictability and sustainability of Italian general government finances.

Italy's uneven regional institutional and financing framework, where five special status regions out of 20 enjoy greater legislative and financial autonomy, could widen. A devolution plan (*regionalismo differenziato*) initiated by three of the wealthiest 'ordinary status' regions – Emilia-Romagna, Lombardia and Veneto – would enable these regions to acquire greater responsibilities and related spending powers over a wide range of policy areas currently held by the central government.

This would happen in a context of already-large regional economic disparities between Italy's northern and southern regions, which are cushioned by redistributive fiscal flows and strict centrally co-ordinated fiscal rules that have ensured fiscal discipline. However, concerns regarding the political feasibility of further devolution have been raised, in light of potential consequences on the regional financing framework as well as on the central government's control over the health of Italy's national public finances.

Scope has identified three main sources of risk stemming from the yet-to-be-finalised devolution plan: (i) an inefficient allocation of responsibilities between central and regional governments; (ii) the failure to balance additional spending powers and revenue rights of wealthy regions with resources redistributed equally across the country; and (iii) weakened oversight over regional public finances by the central government. These risks could collectively lead to greater credit-risk differentiation between regions. Depending on the final outcome of devolution talks, the country's fiscal balance and public debt sustainability may also be affected, with potential implications concerning Italy's sovereign rating (BBB+/Stable).

Figure 1: Italian regions by status, ordinary vs special

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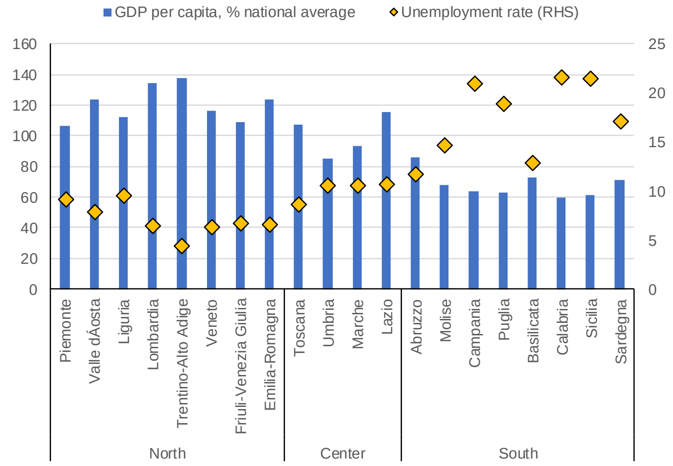
§1 Italy's regional financing framework: sizeable redistributive fiscal flows and fiscal discipline cushion large regional disparities

Despite the economic North-South divide…

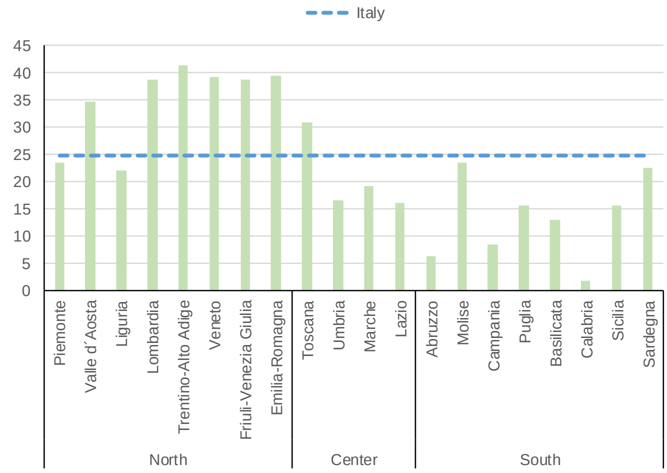
Italy has the highest regional economic disparities among OECD countries in terms of unemployment rates. This large economic divide among Italian sub-sovereigns has further increased between 2000 and 2016[1]. In 2017, the province of Bolzano's GDP per capita level was two-and-a-half times higher than that of Calabria region. All northern regions have per-capita GDP levels above the national average, while all southern regions fall below the line (**Figure 2**).

Figure 2: Economic disparities: North vs South, 2017



Source: ISTAT, Scope Ratings GmbH

Figure 3: Governance quality divide: North vs South



Source: European Quality of Governance Index (2017 edition)

… and pronounced regional disparities in terms of governance…

The North-South divide is also captured by governance indicators, like the European Quality of Governance Index, which measures institutional quality at the regional level in the European Union. The index captures the perceptions of average citizens, their experiences of corruption and the extent to which they rate public services as being impartial and of good quality. The national average level cuts almost precisely across the peninsula just below Tuscany (**Figure 3**). The persistence of these wide differences has fed pressures among wealthy northern regions, such as Lombardia, Veneto and Emilia-Romagna, to seek more control over financial resources and governance over a wide area of policy responsibilities.

… though at an aggregate level, regional debt is low and budget performance balanced.

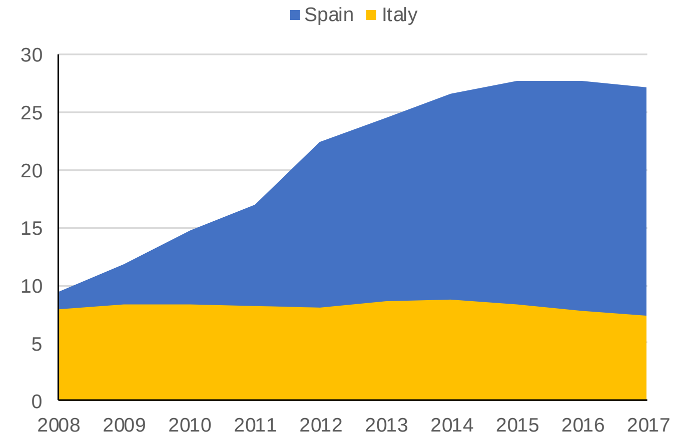
Notwithstanding high regional divergences, the public finance framework at the aggregate sub-sovereign level in Italy stands out for its stability in terms of debt and deficits. Consistent balanced budgets in aggregate and low debt levels were maintained during and in the aftermath of the Global Financial and Sovereign Debt crises. The strength of fiscal prudence that characterises Italy's framework can be seen by comparing aggregate debt and deficit developments at the sub-sovereign levels in Italy and Spain (**Figure 4** and **5**).

Spanish regional and local budget dynamics were heavily affected during the crises, which also brought underlying revenue-expenditure imbalances at the sub-sovereign level, previously cushioned by unsustainable (real estate boom-related) revenue growth, to the surface. Coupled with soft budget constraints, the debt of Spanish sub-sovereigns increased.

[1] OECD, Regions and Cities at a Glance, 2018

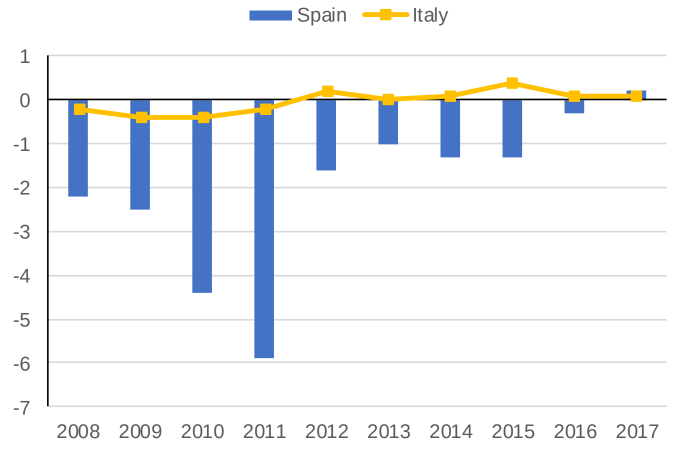
On the other hand, the budget performance of Italian sub-sovereigns at an aggregate level shows resilience; local and regional debt is low. Scope's view is that strict fiscal rules around Italy's sub-sovereign finance framework have been crucial in maintaining low debt levels and stable budget balances in aggregate terms.

Figure 4: Local and regional public debt (% of GDP)



Source: EUROSTAT, Scope Ratings GmbH

Figure 5: Local and regional fiscal balance (% of GDP)



Source: EUROSTAT, Scope Ratings GmbH

Fiscal rules in Italy's public finance framework are among the strictest in the EU

The European Commission's standardised fiscal rule index placed Italy in second place, only behind Bulgaria's among the EU's 28 member countries as of 2016 in terms of strength and coverage of fiscal rules. The same index shows how Italy, after the crises, increased the stringency of its fiscal framework more than European peers: Italy ranks second today, but it was in 14th place in 2006.

The heavy involvement of regions in consolidation efforts that reduced Italy's general government deficit following financial crises included strict fiscal targets, as well as borrowing and expenditure limits. The reinforced role of the central government in co-ordinating national and sub-national public finances reduced the fiscal autonomy of regional governments and related fiscal consolidation pressures forced regions to promote strategies targeted at enhancing performance and accountability. For example, the allocation of resources across regional and local governments has increasingly been based on standard costs, and improvements have been introduced in the standardisation and timeliness of accounting to monitor local financial developments and enforce budgetary discipline.[2]

Sizeable redistributive fiscal flows have cushioned regional disparities…

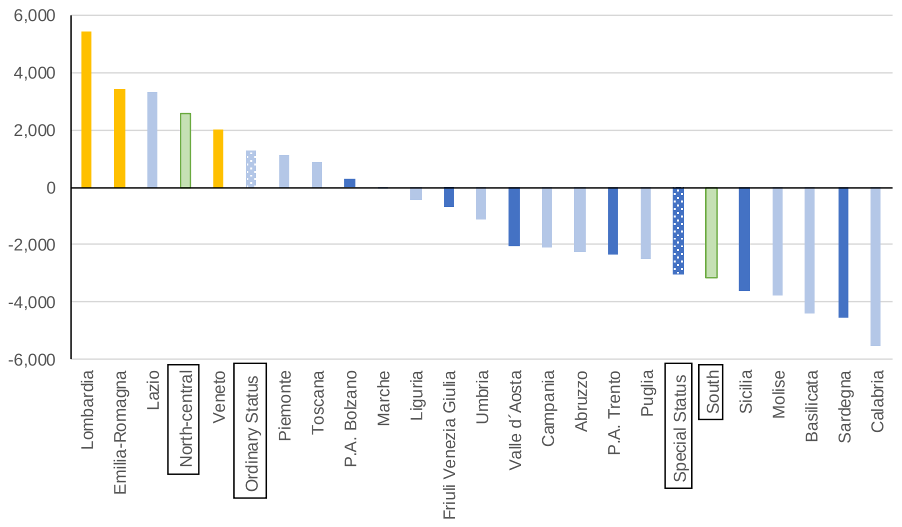
In view of large economic disparities among the Italian regions, however, maintaining stable balanced budgets at the regional level in aggregate terms has come via significant redistributive flows from wealthier to the weakest regions. By analysing differences in per-capita expenditures (excluding interest payments) and revenues referred to each region, Scope has identified which regions are net beneficiaries and which are net contributors (**Figure 6**). These flows derive from the fact that essential public services are offered on a universal basis and financed mostly via progressive taxation. So, while per capita expenses end up being similar across the nation, revenue collections are materially higher in the wealthier regions. As a consequence, excess revenue from wealthy northern regions finances the spending gap in southern regions.

[2] UpB (Ufficio parlamentare di bilancio), "Intergovernmental fiscal relations in Italy: Recent developments", Alberto Zanardi, December 2015.

… but increased pressure on wealthier regions to request more autonomy.

This sizeable redistribution of fiscal resources has contributed to increased pressures on wealthier regions to request greater autonomy and devolution of spending responsibilities. Lombardia, Veneto and Emilia-Romagna are all net contributors.

Figure 6: Redistributive flows: per-capita fiscal balances (expenditures minus revenues) by geographical area, euros, average values 2013-2015



Source: Bank of Italy - "L'economia delle regioni italiane, novembre 2017", Scope Ratings GmbH

$2 Institutional asymmetry, incomplete decentralisation and frequent conflicts in the allocation of responsibilities drive request for more prominent regional role in policymaking

Italian inter-governmental relations: halfway between a unitary and federalist state

The Italian Constitution qualifies Italy as a 'unitary' country, while recognising the principles of local autonomy and decentralisation. As of today, Italy is considered a 'regionalised' country[3]. More specifically, Italy is characterised by an asymmetric decentralisation, with 15 ordinary status regions (RSO) and five special status regions (RSS), the latter enjoying greater legislative and financial autonomy (Valle d'Aosta, Friuli-Venezia Giulia, Sardegna, Sicilia and Trentino-Alto Adige/Südtirol (the last divided into two autonomous provinces, P.A. Trento and P.A. Bolzano)).

Decentralisation process since 2001, targeting more regional autonomy…

The path towards decentralisation has been marked by the constitutional reform of 2001 and the fiscal federalism law of 2009. These targeted greater regional fiscal autonomy, efficiency and accountability while guaranteeing an adequate level of public services across the country. Since then, additional spending obligations have been funded via higher shares of national taxation, reducing central government transfers. As a result, Italy is one of the most unitary decentralised countries[4], entitling its regions to exclusive legislative powers with respect to any matter not expressly reserved for the State. Responsibilities include, among other areas, healthcare (by far the primary area of spending, which accounts for up to 80% of expenditures for normal-status regions), followed by transport, infrastructure and economic development and social housing.

… never completed, due to fiscal consolidation measures following crises.

However, the heavy involvement of regions in consolidation efforts following the financial crises brought the implementation of fiscal federalism reforms to a standstill. Stringent fiscal

[3] European Union, Committee of the Regions, Fiscal decentralisation or federalism, 2014
[4] OECD, Country profiles: regional facts and figures, October 2016

targets and cuts in central government transfers have been obstacles in the regions' abilities to exercise autonomy[5].

Frequent conflicts in the allocation of responsibilities between regions and central government persist

The interrupted federalisation process resulted in an unclear division of legislative responsibilities, which has often led to inter-governmental friction. The Constitution (Art.117) attributes some policy areas to the exclusive competence of the State and others to the shared competence between the State and the regions, while leaving non-specifically mentioned matters to the exclusive competence of the regions.

This division has, since its introduction with the constitutional reform of 2001, often failed to draw a clear cut-off line between State and regional responsibilities. As a result, numerous conflicts have only been resolved by the Constitutional Court. This has contributed to the political debate around redefining the attribution of legislative competencies between State and regions[6].

This topic was also part of the failed constitutional reform embedded in the Referendum of 2016, which planned to abolish "concurrent competences" (i.e. competencies shared by the regions and the national government), by recentralising their legislative responsibility in Rome. Currently, the direction of travel for clarifying this allocation is reverting back towards (asymmetric) decentralisation, centred around only those regions that request additional autonomy, and the competencies each region requests.

§3 Politics divided on the new devolution plans from the regions

Italian Constitution's "*regionalismo differenziato*" principle implemented

In the last few years, a new wave of federalism has spread, which could substantially reshape inter-governmental relations in Italy. Three regions (Lombardia, Veneto and Emilia-Romagna) initiated the process based on the so called "*regionalismo differenziato*" (i.e. asymmetric regionalism) principle, which refers to the possibility – provided for by the Constitution – to grant ordinary-status regions (RSO) with additional conditions of autonomy.

Indeed, according to Article 116, paragraph three of the Italian Constitution, Parliament is entitled to allocate to regions additional specific conditions of autonomy, based on bilateral agreements between the Central Government and interested regions. This possibility was legislated by the constitutional reform of 2001, but, so far, never applied. This additional decentralisation of power to regions may involve a wide set of up to 23 policy responsibilities, which can range across education, infrastructure, social protection, etc.

Lengthy political process for obtaining additional competencies

The process (**Figure 7**) of obtaining additional competencies starts with the initiative of an interested region, which may decide to hold a referendum to consult the will of the local citizenry. What follows is a phase of negotiations with Central Government to define the range and funding of additional competencies. The Central Government then submits draft legislation to Parliament to adopt a bilateral agreement undersigned by the concerned region for final approval.

Standstill after drafts of bilateral agreements were presented to the central government

After preliminary agreements were signed last year, Lombardia, Veneto and Emilia-Romagna carried forward negotiations with the new central government, broadening the set of policy areas to be transferred and specifying their financing mechanisms. In mid-February, updated drafts of bilateral agreements were presented to the central government for approval. Lombardia and Veneto have requested devolution of the maximum allowed 23 additional competencies, while Emilia-Romagna requested 15.

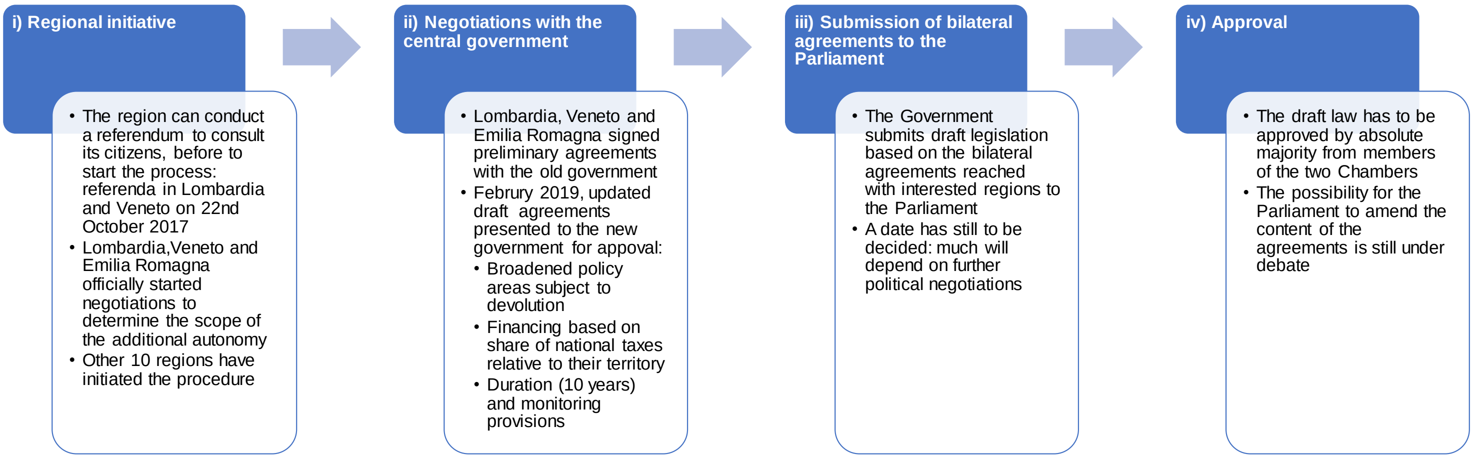
New attributed functions would be funded through a larger share of national tax revenues. The initial allocation would be based on historical costs, namely replacing existing spending

[5] Ibidem 2
[6] Servizio studi del Senato, Il processo di attuazione del regionalismo differenziato, febbraio 2019

of the central government. After a five-year period, allocation of resources would instead depend on standard costs, i.e. real financing needs as calculated on the basis of sociodemographic characteristics of each territory, upon which the government and the regions would have to agree.

Next steps would entail the approval of the agreements by the national parliament. A date has still to be determined and will depend on the disentanglement of the complex political dynamics that surround this topic. Indeed, in view of the interregional redistribution carried out by the public budget, the fact that the three regions are among the wealthiest in Italy raises significant concerns regarding the impact the granting of more autonomy could have on other regions, as well as on the central government itself.

Figure 7: The process for obtaining additional competencies



Source: Scope Ratings GmbH

Contrasting interests in the central government

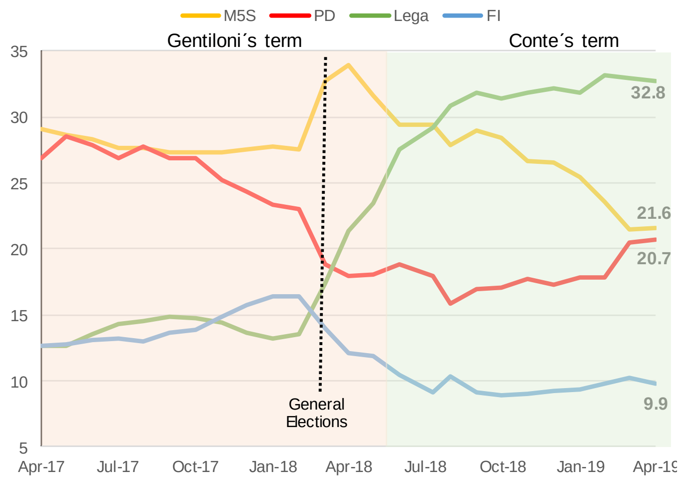
The official presentation in the *Consiglio dei Ministri* of the draft bilateral agreements last February represented a crucial step in the implementation of the process. In addition, the “*contratto di governo*”, namely the pact upon which the two governing parties, Lega and the Five Star Movement, built their alliance following March 2018 general elections, explicitly provides for the implementation of *regionalismo differenziato*. This process, however, is likely to affect multiple conflicting interests going forward.

The results of the latest general elections depicted a deeply fragmented nation: the North under Lega’s rule, and the South bolstering the Five Star Movement (5SM) (**Figure 8**), suggesting that the two parties may be on opposite sides of the debate concerning regional autonomy. The sharp increase in Lega’s support since last summer at the expense of the 5SM, as shown in polls (**Figure 9**), may foster conflicts between the two parties, especially in view of next month’s European elections.

Figure 8: March 2018 general election results, winning coalition by region

Source: La Repubblica

Figure 9: Polls by party, April 2017 - April 2019



Source: Various polling companies, Scope Ratings GmbH

Contrasting interests within Lega

Diverging political interests may arise within Lega itself. The governors of Veneto and Lombardia are members of Lega, yet their interests may clash with those of the party at the central government level. Indeed, nowadays, the party is seeking support from the whole of the country and differs significantly from its past regional, secessionist identity, when its name was the "Northern League". Moreover, the recent electoral successes, with Lega winning several regional elections in southern regions (Abruzzo, Sardegna, Basilicata), may become a double-edged sword, creating internal conflicts in which northern regions – Lega's traditional stronghold – request autonomy, while southern regions – where Lega is building its support – fear the negative consequences on their spending abilities.

Opposition from southern regions

Political pressure will arise from southern regions, which fear being disadvantaged by the process. For instance, the Campania region explicitly expressed its concerns on the fact that the autonomy process started by Lombardia, Veneto and Emilia-Romagna could translate into an unequal redistribution of resources among different territorial areas.[7] In addition, the president of the Calabria region expressed similar concern in a recent interview with the Italian newspaper Il Sole 24 Ore[8].

European elections to tip the balance in the negotiation process

Considering the factors and procedures presented, the resolution of the devolution question will be complicated. Success by Lega at upcoming European elections, as current polls suggest, would put pressure on its leader Matteo Salvini to continue with the devolution process. This also takes into account Salvini's relations with major co-party allies Attilio Fontana (president of Lombardia) and Luca Zaia (president of Veneto).

§4 Three key aspects to monitor

As highlighted by Scope's updated sub-sovereign methodology[9], the institutional framework under which sub-sovereigns operate is of primary importance when evaluating their creditworthiness[10]. Revenue rights and expenditure responsibilities of sub-sovereigns, as well as fiscal relations between government tiers are determined by the institutional

[7] Ibidem 6
[8] Donata Marrazzo, Sole 24 Ore, Interview with Mario Oliviero, president of Regione Calabria, "L'autonomia in Calabria e'un danno ulteriore", 25 febbraio 2019
[9] Link to Scope sub-sovereign methodology (15 March 2019)
[10] In this research piece, Scope focuses on the consequences of the reform on the institutional framework of the Italian regions; in a rating exercise, Scope's sub-sovereign methodology would complement the institutional framework assessment with an analysis of the individual credit profile of each specific region, based on a qualitative and quantitative analysis of: i) the debt burden and liquidity profile; ii) budget performance and flexibility; iii) economy and social profile; and iv) the quality of governance.

framework. Therefore, the framework affects: i) the ability of the central government to exercise oversight over local and regional finances, and related to this, ii) the ability of individual sub-sovereign governments to maintain fiscal sustainability.

The devolution plans would weaken the level of integration between the regional governments and the central government, and at the same time, impair the former's budgetary performance, especially for those regions with a weak economic and governance profile. The result could lead to greater credit-risk differentiation between regions.

Three key aspects

Three key aspects will be crucial in determining how devolution reforms, if implemented, might affect Italy's institutional and fiscal frameworks.

Clear allocation of responsibilities between central and regional governments

The first element to be monitored in the subsequent phases of devolution negotiations concerns the allocation of policy responsibility between the State and regions. As noted, the current framework sees frequent inter-governmental conflicts, caused by an unclear distribution of competencies among the different government levels. In this sense, a reform targeted at better identifying the varying competencies would strengthen central and sub-national governmental ties and foster efficiency in public-service provision and accountability.

However, it remains unclear at this stage to what extent regional governments might be better equipped than the central government at administering service provision in the relevant policy areas, considering economies of scale and management competencies at the central governmental level. These considerations are particularly relevant in the context of pronounced regional disparities.

In addition to Lombardia, Veneto and Emilia-Romagna, 10 other regions have started the procedure of *regionalismo differenziato*. Seven would be in principle ready to start official negotiations with the central government; three are in a preliminary phase[11]. Since each region may request greater autonomy in a different set of policy areas, the resulting institutional framework risks being subject to further conflicts in the allocation of competencies. In Scope's view, the resulting picture lacks clarity and potentially includes overlap in terms of the management of relevant public services, as well as their funding and accountability.

Spending powers and redistribution of resources

The second crucial element to be monitored is the allocation of the necessary resources to carry out the new competencies. In principle, the allocation should be fiscally neutral, with the initial allotment of resources matching as a share of national taxes what the government is currently spending for the same services, and later based on standard costs. This framework might foster efficiency, since regions would be incentivised to improve their service provision, to retain the extra resources saved in their territory.

However, in the context of the Italian regional fiscal framework, financing of the new responsibilities has to be carefully calibrated to ensure equity in basic public services over the whole national territory. In our view, a potential risk is that the allocation of resources will remain based on the share of national taxes anchored to the actual historical costs. The regional tax revenues relative to this share are, however, likely to increase more rapidly in the three regions than they are in the rest of the country, as they are among the wealthiest so would, over the long run, enjoy more resources to finance their spending than other regions.[12]

[11] Ibidem 6
[12] Massimo Bordignon, *La posta in gioco con l'autonomia del Nord*, lavoce.info, 15.02.2019

Fiscal discipline and public finance co-ordination

The third aspect to be monitored relates to the regional framework's track record of resilience, including during crises, when regions bore a large part of the demands for overall fiscal consolidation. It is Scope's view that sizeable fiscal flows between sub-sovereigns, coupled with strict central government oversight over sub-sovereign finances, have led to regular budgetary surpluses at aggregated local and regional levels. This has contributed to Italy's significant track record of general government primary surpluses since 2000, except in 2009, supporting the country's public debt sustainability.

In view of the economic significance of the three regions requesting more autonomy (whose budgets together amount to around EUR 70bn[13]), this alone could potentially translate into a loss of control by the central government over sizeable shares of its revenues and expenditures. As of today, special status regions are in general small territories.

However, should other large and wealthy regions follow the examples of Lombardia, Veneto and Emilia-Romagna and request greater autonomy, the potential impact could be a significant loss of power for the central government in public finances, thus undermining Italy's overall fiscal framework.

This is amplified by the fact that total Italian sub-sovereign expenditures account for around a third of the country's total government expenditure. Therefore, depending on the final outcome of devolution negotiations, the country's primary balance and thus public debt sustainability dynamics may also be affected, with potential implications on the sovereign rating of Italy (BBB+/Stable).

[13] OpenBDAP, Bilanci di Rendiconto 2017 of Lombardia, Veneto and Emilia-Romagna

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