SENATE OF THE REPUBLIC

FIRST STANDING COMMITTEE

Fact-finding with regard to the effects on the legal system of the amendments to Title V of Part II of the Constitution

Statement by the Governor of the Bank of Italy

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The experience of most of the advanced nations with a federal system shows a shift in the course of the last century from the typical federalism of the liberal State, based on the self-sufficiency of the State and local authorities, to a cooperative form of federalism, characterized by the prevalence of "collaborative models". In many systems, including the Swiss and the German, legislative choices are made centrally and implemented locally.

In both the liberal and the collaborative models the State is always assigned the functions of general interest.

It should be noted that implementing federalism is independent of the notion of Federal State.

During the last few decades, both in Italy and in other countries, there has been increased decentralization of taxation and expenditure responsibilities. There are essentially political reasons for this process, which is supported by economic theory but which requires all local governments to be reasonably efficient in order to bring any benefits.

By assigning the management of each public service to the level of government closest to the area where the service is provided, supply is more responsive to user preferences. Citizens can exercise greater control over the behaviour of public administrators and competition between local governments may be stronger, to the benefit of the citizens themselves. There is also an increase in the technical efficiency of the public sector.

The full achievement of these advantages requires that decentralization should not segment the domestic market.

The stability of monetary and financial conditions is a public good falling under the responsibility of the State. The same can be said as regards effective counter-cyclical economic management.

All the decentralized entities must work together to achieve stability by keeping their budgets basically balanced. In the absence of effective control mechanisms, each entity could try to profit from the benefits produced by the disciplined behaviour of the others without making any contribution itself.

It is necessary to have budgetary rules applying at every level of government.

There must be a very close relationship between responsibility for expenditure and responsibility for funding; this presupposes that every level of government has adequate tax bases.

Decentralization must be combined with forms of solidarity designed to reduce the disparities between the various areas.

International experience has shown that local governments can generally borrow, but there are rules setting a limit to the overall deficit and restricting the use of loans to certain purposes. There is a fairly widespread use of mechanisms that redistribute resources across the country.

1. Decentralization in Italy

The republican Constitution of 1948 placed great emphasis on the Regions, five of which were granted a high degree of autonomy under special statutes.

The institution of the ordinary statute Regions was only achieved in the 1970s. The transfer of functions to the Regions began in 1972 and was completed in 1977. As part of this process, the possibility provided for in Article 118 of the Constitution of delegating some regional functions to Municipalities and Provinces was also implemented.

The tax reform of the early 1970s led to the centralization of tax collection at the State level. With the 1978 reform, most of the functions regarding health care were delegated to the Regions.

Consequently, the structure of Italian local finances came to be characterized by a high degree of centralization of revenue accompanied by a significant decentralization of expenditure.

Local government expenditure grew from 11 per cent of gross domestic product in 1970 to 13.1 per cent in 1980 and 14.8 per cent in 1990. At the same time, local government expenditure increased as a proportion of general government expenditure. Local governments' own revenue did not vary significantly; in 1990 it was still equal to 2.8 per cent of gross domestic product.

State transfers totaled 5 per cent of gross domestic product in the mid-1970s; in 1990 they had risen to 10 per cent.

During the 1980s, four-fifths of regional budget revenue consisted of State transfers. Most of this revenue was earmarked and destined to pay for health care. The expenditure of Provincial and Municipal authorities was concentrated on transport, education, culture and social action.

Between the late 1980s and the early 1990s, the persistence of very large public-sector deficits brought growing awareness of the need to increase the responsibility of local administrators with regard to both the management of services and their funding.

Innovations in the electoral system created a more direct relationship between local authorities and their electors, which helped to encourage the reform of local government finances.

Under Law 142/1990, Municipalities were granted all the administrative functions regarding their respective municipal territories and populations. At the same time a process was started to increase local authorities' powers of taxation. This included the introduction of specific new taxes, such as the municipal tax on buildings (ICI) and the regional tax on productive activities (Irap), and of surtaxes, for example that on personal income tax (Irpef), the rates of which could be modified by local authorities, albeit within strict pre-established limits.

Between 1990 and 2000, the ratio of local government revenue to gross domestic product rose from 2.8 to 7 per cent. This increase was basically due to the introduction of ICI in 1993 and Irap in 1998. The ratio of local governments' own revenue and expenditure increased from 19.1 to 52 per cent, but local governments' spending fell slightly in relation to gross domestic product. In 2000 Legislative Decree 56/2000 was passed and replaced most of the previous State transfers with co-participation in central government tax revenues, which for VAT is equal to 38.55 per cent.

2. *Amendments to Title V of the Constitution*

With the recent reform, Italy's institutional system has acquired some pronounced federalist features.

In the previous text of Article 114, the first article of Title V, local authorities were the elements into which "the Republic is divided"; in the new text they are among the constituent elements of the Republic.

The traits of federalism are evident in the reversal of the enumeration of the matters falling within respectively the jurisdiction of the central government and that of the Regions. In the 1948 Constitution the matters falling within the scope of the legislative power of the Regions were established expressly. In the new version, by contrast, the powers of the central government, exclusive and concurrent, are defined; all other powers are entrusted to the Regions.

The jurists who contributed to drafting the amendment to the Constitution and those who have testified here frequently referred to subsidiarity as the principle informing the new relationships between the various levels of government.

Under the principle of subsidiarity functions are allocated to the lowest possible level, where necessary entrusting higher levels with powers that supplement those of the lower levels.

The principle does not call into question the role and importance of the central government, which remains responsible for functions that cannot be performed at a lower level. The State is the ultimate guarantor of the general good, intervening in the matters within the powers of local governments only when the latter are unable to satisfy the needs of their local communities.

The first systematic, strictly juridical consideration of subsidiarity in modern times was that of Johannes Althusius in the seventeenth century. Althusius held that society was composed of a myriad of social bodies at different levels and was the product of a series of compacts concluded for the purpose of preserving the autonomy of each, yet not depriving them of the protection of those above them. The function of these compacts was to transfer to the "higher" levels that quantity of power strictly necessary to satisfy the needs of the members.

The principle of subsidiarity drew powerful impetus from the social doctrine of the Catholic Church. In the encyclical *Quadragesimo Anno*, in 1931, Pius XI asserted that "Just as it is gravely wrong to take from individuals what they can accomplish by their own initiative and industry and give it to the community, so also it is an injustice and at the same time a grave evil and disturbance of right

order to assign to a greater and higher association what lesser and subordinate organizations can do."

This line of thought is a central point of reference in the teaching of John Paul II. In 1991, in his encyclical *Centesimus Annus*, the Pope said: "Malfunctions and defects in the Social Assistance State are the result of an inadequate understanding of the tasks proper to the State. … a community of a higher order should not interfere in the internal life of a community of a lower order, depriving the latter of its functions, but rather should support it in case of need and help to coordinate its activity with the activities of the rest of society, always with a view to the common good."

In Title V the Regions, under the principle of subsidiarity, have become the "preferred level of legislation" for matters devolved to local authorities.

As for administrative functions, the principle is expressly recognized in the new text of Article 118 of the Constitution, which reads: "The administrative functions are assigned to the Municipalities save when, in order to ensure that they are exercised uniformly, they are conferred upon Provinces, metropolitan districts, Regions or the State on the basis of the principles of subsidiarity, differentiation and appropriateness."

Other significant innovations involve relationships with European Community law and with Italy's international obligations. As amended, Article 117 of the Constitution reads: "Legislative power shall be exercised by the State and by the Regions in observance of the Constitution and of the constraints deriving from European Community law and international obligations."

This wording is certainly intended to embrace the innovations that have been made in monetary arrangements and institutions.

Before the amendment to Article 117, Italy had no constitutional provision that expressly attributed "superprimacy" to laws deriving from the ratification of treaties.

The specific reference to the constraints deriving from international obligations would now seem to confer "constitutional" status upon treaties. Domestic laws ensuing from the implementation of ratified treaties are thus apparently superior in rank to ordinary domestic legislation. It follows that the legitimacy of a national law contravening the internationally derived rules arising from the ratification of a treaty could be subject to the scrutiny of the Constitutional Court. It further follows that amendments to such internationally derived rules not consequent on a revision of the treaty would require an instrument of Constitutional rank.

Article 117 of the Constitution carries implications for the relations between the Government and Parliament. Ordinary statutes passed by Parliament, which embodies the sovereignty of the people, are subordinated, *de facto*, to laws whose substance is determined in large part by the Executive.

The amendment of Title V carries major implications for the organization of the public sector. It affects the procedures whereby the public finances perform the tasks of resource allocation, cyclical stabilization and income redistribution.

Article 117 includes among the matters under the exclusive power of the central government, the "determination of essential levels of benefits and services in relation to civil and social rights that must be ensured throughout the national territory." Relative to this power, Article 119 establishes that "State law shall institute a redistribution fund, without any restrictions on how it is to be used, for the areas with lesser tax levying capacity" and that the central government may appropriate additional resources to Regions, Provinces and Municipalities "to

promote economic development, cohesion and social solidarity, to eliminate economic and social imbalances, and to assist the effective exercise of individual rights." Additional funds may be appropriated for the performance of specific tasks.

Financial independence, which the previous version of Article 119 reserved to the Regions "in the forms and within the limits set by the laws of the Republic", is now extended to all local authorities. Local authorities are no longer "assigned own taxes and shares of national taxes" but "have independent resources. They enact and collect taxes and enjoy own revenues … they share in the revenue from national taxes relative to their territory."

Article 119 establishes that own revenues and the redistribution fund must cover the full cost of the functions assigned to local governments. Borrowing is permitted "only to finance investment" and "any central government guarantee of loans is precluded".

Article 120 reaffirms the ban on adopting customs duties or other measures impeding the free movement of goods and persons.

The assignment of responsibility for monetary policy and for banking and market supervision to the central government is a constant of federal states. This is the case in the United States, in Switzerland and in Germany, as well as in some important emerging countries.

In the new Constitution of the Italian Republic, matters regarding "the currency, the protection of savings, financial markets, the safeguarding of competition, and foreign exchange" are reserved exclusively to the central government.

By contrast, matters regarding savings banks, rural banks, banks and real-estate and agricultural credit institutions of a regional nature are the object of concurrent legislation. The actual wording of the allocation of tasks does not appear to be consistent with the developments that occurred in the early nineties, i.e. the transposition of the Second EU Banking Directive and the passage of the 1993 Banking Law.

3. Implementing the new constitutional dictate. A framework law

The wording of Article 117 of the Constitution makes it necessary to specify the relationship between regional laws and State law that lays down fundamental principles, i.e. to clarify whether the Regions may exercise their legislative power even in the absence of a framework law on the matter.

A similar problem had arisen with the previous version of Article 117, which, like the new version, attributed concurrent legislative power on several matters to the ordinary statute Regions, laying down that this power was to be exercised "within the limits of the fundamental principles established by the laws of the State".

The experience of the special statute Regions had already demonstrated the need for a framework law, not least, according to an authoritative opinion, in order to "restore the certainty of law between the Regions and the central government, give the Regions a sphere of real autonomy, protect the Constitutional Court from political tensions that it naturally is not able to resolve."

Owing to contingent factors, such as the delay in adopting framework laws and the necessity of not postponing the reform further, the Regions were granted the power to legislate even without the fundamental principles having been established by the State. Law 281/1970 provided that concurrent regional

legislative power was to be exercised within the limits of fundamental principles either expressly formulated by laws for each individual matter or deduced from the laws in force.

The advisability or, rather, the necessity of a framework law is all the more evident in view of the implications of decentralization for the public sector and the economy. Various aspects require the definition of common rules ensuring harmonious action of the different levels of government, particularly as regards tax-levying powers, redistributive mechanisms, the budget constraint and accounting methods. Only by operating in this way will it be possible to create the conditions that will increase the efficiency of the public administration and induce conduct having a positive impact on the equilibrium of the public finances.

4. Banking

The currency, the protection of savings and the safeguarding of the financial markets and competition are matters of fundamental general interest whose importance for the nation's economy as a whole is enshrined in Articles 41 and 47 of the Constitution.

Some limited decentralization of rule-making and administrative functions with regard to banking was provided for in the case of some of the special statute Regions.

The new decentralization of banking-related functions to the ordinary statute Regions has to take account of the developments in banking, the financial markets and the legislation governing the sector.

The reform law, with specific reference to savings, confirms the continuing validity of the Constituent Assembly's decision to reserve the matter to the central

government so as to ensure the efficient allocation of financial resources within the country. In the proceedings of the Assembly we read that "savings must be invested where they are most useful and in greatest demand, where the best conditions are found for investment."

The decentralized functions lie within the realm of concurrent powers and so the fundamental principles established by the central government must be observed in this case as in others.

The formulation adopted by Parliament in the recent reform, which refers to "savings banks, rural banks, banks and real-estate and agricultural credit institutions of a regional nature", appears to be based on provisions regarding special statute Regions.

The dated nature of the texts employed as models has led to the use of an improper terminology that refers to categories of banks that no longer exist in the Italian legal system. If the constitutional wording cannot be amended, the implementing legislation will surely have to remedy this obvious incongruence.

The experience of the special statute Regions is not likely to offer useful points of comparison. The attribution of tasks to these Regions was grafted onto a legal order — that of the 1936 Banking Law — that has long been outdated. It delineated a controlled and segmented market characterized by scant competition, international closure, the sectoral and territorial specialization of intermediaries and public-sector ownership of the main credit institutions. Special credit, in particular, was a privileged channel for directing credit flows to sectors of the real economy and areas of the country indicated by governmental authorities.

Accompanying this was administrative and structural supervision based on the instrument of authorization and extending to important operating decisions, such as large loans, as well as to intermediaries' geographical expansion. The latter was the principal matter over which the special statute Regions had authority.

With the implementation of the Community banking directives and the passage of the 1993 Banking Law, the construction of the single European market in banking was completed. The entrepreneurial and competitive nature of banking was established for good, and responsibility for supervision was definitively attributed to the country where a bank had its registered office.

Freedom of establishment and the freedom to provide services preclude the possibility of individual member states limiting establishment and engagement in business on the part of EU banks.

Supervision has evolved in parallel towards a technical and prudential approach centred on the verification of sound and prudent management and the establishment of general rules that are neutral with respect to intermediaries' organizational and operating decisions. The scope of authorization has been drastically reduced and the related decisions are made on the basis of rigorously technical evaluations.

These important changes find expression in Article 159 of the 1993 Banking Law, which defines the powers of the special statute Regions. The Constitutional Court, called on to review Article 159, has confirmed its legitimacy. The Article reserves supervisory evaluation exclusively to the Bank of Italy, makes the measures issued by the regional governments subject to approval by the Bank of Italy, and identifies specific provisions of law from which regional legislation may not derogate. Emblematic is the change in the rules on the opening of bank branches, now substantially liberalized and expressly excluded from the scope of decentralized authority.

Article 159 reflects the altered context of institutions and markets.

Starting from Article 159, the framework law must now regulate the legislative powers of the ordinary statute Regions, preserving the consistency of the domestic legal system and the effectiveness of supervisory action.

The framework law must clearly and precisely determine the fundamental principles governing the regional legislative function, with the aim of preventing conflicts between the central government and the Regions.

In order to avoid a proliferation of different, mutually inconsistent notions, the framework law must first of all introduce a single definition of "regional bank". The requisite notion has to be based on parameters indicating a close link between a bank's operations and the Region in which it is established. A definition based only on the location of branches within the territory of a Region would be anachronistic in today's context of markets that are fully globalized and technologically integrated.

In deposit-taking, lending and providing services, traditional bank branches are now flanked by networks of financial salesmen, telephone and online services. Intermediaries avail themselves of remote access to the interbank and financial markets and to payment systems organized by means of domestic and international electronic channels.

The new configuration of the financial system requires that all the measures directly or indirectly aimed at promoting the "sound and prudent management of the persons subject to supervision" remain reserved to the national banking authority, so as to ensure effective and prompt supervisory action, taking account of the unitary responsibility for the credit function repeatedly upheld by the Constitutional Court.

These measures concern aspects directly linked to the protection of savings, for which the central government has exclusive authority even under the new formulation of Article 117.

5. The public finances

The general approach to decentralization — with reference to the definition of powers, the provision for a high degree of autonomous taxation and adequate redistribution mechanisms — creates the conditions for a more efficient public sector. In this respect it is crucial that rigorous budgetary constraints be adopted and observed.

"The harmonization of public budgets and the coordination of the public finances and the tax system" are matters covered by concurrent legislation; Article 117 assigns the power to legislate to the Regions, while reserving the task of laying down the fundamental principles to the central government.

5.1 Autonomous tax-levying powers

It is necessary to define the responsibilities of each level of government clearly, so as to be able to establish the resources needed with certainty and decide the role to be played by taxes payable directly to local authorities, the local surcharges applied to taxes collected by the central government and transfers from the central government budget. It is essential that the first two types of revenue should provide a significant share of local authorities' total resources.

Autonomous taxation must not be an obstacle to the growth of the country's economy. Excessive fragmentation of the tax system can be an impediment to the free circulation of persons and goods. It is necessary to establish in advance the taxes that local authorities can impose. Taxpayers must not be faced with a plethora of new bureaucratic formalities.

Harmful forms of fiscal competition must be avoided. Defining minimum levels of service will help to ensure the availability of public services that meet citizens' needs.

5.2 Redistribution mechanisms

The redistribution fund is an innovation compared with the existing text of the Constitution. Elements of solidarity are introduced to counterbalance the tendency implicit in federalism for differentiation to become more pronounced.

There are two possible models for redistributing resources among local authorities: the vertical model, which redistributes taxes accruing to the central government, and the horizontal model, which uses resources provided by the economically stronger local authorities.

The vertical model prevailed for a long time in Italy. Legislative Decree 56/2000 has introduced a model of redistribution with horizontal features.

The new text of the Constitution does not specify which model is to be used in future. It is essential that the amounts to be redistributed should be established *ex ante* and take account of the different levels of taxation. It is necessary to ensure that expenditure does not exceed the resources available and that central government is not called upon to make good the shortfalls.

The redistribution fund cannot prevent the gaps between the per capita resources available in the various Regions from widening. Differentiating the production costs of public services would make it possible to reduce the related quantity and quality disparities.

5.3 Budgetary constraints

It is necessary to reaffirm the joint responsibility of all levels of government for preserving the stability that is the key feature of the architecture of the European Union's economic policy.

The European rules basically require budgets to be balanced after adjusting for the effects of the economic cycle. The rules refer to the accounts of general government as a whole, but it is the central government that is responsible for seeing they are observed.

The lack of symmetry between the distribution of national powers and the allocation of responsibility established at the European level may result in local authorities having an incentive to behave opportunistically, by overspending and leaving it up to the central government to correct the consequent imbalances.

This would preclude proper use of the scope for implementing stabilization policies under the Stability and Growth Pact.

The Domestic Stability Pact introduced in 1998 is intended to make the budgetary choices of local authorities compatible with the objectives at the national level. The system needs to be improved further, *inter alia* in the light of the amendments to the Constitution.

It is necessary to establish the principle that each entity must balance its budget net of investment expenditure. For local government finances as a whole, precise limits must be set on expenditure on capital account financed by market borrowings. Two thirds of the Regions' revenue comes from taxes, such as VAT, the regional tax on productive activities, personal income tax and sales taxes on energy products, receipts of which depend heavily on the level of economic activity; flexible mechanisms are needed to counter the effects of the business cycle. These could be central government transfers or withdrawals from previously established reserves that would be determined, within given limits, on the basis of the performance of the main macroeconomic variables using a predetermined formula. The possibility of making compliance with the budget constraint a condition for financing investment with borrowed funds should be considered.

As regards the distribution among the various entities of the total deficit permitted for investment purposes, a cooperative method appears preferable. Decisions would be taken in a multi-stage process, moving from the regional to the

municipal level. The limitation of resources and the competing interests of the potential beneficiaries might contribute to increasing the attention paid in evaluating the projects to be financed.

To comply with the European rules, the amounts local authorities can borrow must by offset by a larger central government surplus.

The State could influence the allocation of resources to projects of national interest by matching the funds invested locally only for such works, in conformity with the new text of Article 119.

5.4 Reporting systems. Local government statistics

The application of the redistribution mechanisms provided for in the new text of the Constitution requires a common set of accounting rules.

The harmonization of accounting standards does not limit the autonomy of the Regions. The adoption of rules of disclosure and common methods of reporting is not a diminution of autonomy but a necessary condition for its legitimation, as is also the case outside the public sector.

Local authorities' accounts are not homogeneous, complete or timely today. The transparency of the financial situation of general government is reduced; the market's evaluation of the results of individual entities may suffer. The observation of deficits on the financing side carried out with reference to the change in authorities' financial liabilities gives the overall balance of the public finances but it does not allow the determinants to be analyzed; there is a danger that it will not be possible to correct trends that are likely to increase the deficit.

The services provided by local authorities account for more than half the public sector total and are equal to about 10 per cent of GDP. It is essential that the accounts of the public sector be supplemented by statistics on the type, quality and quantity of services supplied and permit the evaluation of their cost effectiveness.

A broader range of statistics on the most important aspects of local activities will provide valuable data for the economy and, more generally, for society.

The State must fully perform the task of "coordinating the statistical and electronic processing of the data" of central, regional and local government. A common accounting system, capable of making complete data promptly available for all levels of government, must be defined rapidly with a framework law.

6. Conclusions

The federalist principles underlying the amendments to Title V of the Constitution are based on the principle of solidarity.

Decentralization, in line with the choices of the drafters of the Constitution, responds to the needs of self-government; it must use redistribution mechanisms and strengthen the country's unity.

It is an opportunity to modernize the public sector, to bring it closer to the needs of citizens, to make it more efficient and to increase its contribution to growth, in a context of a gradual reduction in territorial disparities.

The measures adopted can be further improved and developed.

It is necessary to address the problems that could arise with regard to the effects on Italian law of international treaties and agreements and study some questions concerning the application of the new provisions.

The autonomy granted to local authorities must be accompanied by responsibility. The benefits of decentralization are reaped where citizens are able to control the work of local administrators effectively, through a suitable balance between political representation and taxation.

The Bank of Italy, as part of the process of decentralization under way, is strengthening the role of its branches, which provide effective points from which to observe the country's variegated local realities.

In addition to the observation and analysis of the regional economies, the role of the branches in the supervision of local and provincial banks and markets has also been reinforced.

The institutional fora that are taking shape are important for the specification of the implementing rules for decentralization policies.

The process must be set within an appropriate legislative framework.

Action must be taken promptly to establish stringent budgetary rules, an adequate degree of fiscal autonomy, forms of redistribution of resources, rigorous criteria for the coordination of the compilation of statistics and data processing, and effective reporting systems.

It is an opportunity for a general reform of public-sector accounting.

The process of decentralization offers the possibility of redefining the boundary between public and private. It is also a change permitting the introduction of more far-reaching forms of subsidiarity. The structural reforms that the economy and society need fall within the scope of the central government's authority. The legal framework can and must be revised in conjunction with these reforms.

Italy's competitiveness and economic growth and employment will benefit.