

Financial Distress and Italian Local Governments

Debating the national special legislation on «deficitarietà strutturale» and «dissesto finanziario»

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1. Introduction

The aim of our contribution is to provide a general analysis of the Italian special legislation on local governments' financial upset, addressing two main questions. We firstly intend to investigate the nature of financial distress by considering if it represents a «pathological» status or rather a «bad habit», in the specific case of Italian Local Governments (ILGs)¹. Then, we focus on the «attitude» of the central government towards distressed and/or insolvent ILGs and analyze to what extent the remedies adopted in our country reflect those proposed by the international literature on financial distress. The chapter proceeds as follows. We first propose a synthetic outline of the national legislative framework on financial distress and insolvency of ILGs and analyze data about the number, dimension and geographical position of currently distressed ILGs. Then, we focus on the effective causes of financial distress for ILGs, by re-ferring both to evidences of national sample-based studies conducted by scholars and to official comprehensive analysis developed by the *Corte dei Conti*. Later, we analyze the methods of involvement by the central government in restoring the financial equilibrium of distressed ILGs, focusing on the legislative measures of intervention and debating if and to what extent they have changed. The last section presents our remarks and also suggestions for further investigation.

2. A synthetic picture of distressed ILGs

In this section, we first recapitulate the national legislative rules on «structurally distressed local governments» (*«enti strutturalmente deficitari»*) and «financially destabilized local governments» (*«enti in dissesto finanziario»*), according to Legislative Decree n. 267/2000. We refer to both the stages formally acknowledged by the Italian legislator as motivation for central authority's intervention, with different methods reflecting the different seriousness of LG's financial conditions. For both the situations of (generally speaking) «financially distressed» LGs, we provide data about the size of the phenomena and the involved LGs.

2.1 The status of «structurally distressed» LG

The L.D. n. 267/2000 identifies a LG as «structurally distressed» when there is evidence of «severe and incontrovertible conditions of disequilibrium», according to

¹ We only refer to Municipalities (8.101 is the total number of Italian Municipalities; 1.397 of them have more than 8.000 inhabitants).

the data shown in a specific table (attached to the official annual financial report) containing a set of ten parameters, recently revised (art. 242)². When more than half of these parameters are out of the acceptable ranges, LGs are subject to controls by a central authority, the national Commission on Finance and Personnel of Local Governments established at the Ministry of the Interior (art. 243). Controls concern personnel expenditures, including hiring of new staff, and costs for services provision: in particular, fees and tariffs for both general services (such as water and waste) and non-general services (such as nursery or parking) must cover at least a specific percentage of total costs of the services. When a structurally distressed LG fails in covering the costs of the services according to the established rules, general ordinary funds from central government are reduced of 1% for each year. Controls by the national Commission cease as soon as the LG restores its financial condition, according to the data verified at the end of each year through the table of parameters quoted above. This means that after a single year, a formerly structurally distressed LG can get rid of central controls by reducing to four the number of parameters out of acceptable ranges, whatever they are.

2.2 The relevance of the phenomenon

Data on structurally distressed ILGs is gathered every year by the Ministry of Interior but the comprehensive list of such LGs remains unpublished. When you want to know if a specific ILG is in structural distress, you can access the Ministry's official web site and check the situation for that specific ILG (data usually refer to the second previous financial year). Just to give a general idea of the relevance of the phenomenon, we refer to recent studies (Farneti & Padovani 2010) analyzing official data about the value of each parameter of structural distress for ILGs: in 2007, about 9% of ILGs had annual financial deficit exceeding 5% of operating revenues; 35% of ILGs had disproportioned un-cashed revenues from current year taxes and fees; 11% of ILGs had disproportioned un-cashed revenues from past year taxes and fees; about 1/3 of ILGs had disproportioned un-paid current and past years operating expenses; for 12% of ILGs the total amount of expenses for personnel exceeded the predetermined specific percentages of total operating revenues, according to the demographic dimension of the LG; 14,5% of ILGs had capital debt exceeding the predetermined percentages of operating cur-

² The parameters revised for the period 2009-2011 refers to: the amount of annual financial deficit related to operating revenues; the amount of un-cashed revenues from the current year taxes and services related to operating revenues; the amount of un-cashed revenues from past years taxes and services related to operating revenues from the current year; the total amount of un-paid operating expenses related to operating expenses; legal procedure of enforced (judicial) compensation related to operating expenses; the total amount of expenses for personnel related to a specific percentage of total operating revenues, according to the demographic dimension of the LG; the exposed capital debt related to operating revenues; off-balance sheets debts occurred in the current year related to operating revenues; un-refunded cash-advance related to operating revenues; maneuvers of budgetary re-balancing via selling assets or affecting reserves related to total operating expenses.

rent year revenues; about 10% of ILGs had off-balance sheets debts occurring in the current year and exceeding 1% of operating current year revenues; 5,6% of ILGs had un-refunded cash-advance exceeding 5% of operating revenues.³ The analyses mentioned above confirm the evidences of other previous studies (Sargiacomo 1999, 2000; Tenuta 2007; Gori 2009) showing that, in general, ILGs financial condition is disturbed by incorrect running in money collection and payments (cash running, in general terms). Values powerfully fluctuate according to the dimension of ILGs and their geographical position (northern ILGs are able to be in the acceptable ranges more frequently than southern and also central ILGs). Personnel expenses and un-refunded cash-advance represent problematic issues, without particular differences related to the dimensional class, both particularly in southern ILGs. Sample-based analyses took into consideration the earlier set of parameters of structural distress and highlighted that in 2006 about 44% of ILGs were completely in accordance with all the parameters and about 56% of ILGs were not in accordance with at least one parameter: out of all these, about 37% of ILGs fail in meeting just one parameter, about 16% of ILGs did not satisfy three parameters and less than 0,2% of ILGs resulted being in the status of «structural distress». Again, un-cashed operating revenues and unpaid operating expenses were identified as the most common issues. As a result of the above evidences, one could think that the greatest part of ILGs do not have so serious financial problems, as few of them seem to be formally recognizable as in structural distress (with enough parameters out of the acceptable ranges). That is not correct, as both Ministry of Economy (through the *Ragioneria Generale dello Stato*, the national general accounting office) and *Corte dei Conti* highlight in their re-ports. National Authorities seem to agree with scholars about the inadequacy of a set of parameters to detect every effective condition of financial distress, as the system of parameters, even after its restyling, just appears to be unable to uncover «systemic frailties and latent condition of crisis» (RGS 2010). Moreover, ILGs are attended to meet growing financial difficulties and the risk of being listed as structurally distressed LGs is expected to increase (*Corte dei Conti* 2010).

2.3 The status of «financially destabilized» LG

The D. L. 267/2000 acknowledges a LG as «financially destabilized» when it is not able to assure the provision of essential services and functions, or when its creditors' rights cannot be pleased according to other permitted procedures (art. 243). When these conditions occur, the LG's Council approves a specific deliberation to formally identify the LG's insolvency; it is transmitted to the Ministry of Interior and to the *Corte dei Conti* and published on the national Official Gazette. Entering the status of financially destabilized LG produces as a result a division between managing the paying off of the past debts by the Extraordinary Board ap-

³ Reported percentages are recalculated on the total population (8.101 Municipalities) according to the content of the new system of parameters, in force up to financial year 2010.

pointed by a Presidential Decree, and recovering the financial condition of the LG by the LG's institutional administrative organization (art. 245). The former authority, more in details, is invested with the role of establishing the whole amount of liabilities to be paid off (art. 254), managing their extinction (art. 255) and paying creditors (art. 256), according to a formally approved recovery plan. Until 2001, central government funded the whole paying off through a guaranteed five-year loan whose total amount was normally defined according to the LG's dimension (number of inhabitants). The LG's officers and politicians are endorsed with the task of dealing with the causes of the insolvency and guaranteeing the return to stable conditions of financial equilibrium, in accordance with specific rules fixing limits on operating expenses and payments (art. 250 and 259), reducing the total number of personnel (art. 259) and compulsory raising of taxes and fees for services (art. 251 and 259). All the maneuvers carried out by the LG are formalized in a specific budget and submitted to the Commission on Finance and Personnel of local governments established at the Ministry of the Interior for approval (art. 261). The entire procedure of payment of past debts and improvement in financial conditions should end within five years from the approval of this budget (art. 265). Other governmental instructions regulate the hypothesis of neglecting behavior by the LG's officers, the powers of the Extraordinary Board, the eventual appealing against the exclusion of creditors from payments and also simplified procedures for paying creditors. Currently, according to the year in which the declaration of insolvency occurred, LGs apply different rules on contracting new loans: LGs entering the special procedure before 2001 could contract loans covered by state's aid; LGs entering the special procedure after 2001 can contract new loans (totally covered by own revenues) just to fund investments. Anyway, during the period 2001–2003 a national special fund for financially destabilized LGs was fractioned among LGs involved in the special procedure. In 2007, special extraordinary national funds were attributed to financially destabilized LGs.

2.4 Significant data about financially destabilized ILGs

Unlike as for structurally distressed LGs, official data about financially destabilized LGs are yearly published by the *Corte dei Conti*. In the remainder of the section, we refer to up-to-date data published in 2010. By 1989, when the special legislation on financial distress was introduced, 441 ILGs entered the procedure of financially destabilized LGs⁴. The number of interested LGs goes down in time: 125 LGs entered the procedure in 1989 and 64 in 1990; between 1991 and 1994, about 50 LGs yearly entered the procedure; by 1995 the number powerfully diminishes and by 1998 at most 4/5 LGs per year entered the procedure. Five LGs entered the procedure twice. Considering the dimension of interested ILGs, 314 have less than 5.000 inhabitants (of these, 103 have between 1.000 and 2.000 inhabitants) and 5 have more than 60.000 inhabitants. Two southern regions (Calabria

⁴ 5,44% of total Municipalities (updated to April 2010).

and Campania) lead the list of financially destabilized ILGs, with respectively 127 and 113 cases; a central region (Lazio) follows with 42 cases. 64% of all financially destabilized ILGs are concentrated in these three regions. Up to April 2010, in 24 ILGs interested in the procedure the amount of total debts to be paid off to restore the financial situation is still undefined. By 1989 to 2001 the total amount of contracted loans covered by state's aid is about 871 billion (Euro). In the period 2001-2008, the total amount of money transferred by the central government decreases to about 400 billion (Euro). According to the *Corte dei Conti*, the lowering of financial aid by the central government is the main cause of reduction in the number of ILGs entering the procedure, and many LGs consider the special status of financial destabilization too risky and less advantageous than masking the real financial situation of crises. The minor amount of total money transferred to LGs also makes the concrete restoring of financial conditions for effective destabilized ILGs more difficult. Both local officers and citizens have become more prudent about the monitoring of financial conditions, but the risk of chronic incorrect behavior, such as hiding eventually serious situations of distress, taking time and delaying the restoring procedure, is still high. The sporadic and extra-ordinary involvement of state and also region (in the case of Sicily), in the shape of extra-funding, can be justified when general socioeconomic conditions of crisis, external with respect to LGs, are the causes of financial distress. Special rules also passed for few big insolvent Cities (Roma, Taranto, Catania), out of the ordinary procedure of recovering: special superintendent authorities were appointed and state aid transferred to avoid the full debacle of LGs' finances (*Corte dei Conti* 2010).

3. Is financial distress a pathological status or a bad habit? Searching for the causes of financial distress.

In this section, we first sum up the theoretical perspectives on financial distress' causes, based on international literature (Chernick and Reschovsky 2001; Kloha et al. 2005; Kihmi 2008). Then, we focus on the national context, where recurrent financial deficits, off-balance sheets debts, recorded un-cashed revenues and un-paid expenses, un-sustainability of existing debt appear to be the most frequent internal factors for LGs financial vulnerability. These situations seem to be «physiological», that is recurrent in years, for certain ILGs despite the formal acknowledgment of either structural distress or financial destabilization (*Corte dei Conti* 2010).

3.1 Theoretical perspectives on LGs' financial distress

In literature, the causes of LGs financial distress have been investigated according to two diverging general approaches. We refer to the «socioeconomic-decline approach» and the «local-management approach»: they differ in that following the first approach, causes of financial distress are supposed to be external to the LGs, laying beyond the control of local officials, whilst the second ap-

proach identifies in internal local management and political environment the real explicators of financial decline (Kihmi 2008). Within each approach, there are different views. National negative business cycles, suburbanization and migration, demographic changes, decline in local business activity, loss of jobs and tax base erosion, bureaucracy and state policies towards local governments, with particular respect to the assignment of public responsibilities without appropriate taxation tools or sufficient transferred funds to finance services, can all be classified as external socioeconomic causes of LGs' financial troubles (Chernick and Reschovsky 2001; Kloha et al. 2005; Kihmi 2008). On the other hand, in-correct managerial practices (poor accounting methods, erroneous estimation procedures, in-correct budgeting practices, erroneous financial disclosure practices, accounting gimmicks and short-term thinking), local officials' ineptness, incompetence and eventually corruption, political size fragmentation and procedural fragmentation (measuring, respectively, the number of social groups participating through their representatives and the level of decentralization in the budgetary processes), and finally vulnerability to special interest groups are all categorized as internal circumstances for LGs' financial distress (Kloha et al. 2005; Kihmi 2008). We totally agree in recognizing that a financial crisis does not evolve for one single reason, as LGs' financial vulnerability is definitely bothered by diverse factors, acting at the same time. Thus, we need to further investigate the relative importance of both external and internal factors causing financial disequilibrium in our national context (Wolmann 1983).

3.2 Evidences about ILGs

According to both scholars (Sargiacomo 1999, 2000; Tenuta 2007; Gori 2009) and national authorities (RGS 2010; *Corte dei Conti* 2010), accumulation of financial deficits, off-balance sheet debts, un-cashed revenues and un-paid expenses (residui), financial sustainability of total debt represents common criticalities for LGs financial management. Just in some cases, these situations are observed as possible symptoms of future financial structural distress or destabilization⁵. In 2008, 82 ILGs reported a deficit (for a total amount of more than 158 billions) but in 40 cases they were not new at this (referring to previous financial years)⁶. In 2009, 1550 LGs has declared off-balance sheet debts (for a total amount of more than 630 billions): of these LGs, 40,51% had declared off-balance sheet debts also in the previous year and 302 LGs had regularly and continuously declared off-balance sheet debts in the last seven years⁷; the amount of debt per capita is higher in very small LGs. Off-balance sheet debts originate mainly from judicial controversy (about 58%), and incorrect running of expenses in purchasing good and services (about 33%); they are almost entirely covered, by existing reserves (about 48%), previous financial surpluses (about 20%) and

⁵ All data exposed in the following are taken from the *Corte dei Conti's* last official report on ILGs' financial conditions (2010).

⁶ Campania and Lazio are the regions with more LGs in deficit.

⁷ Again, more of these LGs are situated in Campania and Lazio.

new loans (about 16%). In 2008, the amount of un-cashed operating revenues and un-paid operating expenses from the current financial year (residui) raised in southern LGs⁸; about 5% of both those revenues and expenses recorded in the previous years were removed from official financial reports (as definitely un-cashable or un-payable); less than 35% of both amounts were effectively cashed and paid. Small LGs have, on average, a higher total debt per capita. The yearly total cost of existing debt (capital plus interests) is unsustainable for almost the half of LGs: when necessary, LGs used extraordinary and non-recurrent revenues (previous financial surpluses, special revenues and gains from transfers of assets) to cover the payments. Finally, about the role of intergovernmental funding, the national Financial Law for the year 2008 has been stricter on revenues than expenses⁹: powerful changes in national regulation on ICI (a LGs' tax on households' property right) produced, on average, a -30% of reduction in total LGs' revenues from taxes, totally covered by rising in transfers from central government: as a result, LGs' financial condition is currently more dependent on central transfers than before. Looking at the data by means of the theoretical perspectives mentioned above, we recognize both external and internal factors of financial distress: recurrent financial deficit, off-balance sheets debts from incorrect procedures of purchasing goods and services, recorded un-cashable revenues and unpayable expenses, financial unsustainability of total debt seem all to be ascribable more to incorrect managerial practices and/or political fragmentation than to socio-economic external circumstances. External factors can be acknowledged in changes in national legislative framework related to taxation tools and expenses originated from non recurrent events (as defeats in judicial controversies). Other factors detected in the literature seem to deserve further indepth investigation (socioeconomic conditions, political fragmentation and vulnerability to interests groups). Some of the above identified factors of financial distress seem to represent a «bad habit» more than a «pathological status»: we particularly refer to the off-balance sheet phenomenon, the accumulation of recurrent financial deficit, the difficulties encountered in disposing of cashing and paying for previous years recorded revenues and expenses, when these situations occur with a certain recurrence in the same LGs. In fact, the attitude of the central government seem to support this idea, as only over certain thresholds these situation become significant in detecting the formal status of either structurally distressed or financial destabilized LG. The problem is that when the formal acknowledgement of financial distress occurs, it seem that the «bad habit» has developed into a «serious disease». In short, ILGs appear to be largely involved in «vicious» financial managerial practices, capable of evolving into critical situation of financial distress, although sufficiently tolerated by the central government. Only in very few cases (and when no alternative solutions come into sight) official special procedures of financial recovery are entered. This usually occurs in small and medium size LGs, when their financial condition is already dangerously compromised. Also in lite-

⁸ Un-cashed revenues, when recorded, affect the financial result shown in the Annual Financial Report, by diminishing the eventual deficit or raising the eventual surplus.

⁹ Referring to controls on expenses, ILGs are in any case subject to the National Stability Pact.

ature, buying time (using existing surpluses, re-budgeting, selling goods, short-term borrowing and creative bookkeeping) with the risk of precipitating in major fiscal difficulties, and asking for intergovernmental aid through bilateral negotiation are identified as the preferred local responses to fiscal pressure (at least in both the USA and the UK); in-creasing revenues (especially in the case of governments facing referendum requirements or nearly local election), expenditure reduction strategies, including cutting costs directly re-ferred to the services provision and personnel (usually starting from marginal activities), just seem to represent very last chances (Wollmann 1983).

4. The «attitude» of the central government

In this section, we focus on the «attitude» of central governments towards formally acknowledged financially distressed ILGs and analyze to what extent the «remedies» adopted in our Country reflect those proposed by the international literature on financial distress.

4.1 Theoretical analysis of state's role

Generally speaking, scholars agree on the need for financially distressed ILGs to obtain support from the upper levels of government in restoring their financial conditions (Coe 2008; Cahill et al. 1994; Gannon 1993; Chernick & Reschovsky 2001; Kihmi 2008). The reason is that intergovernmental funding system and settled (state) rules related to LGs' authority in collecting and spending revenues usually have remarkable implications for local fiscal health. With particular respect with the USA context, three diverging approaches have been identified, differing in that some states do not formally recognize any status of financial distress (even if providing special aid for fiscally depressed LGs), others use an ad hoc approach (by settling formal legislation to address any special case related to a specific LG), others use a multijurisdictional policy approach consisting in a general legislation formally recognizing distress in one or more classes of government (Cahill et al. 1994). This, in turn, also affects the possible remedies to be adopted. When the third approach is used, different practices have been detected, according to the monitoring of financial emergencies, the assistance in case of financial distress and the possibility of direct intervention by central governments (Coe 2008; Cahill et al. 1994). In any case general legislation attempts to accomplish the same functions: identifying criteria determining the entering in and the going out from the formally acknowledged status of financially distressed LG; defining parties, programs, processes and actions utilizable in restoring the financial situation; defining mechanism to oversee and control the ongoing implementation of the recovery (Cahill et al. 1994). Sometimes, state's intervention differs according to the dimensional class of involved LGs (Gannon 1993). Cross analysis reveal that states' responses are largely reactive (identifying distress after it had occurred) and that adopted remedies assume distress is a short-term managerial (in nature) phenomenon (Cahill et al. 1994).

4.2 The remedies adopted for financially distressed ILGs

The attitude of our central government towards distressed ILGs appears to be similar to the above quoted multijurisdictional policy approach, consisting in a general national legislation formally recognizing different types of distress in one or more classes of government (Cahill et al. 1994). The Italian approach seems to be highly reactive, assuming distress is the result of both internal and external factors. Only at a first look, the general approach appears to be quite stable in time, while the financial involvement seems to be drastically changed (*Corte dei Conti* 2010). After 2001, consistent with the new constitutional framework reshaping the relationship between national, regional and local levels of government in terms of fiscal responsibility, the legislation on financial destabilized LGs was modified; more recently, also legislation on structurally distressed LGs has been changed.

As highlighted above, parameters identifying the condition of structurally distressed ILGs have been reformed: they have been changed both in number (eight parameters until 2009, ten parameters by 2010) and content, according to the result of a process of negotiation between the Ministry of Interior and representatives of local governments (Conferenza Stato-Città). Suggestions from academics have been partially taken in account¹⁰. At the moment, it seems to be hazardous to discuss the extent of such changes in terms of a better ability in detecting and preventing the emerging of situations of financial distress.

With reference to the national legislation on financial destabilized ILGs, two different level of central government's involvement can be detected up to now, according to the moment the LGs entered the special status. 330 financially destabilized ILGs formally recognized before November 2001 could rely on special loans from central government (from 1990 to 2001, the total amount of state mortgages is about 871 billion). 43 ILGs entered the procedure between November 2002 and December 2003 without the same opportunity, but each obtained a special annual aid of 600.000 Euro for three years (2004/2006). For ILGs entering the procedure up to 2004, according to the new rules, central government guarantee financial support when current revenues are under the national average (according to the demographic dimension), by means of adjustment in state ordinary contributions and special aid in case of personnel reductions. In fact, both central and regional authorities continue to intervene with special, extra-ordinary measures, formally directed to remove the external causes of financial distress and to promote equality between citizens (for example, a special fund was created and distributed in 2007). This is also the case of big cities, like Rome, Taranto, Catania: none of them officially entered the special procedure of financial destabilized ILG, but special superintendents invested with exceptional authority were directly appointed by the Ministry of Interior and special fund continue to be transferred to restore the financial situation.

¹⁰ Gori (2009) highlighted the need for parameters able to catch the effects of services externalization and financial market volatility.

As a result, one could note a shift in the attitude of central government from general towards specific forms of intervention: formally, central government's involvement in the general case of financial destabilized ILGs has been drastically reduced; in fact, central government continues to powerfully intervene in «unofficial» restoring procedures, especially in case of big cities. This is probably due to differences in the relationship between state and big ILGs on one hand, and state and other ILGs on the other.

5. Concluding remarks

The purpose of our study has been to provide a general overview of the Italian special legislation on local governments' financial upset. We have started to investigate the very nature of financial distress in our national context, according to data available on the financial conditions of ILGs. ILGs appear to be largely involved in «vicious» financial managerial practices, capable of evolving into critical situation of financial distress, although highly tolerated by the central government. External causes of financial distress, already detected in the international literature, seem to deserve further indepth investigation, with particular reference to political fragmentation and vulnerability to interests groups. Then, we have focused on the «attitude» of the central government towards both structurally distressed and financially destabilized ILGs. Available data seems to confirm a shift in the attitude of central government from general form of intervention (codified in explicit law of general application) towards specific form of special, one-time involvement, especially in case of big Cities. Further studies should investigate to what extent power relations between state and singular dimensional class of ILGs diverge and affect the eventual involvement of central government in restoring distressed financial situation.

Zusammenfassung

Eine Übersicht über die italienischen Rechtsvorschriften betreffend notleidende Kommunen wird präsentiert, um sowohl die Art der finanziellen Notlage als auch die Haltung der Zentralregierung gegenüber notleidenden italienischen Kommunen zu erforschen. Im Allgemeinen scheinen italienischen Kommunen häufig in Praktiken des finanziellen Missmanagements verwickelt zu sein, die, obwohl sie weitgehend toleriert werden, zu kritischen finanziellen Situationen führen können. Verfügbare nationalen Daten scheinen eine Verschiebung in der Haltung der Zentralregierung vom allgemeinen zum besonderen Formen der Intervention zu bestätigen, insbesondere im Falle von grossen Kommunen.

Resumé

Cette étude présente un aperçu de la législation italienne sur les gouvernements locaux en détresse financière, en explorant la nature de la détresse et l'attitude du gouvernement central par rapport aux gouvernements locaux en détresse. En termes généraux, ces derniers semblent être largement impliqués dans des pratiques «vicieuses» de gestion financière, capables de se transformer en situations critiques de détresse financière, bien que très tolérées. Les données disponibles semblent confirmer l'existence d'un changement, du générique au spécifique, des formes d'interventions du gouvernement central, en particulier dans le cas des grandes villes.

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