

SUGGESTIONS FOR FISCAL FEDERALISM FROM THE 2007-2013 REGIONAL
PERFORMANCE MECHANISM FOR ESSENTIAL SERVICES

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ABSTRACT

The recent move towards a more decentralized setting through the Italian fiscal federalism reform raises the question of whether increasing budget responsibilities for lower levels of government will help attaining more comparable living conditions for residents in regions that currently differ in levels of development and wealth. The reform is a chance to fully enact the constitutional promises of pursuing essential service standards across the national territory and to create incentives for more a performing public sector.

Based on the experience of a performance-based mechanism directed to the eight regions of Southern Italy within the 2007-2013 regional development policy cycle, we highlight the complexity of setting standards in a multi-level government framework and suggest additional actions to sustain achievement of objectives and enhance accountability, to improve local government capacities and spur citizen engagement. We also argue that, far from being a merely technical choice, the standards can have a major impact on the future shape of the overall progress of the country and the internal inequalities. Finally, we discuss the potential and limits of implicit and explicit incentive mechanisms within the new federal framework.

1 FOREWORD

Italian Parliament recently approved a reform aiming at introducing new principles in financial relations among levels of government by increasing fiscal autonomy and spending responsibility of Regions, Provinces and Municipalities.

The reform on “fiscal federalism” has been largely driven by pressure from the North of Italy to reduce inefficiencies in the management of public resources in the South, and, as a consequence, the flow of transfers from North to South. However, the principles underlying the reform are also looked with interest by those who consider this as a chance to fully enact the constitutional promise of setting essential service standards across the national territory and to create incentives for more performing public sector.

But to what extent and under which conditions can this favorable outcome be realized? In presence of strong structural disparities between regions, will this new institutional frame foster more comparable living conditions for residents across the whole country or are there risks that weaker regions end up with higher taxes and a lower provision of services?

This paper puts forward some reflections based on the experience gained in the setting up and first implementation of a performance-based mechanism in which financial rewards are paid to Regions in Southern Italy according to their attainment of targets on coverage and quality in the provision some essential public services, measured through eleven indicators. The mechanism, known as “obiettivi di servizio” with reference to its targets, is part of the larger regional development policy for the period 2007-2013 and has already received some attention by external observers (see for example Bank of Italy, 2008 and *Il Sole 24 Ore*, 28 April 2008).

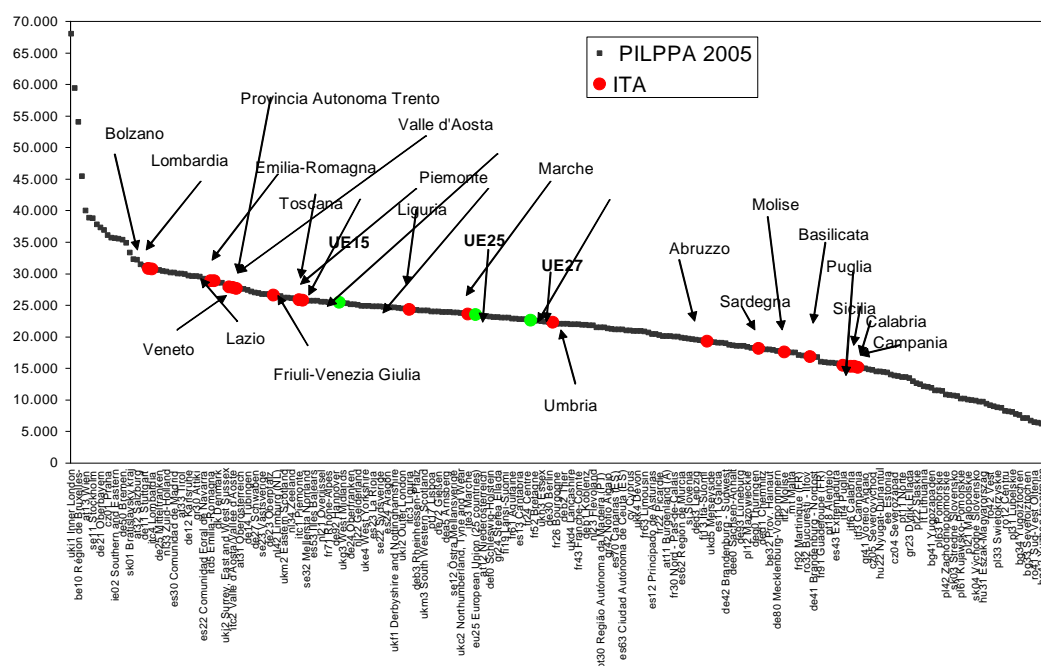
2 TACKLING THE ITALIAN DIVIDE WITH FISCAL FEDERALISM

The fiscal federalism reform recently approved by Parliament (Law 42, 5th May 2009) aims at introducing principles of sound financial management and new criteria for transfers of resources (from the State to Regions, Provinces and Municipalities). These principles and criteria should foster efficiency in the use of resources, improve accountability and “effectiveness and transparency of democratic control on elected representatives” by increasing fiscal autonomy and responsibility. The reform is directed at implementing the 2001 revision of articles 116-119 of the Constitution and mainly sets general rules which need to be detailed in subsidiary legislation to be approved in the next two years.

The main inspiring principle of the reform is to clarify central and territorial governments’ responsibilities in the provision of public services and the exertion of public functions, by reducing the role of transfers from the State and giving territorial authorities more power in

maneuvering local taxes, while adjusting for per capita fiscal disparities through specific equalization funds. Existing disparities in the tax base across country are relevant also because of the well-known internal divide in the general level of economic development. To appreciate the extent of these differences it is worth recalling the fact Italy is a country where some among the most affluent and the poorest regions of the EU coexist (see Figure 1).

Figure 1 Per capita GDP at purchasing power, 2005



Source: Eurostat, regional database

The building blocks of the reform can be summarized as follows:

- Spending responsibilities for “essential” services – representing civil and social rights to be guaranteed to every individual – are devolved to Regions and those for “fundamental” functions are devolved to Local authorities. For these services and functions, centrally-defined performance standards are to be guaranteed across the country.
- Public funds covering essential services and fundamental functions are meant to gradually shift from central funding, based on historical expenditure, to block grants quantified according to the “standard costs” achieved in the most efficient Region. To cope with financial needs exceeding the amount calculated on the standard cost base, additional revenues can be obtained by local taxation. Since essential levels of performance have to be ensured in any case, there are incentives to reduce costs in order to avoid higher taxes for residents. Given existing disparities in terms of current costs, performances and fiscal capacities, the shift is to take place within a five-year transition period.

- All other (non essential) public services and (non fundamental) functions are considered of local interest and can, therefore, be differentiated across regions and municipalities, according to local preferences and decisions. The source of their financing is twofold: an equalization fund to adjust for different fiscal capacities and revenues from local taxes. No performance standard is envisaged: local policy makers and administrators can hence decide to obtain savings by limiting, or eliminating, the provision of a specific service (with potentially undesirable consequences, if democratic control mechanisms are weak and citizens preferences unclear).
- “Special interventions”, financed through specific State appropriations to be defined in the Budget law and with EU contributions (plus national co-financing), are envisaged in order to promote territorial development (i.e., equalization of structural socio economic disparities and infrastructural endowments) and also to guarantee conditions for effective assertion of personal rights and conservation of cultural heritage.
- the National Government and the Conference of Regions agree on a “Convergence Pact” aimed at achieving convergence of costs to the standards of the most efficient Region. The Pact also promotes the convergence of service delivery and performance levels, at least when such standards for essential services are defined. The document should also establish the fiscal equilibrium Regions must achieve as well as the planned debt and tax pressure. In case of significant deviations from those values, especially in the cost of services per head, a special procedure is implemented. This is called “Plan for the achievement of convergence objectives” where the causes of the deviation are examined, technical assistance is provided and corrective actions are suggested, also on the basis of best practices from successful experiences. In case of permanent or systematic deviations from the financial and essential service targets, sanctions are applied¹.

The idea underlying the reform is that once standards are fixed, a hard budget constraint can be enforced on the lower levels of government and this provides an incentive for least efficient administrations to improve their organization, management and technology for the provision of services in order to avoid additional local fiscal pressure. It also provides an incentive for more efficient administrations to maintain a cost efficient system, given that financial surplus may be reinvested according to their preferences.

The levels to which the standards will be set, however, become crucial for general progress both in terms of efficiency and for perspectives of improvement in the quality of services provided to citizens, as well as in terms of overcoming territorial disparities. In fact, despite some progress made in the last few years, most service provision levels in the South of Italy (Mezzogiorno) has not caught-up with those in the Centre-North (see Table 1). According to

¹ Sanctions concern blocking turn-over and discretionary expenses, automatic increase of local tax pressure and other measures to achieve fiscal balance, as well as restrictions on public managers (such as not being admitted as candidates in elections). Rewards are also offered in case of virtuous and efficient behaviour in financial management and in case of achievements in fighting tax elusion and evasion.

some indicators on living conditions and the availability of basic public services, performance in the South is often less than half, or even a third of what experienced in other regions of the country (Casavola and Utili, 2008).

Table 1 Centre-North / South divide in the provision of selected services

level of service provided	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	redcuton of the divide since 2000 (*)
Households complaints for irregular water supply (%)															
Mezzogiorno	26,7	19,8	20,5	23,7	25,1	28,6	31,6	29,2	30,1	23,8	22,7	21,8	20,6	7,9
Center-North	8,7	8,1	8,6	9,3	9,8	8,3	8,6	7,5	10,7	9,0	9,8	9,2	7,5	
Kilometres of polluted coastline (%)															
Mezzogiorno	8,6	7,0	6,2	6,1	6,0	6,0	5,9	6,1	5,9	6,4	6,2	6,6	6,5	6,5	0,0
Center-North	7,5	5,5	7,1	6,0	4,7	4,0	4,0	5,1	4,2	4,3	4,0	5,6	4,5	4,5	
Recycled urban waste (%)															
Mezzogiorno		1,1	1,4	1,6	2,0	2,4	4,7	6,3	7,7	8,1	8,7	10,2	11,6		20,9
Center-North		10,4	13,6	15,9	18,6	20,3	23,5	25,4	28,2	29,8	31,8	33,2	35,2		
Average number of long disruptions in the electricity service per user															
Mezzogiorno				5,5	5,0	5,2	5,0	3,9	4,0	3,4	3,7	3,7	3,6		0,2
Center-North				3,1	3,2	2,8	2,4	2,2	2,1	2,0	1,8	1,7	1,4		
People receiving treatment in hospitals outside of their region of residence (% over people treated in region of residence)															
Mezzogiorno					10,4	10,7	10,3	10,0	9,9	9,8	9,7				1,1
Center-North					5,0	5,0	5,1	5,2	5,3	5,2	5,1				
Fifteen year-old students with poor reading competences (%)															
Mezzogiorno						28,5	-	-	35,0		37,0				-3,9
Center-North						11,6	-	-	14,9		18,2				
Kilometres of public urban trasport lines per 100 km2 in main city of each province															
Mezzogiorno						104,7	104,6	105,1	106,5	108,5	109,9	111,7			10,0
Center-North						147,2	148,2	149,5	150,5	149,5	149,5	150,4			

Note: (*) The indicator measures the difference between the year 2000 and the last year available, in terms of the relative South to Center-North distance (with positive values representing a decreasing gap, negative values an increasing one). Source: DPS-Istat, Regional context indicators.

Indeed the demand for public services may differ on the basis of local preferences; however, disparities regarding access and quality of such services affect not only residents quality of life but also any area's capacity to attract jobs and businesses. In a country like Italy, this has serious consequences both in terms of equality of opportunities for citizens and in terms of the overall competitiveness of the economy. Moreover, in presence of widespread backwardness, preferences often adjust to lower levels and even the demand for better services is not easily acknowledged. These circumstances hence weaken the typical democratic control mechanisms.

So far, observers have mainly highlighted forthcoming difficulties in the implementation of the reform related to the quantification of resources to be transferred, to the definition and identification of standard costs and appropriate parameters for the equalization funds (Arachi and Zanardi, 2009). In what follows we will focus instead on the issues of defining essential services, fixing measurable standards and supporting adequate services delivery on the side of territorial governments. We discuss the role of both implicit and explicit financial incentive mechanisms and adequate planning, and we also hint to the need of sustaining effective democratic control. Our arguments largely stem from the observation of the performance-

based incentive mechanism put in place within the 2007-2013 regional development policy cycle, aimed at improving a set of essential services in the Regions of Southern Italy.

3 A RECENT POLICY EXPERIENCE IN TARGETING ESSENTIAL SERVICES

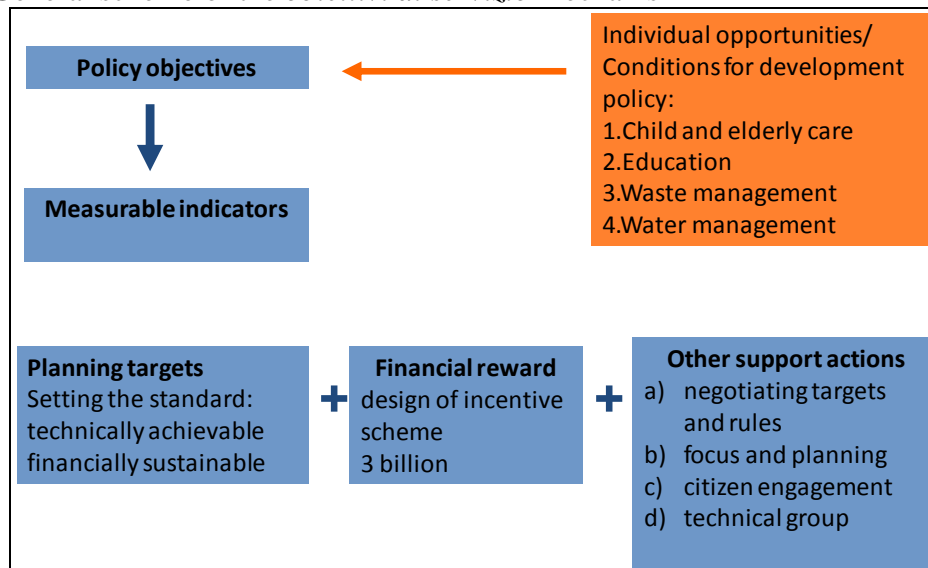
In the past years, Italy has witnessed some small-scale examples of the use of measurable indicators and targets on the side of local governments setting precise commitments on service provision². The main purpose of these initiatives is generally related to making service delivery accountable towards citizens or “customers”, but they rarely involve formal negotiation processes between different levels of governments concerning the financing of these services.

A recent example of a structured multi-level government agreement aimed at reaching performance standards for the provision of a set of essential services is the one designed within the 2007-2013 Italian regional development policy, involving the eight Regions of Southern Italy (Mezzogiorno: Abruzzo, Basilicata, Calabria, Campania, Molise, Puglia, Sicilia, Sardegna). Along with the more general purpose of improving competitiveness in the area, this policy framework explicitly introduces targets on the quality and coverage of education, child and elderly care, water and urban waste management. The aim is to promote progress in the Mezzogiorno through an attenuation of the observed divide with respect to both other Italian regions and EU standards. Regional programmes financed by national resources and the 2007-2013 EU structural funds are supposed to invest, among other objectives, in the sectors related to the above mentioned targets. Moreover, a total 3 billion euro worth financial rewards will be distributed to Regions achieving the targets (or demonstrating significant progress) by 2013, as measured by eleven indicators (see Table 2). A general overview of the scheme, called “Meccanismo degli obiettivi di servizio”³, is provided in previous work (Brezzi and Utili, 2007) describing the motivations and process followed to identify relevant objectives and choose indicators, the design of the incentive mechanism and its rules, and the additional supporting actions (see Figure 2). This paper will only focus on the main features of interest for our discussion on the issues and challenges the new fiscal federal reform will have to face.

² Some examples: the social budget of Forlì municipality (www.comune.forli.fo.it), some service-level agreements (“*Carte dei servizi*”) adopted by municipalities such as Comune di Trento (http://www.comune.trento.it/comune/progetti/qualita/qualita_02.htm) or in given sectors at regional level, for example Toscana in the case of health (<http://www.salute.toscana.it/parliamodi/cartaservizi/osservatorio-regionale-servizi-sanitari.shtml>).

³ Detailed information on the mechanism, the data used, and the ongoing monitoring activities are available in Italian at http://www.dps.mef.gov.it/obiettivi_servizio/ or to www.dps.tesoro.it/obiettivi_servizio/eng/performance_mechanism.asp in English.

Figure 2 General scheme of the *obiettivi di servizio* mechanism



3.1 Standards on essential services within the “*obiettivi di servizio*” performance mechanism

In the case of the 2007-2013 “*obiettivi di servizio*” the targets set for service delivery are not only a general desirable situation to be monitored across different territories, but a political commitment and planning effort which can be tracked in the official documents. The mechanism was designed within a policy aimed at sustaining development (a frame which is quite different from that addressing the question of the ordinary delivery of public services), under the assumption that enhancing capabilities of residents in a backward area can contribute positively to their opportunities and to make the territory more competitive. Better education, adequate family care, a healthier and cleaner environment are seen as key factors to attract business, to increase participation in the labour market and to foster growth. This represents in itself an interesting shift in the development policy paradigm, since the focus on better services was meant to anticipate development and growth instead of following it (Casavola and Utili, 2008).

The identification of objectives and targets involved a lengthy process which saw the active participation of representatives of the regional governments, responsible for taking action to reach the fixed targets and aware of existing organizational and financial constraints affecting their chances of improvement in the selected sectors. In spite of relevant differences in starting points, the services examined were considered so essential (as they represent rights to be guaranteed to all individuals) that the same targets were accepted for all regions. However, targets could not be excessively ambitious, in order to avoid a lack of commitment on the side of those Regions which could not reasonably reach the target within the fixed time span

available and their consequent retracting from and/or cheating on the agreed services improving scheme (Table 2).

The targets were often set with reference to objectives existing in national legislation (in particular for waste management) and in EU initiatives (for example the Lisbon agenda as concerns early school leavers and child care), and in general to levels achieved by the more developed Centre-North⁴. However, it should be mentioned that the mechanism – given its limited duration – actually aims both at reducing internal disparities (more than at eliminating them) and at urging focus on key issues, of relevance even at the national level, but particularly crucial for the South. For this reason, for some services positive increasing trends in the best performing regions were not considered, while for some other services current levels attained in the Centre-North were not considered satisfactory milestones. More ambitious targets were considered when the internal variance of the regions in the South (with some regions already performing better than or close to the national average) proved that advancements could be attained with a better management of existing resources (see for example the case of Figure 3).

As a result, targets set for child care (percentage of municipalities offering child care, number of children in child care) are close to current Italian average, but below the level of Centre-North; while the target set on early school leavers is challenging also for regions of the Centre-North. The same applies for targets on waste management (amount of urban waste in landfills per head and percentage of recycled urban waste) where national legislation already requires the high standards for all regions, in coherence with EU directives. Finally the targets for water management, where the baselines are already at a reasonable level, the distance between South and Centre-North is not really significant and further improvements require costly investments, are set at the value required by EU regulations, which is also higher than the current levels in the Centre-North (see Table 2).

Measurement problems were addressed in order to select appropriate indicators. The choice was sometimes constrained by the availability of reliable and timely information, of comparable data across the regions and sufficiently long time series. In some cases (for example, competence of students in reading and in math; water management) specific measurement initiatives were taken as part of the mechanism to ensure the availability of data for all regions and the continuity of data production. An ad hoc effort, involving independent bodies such as the National statistics office (ISTAT), the Education evaluation institute (INVALSI) and the Environmental Protection Agency (APAT), was put in place to ensure that information on yearly advancement made by each region is made public.

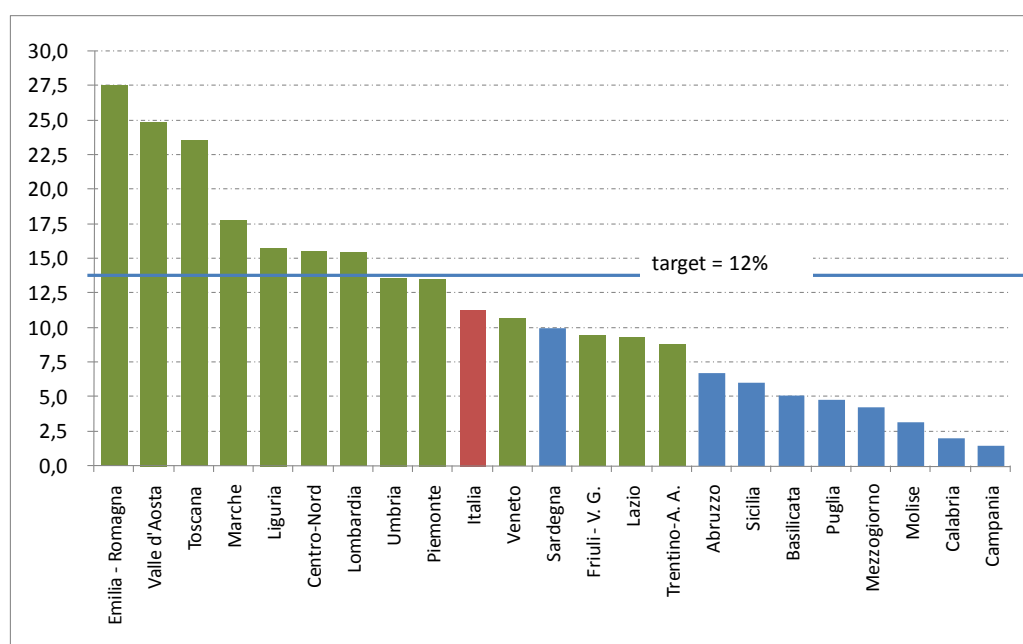
⁴ Target values were sometimes rounded in order to be easily spoken of and remembered.

Table 2 Indicators, baselines and targets of the performance mechanism on essential services

objective	indicator	baseline_South	baseline_CN	baseline_Italy	target
child and elderly care	ratio of municipalities with child care available	21,1%	47,6%	39,2%	35%
	ratio of children in care	4,2%	15,5%	11,3%	12%
	ratio of elderly receiving home care	1,6%	3,5%	2,9%	3,5%
waste management	urban waste in landfills per capita (Note: KG.)	400	260	310	230
	ratio of differentiated waste on total urban waste	8,7%	31,8%	24,3%	40%
	ratio of compost on total urban waste	2,6%	29,1%	20,5%	20,0%
water management	ratio of water accessible to users on water distributed	62,6%	73,4%	69,9%	75,0%
	ratio of population served by depurator	56,6%	67,2%	63,5%	70,0%
education	early school leavers	25,5%	16,8%	20,6%	10%
	poor competencies in reading	35,0%	14,9%	23,9%	20%
	poor competencies in maths	47,5%	19,3%	31,9%	21,0%

Source: *Delibera CIPE n. 82/2007*. The documents also includes details on the data sources used: Istat for child care and water management, Istat and INVALSI for education, APAT for urban waste management. Note that the baselines can be referred to different years according to the availability of data. See also http://www.dps.mef.gov.it/obiettivi_servizio/

Figure 3 Ratio of children in child care over 0 to 3 years population, 2004 baseline and target.



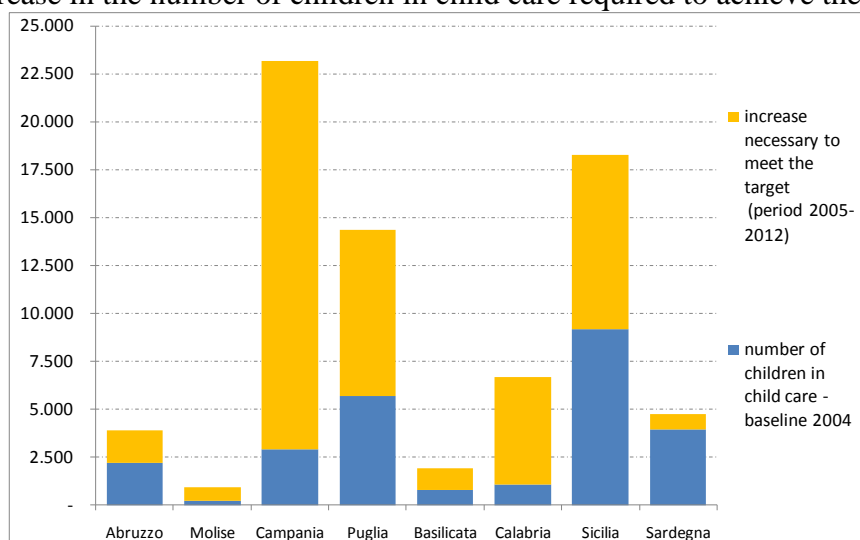
Source: Istat and http://www.dps.mef.gov.it/obiettivi_servizio/.

The setting of targets was not based on cost-based estimations (although Regions were required to make financial commitments on the resources they would direct to reach them). This is mainly due to the fact that the provision of the selected services cannot be exclusively attributed to the resources allocated in the development programmes but involve ordinary public expenditure as well, and in part to the fact that such exercises are simpler with output indicators than outcome indicators (while here we have a mix). Moreover, in some cases, the starting point was so low that a debate on the optimal provision of services on efficiency grounds would not have been appropriate.

An approximate idea of the number of children that should be reached by child care services⁵ (Figure 4) or of the number of kids that should be met by specific school drop-out policies (Figure 5) helped Regions estimate the financial effort to put into place and to monitor, in the course of time, the actual share of beneficiaries and the outcomes. In many case these exercises highlighted that finer information is needed, both at lower territorial levels (in the case of school drop-out ideally at the school or neighborhood level) and on the individual characteristics of potential beneficiaries.

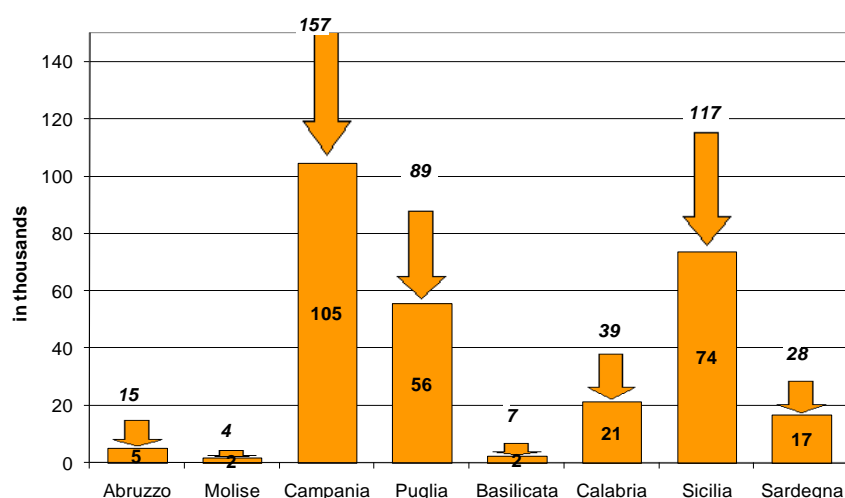
⁵ Simulations were made on what reaching those targets would mean for each of region taking into account the dimension of municipalities, the cost of building a new child care facility, the number of children that, according to population projections, would have to be granted a place in the facilities. Sardegna, is already above the target for one indicator. This shows that, notwithstanding the intensity and the variety of disparities existing between the two macro regions there is a case where with a better focus, management of resources and organization, the objective was achievable.

Figure 4 Increase in the number of children in child care required to achieve the target



Source: our elaborations on Alfani (2008) and Istat.

Figure 5 Estimated number early school-leavers in 2007 e in the case the 10% target is met in 2013



Source: our elaborations on Istat demographic projections.

Finally, since the targets are used within a performance rewarding scheme, decisions have to be trustworthy, sensible and based on feasibility checks. Therefore the standards set for policy can be different from the desirable ones, because of a number of practical reasons. Of course one should also take into consideration the existing technology and whether there are innovations that can be introduced to speed up the achievement of the targets.

3.2 The performance rewarding scheme, financial prizes and additional provisions

The mechanism provides financial rewards to regional governments conditional to the achievement of the targets set for the eleven indicators (the Ministry of Education also competes for financial prizes but only for the education targets). At a midterm deadline, set at the end of 2009, a fraction of the prize will be assigned more than proportionally to the progresses achieved with respect to the baseline values of the indicators. At the final deadline, set for year 2013, the remaining part of the prize is assigned if the targets are reached.

The “obiettivi di servizio” performance rewarding scheme is formally acted by the Central level of government and directed towards the Regional level of government, even if responsibilities for the delivery of the services are distributed among several actors, also at the sub regional level. This is mostly determined by the fact that the regional governments still hold the largest share of responsibility in meeting the targets as they have the possibility of orienting and/or conditioning actions of lower levels of governments with financial and normative tools⁶. The choice of directing the performance mechanism towards the Regions was also consistent with the fact that sound and comparable indicators are available in most cases only at the regional level.

Once targets were agreed, Regions were asked to draft and implement a dedicated Action Plan, to approve it formally and to make it available to the public. The Plan is required to describe the actions they intend to implement on their territories, how they will be implemented, how many resources are required (both financial and in terms of dedicated personnel) and the instruments adopted to ensure their effective undertaking. This additional requirement is quite demanding for administrations as their usual programming activities – also those linked to regional policy and EU structural funds – are typically built around more general objectives and do not refer to stringent targets (Casavola, 2009).

In order both to evaluate effective progresses achieved and to provide for support along the way, an independent technical working group was established at the central level. Each Region is supposed to produce an Annual Execution Report to account on the progress made and obstacles encountered.

4 SETTING STANDARDS AND MEASUREMENT ISSUES

The fiscal federalist reform raises a number of questions on how standards for the provision of essential services should be set. Theoretically, standards should represent satisfactory levels to be guaranteed to all individuals across the territory. However, considering current financial budget difficulties, a preoccupation has emerged that standards could be set

⁶ Among the available tools there is also the possibility of implementing performance mechanisms involving lower levels of government, e.g. among municipalities or sanitary districts (see below).

particularly low, so as to have everyone fit in. On the other hand, the credibility of this scheme stands in fixing standards which are sufficient, but also realistic and achievable.

Current legislation for the identification of exactly which services should be considered essential and which functions fundamental and on how to define standards is still patchy and incomplete. Health, social assistance and education are considered sectors for which essential services apply; territorial management, transportation and employment services are mentioned as fundamental functions; however much is left for subsidiary legislation to clarify.

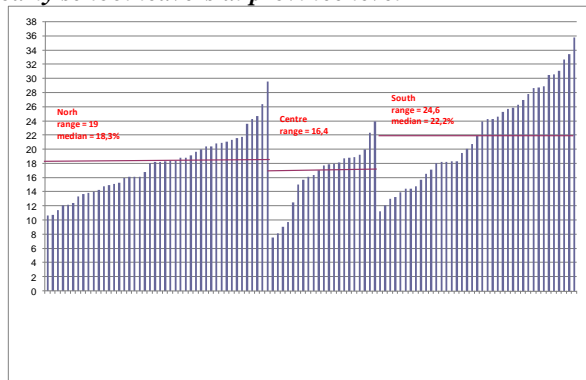
A first set of observations concern performance levels for the essential services to be fixed by the central government at the national level (together with the standard efficient costs of services). While there is some experience in setting standards in the health sector (which has already been affected by a major devolution of responsibilities to the Regions) and in the case of social assistance, the picture is much more uncertain when it comes to education.

There are many possible combinations of costs and performances, but given the emphasis in the fiscal federal reform on cost reduction, there is a risk that standards set chosen will correspond to a minimum level of service. This can have undesirable implications in terms of progress for the country as a whole and, in particular, for less developed regions. In addition, acceptable standards change in time and in case of fundamental rights, governments should be able to ensure to their citizens “dynamic rights” that advance according to progress in economic and social development.

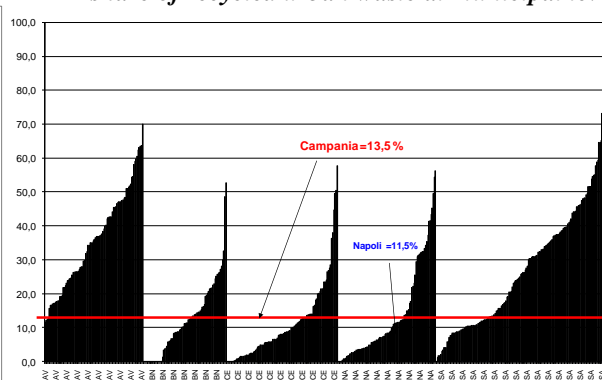
Setting standards for essential services requires a decision on the level of inequality which is deemed acceptable and sustainable between territories and between individuals. Controlling for average values to be reached at the regional level does not necessarily guarantee small variance within regions. In fact, disparities in service provision in Italy are not limited to the traditional North-South divide, but to huge differences within regions. For example, the share of early-school leavers is on average greater in the South than in the Centre-North, about 20% of the Southern provinces perform better than the median province in the Center-North. Similar observations apply to the variance in the share of recycled urban waste at the municipal level (see Figure 4).

Figure 4 Variability at sub regional level for some basic public services, 2007.

early school leavers at province level



share of recycled urban waste at municipal level



Source: Istat, Labour Force Survey and APAT.

Moreover, standards for essential services should be considered operational. This circumstance is very different from the one of other multi-level government agreements where targets are used as orientation devices - such as those adopted by Member States within the EU Lisbon strategy or the Millennium Development Goals (MDGs) - which point to general progress or desired focus on specific a long term issues (United Nations, 2007; Fukuda-Parr, 2008). In these cases, the benchmarks are used as judgment criteria to monitor progress, but they are not intended to be “planning targets”, i.e., to be directly connected to financial budgets, to a delivery schedule and to a stringent intervention plan.

Another aspect to consider is that appropriate thresholds for service provision may vary considerably over time, as technology, production process and cultural views evolve. This implies a dynamic negotiation process; however, should standards change every year, their credibility would be reduced, there would be too much room for discretionary choices on the appropriate thresholds and their use in the planning process would be undermined.

Delicate measurement issues will have to be addressed in order to set the standards. The indicators selected need to be comparable in time and space and must satisfy a number of requirements on their reliability (e.g., certified statistical sources), accountability (i.e, the institutions responsible for the implementation and delivery of the service must be clearly identified), easily understood by policy makers and the public (UVAL, 2005). The debate on the reform has not clarified whether the standard levels of service to be guaranteed are to be defined in terms of inputs, outputs or outcomes. The “type” of indicator may have implications on the financial requirements and on attribution of responsibility for inefficiencies in expenditure. Financial requirements (standard costs) are easier to calculate and responsibilities are easier to attribute for given levels of inputs. When it comes to outputs, it presumes knowledge on the production function underlying the service delivery process; in the case of outcomes, the matter is further complicated by the difficulties in identifying a causal relationship between the observed trend and policy effort. In any case, new statistical

infrastructure will be needed to identify appropriate indicators, quantify standard costs and standard performance levels for service provision, and to monitor improvements.

A second set of observations concern what might happen for the provision of services that are not considered essential and, therefore, not guaranteed by a national standard. The capacity of local governments to adequately address the needs of their citizens in this realm will be challenged by local pressures on allocation of resources or by demands of tax reduction. Although the purpose of the reform is to let local preferences define the demand for public services other than essential ones (health, social assistance and education), strong disparities regarding access and quality of these other services may in the long term pose serious problems. Social conflict could arise if further inequalities were to appear and the overall competitiveness of the economy in some areas were to worsen; a deterioration of economic conditions could also adversely affect the future sustainability of the equalization funds on per capita fiscal capacity. The question in this case is to explore whether the fiscal federal framework should provide explicit incentives for improving *other services* in order to promote the progress of areas suffering structural socio economic disparities.

The special interventions purposes envisaged in the law do not seem to take this argument into consideration. However, it should be considered that even if the initial financial investment to attain structural conditions for services delivery in a backward area is provided, there are no guarantees that services will be actually delivered or that their provision will continue over time in absence of sufficient resources. This is a case of cost underestimation which typically occurs in backward regions, where local governments are “poor” and fees to be covered by consumers are necessarily low⁷.

5 COORDINATION, CAPACITY, PRESSURE AND LOYALTY CHALLENGES

The reform aims at the simultaneous achievement of better services and lower costs. However, the shape of the multi-level government agreements that will endorse these principles, the necessary governance mechanisms and the procedures for control are not yet in place. As discussed above, there are several reasons to believe that the reform framework in itself – mostly relying on hard budget constraints incentives – may not be sufficient to overcome, or may even worsen, existing disparities.

Drawing from the experience of the “obiettivi di servizio” mechanism, after setting standards and addressing measurement issues, a number of challenges will still be open as concerns coordination mechanisms, local governments’ capacity, the exercise of pressure and control by local communities, loyalty and consistency in actions by the central authority.

⁷ The simulations carried out for the indicator on child care within the “obiettivi di servizio” mechanism showed that functioning costs of the new child care structures activated to reach the target of at least 12 per cent of children aged 0-3, - i.e. increasing the number of places from the existing 26,000 to 74,000 - are equal to approximately 370 billion euro - three times as much as the current costs.

5.1 Coordination and responsibility

A common drawback of the policy coordination processes attempted at the EU level so far (for instance the so called Lisbon strategy) is that they often fail in ensuring the necessary sense of ownership of the commonly agreed goals. Despite the relevance of the various commitments (from welfare to environmental issues), most key actors on the ground do not perceive those goals as their own. This is partly due to the fact that the main strategic decisions are not necessarily taken by the most critical actors for achieving the goals. While unavoidable to a certain extent, as the chain of responsibilities in service delivery is always long and complex, this should remind the central coordinating authority that key actors participation in the negotiation process must be ensured.

The targets for “obiettivi di servizio” were not imposed top down; they involved a lengthy and formal discussion with regional authorities which lasted more than two years. Although a participatory approach to target setting was somehow required by the organizational principles underlying regional policy⁸, it can be critical for the prospective effectiveness of the agreement made. In fact, the negotiating process was helpful in clarifying key aspects related to the delivery of public services, for which crucial responsibilities are typically distributed among many central, regional and sub-regional actors⁹. The acceptance of the targets on the side of the regional government – which was the main actor involved in the negotiation – implies a commitment on the best implementation of its own coordination responsibilities towards local governments. In fact, any credible move towards improvement implies actions and changes to be implemented along the chain. And a clear and open discussion phase on the targets paves the way for an assessment on what kind of changes are necessary and which other actors have to be involved¹⁰.

Relations between levels of government in the attainment of goals in the interest of citizens are more about cooperation than competition. More than a prize contest between Regions, the explicit incentive provided by the “obiettivi di servizio” mechanism should be perceived as a tool to encourage learning on how to do better in the view of a common interest.

⁸ Regional policy is in general responding to a principle of partnership which national processes have absorbed from EU regulations on Structural Funds.

⁹ Improvements are dependent on the coordination of many actors : a) for education services (the Ministry for Education and its territorial regional office, the Region, the Provinces and Municipalities, the Schools); b) for child care provision (the Region, the Municipalities and the Social services territorial councils); c) for home elderly care provision (the Region, the Territorial health departments- ASL- and the Social services territorial councils); d) for water management (the Region and the Territorial institutions responsible for water cycle planning – ATO); e) for urban waste management (the Region, the Provinces, the Municipalities and the Territorial institutions responsible for waste cycle planning).

¹⁰ It is interesting to note that an additional outcome of target setting and design of the rewarding mechanism was the acknowledgment that other territorial actors (and not only the regional authorities) might need additional incentives. The final agreement implied that part of the financial prizes could be devolved to those actors who are the most critical on the ground for the delivery of the services.

Performance rewarding schemes for public institutions are not as frequent as those for individual agents. In both cases, they are more likely to work if they are perceived as fair and their rules and implications are clearly understood. When it comes to organizations, information asymmetries between actors which are further or closer to the ground make the rewarding criteria particularly tricky. Observed performance may differ from expected performance for many reasons which are actually unknown and/uncontrollable.

The “obiettivi di servizio” history does not necessarily provide general insights on how to deal with all of these aspects. It is, however, interesting to note that during the negotiation phase some features of the original proposal designed by the central authority technicians were modified. Discussions with regional representatives helped in finding a way to make the rewarding scheme (based on achieving the same targets for all regions) acceptable, despite their different starting points. The final scheme includes a “flexibility clause” which allows for financial prizes to be obtained even if some of the targets are not all completely achieved, but a significant improvement is indeed obtained¹¹. This should not be considered the result of a “bad” compromise: it has improved the potential success of the rewarding scheme. It also proves that serious negotiations must be carried out transparently and with the appropriate mix of technical expertise and political sensibility.

In our view the federal reform will have to address these issues when setting essential service standards, standard costs and the related agreements on regional funding. Effective partnerships with regional (and local) governments are necessary to avoid formal compliance and lack of commitment. Specific committees will be in charge of those tasks, but political commitments will be needed to make their role effective on substantial issues.

5.2 Capacity to focus and to plan

The supply of good quality services to residents depends on local government’s capacity to manage the available resources for organizing the services and to invest in their improvement. This requires, at each point of time, both the availability of adequate resources and correct incentives to deliver the best possible services. In territories where major improvements are required, filling the gaps may not only be a question of resources and incentives, but also of adequate planning and implementation capacities.

In the “obiettivi di servizio” mechanism the financial prizes aim at reinforcing incentives and inducing legitimacy for prioritizing resource allocations: if delivery occurs actors get a financial reward; if it doesn’t, they incur in a loss, which is both financial and reputational. In less developed (and less affluent) areas local budgets are typically constrained and resources do not suffice to fully meet the many and diverse demands coming from both stronger and

¹¹ The attainment of at least 60% of the full improvement (the distance between the target and the baseline) in no more than four cases out of eleven is considered sufficient for awarding the corresponding prizes.

weaker local communities. This situation might imply that the local governments never focus or order their priorities. Contrary to what some first commentators have suggested, the key challenge is whether the mechanism will ensure the needed focus on the selected services rather than the preoccupation that administrations will focus on them too much¹².

Moreover, without focusing, the need of acquiring greater specific planning and management capacity is never perceived by administrators as crucial. The capacity issue must be therefore be dealt with directly. The regional Action Plan serves this purpose. The plan is drafted by the regional administration, formally approved by regional government and is published on the regional website. The publicity of the plan helps monitoring and contributes to increasing accountability of local administrators. Moreover, drafting the Plans has unveiled gaps in the available information and the need to better understand the links between policy actions and final outcomes. Devising plans for achieving specific predetermined targets has already had the effect to show that much more measurement activity is required in order to see where interventions are needed and which beneficiaries should be reached¹³. A specific technical assistance programme was designed to support the acquisition of technical capacities at the regional level and to involve central administration with responsibilities in the different sectors.

The capacity challenge is overlooked by the federal reform framework, which basically relies on implicit incentives created by the hard budget constraint for region to be able to do better. The Plan for achievement of convergence objectives foreseen by the law in case of failure to meet the fiscal targets should be more stringent on controlling for the standard levels of service to be delivered as well. Moreover, it should require regional governments to describe how the performance standard can be achieved, where and when needed interventions will be made, internal monitoring and oversight procedures, what information will periodically be made public. However, making these items mandatory will not suffice if the reform will not gain a much clearer scope towards serving the citizens and public political discussion moves more towards “targeting” real services and away from simple “budgeting” rules.

¹² Simple interpretative frameworks usually do not consider the state of existing capacity and the costs associated to its improvement. The idea is that actors react automatically to incentive schemes and any partial set of indicators can provoke undesirable distortions (people focus only on what gets monitored and rewarded, disregarding the rest). While this warning has to be taken seriously in the choice of indicators, its general validity has to be checked against other factors. In contexts in which important issues (such as the provision of essential services) are consistently disregarded, it is likely that the required change is very costly for the key agents (as it implies acquiring abilities that they do not have) and there is, in fact, the risk that their neglecting attitude will persevere even when confronted with explicit incentives to do otherwise.

¹³ In fact, already at this stage, an important by-product of the process is the increased awareness for measurement issues. Several regional administrations are putting into place surveys or re-organizing fragmented and sparse administrative data to sustain their planning capacities. Analysis of regional sources has also caused further discussion on the indicators and targets adopted for the rewarding scheme, as administrators discovered that their data did not always match the data provided by official independent sources, because definitions used were different or because local peculiarities were not taken into account. This could have created a negative side-effect (on the acceptance of the targets), but in fact it has reinforced the more profound understanding of the target, its implications and what other aspects related to the same objective must not be left behind.

5.3 Pressure challenge (incentives between levels of government/responsibilities and citizen participation)

In the simplest theoretical framework, citizen control over the local government provides incentives to deliver the best possible services. However, this does not always happen in reality. In the Italian case, apart from extreme and episodic cases, citizens do not penalize their governments for insufficient delivery (and the reverse is also true, as working for providing better public services, does not necessarily grant a premium in the political market). Pressure to improve services (in terms of both final quality and efficient management) should come from actors that receive a benefit from the improvements. In our case both the regional governments and citizens have a direct interest, although from different point of views. Regional governments – a part from their interest in obtaining the financial prizes – should benefit from more efficient services provision both for political reasons and, especially, for budgeting concerns. They are not the sole actor responsible and hence they have an interest in exerting pressure on lower level of responsibilities, not only to achieve the targets but also to avoid excessive expenditures (as bad management is often linked to costly emergency interventions). Citizens should be interested in having better services in all cases. However acting pressure is costly (especially for citizens) and its repayment is uncertain.

In the real world, it is difficult for citizens to fully understand who is responsible for what and hence citizen control might be weak. This is true especially in areas in which residents have become accustomed to low quality service provision and there is little available information on what good services should be like.

In this last respect, a better public level of information on the progresses or the halts registered can be of help. A qualifying provision of the “obiettivi di servizio” mechanism is related to an increase of easily accessible public information in the hope that public discussion and interest will gain momentum as long as more data become available.

In the international debate, there is growing interest for measuring public institutions and government performance as a way to ensure accountability, protection of common constitutional values and more informed political choices¹⁴. These issues are less debated in Italy where monitoring (and evaluating) the performance of policies and programmes and even simple public reporting obligations are very limited and somehow perceived as imported technical devices rather than major features of the democratic relation between citizens and governments. Given the situation, it is wise to think about the application of indicators, performance measurements and targeting systems more as learning processes than accountability instruments.

More public information helps, but does not automatically or quickly translate into greater pressure to improve (Holzer, and Kloby, 2005). The mechanism envisages some actions that

¹⁴ For instance the OECD Global Project.

could lead to an increase in pressure on key actors. The first one is a provision – which is not mandatory, but strongly advised – which allows Regions to devolve a definite amount of the financial prizes to those territorial actors whose responsibility in service provision is the most direct and that contribute the most in achieving the targets. The second one is to define a potential formal role of surveillance for the representatives of interests and citizen associations. These institutional devices might play a role in opening some spaces, but they will never completely substitute democratic control or active citizen participation.

The federal reform expects citizens to express their pressure through voice and exit mechanisms. This presumes complete and clear information on policy objectives and a highly developed judgment capacity. Standard costs are not immediately understandable to the public; while a transparent and wide availability of data on the quantity and quality of services (therefore outputs and outcomes) can more easily be appreciated. In addition, in weaker areas, the typical underdevelopment trap may hinder awareness of possible room for improvement and trust in democratic control. If the fiscal federalist reform really intends to spur democratic control, it should provide for specific policy actions to improve citizen information and participation.

5.4 Loyalty and consistency issues

The multi-level government agreement on the objectives to be achieved within a period of time (in terms of standard costs and targets for essential services and the consequent decisions on the dimension of the equalizations funds and tax incidence) will be set in the federal reform's Convergence Pacts. Stability in the institutional contract among levels of government is required, but it is difficult to achieve as proven by the history of previous agreements between the Central government and Regions and Municipalities (the so-called internal stability pact). Moreover, the hard budget constraint is credible only if the central government keeps its no bailout clause.

As the political cycle could differ from the timing of the Pact, temptations may arise to renegotiate conditions or even unilaterally exit the Pact. The reform provides for a Commission including members of all levels of government with technical expertise: that will have to grant impartiality in progress measurement and ensure compliance with the rules. However, this might not suffice: capacity, loyalty and consistency are also required from the central government (and not only from the lower levels of government).

This fact stands out in the experience drawn from the “obiettivi di servizio” mechanism, where it is particularly strong given that targets accompany an explicit financial rewarding scheme. In general, rewarding schemes require for a central authority with solid technical capacities. The establishment of independent groups in charge for oversight and supporting the central authority appears to be common in the international experience as well. However,

to ensure ongoing significance of the whole process they must function correctly, well-interpret their mission for the whole time the scheme is in place¹⁵. Moreover, once the agreement is reached, the incentive scheme can survive efficaciously only if no party deviates (too much) from the original terms of the agreement. Rewarding schemes between levels of government are generally partnership agreements, in which each party – and not only those whose performance gets assessed - are committing to act with loyalty. They are possible only if long term trust relationships have been established¹⁶ and/or if some other ad hoc instruments to ensure credibility are adopted.

Put aside the technical issues, the credibility of the multi-level government agreements strongly depends on the consistency of the central authority. The effectiveness of the “obiettivi di servizio” mechanism could potentially be undermined because of inconsistent central government behavior. After the formal adoption of the mechanism, the total available financial resources for the 2007-2013 regional development policy cycle were reduced by the summer 2008 manoeuvre on public accounts (which envisaged a general reduction in public capital expenditure for the 2009-2011 period), by measures to face the recent economic crisis and by a redefinition of the main policy priorities at the national level. The budget available for the “obiettivi di servizio” rewarding grants was left unchanged, but the general amount of resources for territorial development has decreased. Objectives related to education were also directly affected. They were inserted in the mechanism along with a strong national commitment to reinforce conditions for quality services in the Southern regions (whose measured level of students’ competence was found unambiguously insufficient with respect to average Italian and OECD attainments) and a specifically dedicated programme funded with national resources. However, the latter has not yet received official funding.

Other experiences also report central government consistency as crucial for incentive schemes to work. In the case of Local Area Agreements in the UK, target-based rewarding schemes have been operating since 2001. In recent consultations (2008) about modifications in the rewarding scheme - which also implied a reduction of the available budget for rewarding grants- concerns for the global amount of funds were expressed, as local government put forward that the new scheme would not be completely apt in providing incentives to reach the challenging targets agreed with the Government and “this would be a serious blow to the notion of the scheme being an incentive”.

¹⁵ In the “obiettivi di servizio” case, whether many provisions will work or not will depend on how functional and independent in judgment this body will be.

¹⁶ This issue is a sensitive one and difficult to tackle in general terms. It is somehow related to the subtle difference between issues attaining to the responsibility of in term governments and their policy objectives (that are expected to change in time) and issues related to governance practices and values (which as part of the material or immaterial constitutional agreements should persist irrespective of different governments’ political orientation).

5.5 Financial issues and long term sustainability

The chances of introducing permanent changes in the quality of essential services in Italy will also depend on the future systemic response to the issue of financial resource allocation. In the Southern Regions, the available evidence suggests that the quality of the services provided on their territories will indeed be favored by an increase in their management and institutional capacity, but also it will depend on sufficient availability of future financial resources. While the “obiettivi di servizio” mechanism tries to deal with the first aspect, the second remains to be tackled within the framework of the budget determination for regional and local governments.

It should be clarified that explicit incentive mechanisms alone won't be able to overcome completely (or lead to an acceptable dimension) the actual observed disparities in services provision among Italian regions in absence of a continuation of transfers to less developed ones. This latter issue should then remain a lasting preoccupation for reformers. Most analysis and data suggest that even the current large fiscal redistribution flows are not such to imply full equalization in expenditure and a more partial equalization – as it is to some extent devised by the new fiscal federalism framework – will nevertheless still imply consistent flows (Ambrosiano, Bordignon and Cerniglia, 2008). If those will not be secured, the risk of an increase in disparities is present.

Reformers should also be aware of the fact that even in presence of efficiency gains, given the strong existing disparities, improvements in the provision of services in terms of outcome are unlikely to be obtained without an increase in the amount of resources. Furthermore, in weaker areas, essential services may concern a wider range of sectors than those expected to be covered by State transfers, thus increasing financial needs. This calls for a serious reflection on the dimension and scope of “special interventions” provided to address socio-economic disparities. Should they be limited to selected investments, it might be necessary to find other ways for coordinating the different levels of government in promoting overall development in backward areas.

6 SOME LESSONS FOR FISCAL FEDERALISM

Different implications will derive from how several issues and challenges will be tackled.

The decisions that will shape the actual implementation of the fiscal federalism reform must still be taken. All of them require adopting complex choices which will determine how the country as a whole will proceed in the next decades on the ground of both cost efficiency and capacity of ensuring adequate public services to all of its citizens.

The extent of the actual divide between the North and the South both in economic development and in the access and quality to basic public services raises serious questions on

the consequences that the whole process will have in terms of equity between individuals in the exercise of fundamental rights and in terms of general development of the nation. If negative, these can in turn determine negative side-effects on the social and financial sustainability of the whole process.

Therefore, the decisions to be taken should not be considered just a technical complement of an already completed framework, nor as a mere question of writing the “good” rules. The way in which standard costs will be defined, will implicitly affect equality or inequality among citizens. In addition, the implicit incentive mechanism embodied in the federalist framework for ensuring good government to citizens in different territories may not work without other major investments in administrative capacity and availability of detailed public information on the services provided. Also, a strong cooperation among levels of government will still be required and in many cases improvements will be realized at some level only if other levels (including the central one) act consistently.

Despite a certain concern for the scarce attention these issues have received within the current debate on fiscal federalism, the reform indeed provides a precious opportunity to clarify responsibilities between levels of government on service delivery, to force our institutions to explicit performance standards for essential services and adopt a more result-oriented approach, to increase cost efficiency in the management of public resources and to learn about major policies for our well-being. Translating these potentials into practice will not however be easy.

The experience made so far within the “obiettivi di servizio” mechanism, although aimed at providing incentives for sub-national actors to focus on final policy objectives (and not to standard costs as in the fiscal federalist reform), can however offer some practical insights with regard to many crucial issues and challenges that will have to be tackled.

If standards are meant to work as a result-oriented discipline for regional and local governments (and not only as an instrument to decide over the dimension of funds), performance levels must be based on output or outcome indicators, and cannot be limited to inputs or costs. This implies strong action as regards measurement issues as data availability must significantly increase in key sectors. Moreover, if reformers are taking citizen control really seriously, data on quantity and quality of public services at appropriate territorial levels, must be easily accessible and widely publicized.

In the case of fiscal federalism, the theme of coordination concerns mainly financial issues (and the credibility of the no bailout clause on behalf of the national government). However, the many actors involved in the provision of essential services require strong attention as it is ultimately on their behavior that the entire functioning of the system will depend. The most should then be done for ensuring a general acceptance of the standards set (in terms of performance and corresponding costs) so that they are perceived as fair and achievable. To this aim it would be useful that consultations are sufficiently extended and proposals are made

open along the way and that Convergence Pacts include not only financial agreements but also details on how performance standards will be achieved.

We should not deny that there are at least two risks in the current reform design. The first one is that the performance standards for essential services could be set too low only for financial reasons. The avoidance of this occurrence will depend on the openness and inclusiveness of the process that will lead to the definition of the standards, so that different options can be fully appreciated by interested actors and the public.

The second risk is that other important (but not considered essential) services, that affect residents' opportunities and development potential, might not be guaranteed at an adequate level in all territories. Many see a danger that weaker regions will experiment higher taxes, with worse services and management inefficiencies. In order to correct for the lack of incentives to improve service delivery beyond what strictly requested, explicit temporary incentives could be considered. In particular, the "implicit" incentives provided by fiscal federalism could be accompanied by an "explicit" incentive on the improvement of the quality of local services, similar to the performance mechanism of "obiettivi di servizio" regional polices or to the Local Area Agreements performance grants of the UK.

The choice of devising explicit incentives schemes (allowing for performance grants) between levels of government is possible but requires specific efforts and capacity on side of the central government. Once in place, crucial factors for success depend on the fact that any unilateral change, or breach of the agreed rules, perversely affects the potential of the scheme. In order to work within the new setting, a good level of reciprocal trust among levels of government must then be attained.

Although the reinforcement of incentives for better and more capable territorial government is a key aspect of the reform, it cannot be seen as a solution to tackle existing disparities. Positive action must be taken to spur an improvement in management capacity for regional governments in the Mezzogiorno Regions, not only in order to face possibly declining transfers, but also to confirm the legitimacy of the necessary transfers. However, better incentives and greater capacity will not per se resolve economic territorial disparities. The availability of enough resources to secure to all citizens an acceptable level of essential services still remains an issue which should be shared by all levels of government across the whole country.

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