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FISCAL FEDERALISM IN THE CONTEXT OF PUBLIC FINANCE

Introduction

Globalisation requires new models of public finance that allow economically developed countries to compete in the challenge for efficiency that plays and will play more and more in the future a central role in economic development.

In the context of public finance a country's taxation plays such a vital role that we can say an individual's choice of residence and a company's choice of domicile are heavily influenced by level of taxation.

In substance, in an attempt to minimise costs, companies, but also private individuals, attach great importance to the cost of taxes. Fiscal policies thus become one of the public finance tools that are able to influence individual behaviour and to attract resources, setting off a positive cycle of increasing wealth for the country.

Italy experienced uninterrupted rapid economic growth since the end of the Second World War until the global economic crisis of 2008, accompanied by a gradual growth in the tax burden and, paradoxically, in the national debt. However, this did not affect the country's international credibility as it was compensated for by the population's propensity to save.

From the end of the war until the 1970s the Italian tax system was characterised by a dual tax system, national taxes and local taxes. In the 1970s Parliament passed a tax reform that gave almost exclusive control over tax collection to the central government, due to the general incapacity of local authorities to collect taxes. Local authorities were given limited autonomy over deciding how to spend public money.

This brought about a certain degree of simplification in tax compliance and greater transparency regarding collection, but it also led to a gradual increase in the tax burden, to the point that Italy now has one of the highest tax burdens in the European Union. On the other hand, as local authorities are no longer held responsible for taxation, they have greatly increased their spending, leading to a huge increase in public spending and thus of the national debt.

This has forced a cultural change in fiscal policy models and, helped the push for autonomy by the richer regions of the country, there has been a growth in demand for tax autonomy, alongside financial autonomy.

In essence, the introduction of a new taxation system in Italy “FISCAL FEDERALISM” is now considered unavoidable.

Fiscal federalism is not just a technicality; it is first and foremost a media message, which accordingly will bring greater prosperity and economic growth, as a result of decisions and choices made by local communities, which will be able to decide autonomously the level of public services they want and, consequently, the amount of tax to pay in order to finance these services.

The Italian Constitution provides for a federal type of government but this has not been widely implemented. Moreover, we should remember that an institutional structure that enhances the functions of local authorities can be identified with the European model of regionalist federalism based on the principle of *subsidiary*, as laid down in art. 3B of the Maastricht Treaty. This article states that the State shall act only in matters regarding which subordinate bodies, within the scope of their competences, cannot take decisions and act effectively. Priority is thus given to the role of fundamental communities within society (the family, the community, regions) over the central authorities.

The principle of subsidiary, moreover, can be traced back to Europe’s and Italy’s Christian roots and the social doctrine of the church, laid out in the 1931 encyclical *Quadragesimo anno*, reiterated in the 1961 encyclical *Mater Magistra*, and more recently in *Caritas in veritate*. This doctrine holds that freedom and sense of responsibility are values that originate in the individual, considering his/her natural propensity for a life of association which must not be repressed by higher political bodies.

Reform of Title V of the Constitution

There has been growing “demand” for fiscal decentralization, motivated not so much by the need for a more efficient allocation of resources (through the differentiation of the “supply” of public services according to the preferences of citizens-users), as by the desire to satisfy the push for autonomy from the richer areas of the country (particularly the North), which feel (and not without some justification) that resources they pass on to the state in the form of taxation are used, often in an inefficient manner, to fund economically weaker areas of the country¹. This pressure has achieved some results with the reform of Title V of the Constitution, which represents a new scenario, both in terms of content and of “**underlying philosophy**”. **Significantly, this reform turns the institutional pyramid upside down, stating that the Republic is made up of Municipalities, Provinces, Metropolitan Cities, Regions and the State, specifying that the Local Authorities** indicated in the Constitution are autonomous and that their autonomy can be exercised through functional articulation governed by their own statutes, powers and functions according to the principles laid down in the Constitution.

¹ Cfr. M Rey: *La scelta della materia imponible da decentrare agli Enti locali, con particolare riguardo al settore immobiliare*, in *La Finanza Locale*, 1994, pp. 86.

Fiscal federalism in the technical sense is dealt with in art. 119 of the Constitution, which provides for the financial autonomy of the Municipalities, Provinces, Metropolitan Cities and Regions. In Italy this autonomy has traditionally been exercised regarding expenditure, rather than from the tax collection point of view.

The ultimate aim of the institutional framework set up with the reform of Title V of the Constitution is that of achieving full scale financial autonomy of Local Authorities, a principle that is clearly stated in **art. 119 of the Constitution, which expressly indicates that the resources assigned to Local Authorities allow them to fully finance the functions they are required to fulfil.**

With regard to the resources controlled by Local Authorities, alongside the taxes they collect directly and those they share with the State, a very important role is also played by **an equalization fund set up by the State, with no restriction of use, for those areas with lower tax collection potential.**

This means that a principle of so-called vertical equalization is introduced, as the costs are sustained by the State, thus seemingly abandoning the alternative of combining it with horizontal equalization, which would have better fulfilled the principle of economic solidarity, which is one of the characteristics of a unitary State.

It also seems very evident that such a mechanism of equalization does not resolve the problem of the so-called “dual” economy characterising Italy, in which some Regions – particularly those in the North – have average per capita incomes among the highest in Europe and Regions with average per capita incomes similar to those in the Eastern European countries that joined the EU on 1st May 2004.

Nor does it seem to us that this problem can be solved by the provision of art. 119 of the Constitution whereby the State can provide additional resources and make special interventions for particular Municipalities, Provinces, Metropolitan Cities and Regions in order to promote their economic development, social cohesion and solidarity, to remove economic and social imbalances, to encourage the effective exercise of individual rights, or to provide for purposes that are not part of their normal functions.

Passage of Law n.42, 5 May 2009

Following the reform of Title V of the Constitution, the next step was the passing of Law n. 42, 5 May 2009, which enacts the principles for the reform of Title V of the Constitution. In reality, this law requires the Government to issue numerous decrees within two years in order to complete their concrete enactment.

The enactment of federalism should create greater competitiveness in the Italian tax system, so as to reverse the trend of delocalisation of firms that has characterised the industrial economy over the last decade and help to attract resources on the international financial markets.

From a socio-political viewpoint the choice of a federal system over that of a centralised system has been justified by a series of reasons that can be summed up as follows:

- a) **efficient allocation of resources**, since there is an important incentive to efficiently allocate resources when those that benefit from a public service are the same people that pay for it through taxation;
- b) greater **assumption of responsibility by local administrators**, who can only spend money on programmes that are approved by the citizens;
- c) **reduction of wasteful public spending**, especially through the setting of standard costs for public services which must also be adhered to by less efficient regions, thus avoiding waste;
- d) **reduction of tax evasion** thanks to fact that local communities are better able to control this phenomenon and thus bring about an increase in overall tax collection rates;
- e) achievement of the so-called **benefit principle**, according to which a citizen pays in relation to the services supplied by Local Authorities, rather than using the criterion of sacrifice, which requires richer people to pay more tax, with the potential for waste by those who do not pay but benefit from public spending just the same (free riders);
- f) **greater democracy in the choices made** by individuals belonging to the collectivity, since the State is no longer superordinate to the regions and the smaller the community is the more democratic the criteria for making choices become;
- g) **greater tax competition** among local authorities and thus greater efficiency in public service management. Regional governments behave like companies in competition with one another and offer products (public services) of better quality at lower prices (taxes) in order to attract citizens, businesses and residential developments and any other potential source of tax revenue to their area.

Alongside these positive aspects, the introduction of fiscal federalism could bring with it risks that need to be adequately evaluated.

Many experts believe that federalism may lead to an increase in the tax burden because local taxes will only partially replace national taxes, since the need to finance public expenditure often leads to an overlapping of tax collection.

Moreover, we must not underestimate the risk that fiscal federalism will increase the gap between the richer and poorer regions. Indeed, in a country with large differences of resources, both in terms of income and wealth, the gap tends to grow wider and thus the poorer areas could end up in a Catch-22 situation: on the one hand fewer resources as the inevitable result of the local economic situation and on the other the impossibility of raising local taxes that are incompatible with constitutional or European regulations, but necessary to provide funding for a minimum level of public services.

Therefore, without an effective equalization mechanism, which needs to be supplied by the State, the economic gap will continue to grow and the number of young people emigrating from the poorer regions to the richer ones will rise steeply.

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Summary

In the context of public finance a country's taxation plays a vital role that we can say an individual's choice of residence and a company's choice of domicile are heavily influenced by the level of taxation.

Fiscal federalism is a new model of public finance that allows economically developed countries to compete in the challenge for efficiency that plays and will play more and more a central role in its future economic development.

From a socio-political viewpoint, the choice of a federal system over that of a centralised system has been justified by a series of reasons that can be summed up as follows: a) efficient allocation of resources; b) greater assumption of responsibility by local administrators; c) reduction of wasteful public spending; d) reduction of tax evasion; e) achievement of the so-called benefit principle; f) greater democratic choices; g) greater tax competition among local authorities.

Alongside these positive aspects, the introduction of fiscal federalism could bring with it risks that need to be adequately evaluated. For example an increase in the tax burden and the risk that fiscal federalism will increase the gap between richer and poorer regions.

Therefore, without an effective equalization mechanism, which needs to be supplied by the State, the economic gap will continue to grow and the number of young people emigrating from the poorer regions to richer ones will rise steeply.

The aim of this paper is to discuss the effect of fiscal federalism on Italy.