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DISSERTAÇÃO

FISCAL FEDERALISM, INSTITUTIONS AND SOCIAL CAPITAL: LESSONS FROM THE ITALIAN MEZZOGIORNO

LUÍS ANDRÉ PINHEIRO DE MATOS

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ORIENTAÇÃO:
PROFESSOR JOÃO CARLOS LOPES

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Aos meus pais.

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Abstract

The aim of this paper is to investigate whether fiscal federalism can represent an effective barrier for regional development. We discuss the relationship between decentralization, lack of appropriate institutions and feeble economic growth, based on the existing literature. In order to identify the conditions that can hinder a successful progress towards fiscal federalism, we study the case of the Italian Mezzogiorno, exploring complementary ways to explain this reality.

We review literature on fiscal federalism, institutions and social capital, and we critically discuss the previous findings, trying to disentangle the main features of this region that obstruct the possibility of looking at fiscal federalism as a good solution for development, without previous institutional improvements. Decentralization comes then as a potential danger, representing an additional problem rather than a solution to the region.

We observe that the process of decentralization can be part of the explanation for the non-convergence of the Mezzogiorno, as it fostered the magnitude of low levels of institutional capacity and social capital of the region and turned them into an effective barrier to economic growth, creating a steady fiscal dependence and letting regional administrations exposed to free-riding, rent-seeking and corruption. In this vein, we suggest a set of substantial institutional and economic reforms. The lessons from this case study can be useful for assessing the potentials and bottlenecks of Portuguese regions' economic development.

Keywords*: Fiscal Federalism; Mezzogiorno; Regional Development; Social Capital;*

JEL: R51; O18; R11; Z13.

Resumo

O presente estudo tem como objectivo averiguar em que medida poderá o federalismo orçamental representar uma barreira efectiva ao desenvolvimento regional. Debatemos a relação entre descentralização, carência de instituições apropriadas e frágil crescimento económico, com apoio na literatura existente. A fim de identificar as condições que podem obstruir um avanço próspero em direcção ao federalismo orçamental, estudamos o caso do Mezzogiorno italiano, explorando diversas formas de explicar esta realidade.

Revemos a literatura sobre federalismo orçamental, instituições e capital social, e discutimos criticamente os resultados anteriores, tentando discernir as características essenciais desta região que possam obstruir a possibilidade de olhar para o federalismo orçamental como uma solução para o desenvolvimento, na ausência de melhorias institucionais prévios. A descentralização apresenta-se assim como um perigo potencial, representando um problema adicional e não uma solução para a região.

Observa-se que o processo de descentralização pode ser parte da explicação para a não-convergência do Mezzogiorno, tendo sustentado a magnitude dos baixos níveis de capacidade institucional e de capital social da região, tornando-os numa barreira efectiva ao crescimento económico, criando uma dependência orçamental firme e deixando as administrações regionais expostas ao *free-riding*, ao *rent-seeking* e à corrupção. Nesta linha de entendimento, sugerimos um conjunto de reformas substanciais, no plano económico e institucional. As lições deste estudo de caso poder-se-ão demonstrar profícuas para avaliar as potencialidades e os riscos para o desenvolvimento económico das regiões portuguesas.

Palavras-chave: *Capital Social; Desenvolvimento Regional; Federalismo Orçamental; Mezzogiorno;*

Résumé

La présente étude vise à enquêter si le fédéralisme budgétaire peut constituer une barrière effective au développement régional. La relation entre décentralisation, défaut d'institutions appropriées et croissance économique faible est débattue, sur la base de la littérature existante. Afin d'identifier les conditions qui peuvent prévenir un progrès fructueux dans la direction du fédéralisme budgétaire, le cas du Mezzogiorno italien est étudié, en explorant des moyens complémentaires d'explorer cette réalité.

Nous passons en revue la littérature sur le fédéralisme budgétaire, les institutions et le capital social, et les résultats précédents sont discutés de manière critique, en essayant de percevoir les principales caractéristiques de cette région qui puissent obstruer la possibilité de considérer le fédéralisme budgétaire comme une bonne solution pour le développement, sans des améliorations institutionnelles préalables. La décentralisation apparait alors comme un danger potentiel, représentant un problème additionnel plutôt qu'une solution pour la région.

Nous observons que le processus de décentralisation peut être une partie de l'explication pour la non-convergence du Mezzogiorno, étant donné que ceci a soutenu les bas niveaux de capacité institutionnelle et de capital social de la région et les convertis en effectives barrières à la croissance économique, créant une dépendance budgétaire constante et laissant les administrations régionales exposées au *free-riding,* au *rent-seeking* et à la corruption. Dans cette optique, nous suggérons un ensemble de substantielles réformes institutionnelles et économiques. Les leçons de cette étude peuvent être utiles pour évaluer les potentiels et les risques au développement économique des régions portugaises.

Mots-clés: *Capital Social ; Développement Régional ; Fédéralisme Budgétaire ; Mezzogiorno ;*

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1. Introduction

The case study of the Italian Mezzogiorno[1] is well-known in the economic literature and it is widely recognised that the persistent gap between this region and the Central and Northern Italy is rather an exceptional one (Mauro & Pigliaru, 2011). Notwithstanding, the powerful lessons that we can draw from this study are the main justification of the pertinence of furthering our knowledge on this region. We will analyse this case as an outlier that can bring important insights on economic development, bearing in mind the importance of case studies, as an instrument for a better understanding of how the economic principles function on the ground (Rodrik, et al., 2002), as well as their context-specificity (Davis & Trebilcock, 2008), complementing cross-country studies, and identifying causal mechanisms between institutional design and governments' behaviour, which is particularly relevant for policymaking (Rodden, 2003). Hence, case studies provide an essential source of evidence (Freille, et al., 2007).

The aim of this paper is to inquire whether the process of fiscal federalism launched in the early 1970s, and further deepened during the following decades, has had a significant impact on the convergence process of the Mezzogiorno with the rest of the country, discussing the main features of decentralization that could have hindered regional development. For that purpose, we systematically review relevant literature on the subject, exploring in particular the relationship between decentralization, corruption, lack of social capital and economic convergence. We perceive that the process of decentralization can be part of the explanation for the non-convergence of this region, since the early 1970s. The inadequate institutional design and the reduced capacity of regional administrations to foster growth and to provide public goods upheld a steady

[1] *Mezzogiorno* is a term generally used in the literature referring to a macro-region in Italy, which includes the regions of the South (Campania, Molise, Abruzzo, Puglia, Calabria and Basilicata) and the islands (Sicily and Sardinia). However, we should note that, for statistical purposes, we can restrict our analysis to the Southern regions.

fiscal and economic dependence, exposed weak subnational governments to free riding and created further incentives for activities related to rent seeking and corruption. In short, public administrations were transformed into incapable bodies of governance at the service of private interest groups and prevented regional economic development.

This paper proceeds as follows: in the next section we review the literature on the Mezzogiorno. In the third section, we present an overview of the main issues on fiscal federalism and institutions. In the fourth section, we look at the main issues on the Italian experience of fiscal federalism and we discuss the previous findings, trying to reach a consensus between the diverse waves of literature. In the last section we present some final remarks and a range of policy recommendations, and we also ought to draw some lessons that could be useful for analysing the Portuguese regional economic development, identifying threats to future movements towards fiscal federalism.

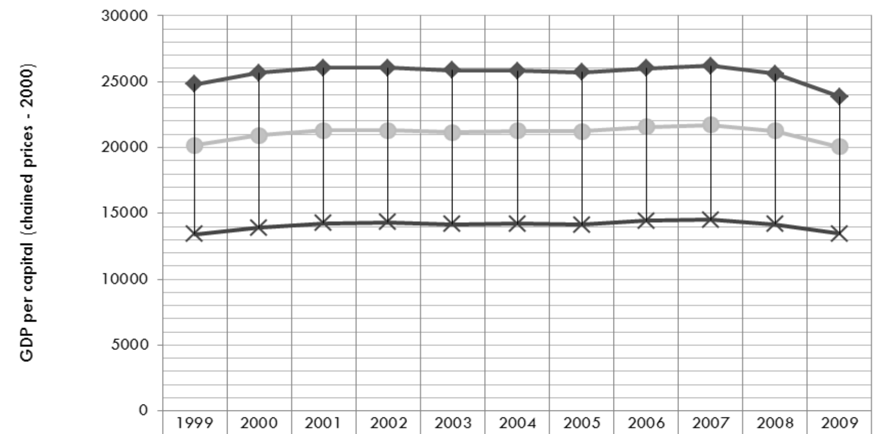
2. The Persistent Backwardness of the Italian Mezzogiorno

In this section we will succinctly review the literature on the Mezzogiorno, aiming at generally introducing the theme, presenting a wide range of contributions and analytical approaches to the Mezzogiorno problematic and fully demonstrating the significance of this case study. The case of the Mezzogiorno is widely known in the economic literature, and much was already said about the region. The intent here is to give a comprehensive view of this question, trying to address a broad range of interrogations and to reach an overall compromise on this matter. To this end, we will now shortly analyse the current situation of this macro-region and we will proceed with a review of the main causes of this persistent backwardness.

2.1 The current situation of the Mezzogiorno

The Italian Mezzogiorno is broadly perceived as an extremely dependent economy (Emiliani, et al., 1997; Sinn & Westermann, 2001; Mauro, 2004; Aiello & Pupo, 2011), with a fragile industrial structure (Guerrieri & Iammarino, 2007; Cutrini & Valentini, 2011), and the Italian national economy is generally conceived as geographically unequal (Signorini, 2001; Marrocu & Paci, 2010), having experienced a troubling dualistic development path (Mauro, 2004).

There are no signs of persistent convergence during the last decade (Figure 1.), and more generally since the 1970s (Figure 2.). Two clear convergence clubs are in place, approximately corresponding to the Centre-North and to the Mezzogiorno (Mauro, 2004), with different productivity levels (Marrocu & Paci, 2010) (Figure 3.), and regional business cycles with different characteristics, attributed to the dissimilar economic structure (Figure 4.) and to the different impact of the political business cycles (Mastronarco & Woitek, 2007). Hence, the dualism of the Italian economy is interpreted as an expression of the major underlying structural gap (Erbetta & Petraglia, 2008).



	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
North-West	24806,9	25660,1	26054,8	26071,3	25851,3	25821,2	25722,4	26021,8	26222,4	25582,9	23872,9
South	13427,7	13903,5	14240,1	14326,6	14180	14207,4	14145,7	14421,7	14502,5	14172,3	13463,1
Italy	20181,1	20917	21284,2	21313,4	21144,4	21257,7	21239,5	21548,9	21708,6	21258,8	20066,8

Figure 1. Gross Domestic Product (GDP) per capita at chained prices (reference year 2000 Euros) for Italy, North-West and South of Italy, from 1999 to 2009 (Source: Integrated economic accounts and analysis by industry – Istat)

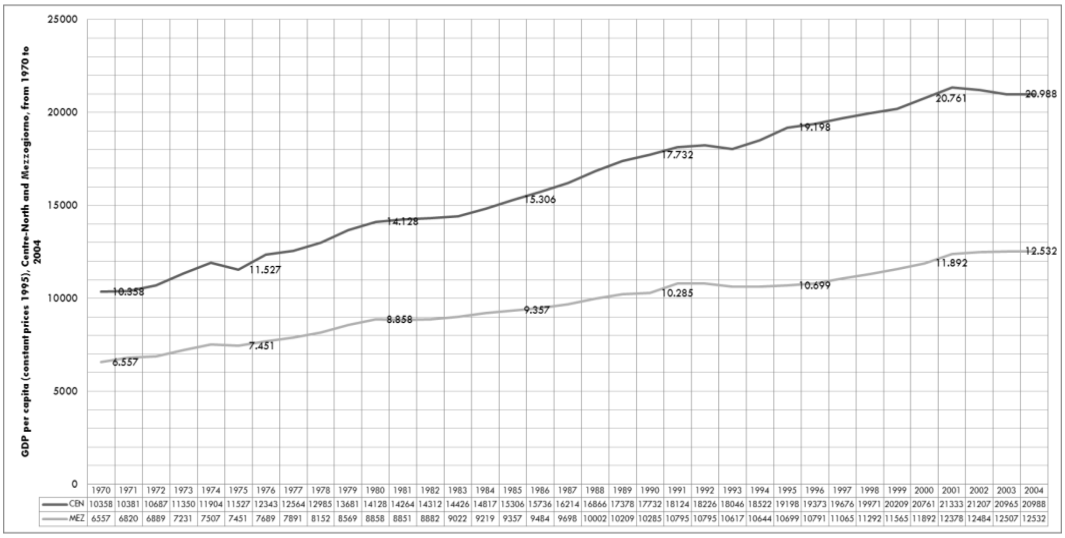


Figure 2. Gross Domestic Product (GDP) per capita (at constant 1995 prices), of the Centre-North and the Mezzogiorno, from 1970 to 2004 (Source: CRENoS, University of Cagliari, Regio-It 1970-2004. Database on the Italian regions, version: December 2007

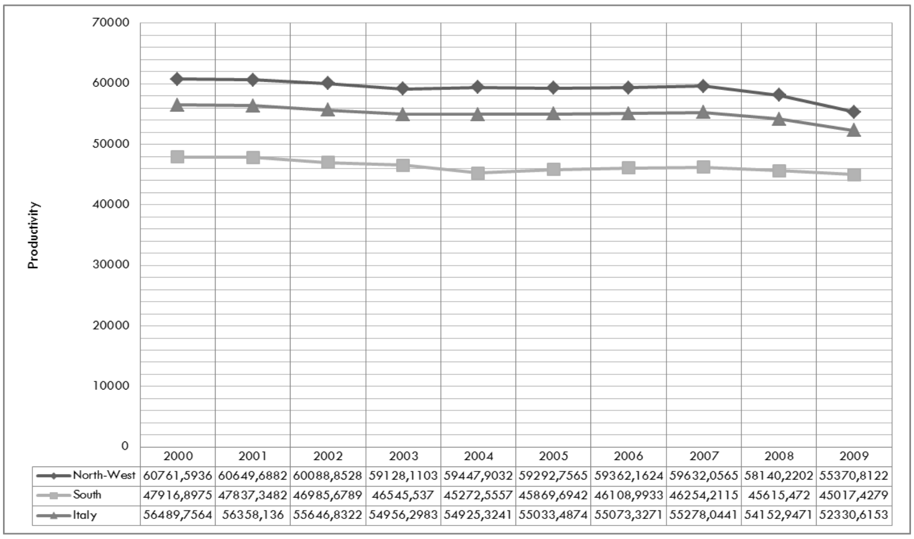


Figure 3. Productivity for Italy, North-West and South of Italy, from 2000 to 2009 (Sources: Eurostat and Integrated economic accounts and analysis by industry – Istat)

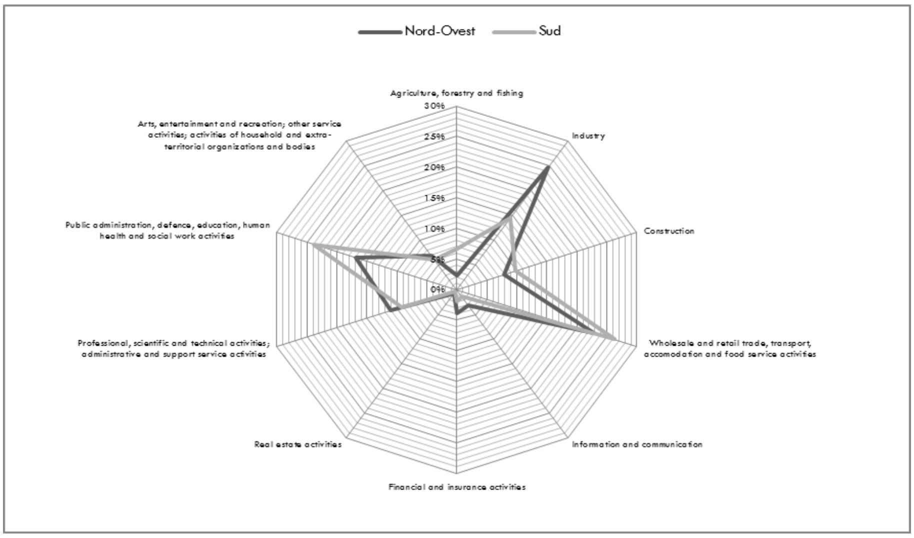
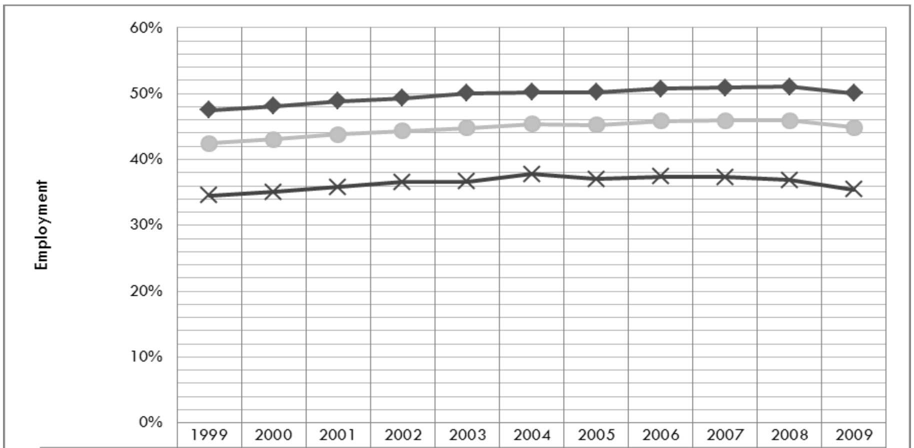


Figure 4. Comparison of the industrial structures between the South and the North-West (2010) – Employment by economic activity (Source: Eurostat)

Furthermore, it is argued that the productivity levels have shown signs of divergence in recent years (Mauro, 2004; Rossi, 2004). In this sense, looking at the private sector value added, we observe signs of actual divergence (Mauro, 2004). Regarding employment levels, these are particularly low in the Mezzogiorno (Figure 5.), and the extraordinary rates of unemployment, particularly youth unemployment, are somewhat worrying (Figures 6. and 7., in the Appendix).

Bearing this in mind, the spatial rigidity of the labour market is a major feature of the Italian economy (Brunello, et al., 2001; Mauro & Pigliaru, 2011), especially if we take into account the low employment rates of the South, which consequently reduce the efficiency of human capital accumulation, one of the key conditioning variables of economic growth (Carmeci & Mauro, 2002; Mauro, 2004; Mauro & Pigliaru, 2011).



	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
North-West	47,48%	48,14%	48,90%	49,34%	50,04%	50,24%	50,23%	50,77%	50,92%	51,05%	50,10%
South	34,54%	35,10%	35,83%	36,55%	36,61%	37,75%	37,00%	37,38%	37,31%	36,91%	35,45%
Italy	42,44%	43,09%	43,83%	44,37%	44,82%	45,41%	45,25%	45,83%	45,94%	45,93%	44,87%

Figure 5. Employment levels Italy, North-West and South of Italy, from 1999 to 2009 (Sources: Quarterly Labour Force Survey and Labour Force Survey – Istat – Note: cannot compare data until 2003 and since 2004 due to reorganization in data)

The high rates of crime are another frequently pointed feature which is believed to undermine the efficiency of local administrations (Daniele, 2009) and to block markets functioning, being particularly harmful for certain activities, such as foreign investment, credit to firms and industrial development (Peri, 2004; Sarno, 2005; Sarno, 2008; Daniele, 2010; Daniele & Marani, 2011; Pinotti, 2012). Accordingly, we find a considerably higher frequency of extortions and murders in Southern regions (Figure 8.)[2]. In particular, Pinotti (2012) finds out that organized crime has deep social, psychological and economic consequences, both in the short and in the long run, destroying physical and human capital stocks as well as increasing the riskiness of the business environment.

[2] Following Pinotti (2012), we use the murder rate as proxy for the presence of criminal organizations. In fact, a nearly perfect linear relationship is found by the author between the former and the latter, as under-reporting is allegedly negligible for homicides.

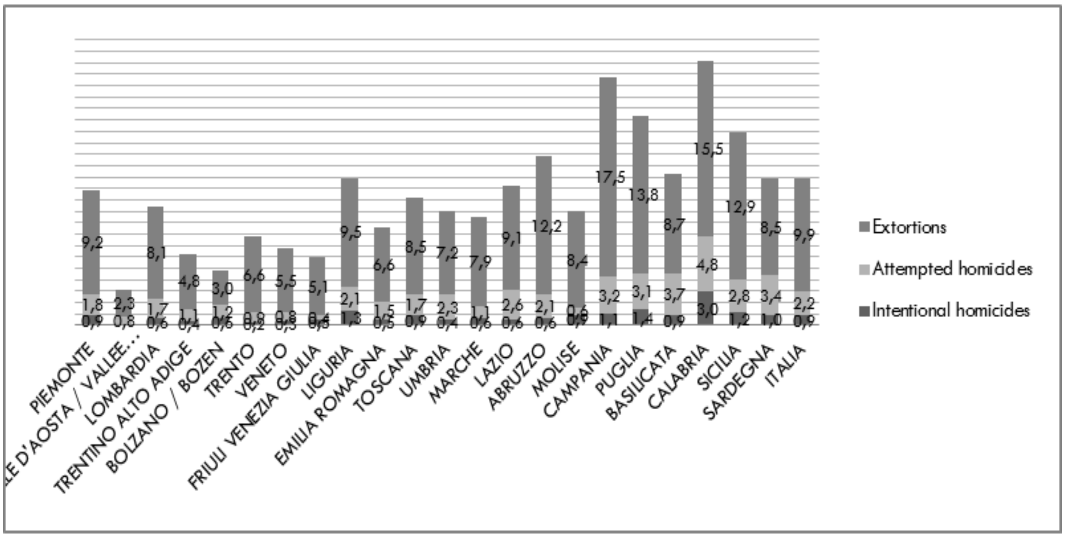


Figure 8. Number of extortions, attempted homicides and intentional homicides (reported by the police forces to the judicial authority) per 100.000 population in 2010 (Source: Istat)

This consequently hinders long-run economic growth, implying a significant reduction of GDP per capita, through a sharp contraction of private investment that is partly reallocated towards lower productive public investment, which is in turn captured by the criminal activity inside public administrations. In this context, the author refers that the roots of these criminal organizations can be found in the nineteenth century, especially after the Unification of the country, in 1871, when there was a demand for an "informal governance structure" (Pinotti, 2012, p. 10). Let us look, then, at the underlying causes of this dualism in the Italian economy.

2.2 The causes of a chronic backwardness

Since Putnam's seminal work (Putnam, et al., 1993) on the role of social capital[3] and civic traditions in Italy, several authors looked into this subject, explored the causes of the region's current situation, especially in comparison with the developed North, and gave way to a wide debate around the roots of the persistent economic and social backwardness of Southern Italy.

[3] We should note here the fuzzy definition of "social capital", which is frequently brought up and discussed, as well as the complexity of the mechanisms between social capital and economic growth (Iyer, et al., 2005) and the difficulties in measuring it (Durlauf, 2002). Although, while acknowledging the pertinence of such discussion, we will refer here to the common meaning of this expression, related to trust and cooperation (Knack & Keefer, 1997).

For instance, Helliwell and Putnam (Helliwell & Putnam, 1995) early suggested that the Italian regional growth path was closely linked to the different endowments of social capital and that the behaviour observed during the preceding decades had its roots on the process of political decentralization, which provided substantial economic and political powers to regions. In that situation, regions with a higher level of social capital have enjoyed better economic performance, given their ability to design better policies and to benefit from the potential advantages of the new decentralised institutional framework. As a consequence, despite the great amount of public transfers received by the Mezzogiorno (Tondl, 1998; Milio, 2007; Mauro & Pigliaru, 2011), the process of convergence verified during the 1950s and the 1960s suddenly stopped and gave way to a long period of stagnation.

In this concern, Guiso, Sapienza and Zingales (2008) find that the different political systems that developed in Italy before Unification, led to long-lasting disparities in the stocks of social capital, which determined different growth paths. Indeed, in the North, the political system brought by free city-states have apparently promoted cooperation through the protection of property rights, whereas in the South the hierarchical system imposed by the Norman kingdom will have prevented this initial accumulation of social capital, giving rise to divergent civic traditions in Italy. As well, Pigliaru (2009) suggests that there is "a widespread and deeply rooted problem of institutional quality [...] with a significant local component" (p. 13) due to cultural heritage, transmitted by successive generations.

The grounds of Southern Italy's economic backwardness are not infrequently attributed to historical factors, such as the late feudal system, the prevalence of hierarchical economic relations and the state-led industrialization process, during the economic miracle of the 1950s and 1960s, which was mostly capital-intensive, with little possibilities of generating local spillovers (Iammarino, 2005), that could have generated industrial linkages and the roots for sustainable local development. In fact, concerning the industrialization process, past institutions and geography were presumably of major significance defining the localization of agglomeration economies in the country (Percoco, 2009), and a great importance is given to the initial natural conditions of the North and to its closeness to the industrialized European countries, responsible for having attracted early industrial development and the ensuing satellite industries (Clough & Livi, 1956).

In referring to these factors as major causes of the current state of affairs in the Mezzogiorno, and admitting long-lasting cultural effects on economic performance, important policy implications will follow, for the reason that conventional economic policies are not expected to meaningfully amend the actual conditions that hinder the development of the region. Against this background, public policies merely involving direct income transfers and public investments in physical infrastructures will be largely insufficient (Tabellini, 2007; Shankar & Shah, 2009). In that case, policymakers have a great challenge in designing important structural reforms (Bibee, 2007; Pammolli & Salerno, 2008), which must be capable of promoting social capital accumulation (Boschma, 2005). Indeed, in such circumstances, it would certainly be helpful to invest in education (Helliwell & Putnam, 2007; Tabellini, 2007; Cannari, et al., 2009; Arghyrou, 2010), generally in human capital (Shankar & Shah, 2009), cheap financing (Tabellini, 2007), as well as making the labour market more flexible (Bibee, 2007) and reforming public administrations (Pammolli & Salerno, 2008), as a means of developing local entrepreneurial networks and reducing the tenacious structural gaps, particularly employment gaps (Erbetta & Petraglia, 2008).

It would then be particularly useful to look at the long-run macroeconomic evolution of the Southern Italian economy. We can essentially discern three main phases in the economic convergence between the Mezzogiorno and the Centre-North (Daniele & Malanima, 2007; Iuzzolino, et al., 2011; Felice, 2011; Mauro & Pigliaru, 2011). A first period of divergence over nearly a century, from the middle of the nineteenth century until the end of the Second World War, a short period of convergence, between the 1950s and the early 1970s, and another thirty years of stagnation, until our days.

2.2.1 Northern industrialization, standard divergence and failed new turn

The first period corresponds to the standard divergence observed between regions as a consequence of the early days of industrialization in the North, closer to the core of the Industrial Revolution and better prepared to receive new technical evolutions, namely in reason of a better endowment of human capital (Felice, 2010; Gagliardi & Percoco, 2011; Mauro & Pigliaru, 2011; Felice, forthcoming). In truth, it is useful to stress that, despite the initial relative proximity of the mean income across the country (Felice, 2011), the initial conditions were remarkably different. As regards the distribution of well-being, we perceive a higher inequality within the Southern regions, and a general scarcity in the prerequisites for industrial development, such as basic infrastructures, operative institutions and the availability of human and social capital (Iuzzolino, et al., 2011). Besides these limitations, the protectionist policies conducted during the early days of industrialization of the North and the World Wars were a major encumbrance to the economic convergence of the Mezzogiorno, encouraging Southern regions to specialize in the primary sector, and sponsoring the ensuing lack of technical progress in the economy (Gagliardi & Percoco, 2011).

Concerning the initial lack of human capital in Southern Italy, it must be mentioned that the education was originally financed by local governments (Iuzzolino, et al., 2011). In this sense, the unequal fiscal capacity impeded any sort of convergence in this ground, particularly in the literacy rates. As a result, the early decentralization in the education system is held as, not only an obstruction for closing this gap, but as an instrument for its widening (Iuzzolino, et al., 2011). This draws particular attention to the on-going process of fiscal federalism, as strong evidence that decentralization measures in the education system are likely to exacerbate the existing inter-regional disparities (Bibee, 2007) (Figures 9. and 10., in the Appendix), therefore further hampering any chances of economic convergence and development in backward regions.

The broader rationale for the lack of convergence up to the middle of the twentieth century can in fact be found in the absence of a political compromise to fight the latent economic gap in the Italian economy. The priority was to promote the accumulation of capital in the most promising regions of Northern Italy (Iuzzolino, et al., 2011; Mauro & Pigliaru, 2011). Moreover, a "failed new turn" is identified, during the first half of the century, which transformed a "normal" disparity "into a gap that would be exceedingly hard to close" (Iuzzolino, et al., 2011, p. 7). This suggests that, at least part of the "geographical fracture in Italian history was shaped by the experience of world wars and the dictatorship" (Iuzzolino, et al., 2011, p. 27). This view is also shared by Felice (forth.), who refers that most of the divide between the North and the South of Italy has emerged during these fifty years.

2.2.2 *The economic miracle*

During the second period, the two decades of the "economic miracle", one of the keys to the convergence process observed were precisely the public policy programmes specially directed to the South of Italy (Felice, 2010) and managed by a local development agency, alongside with the natural functioning of the market forces, expected by the neo-classical convergence models (Solow, 1956; Barro & Sala-i-Martin, 1991; Mankiew, et al., 1992), with the resulting shift from the primary to the industrial sector and the corresponding TFP gains (Mauro & Pigliaru, 2011). However, the large investments made in the region were reportedly unable to modify regional structural conditions and to generate a sustainable growth trajectory (Chenery, 1962). Likewise, public subsidies aiming at encouraging regional growth and industrial development during this period encouraged capital-intensive sectors (Fenoaltea, 2007), and will not have stimulated the creation of local spillovers.

The kind of public policy needed to promote economic development in the Mezzogiorno, able to put the region at the top of the political priorities (Giannola, 2010), with clearly identified goals (Cannari, et al., 2009) and ambitious reforms capable of deterring the vicious circles caused by corruption, political instability and low investment (Del Monte & Papagni, 2001; Mauro, 2004), independent from political bargains (Iuzzolino, et al., 2011), if it ever existed, ended by 1970, which is the turning point to the third period.

2.2.3 Divergence and decentralization

The process of convergence quickly stopped as we moved to the 1970s and the process of decentralization effectively started (Terrasi, 1999). In truth, another important change has brought a serious threat to the economy of the Mezzogiorno, with the adoption of a uniform national wage level, which was particularly harmful for regional competitiveness (Carmeci & Mauro, 2002; Mauro & Pigliaru, 2011). Albeit the relevance of the spatial wage rigidity should not be overlooked, the focus of the present paper is specifically on the economic consequences of the decentralization in the region.

In truth, the sudden halt of convergence in the 1970s is most likely due to the “threefold wage, oil and budget shock” and further intensified by the decentralization process launched in the beginning of the decade (Iuzzolino, et al., 2011). Indeed, the trends of fiscal federalism introduced in the early 1970s were unlikely to foster economic growth, and hence convergence, in an institutional framework taken by corruption, which causes significant negative externalities and inhibits regional development. In this case, decentralization is more likely to reinforce institutional inefficiency, so that without outside intervention the region may be stuck in a vicious cycle (Mauro, 2004). In fact, public spending, especially current expenditure, potentially boosts corruption and rent-seeking activities (Daniele, 2009), and these can be further strengthened as a result of the decentralization process, conceivably even spreading to other levels of administration (Bibee, 2007). On top of that, the spread of corruption is expected to create further incentives to corruption, i.e. corruption plausibly has increasing returns (Del Monte & Papagni, 2007)[4].

In this vein, the lack of social capital is partly responsible for the weak regional institutional capacity and for the differences in efficiency (Francese & Romanelli, 2011). This fact can help to explain the enduring mismanagement of European structural funds in recent decades (Milio, 2007; Accetturo & de Blasio, 2012), which were unable to boost productivity and to improve the structural conditions in the Mezzogiorno. Hence, the weak institutional background explains the inability to assure a high growth impact of public funds and to promote the evolution of the region and of its institutions (Tondl, 1998), once again bringing us to the historical explanation and suggesting important path dependencies.

Still, it is in fact probable that regional administrations have been more exposed than the central government to moral hazard and rent seeking (Scoppa, 2007), and that the right incentives were not present for using funds in industrious projects (Aiello & Pupo, 2011). Likewise, public officers might pursue opportunistic activities associated with agency problems, or do little effort to reduce costs (Aiello & Scoppa, 2008). This is related to the indicator of corruption proposed by Golden and Picci (2005), which evaluates investments efficiency measuring the disparity between the actual quantities of public infrastructures and the price government paid for them.

These results clearly point to the need for central government intervention and to the inevitability of a greater focus on institutional problems, particularly in what concerns

[4] We should note that this is entirely consistent with the previous findings of Krueger (Krueger, 1974), which bring up the vicious circle that may be set in place in the economy, if there are suspicions of permeability to rent-seeking, hence expanding the temptation to engage in further rent-seeking activities. In this context, a non-cooperative Southern Italian society, characterized by its “unwillingness to trust” since the early days of Unification, is found in the literature (A'Hearn, 2000).

subnational governance (Arpaia, et al., 2009), reducing barriers to growth (Aiello, et al., 2011). Thus, policymakers must be aware that the improvement of conventional economic variables is not sufficient and that one must also look at social and institutional factors (Aiello & Scoppa, 2008).

Likewise, bearing in mind that the same formal institutions can work in a very different way, depending on the context they are embedded in, important informal institutional differences persist between Northern and Southern Italy (Tabellini, 2007). More proof of the Mezzogiorno's weak institutional capacity is the finding of different efficiency levels of public capital between the two macro-regions, particularly when European structural funds are concerned (Gómez-García, et al., 2012) and when data is disaggregated by government levels (Marrocu & Paci, 2010). In fact, we generally find much less efficient local and regional administrations in the Mezzogiorno (Francese & Romanelli, 2011), which is rather worrying, given that it illustrates the inability of local administrations to exploit the benefits of closeness to their citizens' problems and preferences (Marrocu & Paci, 2010), one of the noteworthy advantages that decentralized governments can bring, providing closer information of local necessities. This brings additional concerns about decentralization, recalling the increasing responsibilities of lower levels of administration as the process of fiscal federalism deepens.

Finally, there is support to the view that local public goods are crucial to determine regional productivity levels, and differences in the former can be explained by the institutional capacity at subnational level (Acemoglu & Dell, 2010), which represents an important link between institutional capacity and economic growth. In addition, a strong impact of public capital is found in the Mezzogiorno (Picci, 1999; Paci & Saddi, 2002; Destefanis & Sena, 2005), particularly in what concerns investment in infrastructures. Even if it could be seen as quite misleading, these findings are coherent with the view that the region lacks in infrastructure and that there is still way to additional investments in that component, bridging regional locational and infrastructural disadvantages. However, we must recall that these investments must be complemented with additional reforms, which can help improving overall productivity levels, both in the private and in the public sector, and removing local structural factors that hinder economic growth (Destefanis & Sena, 2009). Bearing this in mind, it is important to recall the importance of undertaking carefully designed projects, and minimizing inefficiencies related to the misuse of public resources.

Accordingly, equally linked to the quality of institutions, it is also imperative not to forget that the preservation of the existing infrastructural stock is as important as undertaking new investments, despite the political incentives, which mostly encourage new investments, more visible and political rewarding. Again, this highlights the importance of bearing in mind institutional issues, since it is expected that, in weaker institutional contexts, there may be a great bias towards often unproductive new investments, overlooking maintenance and implying great costs in the future (Romp & de Haan, 2005).

Indubitably, low quality institutions are paramount to an eclectic understanding of the economic backwardness of Southern Italy, thus highlighting the importance of public policies aimed at accelerating the accumulation of social capital and at improving institutional quality, through the enhancement of trustful relations and organizational capacities (Pigliaru, 2009). As mentioned above, the origin of the regional gaps may be found in "viscous cultural components" (Pigliaru, 2009, p. 22) and there are serious doubts about the capacity of the mechanisms created by the model of fiscal federalism in Italy to overcome this problem, which neither consider the width of the regional discrepancies in institutional quality and economic structure nor reflect their cultural origin. In fact, regional inequalities are probably too large for a successful functioning of a decentralized system (Pigliaru, 2009).

Likewise, the poor economic performance of the Mezzogiorno cannot understandably be explained merely by differences in employment, human capital or industrial structure, but rather by differences in informal institutions and social capital (Felice, forth.). The "key fixed resource" in the post-Fordist age is, in fact, social capital, being responsible for the attraction of mobile resources, such as physical and human capital (Felice, forth.). This is mainly explained by the growing mobility of human capital and the growing transaction costs involved in modern economic growth, which converted social capital in a crucial resource. In effect, a dynamic approach to the region's long-run economic evolution reveals that social capital began to be the main determinant of economic growth in the 1970s, also as a result of the process of administrative and political decentralization. Following this interpretation, based on a long-term analysis, technological regimes define the genuine conditioning variables in each period. In this context, in the early industrialization, natural resources were the main determinant. During the second wave of industrialization, which lasted until the 1960s, human capital was the essential engine of economic growth. Finally, social capital became increasingly important as we moved forward to the modern economic era, after the 1970s (Felice, forth.).

To sum up, the Mezzogiorno is now a dependent economy. Dependent on transfers from the Italian central government and from the European Union, dependent on foreign technology and on foreign investment flows. Most of all, dependent on central government's will to undertake vital reforms capable of bringing a momentum of growth and sustainable development to the region, removing obstacles to markets functioning, building effective institutions and eliminating the burden of crime. There remains a huge economic gap and quick responses are needed, if the aim is to close this breach in the Italian development path.

As we have just seen, the origins of this gap are many, but a few comprehensive reforms would be enough to improve the regional economic potential and well-being. Such set of policies is far from obvious and, undeniably, one needs to understand the real grounds that block regional development, carefully looking at history and institutions, before starting a new period and expecting a "successful new turn".

From the analysis developed here, we can conclude that conventional economic policies won't have much success, without a concomitant institutional reform. In fact, whatever the specific distant causes are in civic traditions, culture, geography or past institutions, we must remember that the existing problem is definitely on the incapability of current institutions. Even admitting a strong influence of culture and past institutions, and the presence of important path dependencies, it doesn't mean that the current situation is ineluctable. Rather, it means that crucial structural and institutional reforms are the way forward. For that reason, we need to reform current institutions bearing in mind the important lessons drawn from the past.

In this context, let us now recall some theories related to fiscal federalism, in order to analyse the outcomes shown in this chapter in the light of those theoretical foundations, exploring the main issues related to the case of the Italian Mezzogiorno.

3. Institutions, Fiscal Federalism and Budget Constraints

While acknowledging that the achievement of optimal institutional designs is a fairly challenging task (Wildasin, 2004), largely dependent on the context they are embedded (Rodrik, et al., 2002), there is increasing empirical evidence that institutions are crucial in determining long-run economic development (North, 1991; Olson, 1996) (Rodrik, et al., 2002; Davis & Trebilcock, 2008; among others). In this regard, it is also recognized that applying similar policies to countries whose institutional arrangement and capacity are widely distinct is likely to fail (Shah, 2006). It is therefore essential to focus research in deep analysis of specific contexts, in order to understand which specific institutional arrangements are desirable, and under what circumstances new institutional reforms are crucial to promote economic growth.

3.1 Decentralization and corruption

Shah (2006), for example, finds that measures envisioning greater decentralization are not expected to produce the expected positive results in the absence of rule of law. In fact, a larger share in local income and the interjurisdictional competition usually fostered by decentralization do not increase *per se* local governments' capacity to reduce corruption (Fan, et al., 2009). In this vein, Pammolli and Salerno (2008), referring to the case of the Mezzogiorno, denote that federalism *per se* won't solve all the problems and that the excess of confidence in the "shock therapy" introduced by such an institutional system can disregard key structural reforms and lead to the perpetuation of the blockages to regional development.

The improvements in administrative abilities is actually one of the most important expected benefits of a process of decentralization (Shah, 2006), by improving governments' accountability, but this requires a favourable atmosphere and governments which have not been taken over by corruption. For instance, even if decentralization can, in certain cases, be an important tool to tackle corrupt behaviours, in some environments characterized by a high risk of local capture by interest groups, decentralization can, instead, enhance the opportunities for corruption (Shah, 2006; Bordignon, et al., 2008). In this context, if there is higher prevalence of corrupt behaviours in lower levels of government, corruption will probably increase, as a consequence of the fewer barriers and the greater opportunities set up by federal systems (Prud'homme, 1995). As such, it is straightforward to recognize that corruption and bad governance can absolutely undermine local institutions (Wildasin, 2004), preventing them to evolve and blocking them into a trap of corruption and misuse of public funds.

In this respect, Weingast (2005) finds out that only some types of federalism are desirable to foster development in backward regions, where local governments usually face several perverse incentives, related to common pool problems, as soft budget constraints and race to bottom, and incentives towards rent-seeking and corruption. Furthermore, Prud'homme (1995), comparing decentralization to a potent drug, mentions that in the wrong circumstances decentralization "can harm rather than heal" (p. 201).

3.2 The hard budget constraints

It will thus be of major importance to have a better knowledge of the role of particular institutional arrangements in different federal systems (Wildasin, 2004) and it is useful to review some of the aspects that are more likely to produce a virtuous process of fiscal federalism. After all, we know that "the devil is in the details" (Rodden, 2003, p. 725).

The recent literature on fiscal federalism has been particularly concerned with the problematic of the hard budget constraints (Oates, 2005). The primary concern is linked to debt financing and to the risks of an excessive reliance on intergovernmental transfers, instead of collecting taxes, eventually worsened by wasteful spending, leading to financial unsustainability (Wildasin, 2004). The issue of hard budget constraints is generally seen as an essential feature of federal systems (De Mello, 2000); either as a means of limiting the size of the public sector (Oates, 1985); inducing competition among subnational governments, fostering the so-called market-preserving federalism (Weingast, 1995); enhancing the efficiency of local governments (Oates, 2002); controlling corruption (Weingast, 2009); or reducing local officials motivation to extract bribes (Fan, et al., 2009). Accordingly, the design of the systems of intergovernmental transfers is an issue of prime importance in federal systems (Oates, 2008).

In fact, many authors (Weingast, 1995; Bucovetsky, 1997; De Mello, 2000; Goodspeed, 2002; Rodden, 2003; Oates, 2005; Weingast, 2005; Oates, 2008; Fan, et al., 2009; Weingast, 2009) have examined "the potentially distorting and destabilizing effects"

(Oates, 2005, p. 362) that can arise with the softness in budget constraints. Indeed, the bottom line is on regional governments' incentives, which depend on the expectations regarding central government's reaction function (Goodspeed, 2002). In this case, expectations will depend on the credibility of the commitment. In other words, the "hard budget reputation" of the central government and the proportion of the budget that is own-financed will determine the likelihood of the central government to maintain the hard budget policy here in question.

It is recognized that expenditure decentralization funded by transfers, such as grants and revenue-sharing, might break the link between taxes and benefits, thus contributing to the opacity of the system, to the promotion of fiscal illusion and to the deepening of the common pool problem (De Mello, 2000; Rodden, 2003). The redistribution between states induces a moral hazard problem, as a consequence of the breaking of the link between the reduction of tax base and its costs (Bucovetsky, 1997), potentially leading to a race to bottom among jurisdictions (Prud'homme, 1995; Weingast, 2005) and to the erosion of the tax base, limiting the scope for redistributive and development policies.

In fact, if the fiscal system is expected to provide a ready bailout, e.g. heavily subsidizing local governments, there are strong endogenous incentives for the local governments to raid the commons and to overspend (Oates, 2005). In turn, there is evidence of an incentive problem with the federal systems in rich countries that have the responsibility to provide subsidies to the poorest regions, creating dependency and softening budget constraints (Weingast, 2009). Indeed, these intergovernmental transfer systems are thought to be the main source of soft budget constraints (Oates, 2008). In this vein, Desmet and Ortín (2007) call attention to the situation of "rational underdevelopment" that may arise with high amounts of intergovernmental transfers enduringly directed to the poor region.

The soft budget constraints-related troubles can only be amplified if the definition of the functions of each level of government is not clear (Mosca, 2006), and if local governments have access to autonomous borrowing (Rodden, 2003), especially if these funds are directed towards current expenditure or unproductive investments.

Still, central governments have a crucial role to play in this framework (Goodspeed, 2002). In reality, it is difficult to credibly commit to a hard budget policy (Bertero & Rondi, 2000). When subnational fiscal crises jeopardize the banking system, the national economy, or even government's re-election chances, the central government can be forced to intervene (Rodden, 2003). Furthermore, if subnational governments are heavily dependent on intergovernmental transfers it will be more likely that central governors will be held responsible and the higher impact of a default will certainly force an intervention. In fact, "perversely structured systems of intergovernmental finance can destabilize the public sector and the economy as a whole" (Oates, 2005, p. 354).

A system based in soft budget constraints has endogenous incentives for local actors to behave in a fiscally irresponsible way and, in that case, the solution is to reform the federalist structure, inducing the right incentives in the system (Oates, 2005). The source of the problems is then the basic structure of incentives that lead to a destructive fiscal behaviour (Oates, 2008). In other words, institutional systems have in themselves the sources of their own success or destruction (Oates, 2005).

In the end, it is the form of fiscal decentralization that will determine the success of any federalist reform (De Mello, 2000; Darby, et al., 2003; Rodden, 2003). The implications here are quite clear. The role of intergovernmental transfers must be limited (Ahmad & Craig, 1997; Darby, et al., 2003), avoiding the creation of strong vertical dependencies between governments, and reliable systems of local taxation must be set in place (Oates, 2008; Weingast, 2009), supported by capable local governments (De Mello, 2000). Similarly, there are some fundamentals that can help hardening budget constraints, such as efficient credit markets, systems of intergovernmental grants not subject to political manipulation, and a set of laws imposing balanced-budget restraints, limitations on borrowing and providing guidance to public bankruptcy and to the handling of fiscal crises (Oates, 2005).

3.3 Decentralization and development

It must be recalled that, in a federalist framework, however interjurisdictional competition can actually promote efficiency at local level, the constraints that solid federal systems impose on public sector functions, such as the promotion of development, macroeconomic stabilization and redistribution, shall not be neglected (Oates, 2002).

It is widely acknowledged that redistribution in local governments is unlikely to succeed (Prud'homme, 1995; Musgrave, 1997), because of the incentives that are introduced towards a race to the bottom with the aim of attracting investments. In this regard, if any jurisdiction aims at introducing a redistributive reform, e.g. with a progressive tax system, it is likely that the richest taxpayers move to other regions, and the jurisdiction will attract the less privileged population, eventually compromising regional competitiveness. Thus, redistribution must be set at higher government levels (Prud'homme, 1995; Musgrave, 1997).

This, in turn, brings an additional question. Should income be redistributed among regions or among individuals? In this context we should cite Prud'homme (1995), who raises that "poor people in low-income regions are poor for good reason: they live in a place that offers fewer economic opportunities and less infrastructure and lacks economies of agglomeration and other location-specific externalities" (p. 203). As outlined above, in federal systems, redistribution among regions can entail several perverse incentives related to soft budget constraints. But, certainly, if income redistribution is carried out among individuals, the structural conditions that hinder regional development are unlikely to be modified. Then, poor jurisdictions are likely to be stuck in a vicious circle (Tanzi, 2001), with lower tax bases, lower-quality services, less public goods, non-competitive for businesses and uninviting for families (Prud'homme, 1995). It is then straightforward to consider that “decentralization can therefore be the mother of segregation” (Prud'homme, 1995, p. 203). Furthermore, governments and individuals in the richer regions may wish to avoid the charge of contributing to the poorer, and have the desire of being independent (Tanzi, 2008).

In summary, we shed light on the importance of sustaining hard budget constraints in decentralized systems of governance, if the aim is to build sustainable federal systems. Nevertheless, it must also be restated that there are numerous challenges in building federal systems. First of all, it is imperative to refer that the endogenous incentives introduced in the system will be the vital factor to any federalist reform. In this sense, the central government must create expectations of hard budget constraints.

This can be achieved through a wide variety of complementary policies. Well-defined rules inhibiting bailouts and defining bankruptcy procedures, as a means of creating credible threats; limited role for intergovernmental transfers and effective systems of local taxation, with the objective of improving local financial autonomy and responsibilities; and improving managerial capacities in local governments, as well as promoting accountability and transparency, in order to build a culture of good governance and intergovernmental cooperation. These are some general recommendations that fit in fundamentally any federal system and the key to successful decentralization is, primarily, good planning (Tanzi, 1996).

Notwithstanding, another issue is if a system of fiscal federalism is desirable in any situation and, in particular, in scenarios of great inter-regional disparities. In such circumstances, the road to federalism can equally encourage cessation of the richest regions and become an additional barrier for development and convergence. In that case, we can think about the consequences of a “federalist trap” to the most disadvantaged regions, hence locked into a vicious circle of ineffective institutions, corruption, external dependence and slow economic growth. We must then think of which set of policies can prevent the perpetuation of this undesirable situation. However, it is important to highlight that a system in which fiscal responsibilities are assigned as suggested by the literature on fiscal federalism will entail a contraction of the scope for welfare policies (Bouton, et al., 2008).

Bearing this in mind, it is useful to look more closely at a concrete scenario, which brings important insights to this discussion. The analysis of the Italian experience of fiscal federalism provides a powerful case study and permits key interpretations of issues on fiscal federalism, particularly in the context of developed countries with lagging regions dependent on income transfers from the richest ones, but also containing important lessons for developing countries.

4. The Mezzogiorno in the Light of Fiscal Federalism

The case of Italy in the light of fiscal federalism brings essential insights to the public finances and development economics and has been broadly studied in the economic literature (Emiliani, et al., 1997; Bertero & Rondi, 2000; Bordignon, 2000; Cerase & De Vivo, 2000; von Hagen, et al., 2000; Rossi, 2004; Bibee, 2007; Pammolli & Salerno, 2008; Bordignon & Turati, 2009; Padovano, 2012).

In particular, the evolution of the Italian public finances since the federalist reform in the 1970s must be carefully analysed in order to identify concrete threats to this federal system, which can be fundamental to prevent fiscal imbalances, macroeconomic crises, the spreading of regional economic inequalities and the possible fragmentation of decentralized systems.

In this context, McKinnon (1997) refers to the Italian experience of fiscal federalism, stating that intergovernmental equalization grants softened budget constraints and inhibited the “natural process of equalization through competition” (p. 1579), consequently perpetuating a situation in which the weak economy of the Mezzogiorno lags behind and depends on income transfers from the rich regions of the Centre-North.

4.1 The main features of the Italian fiscal federal system

With respect to the local tax system, the reform introduced in the early 1970s had devastating effects on the fiscal autonomy of municipalities and regions (von Hagen, et al., 2000), and it is argued that the public finance reform occurred in the 1990s wasn’t able to significantly amend this framework (Emiliani, et al., 1997; Bordignon, 2000; von Hagen, et al., 2000). As a result, intergovernmental transfers grew from 30 per cent of total current revenues to about 80 per cent in the 1970s and currently own revenues do not cover more than 20-30 per cent of the expenditure in the Mezzogiorno (Bordignon, 2000). Therefore, the Italian fiscal system is characterized by a high fiscal imbalance between own revenues and expenditures (Figures 11. and 12.).

This has particularly affected Southern regions, with lower tax bases, since own revenues were not sufficient to finance current spending, and new transfers had been mostly directed to finance current expenditures, therefore surrendering a significant part of public investment (Bordignon, 2000) and overlooking indispensable projects that would have been crucial to improve the competitiveness of the region. In this sense, Mastromarco and Woitek (2006) refer that, after the end of the 1970s, the infrastructure gap increased between the Mezzogiorno and the North, and that there was hardly any public capital growth during the 90s.

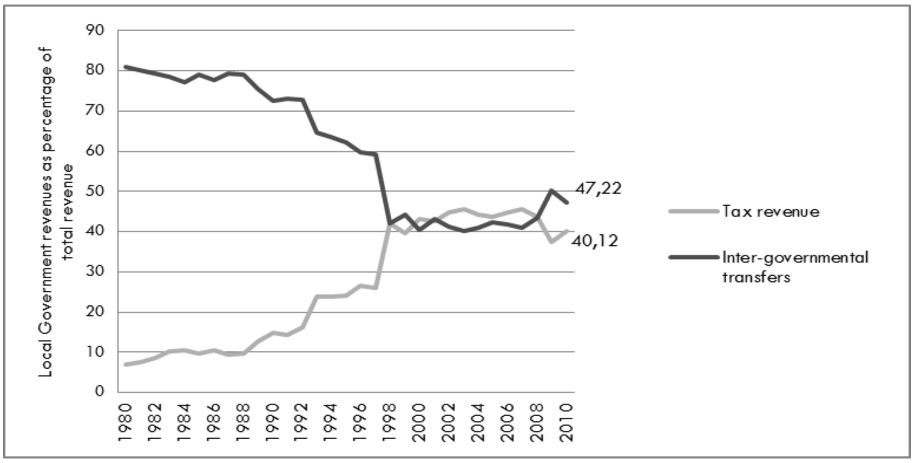
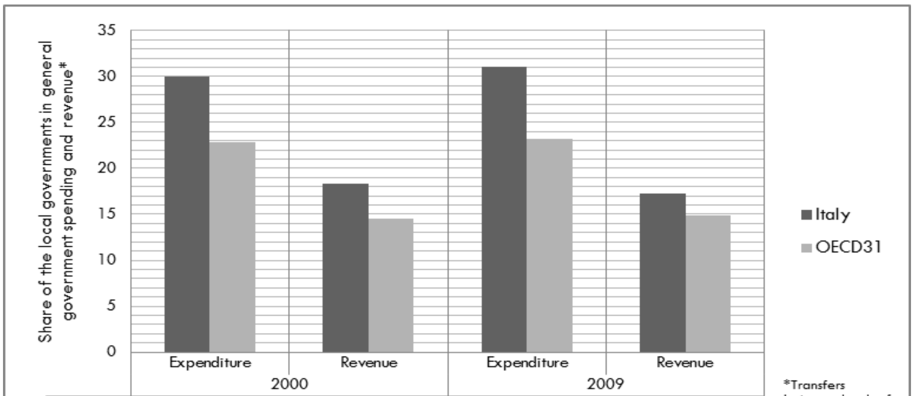


Figure 11. Local Government revenues as percentage of total revenue, from 1980 to 2010 (Source: OECD Fiscal Decentralisation Database)



	2000 Expenditure	2000 Revenue	2009 Expenditure	2009 Revenue
Italy	30,0	18,3	31,1	17,3
OECD31	22,8	14,6	23,2	14,9

Figure 12. *Share of the local governments in general government spending and revenues, in 2000 and 2009 (Source: OECD National Accounts Statistics)*

The lack of commitment to well-defined policies and the inexistence of clear rules concerning intergovernmental grants led to indiscriminate financing, rewarding inefficiency in local administrations and creating expectations of soft budget constraints (Emiliani, et al., 1997; Bordignon, 2000). Moreover, the lack of credible punishments, such as well-defined public bankruptcy procedures, further encouraged irresponsible behaviour (Emiliani, et al., 1997). Bailout expectations were intensified and irresponsible spending was rewarded by repeated central government's decisions, particularly in the 1970s and 1980s, to assume responsibility over subnational debt (Emiliani, et al., 1997). These local fiscal distortions are at the origin of an inconsistent system that is highly vulnerable to political manipulation and lobbying, and is partially responsible for social and economic inequalities in Italy (Bordignon, 2000; Rossi, 2004). What's more, this decentralization is expected to experience a setback, bearing in mind that further fiscal autonomy, in such a dual country as Italy, is doubtless intolerable (Bordignon, 2000), especially if suitable complementary reforms are not introduced.

It is straightforward to note that the separation of revenues and functions has brought "the worst of all possible worlds" (Bordignon, 2000, p. 24) and the evidence is clear showing that a clear definition of resources and responsibilities is essential to sustain decentralized systems (Cannari, et al., 2009). In parallel, the Italian experience also suggests that decentralization and geographical redistribution do not get along (Emiliani, et al., 1997; Bordignon, 2000). In this context, one must be aware that the potential benefits that decentralization can bring, as experience demonstrates in several federal countries, will likely come through the exploitation of local capabilities, with a limited role for interregional redistribution.

Thus, considering that the progress towards federalism should be the way, it is useful to recall that effectively building local administrative capacities (Cerase & De Vivo, 2000) and maintaining the commitment to hard budget constraints (Bertero & Rondi, 2000) may be a tough challenge. In the latter case, the issue of soft budget constraints has been raised several times (Emiliani, et al., 1997; Bertero & Rondi, 2000; Bordignon, 2000; von Hagen, et al., 2000; Bordignon & Turati, 2009) as one of the greatest threats to and challenges of the Italian public finances. As seen before, this issue is essential to understand the concrete functioning of decentralized systems. Furthermore, it should be noted in this context that perversely structured systems of fiscal federalism and, namely, systems with high vertical fiscal imbalances, have recently been the source of important macroeconomic crises (De Mello, 2000; Jones, et al., 2000).

4.2 Soft budget constraints in Italy

Quite a few linked factors are responsible for the soft budget constraints in the Italian subnational administrations. The effective mismatch between own revenues and expenditures at the local level (Emiliani, et al., 1997; Bordignon & Turati, 2009) is one of the main sources, particularly in the poorer regions of the Mezzogiorno (Emiliani, et al., 1997). In addition, the incapacity of the central government to define a stable and coherent framework for the local finances (Emiliani, et al., 1997) and the ex-ante underfunding of transfers to subnational governments (Emiliani, et al., 1997), as a means of virtually limiting the general government deficit and creating the impression of a sustainable system, result in bailout expectations, in the form of future intergovernmental transfers, and encourage overspending and inefficient management of public resources. Furthermore, the inaccurate definition of functions and financial responsibilities between different levels of administration (Emiliani, et al., 1997) brings governments to free riding behaviour and weakens accountability (von Hagen, et al., 2000), and the lack of quality and standardization in budgetary procedures (Emiliani, et al., 1997; von Hagen, et al., 2000) undermine the fundamental issue of transparency.

Regarding the lack of transparency in grants distribution, it is argued that it had a significant negative impact on the level and quality of local public expenditure (Emiliani, et al., 1997). There also persist great disparities in fiscal capacities, given that richer municipalities can easily collect sufficient resources to assure the majority of its expenditures, whilst poorer municipalities cannot frequently cover current expenditures (Emiliani, et al., 1997). These features have probably affected the regions and municipalities with lower tax bases and lower managerial capabilities or, in other words, the Mezzogiorno.

The overall result is the unclear definition of intergovernmental transfers (Emiliani, et al., 1997; Bordignon, 2000), the formation and ensuing centralization of ex-post subnational deficits, consequently increasing the overall deficit, as well as the debt and interest costs (Emiliani, et al., 1997), thus endangering the sustainability of Italian public finances. Moreover, the system generated a fiscal illusion related to the breakdown of the link between taxation and spending and an overall lack of transparency in local public finances (Emiliani, et al., 1997), namely in what concerns the distribution of grants. The system of intergovernmental grants, particularly subject to political influence and lobbying (Padovano, 2012), further limited the efficiency and accountability at subnational levels (Emiliani, et al., 1997; von Hagen, et al., 2000).

The kind of federal system developed in Italy failed to promote fiscal effort (Emiliani, et al., 1997), sponsored moral hazard and fiscal irresponsibility related to bailing out expectations (Emiliani, et al., 1997) and created a strong endogenous incentive to free-riding and overspending (Emiliani, et al., 1997; Bordignon, 2000).

4.3 Reforming the Italian federal system

In view of that, it is suggested that an extensive institutional reform is badly needed to promote regional economic development (Emiliani, et al., 1997; Arpaia, et al., 2009; Pigliaru, 2009; Marrocu & Paci, 2010; Aiello, et al., 2011; Padovano, 2012). For instance, it is important to improve local administrative capabilities, namely in dealing with additional sources of revenue, and to make considerable progress in budget management issues, such as accountability (Emiliani, et al., 1997; Padovano, 2012), standardization of procedures and external auditing (Emiliani, et al., 1997). Furthermore, it is essential to implement clear formula-based systems for the distribution of grants (Padovano, 2012), trying to reach a clear delineation of real necessities, instead of basing current intergovernmental transfers in historical data, often characterized by high levels of permeability to political manipulation and wastefulness, and contributing to the perpetuation of this unsustainable situation.

We should note, however, that, besides these general recommendations, there are important constraints to further decentralization in light of the great geographical disparities in income and institutional performance, and the recognition that the policy choices of the last decades have been unable to narrow these gaps (Emiliani, et al., 1997). Likewise, if policymakers decide to progress towards further decentralization, although empirical evidence is inconclusive concerning the link between territorial disparities and decentralization, which is fairly dependent on specific circumstances (Rodríguez-Pose & Ezcurra, 2010), regional gaps can widen even more in Italy, because there is a potential intrinsic incongruity between increased decentralization and regional redistribution (Prud'homme, 1995; Emiliani, et al., 1997; Ferrario & Zanardi, 2011), especially with spatially rigid labour markets and in frameworks characterized by weak institutions and widespread corruption (Lessman, 2009), which is the case in the Mezzogiorno.

The current situation of the Italian public finances is quite untenable. In particular, the current system of intergovernmental grants is subsidizing a significant fiscal imbalance, rewarding inefficiency and prolonging the fiscal and economic dependence of the Mezzogiorno. Several issues must be considered here and this case study also contributes to the demonstration of the importance of some broad principles highlighted by the theories on fiscal federalism and public finances. Rather than trying to find any Leviathan in the public finances, one should primarily look at the fundamental issues evidenced by the literature on fiscal federalism, such as transparency, accountability, efficiency and hard budget constraints, which we have raised in the previous chapter. To this end, it is required that the central government launches some important reforms. It is behind the scope of this paper to point to particular policies, but we aim to emphasize fundamental principles that must not be disregarded and that must be set in place at any rate, in Italy and in the Mezzogiorno, in particular. In our case, we can point to a few desirable policies, such as improving governance and managerial capacities, particularly in Southern subnational governments, as well as implementing a comprehensive body of national rules, concerning budget transparency, the delineation of functions between government levels and the calculus of intergovernmental grants.

However, concerning the Mezzogiorno, these measures aiming at achieving hard budget constraints and following the path of decentralization are insufficient for the improvement of the social and economic conditions and to allow a sustainable convergence of the region with the Centre-North. Thus, we should recall the dangers that the decentralization of powers can bring to the region. Firstly, if not accompanied by an effective progress of governance, efficiency and transparency, it is likely that more decentralization will rather reinforce corruption, inefficiency and opacity. Secondly, if hardening the budget constraints involves severe restrictions on intergovernmental grants and limits the scope for future public investments in the region, the markedly lower fiscal capacity in Southern regions will mean an uneven shortage of public capital, hardly any significant public investment and low-quality public goods and services. Finally, decentralization may not be the mother of segregation, but it won't be an instrument for integration. Even if the beneficial effects of interjurisdictional competition must not be underestimated, we shall understand that decentralization will limit the room for redistribution (Bouton, et al., 2008), endangering any hopes of convergence, at least in the short and medium run.

The hope will thus be in the long-run positive effects that decentralization can have on efficiency and in the belief that this process will be wisely conducted and complemented with additional structural reforms. Above all, for this process to succeed, a strong political commitment is indispensable, as well as the awareness that these reforms will be determinant for the future of the Mezzogiorno and of the country as a whole.

5. Conclusions

The aim of this study is to analyse and draw lessons from the process of fiscal federalism launched in Italy in the early 1970s, looking at the impact it had on the convergence of the Mezzogiorno with the rest of the country and discussing the main features of decentralization and development. We reviewed the relevant literature on the subject, exploring the current situation of the Mezzogiorno and the roots of its backwardness, as well as the main issues on fiscal federalism. We observed that the process of decentralization is a relevant factor explaining the non-convergence of the region. The slight capacity of regional administrations to foster growth and to provide public goods is further intensified by the inaccurate design of the system, feeding a steady fiscal and economic dependence and leaving weak governments at the mercy of free-riding, rent-seeking and corruption.

The Mezzogiorno is a dependent economy and a huge economic gap prevails in the Italian development path. The Italian central government is asked to adopt crucial comprehensive reforms, namely concerning the institutional design, but fundamentally building potential for local development, which cannot be done solely through further decentralization. To this end, important structural reforms are required (Pammolli & Salerno, 2008) to complement the fiscal reform (Bibee, 2007), such as improving markets functioning and public administrations quality, promoting employment (Pammolli & Salerno, 2008) and investing in human capital (Shankar & Shah, 2009). Hence, a strong commitment is essential to narrow the structural gap between the North and the South (Erbetta & Petraglia, 2008). The Mezzogiorno must become a national priority and major barriers to growth have to be steadily removed.

Undeniably, one needs to understand the causes of this backwardness, looking carefully at history and institutions, before having the aim of launching a successful new period of convergence in the South. In this context, conventional economic policies are not expected to have much success, without corresponding institutional reforms, and vice-versa. The foremost barrier is indeed institutional, taking into account the severe consequences it has on the economy. For that reason, we need to reform current institutions taking into account the important lessons from the past.

We shed light on the importance of creating the right incentives and on the several challenges to federal systems. To achieve a sustainable federal system, the central government must create expectations of hard budget constraints, through clear laws defining bankruptcy procedures, limiting the role of intergovernmental transfers, building effective systems of local taxation, clearly defining functions between levels of government and improving governance, accountability and transparency in local governments. In addition, performance oriented grants are a valuable instrument to help inducing the right incentives in the system, strengthening accountability, focusing on value for money and exposing corruption and inefficiency (Shah, 2010).

Nonetheless, another question is if a system of fiscal federalism is desirable in a situation of great inequalities between regions, as observed in Italy. In such circumstances, the road to federalism can also be the synonym of an additional barrier to convergence. The consequences of a "federalist trap" are severe to the most disadvantaged regions, henceforward locked into a vicious circle of ineffective institutions, corruption, low competitiveness and slow economic growth.

In this vein, future measures aiming at achieving hard budget constraints and following the path of decentralization are not sufficient for a sustainable convergence of the Mezzogiorno with the Centre-North. In fact, after forty years of decentralization, we have the empirical proof that fiscal federalism *per se* does not support convergence. Indeed, decentralization entails important dangers to the Mezzogiorno. Primarily, if not preceded by effective progresses of governance, efficiency and transparency, decentralization will rather reinforce corruption, inefficiency and opacity.

In addition, severe restrictions on intergovernmental grants can lead to a disproportionate shortage of public capital, inhibiting substantial public investments and leading to low quality public goods and services.

Moreover, the Italian experience suggests that the lack of consensus within local governments regarding major institutional reforms, especially together with high vertical fiscal imbalances, entails substantial dangers and probably leads to significant disruptions in the system. Accordingly, only a broadly accepted reform will create substantial change. To this end, time is needed to reach a wide consensus, undoubtedly more than a single legislature, and political cooperation is imperative, involving different governing majorities and a great number of local governments (Lanzillotta, 2008).

Concerning the burden of corruption, it is highly suggested that ambitious reforms are undertaken, in any event. With the growing evidence in the economic literature of its destructive impact on development, measures for combating corruption are essential. In this vein, improvements of the judicial system and better contract enforcement are critical to increase regional economic competitiveness, by significantly reducing transaction (Shah, 2006) and iceberg costs (Mauro & Pigliaru, 2011).

Likewise, in any instance, we must recall that an essential point in any future set of policies is the investment in high quality education, taking into account the different needs between the various regions of the country. In the Mezzogiorno, in particular, there is still much to do; important developments in education are desirable as a way of inclusion of young people and stimulus of the sluggish labour market, in addition to the strengthening of the stocks of human and social capital (Helliwell & Putnam, 2007). These two factors are essential for the future development of the Mezzogiorno. Bearing in mind the increasing mobility of productive factors and complexity of market transactions, the investment in local capabilities is vital and regions will definitely be the strategic geographical focus where policymakers must intervene.

The lessons from this study are relevant to analyse the Portuguese case, especially if a path of decentralization is undertaken, taking into account the evidence of some analogous characteristics. A strong vertical imbalance (Veiga & Pinho, 2007; Silva, 2008; Veiga, 2010) is found, as well as the existence of inequalities in fiscal capacities across different municipalities (Silva, 2008), the use of investments as political tools at the local level (Silva, 2008; Veiga & Veiga, 2007) and the prevalence of political lobbying in the of grants (Veiga & Pinho, 2007; Veiga & Veiga, 2010). However, further research is needed, permitting a closer look at this particular case, which is of particular relevance for preventing future institutional problems.

Despite the relevance of the present findings, the intrinsic limitations of this study do not allow to generally apply these lessons to other contexts. Therefore, it would be particularly interesting to develop comparative case-studies, permitting international contrasts and helping to understand the specific circumstances that are determinant for regional development. In this vein, it would also be noteworthy to compare between different regions in the same country.

In view of the growing evidence that institutions matter for economic development (North, 1991; Olson, 1996; Rodrik, et al., 2002; Acemoglu, 2009), future research on the economic impact of formal and informal institutions is desirable. Research on fiscal federalism should carefully look at specific case studies and further our knowledge on the effects of particular institutional arrangements, supporting future policies to better adapt to different environments. It would also be useful if future studies materialize the concept of social capital, exploring the diverse facets of this concept and applying these findings on the ground, wisely investigating diverse realities and examining concrete ways of strengthening social capital, trust and cooperation at the local level, especially in adverse economic and institutional environments, as the Mezzogiorno undoubtedly is.

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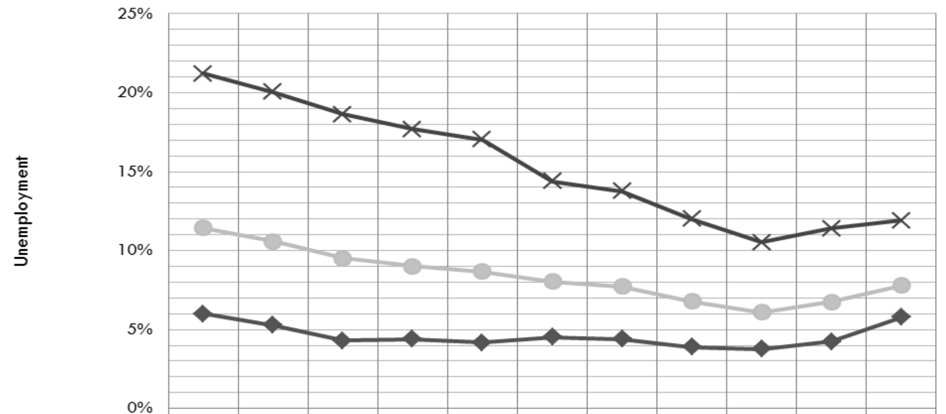
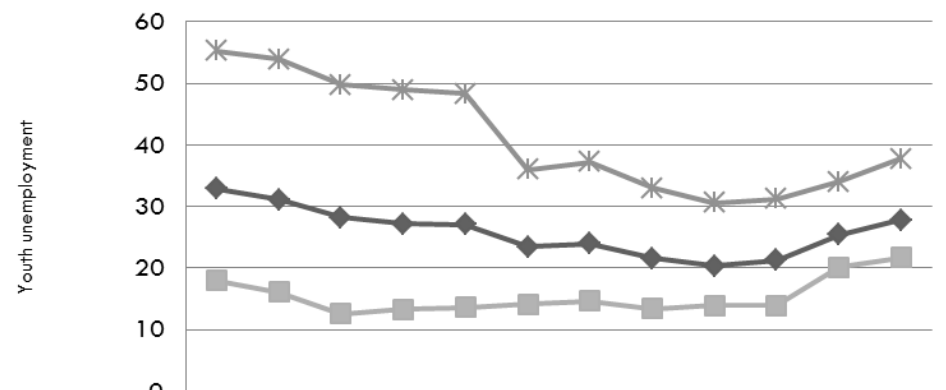
Appendix



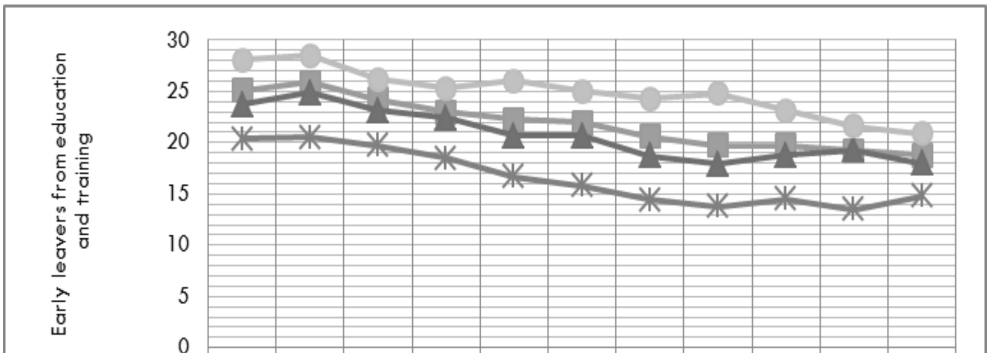
	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
North-West	6,01%	5,28%	4,32%	4,41%	4,17%	4,53%	4,39%	3,89%	3,78%	4,24%	5,79%
South	21,21%	20,05%	18,63%	17,70%	17,03%	14,40%	13,78%	12,00%	10,52%	11,39%	11,91%
Italy	11,43%	10,58%	9,53%	9,02%	8,68%	8,05%	7,72%	6,79%	6,09%	6,74%	7,79%

Figure 6. Unemployment levels (%) in Italy, North-West and South of Italy, from 1999 to 2009 (Sources: Quarterly Labour Force Survey and Labour Force Survey – Istat – Note: cannot compare data until 2003 and since 2004 due to reorganization in data)



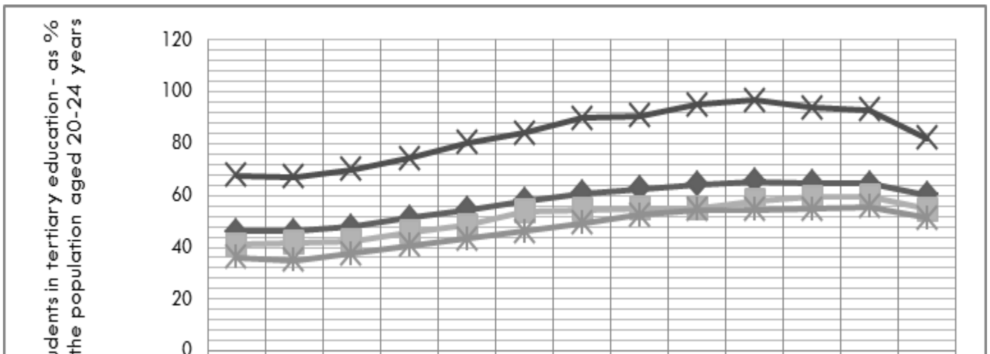
	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Italy	32,9	31,1	28,2	27,2	27,1	23,5	24,0	21,6	20,3	21,3	25,4	27,8
Nord-Ovest	18,0	16,1	12,6	13,3	13,6	14,1	14,6	13,4	13,9	13,9	20,1	21,7
Sud	55,3	53,9	49,8	48,9	48,3	36,0	37,2	33,0	30,6	31,2	34,0	37,8

Figure 7. Unemployment levels (%), from 15 to 24 years, in Italy, North-West and South of Italy, from 1999 to 2010 (Source: Eurostat)



	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Italy	25,1	25,9	24,2	23	22,3	22	20,6	19,7	19,7	19,2	18,8
North-West	23,7	24,9	23,1	22,4	20,7	20,7	18,7	17,9	18,8	19,3	18,0
Centre	20,4	20,5	19,7	18,5	16,7	15,8	14,4	13,8	14,5	13,5	14,8
South	28,1	28,5	26,2	25,3	26	25	24,3	24,8	23,1	21,6	20,9

Figure 9. Early leavers from education and training in Italy, North-West, Centre and South of Italy, from 2000 to 2010 (Source: Eurostat)



	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Italy	46,1	46,2	47,8	51,3	54,6	58,1	60,9	62,5	64,2	65,4	65,0	64,6	60,2
North-West	41,0	41,8	42,5	45,9	48,6	53,9	54,6	55,2	55,2	57,9	59,5	59,6	54,7
Centre	67,7	67,2	70,1	74,4	80,4	84,2	89,8	90,8	95,2	96,8	93,9	93,2	82,2
South	36,2	34,9	37,5	40,8	43,4	46,2	49,5	52,5	54,4	54,5	54,7	55,7	51,5

Figure 10. Students in tertiary education (ISCED 5-6) - as % of the population aged 20-24 years at regional level, from 1998 to 2010 (Source: Eurostat)