ALLEGATO N. 4

FISCAL FEDERALISM: OECD POLICY ADVICE

This note summarises the general assessment of trends and recommendations in the area of fiscal federalism in OECD member countries, as well as recent recommendations for Italy, based on the *Economic Survey* published in 2009.

Advantages of a decentralized tax system (federalism)

Advantages of a decentralized tax system can be summarized as follows:

- Citizens' perceptions about differences in tax rates tend to make governments more responsive to their tastes and preferences, thus improving resource allocation

- It tends to improve budget management efficiency as citizens become directly aware of the costs of publicly funded activities. Some authors have found a smaller size of SCG governments under tax competition conditions (Rodden(2003), Fiva (2006), Sorens (2008)

- Tax decentralisation also promotes democratic accountability, since those who benefit from public services decide on taxation levels and finally pay the bill.

- Tax decentralisation provides SCGs with incentives for growth-oriented economic and fiscal policies, since they may fully reap their financial benefits

- It could reduce disparities when smaller jurisdictions could benefit from capturing tax bases from neighbours bigger jurisdictions.

Challenges in fiscal federalism in OECD member countries

OECD analysis indicates that there are lessons to be learnt from country experiences on how to improve inter- and intra-governmental fiscal relations. In particular:

- **The main benefit of fiscal decentralisation is a tighter alignment between the provision of public goods and services and the population's preferences and needs**. Since subnational governments are closer to the people, they can in principle extract information of local preferences and needs more cost-effectively than the central government.

- **The vertical structure of government varies considerably among OECD member countries and is rooted in history**. It is thus not easy to replicate the incentive structures of one country in another.

- **The sub-national share of spending has been rising faster than the corresponding revenue share, with an increasing volume of intergovernmental grants making up the difference**. These trends do not necessarily reflect greater local autonomy, as central governments increasingly impose norms, minimum quality standards, and fiscal rules to ensure national conformity.

- **The assignment of spending responsibilities to sub-national jurisdictions necessitates a continuing assessment of spillover and scale-economy problems**. Various co-operation and joint-provision expedients are being adopted, but the problems have yet to be fully overcome.

- **Matching revenue resources to spending responsibilities is one the most challenging issues of intra-governmental fiscal relations**. With own-tax resources likely to remain limited, the design of intergovernmental grants and transfers is critical for efficient sub-national service delivery. Better alignment of policy objectives between donors and recipients remains the main challenge in the design of intergovernmental grant systems.

- **There is scope for improving sub-national fiscal discipline, with fiscal rules having an important role to play**. But many of the problems of reconciling sub-national fiscal autonomy with national (or supra-national) co-ordination have yet to be solved.

- **Sub-national governments have been affected by the global crisis, especially through higher spending and lower tax revenue**. Most national governments are helping local and middle-tier governments to cope with the crisis, by disbursing additional grants and supporting investment programmes. A better coordination in intergovernmental fiscal relations could be conducive to greater fiscal discipline in the light of increasing pressure for fiscal consolidation across levels of government.

Recommendations for policy reform in Italy

Background

- **A draft law on extending further spending and revenue responsibility to the regions, as foreseen in 2001, was passed in April 2009**. The law sets out a fairly clear blueprint for how to allocate tax revenues to levels of government and includes a sketch for a system of revenue equalisation. However, the definition of standard costs and guidelines on revenue sharing will be issued in subsidiary legislation.

- **The idea is to allocate central funding from national taxes to cover the "standard costs" of providing the centrally defined "essential levels" of services**. This would cover spending responsibility delegated for programmes which are subject to national definitions of objectives, notably in health care, social assistance and education.

- **Revenue equalisation is to be based on compensating the poorer regions for their lower revenue-raising potential, based on variation in the per capita tax bases for income tax**. Similarly, "fundamental functions" devolved to the provincial and municipal governments, would be guaranteed through central funding from national taxes based on the evaluation of standardized spending needs (corrected to take territorial peculiarities into account) and an equalisation mechanism is foreseen.

General assessment

- **The basic lines of the law on fiscal federalism are sound**. Using a standard cost approach, which focuses on financing output targets rather than resource inputs, is essential to ensure that sub-national governments have incentives to improve spending efficiency. But, as in the case of education (reviewed in depth in the *Survey*), where the final choice of which kind of expenditure will remain a central responsibility has yet to have been clearly defined, the definition of output will require difficult choices.

Key recommendations

- **The definition of "essential" expenditure should be carefully defined to match national policy targets and be stable over time**. Variation in local circumstances also needs to be carefully taken into account. The intention to phase in implementation should help to minimise the difficulty of adjusting to the new system.

- **Stability over time, along with transparency, is also important for the revenue sharing mechanism**. A new local tax, partly based on the value of the housing properties, would be highly desirable from the point of view of fiscal federalism.