

INNOVATION IN FINANCIAL GOVERNANCE REFORMS: FOR BETTER OR FOR WORSE?

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ABSTRACT

This paper focuses on a specific case of innovation in financial governance in Italy that aimed to minimize the effects of financial constraints on local government, while managing deficit control goals at the central level. It consisted in a system of agreements between levels of government based on exchanges of fiscal deficit permits. While this system keeps the aggregate government-wide deficit unchanged, it allows individual local governments to deviate from their initial fiscal targets by obtaining deficit permits from governments that have a surplus.

The paper critically analyzes this innovation from three perspectives: the governance model inherent to this mechanism, the new financial management practices emerging locally, and the effectiveness of the mechanism with regard to declared goals and objectives. Our findings show that a critical element limiting innovation in fiscal governance seems to be the simplistic observation that the overall budgetary position of the country's government results from the algebraic sum of all individual government bodies' financial results. At the core of this understanding are collateral effects that occur when local priorities are distorted by the need to achieve top-down fiscal targets set by the central government, as exemplified by the unexpected investment crunch in Italy.

Keywords - *austerity, deficit control, financial management, governance, innovation, local government.*

INTRODUCTION

In recent years, major economies have appeared stagnant, the solvency of major banks remains in doubt, and some countries still risk defaulting on their sovereign debt. Traditional wisdom about fiscal policies has been “challenged and the pre-crisis orthodoxy [has] proven to be fragile,” and at present it seems impossible to anticipate the

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orthodoxy that will emerge (Coen and Roberts, 2012). The global economic recession initiated a search for austerity in public financial management. In addition, international institutions have requested fiscal stability and consolidation from international governments. Fiscal stability, i.e., balancing the national budget, has become a sort of rhetoric *leitmotif* for governments around the world. In OECD countries, fiscal regulation and coordination initiatives in supra-national, national, and sub-national tiers of government have progressively increased. This is especially in the European Union (EU), where several inter-governmental fiscal arrangements have been implemented in order to manage fiscal stability.

Within this context, local governments (LGs) are facing several constraints and challenges to their financial management: they are required to reduce debt and deficits, to save money and resources, but also to increase their provision of public services. Recent literature on austerity has mainly investigated how governments have reacted to the global financial crisis by considering new and innovative methods of service delivery (e.g., Voorberg et al., 2015; Osborne et al., 2016). However, the way in which governments have adapted their financial strategies and management to cope with the crisis has not been adequately researched (Barbera et al., 2016; 2017; Overmans, 2018).

Financial rules and controls are among the most powerful tools adopted to manage the relationships between levels of government. New Public Financial Management (NPFM) reforms over the recent decades have introduced several innovations in financial management, both at the central and local levels, which have been widely investigated in the literature (e.g., Guthrie et al. 1999; Humphrey et al., 2005; Lapsley, 1999; Olson et al., 2001). Nevertheless, studies on financial management reform have analyzed only the technical content of innovations, paying little attention to either the genesis of these reforms (i.e., whether the reforms were introduced because of the financial crisis or not) or to the effective impact and results of these reforms in terms of innovation (i.e., whether these reforms have led to innovation in financial management logics, or whether their results have been effective for the public entities involved). It is therefore relevant to investigate the following research questions:

- 1) How have decentralized governments reframed their financial management and governance systems in response to the crisis?
- 2) Have these innovations in financial governance have been effective, considering their declared objectives, and have they resulted in any unexpected effects?

In this paper, we focus on a specific case of innovation in financial governance in Italy that aimed at minimizing the severe effects of financial constraints put on local government while managing EU deficit control targets at the central level. The regulatory innovation, “the regional stability pact,” consisted in a system of agreements between municipalities and regional governments based on the ability to exchange deficit permits. While this system keeps the aggregate government-wide deficit unchanged, it allows individual local governments to deviate from their initial fiscal balance target by taking deficit permits from governments that have a surplus.

We carried out an empirical analysis of data on regional financial arrangements since the regional stability pact's introduction in 2010, by comparing the decisions taken in each region using a documental analysis of legislation and public acts. Italy is an interesting setting for this analysis because the country has one of the highest levels of general government debt among EU countries, with LGs having autonomy to borrow (within certain limits) without government approval. In this study, we compare innovative fiscal arrangements emerging at the local level and which are led by regional governments. Policy and management implications of the effects of this innovation are considered.

The remainder of this paper is organized as follows. In the second section, we outline the conceptual and theoretical background of the paper. In Section 3, we present the research case study by summarizing the EU's rules for deficit control of member states and the innovative financial governance system arranged at the sub-national level in Italy. Then, in the fourth section, we critically analyze this domestic innovation in financial governance from three perspectives: the governance model inherent to this system, the new financial management practices emerging at the local level, and the effectiveness of the mechanism with reference to its declared goals and objectives. Finally, in Section 5, we outline our conclusions and the implications for future research.

INNOVATION IN FINANCIAL GOVERNANCE: A CONCEPTUAL BACKGROUND

In recent decades, the interest of both scholars and practitioners in innovation in the public sector has increased significantly (e.g., Andersen et al., 2018; Bason, 2010; Borins, 2008; De Vries et al., 2015; Hartley, 2005; Osborne and Brown, 2013; Walker, 2006; 2014).

However, the literature that has been produced has mainly focused on the definition of innovation, the main determinants of its adoption, and the factors affecting the persistence, success, and diffusion of innovation in the public sector (e.g., Borins, 2014). According to De Vries et al. (2015), the focus has mainly been to “conceptually, rather than empirically grasp the meaning and importance of public sector innovation” (e.g., Osborne and Brown, 2011; Sørensen and Torfing 2011), while others addressed “this challenge through a normative approach” (for instance, Bason 2010). In addition, in the opinion of De Vries et al. (2015, 147), “there is a need to look deeper into the goals and effects of the innovation process since, while innovation and improvement have often been assumed to be synonymous, this is by no means always the case” (Osborne and Brown 2013, 4; see also Hartley, 2005). In the literature it is possible to identify several definitions of innovation; nevertheless, as De Vries et al. (2015) point out, these definitions share some common aspects: the perception of novelty in adoption, “novelty in action” (Alschuler and Zegans, 1997) and “new ideas that work” (Mulgan and Albury, 2003); and the idea of discontinuity with the past, and possible disruptiveness of action and effects (e.g., Hartley, 2005; Osborne, 2018). In addition, according to Kuipers et al. (2014), it is worth remembering that the outcomes of an innovation are the “substantive results of the implementation of an innovation that can be intended or unintended and positive or negative.” Another relevant issue is that it is possible to identify different types

of innovation concerning: administrative or technological processes, products or services, governance, or conceptual or strategic innovation (De Vries et al., 2015; Hartley, 2005).

According to the literature (e.g., De Vries et al., 2015; Moore and Hartley, 2008), innovation in government consists in the “development of new forms and processes to address specific societal problems”; it diverges from “standard intra-organizational innovations in products, services, and production processes,” and is related to governments’ networked inter-organizational nature. Hence, this kind of innovation could also refer to financial management reforms, although perhaps in a very wide and general way. From this perspective, the kinds of reforms we are considering also have some elements partly fitting with innovation in administrative processes, although the focus in this category of innovations is usually on single public sector entities.

In any case, as previously mentioned, literature and practice have often also applied the concept of innovation to government reforms, theoretical conceptions of public management, like such as New Public Management (NPM), and to specific instruments and management solutions adopted to implement reform at a specific level of a government (e.g., regional or local governments), or in a function or an area of activity of the public sector (e.g., healthcare, education, civil servant management, etc.). In particular, NPFM is the component of NPM focusing on the financial information and accounting systems of public sector entities (e.g., Guthrie et al., 1999; Humphrey et al., 2005; Lapsley, 1999; Olson et al., 2001;). As is the case for NPM, reforms in NPFM are mainly based on the adoption of instruments and principles derived from the private sector, for example: improving efficiency in the use of resources and effectiveness in the pursuit of goals, increasing internal and external accountability, adopting accrual accounting or accounting standards (Brusca et al., 2015), and improving cost accounting or management control systems. Considering NPFM, Guthrie et al. (1999) identified five different categories of what we refer to as “new public financial management’ reforms”: changes to financial reporting systems (including the promotion of accrual-based financial statements across government departments and sectors and a reliance on accounting standards set by accountancy professional bodies); development of commercially minded, market oriented management systems and structures to deal with the pricing and provision of public services (with emphasis on cash management, contracting-out arrangements, and internal and external charging/pricing mechanisms); development of a performance measurement approach; devolution, decentralization or delegation of budgets; and changes to internal and external public sector audits.

Despite the consistent themes in these reforms, countries all around the world have adopted different kinds of financial and accounting tools, and have obtained different results (e.g., Caperchione, 2006; Caperchione and Mussari, 2000; Humphrey et al., 2005; Lüder and Jones, 2003). This has happened according to countries’ history, their political-institutional and socio-economic systems, and the characteristics of the financial management and accounting systems adopted within their public sector entities or specific level of government (e.g., local government) or function (e.g., healthcare). Guthrie et al. (1999) underlined that even though the field of NPFM is “replete with jargon of terms such as ‘accrual accounts’, ‘performance indicators’, ‘delegated budgets’,

‘devolved budgets’, ‘full costs’, ‘output groups’, ‘outcome statements’, ‘accrual output-based budgeting’ and ‘fiscal responsibility statements’,” the examination of actual practice and reforms inspired indicates significant differences in how these concepts are applied and operationalised and it was almost impossible to define a “globally standardised NPFM system,” and studies of national practice have appeared very valuable.

Literature on NPM and NPFM mainly refers to reforms, not to innovations, as a key word, even though some general innovation elements are often mentioned. In any case, the literature has shown that sometimes these managerial innovations have resulted in changes in form, but not changes in substance (e.g., Guthrie et al., 1999; Ter Bogt and Van Helden, 2000). In addition, public management literature has also revealed that sometimes NPM and NPFM reforms have led to unexpected and unintended effects (e.g., Lapsley, 2009).

During 2018¹, we consulted three academic databases (Jstor, Web of Science, Scopus) and Google Scholar, looking for contributions specifically focusing (title, key words and abstract) on innovation and/or change in financial management and governance. From this analysis of the literature, we noticed a general lack of study of innovations in financial management and governance practices across tiers of government. In our case, we consider innovations in financial governance at the sub-national level that have consequences for the whole public governance system, i.e., inter-institutional relationships at the same institutional level, among local governments, but also between different institutional levels, in this case between the central government and regional and local governments. This may be considered a gap in the literature concerning the systemic nature of public sector financial management: the literature (and practice) generally considers financial management innovations within individual public sector organizations, but tends to ignore the governance of inter-institutional relationships within and between governmental levels.

FINANCIAL GOVERNANCE REFORMS: THE ITALIAN CASE

EU Financial Governance

The European Union (EU) regulates economic, fiscal, and financial behavior of member states. The “Stability and Growth Pact” (SGP) is an inter-institutional financial agreement between the member states of the EU, which aims to facilitate and maintain the stability of the Economic and Monetary Union (EMU) and to establish a financial control system over countries. The SGP requires member states to comply with limits on government deficit (3% of GDP) and debt (60% of GDP); in case of a debt level above 60%, the level should be reduced each year at a satisfactory pace. Furthermore, in March 2012, all EU member states, except the Czech Republic and the United Kingdom, signed the Fiscal Stability Treaty (formally, the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union), a new stricter version of the previous SGP, which entered into force in January 2013².

It is worthwhile to note that SGP rules on debt and deficit targets are set based on the overall fiscal position of governments, while the positions of public entities at particular levels within the government layers are not considered. This has made national governments accountable for deficits and debt incurred by sub-national government bodies, as well as for the costs of non-compliance, in terms of either sanctions or reputational cost. Member states have adopted different strategies and approaches to the control of public finances, while devolving some part of the national responsibility for debt and deficit reduction to sub-national governments bodies (the so called “domestic stability pact”). All EU countries have set financial constraints on the annual fiscal balances of lower levels of government, sometimes combined with ceilings on expenditure and debt. Some countries (including Austria, Belgium, Germany, and the Netherlands) have adopted a cooperative approach based on negotiation of financial targets between government tiers, while other countries (including France, Portugal, and Italy) unilaterally imposed legally binding fiscal rules on local government budget balances (Ambrosanio and Bordignon, 2006; Morris et al., 2006). In both cases, the process involves setting fiscal targets for lower government tiers and monitoring results, although the cooperative approach allows a certain degree of financial autonomy and budgetary flexibility at the local level.

The Deficit Control system in Italy

Italy is a unitary State with a decentralized government split into central and local levels: there are currently 20 regional governments, 82 provinces, 14 metropolitan cities, and 7,914 municipalities³. Local government has responsibility for approximately 29% of general government expenditure (14% of GDP), with responsibility for functions including health services, welfare services, education, and local transportation. LGs’ capital expenditure plays an important role in the economy, accounting for approximately 55% of general government investment expenditure (or 1.3% of GDP) (OECD, 2018).

In order to comply with EU fiscal requirements, Italy has reviewed budgetary coordination between levels of government, including a planning and control system for budgetary balances. This process led the central government, in 1999, to launch the “domestic stability pact” arrangement (“*patto di stabilità interno*”), an *ad hoc* financial control system aimed at setting fiscal balance targets for local governments. The aim of this mechanism was to directly involve sub-national government bodies in the country’s compliance with EU requirements, and to allocate such bodies responsibility for the reduction of government deficit and debt. The domestic fiscal constraints have been differentiated for regional governments, provinces, metropolitan cities, and municipalities: regional governments have been required to respect nominal ceilings on the growth rate for operating expenditure, while the targets for provinces, metropolitan cities and municipalities have been based on the improvement of fiscal balances on a yearly basis (except for the years 2005 to 2006, in which the targets were formulated in terms of spending limits). These rules also changed significantly over the years, through either the variation of budget balance items included in the fiscal target, the municipalities involved, the fiscal targets and their accounting basis, or the sanction and incentive system. Since 2008, the budget balance considered for deficit control (“fiscal balance”)

has been based on a mixed “accrual-cash” accounting basis, i.e., the current revenues and expenditures are counted on a modified cash basis, whereas capital revenues and capital expenditures are counted on a cash basis. Moreover, some misalignment exists between the accounting items counted in the fiscal balance and those counted in the annual budget balance. Excluded budget items are accumulated surplus, new loans, and commitments for capital expenditures. For example, since new loans are not counted in the fiscal balance, a balanced annual budget may yield a fiscal deficit, making it inconvenient for a municipality to budget for new debt to finance capital expenditures. This “forced” accounting misalignment was an indirect control system specifically intended to encourage municipalities to finance new investments by operating surpluses rather than borrowing.

This new accounting basis, which has features that are not found in the experience of other EU countries (Giuriato and Gastaldi, 2009), was primarily introduced to make the LGs’ budget targets consistent with the control of national fiscal balances, as LGs’ capital expenditure has a direct effect on the national public sector account (Corte dei Conti, 2009). However, the most relevant effect of the change in the fiscal balance’s accounting basis was that municipalities delayed payments of capital expenditures and cut investments while holding year-end budget surpluses. This financial behavior exacerbated the impact of the financial crisis at the local level and caused the bankruptcy of several small businesses (Corte dei Conti, 2010; 2011).

Innovation in Financial Governance: The Organized System of Deficit Permits Exchanges

In order to overcome the above-mentioned weaknesses, since 2010 the central government has supplemented the domestic fiscal framework with a complementary mechanism of “tradable deficit permits” (Casella et al., 1999) at the local level, the so-called “regional stability pact,” (“*patto di stabilità regionale*”), later re-labeled as “regional solidarity pact” (“*patto di solidarietà regionale*”). According to this new inter-governmental financial arrangement, regional governments can adjust the fiscal balance targets of individual municipalities, metropolitan cities, and provinces within their territorial jurisdiction by setting up “deficit permits” for investments spending, while ensuring the achievement of the overall fiscal balance targets in their jurisdiction.⁴

At the operational level, the regional government acts as a “clearing house” of fiscal targets for government bodies within its jurisdiction by means of “vertical” or “horizontal” adjustments (see Table 1 for example data).

First, the regional government can tighten up its own fiscal target and permit municipalities within the jurisdiction to relax their own targets by the same amount (“vertical adjustment”). As a consequence, new adjusted fiscal balance targets will be set for municipalities and the central government will expect an increased surplus (or lower deficit) from the regional government itself. This means that additional cash payments for capital expenditure can be made by municipalities, over the amount permitted within the initial limits.

Table 1. The ‘regional stability pact’ arrangement

	Budgetary coordination	Regional government (RG)	Municipality			Municipal target	Jurisdiction balance (RG+A+B+C)
			A	B	C		
a	Fiscal balance targets set by the central government	100	200	400	300	900	1000
b	Vertical adjustment	+ 100	- 60	- 40	0	0	0
c	Horizontal adjustment		- 40	- 60	+ 100	0	0
d=b+c	Adjustment at regional level	+ 100	- 100	- 100	+ 100	-100	0
a+d	Revised fiscal balance targets	200	100	300	400	800	1000

Source: Adapted from Guarini and Pattaro (2016).

Second, deficit permits are also exchangeable between municipalities, under the direction of the regional government (“horizontal adjustment”); municipalities able to release a certain amount of surplus within their target receive a bonus, a lower target equivalent to the same amount split across the next two years (“recovering”), and the receiving municipalities will be subject to an equivalent tightened target in the following two years (“restoration”).

It is relevant to notice that any distribution of deficit permits will result in the same overall equilibrium, whilst resulting in a different distribution of individual entities’ targets. This mechanism is based on the following: i) the requirement that the net total of fiscal target adjustments within the regional jurisdiction must be equal to zero, i.e., deficit permits cannot allow the initial target to be exceeded; and ii) the assumption that municipal year-end balances will be aligned to the revised target. Regional adjustments and new targets are reported to the central government before the end of the fiscal year to facilitate the control over the achievement of individual entities’ fiscal target. Regional governments have the power to define their own rules for the fiscal target adjustments, but the central government maintains the power to apply sanctions to municipalities not achieving their individual targets regardless of whether targets for the overall jurisdiction are reached.

Since 2012, a parallel “vertical” and “horizontal” clearing house mechanism (“*patto di solidarietà nazionale*”) has also been arranged at national level, between the central government and municipalities, to maximize the effectiveness of the regional stability pact. According to this system, municipalities can benefit from additional deficit permits released by municipalities from other jurisdictions.

The new mechanism of the “regional stability pact” has been welcomed by the *Corte dei Conti* (the Italian National Audit Office) and by ANCI (the National Association of Italian Local Governments) as an innovative solution for mitigating LGs’ delays of payment of capital expenditures and the country’s investment crunch. This approach combined the rigid top-down formulation of financial targets by the central government, with flexibility ensured by cooperative mechanisms at the decentralized level. We are not aware of other EU countries operating similar financial governance mechanisms, especially in terms of the complexity of managing a process of budgetary coordination involving approximately 8,000 entities.

A CRITICAL ANALYSIS OF THE INNOVATION: FOR BETTER OR FOR WORSE?

In this section, we critically analyze the financial governance innovation presented above from three perspectives: the new financial management practices emerging at the local level, the effectiveness of the mechanism in relation to declared goals and objectives, and the governance model inherent to this mechanism and the influencing drivers.

New Financial Management Practices Emerging at the Local Level

Findings from our analysis show that currently all the 17 regional governments in charge of the new mechanisms have set local arrangements, which diverge according to the following items:

- The criteria for allocation of deficit permits (see Table 2); and
- The amount of fiscal target adjustment permitted.

Table 2. Regional rules for deficit permits

<i>Qualification</i>	<ul style="list-style-type: none"> • achievement of the previous year’s fiscal target • cash availability • speed of payment of commercial debts • effective use of the deficit permit obtained in the previous years,
<i>Allocation drivers</i>	<ul style="list-style-type: none"> • size of outstanding cash payments for capital expenditures • stock of debt • residual liabilities for capital expenditures • consistency of capital expenditures with regional (and EU) priorities
<i>Accountability system (incentives/sanctions)</i>	<ul style="list-style-type: none"> • no fiscal adjustment in case of past fiscal target overshooting • use of vertical/horizontal plafond obtained in the past • achievement of the previous year’s fiscal target

Source: Authors’ analysis based on data from Corte dei Conti (2015).

Thirteen of the 17 regional governments have set specific pre-requisites for municipalities to take part in the clearing house. Among the significant criteria we observed there were

the achievement of the previous year's fiscal target, the rate of use of the previous year's deficit permit⁶, the availability of cash funds, and speed of payment of commercial debt. All the 17 regional governments set multiple criteria for allocation of deficit permits and they often granted deficit permits to local governments affected by natural emergencies (flooding, earthquakes, etc.). Other common drivers were the size of outstanding cash payments for capital expenditures (because the mechanism was intended to reduce payment delays) and the consistency with regional priorities of the municipality's capital expenditure. Some regional governments (11) also introduced a specific accountability system intended to incentivize municipalities and provinces to fully use their deficit permits in order to avoid overshooting of fiscal targets for the overall regional jurisdiction at the end of the year.⁷ In this case, nine regional governments avoided granting deficit permits to those entities which had not completely used the revised limit obtained in the previous year from the regional government ("vertical adjustment") or from other municipalities of the region ("horizontal adjustment"). The innovative practices of these eleven regional governments, aimed at introducing a proper financial management and control system of local fiscal balances, point to a more active role played by them within the inter-governmental arena than simply acting as a clearing house of deficit permits.

With regard to the parallel deficit permit system arranged from 2012 onwards between municipalities at the national level ("*patto di solidarietà nazionale*"), priority was given to municipalities that were generally funding capital expenditure through budget surpluses rather than borrowing, and to the type of investments, specifically refurbishment and improvements of school buildings, seismic preventative maintenance of public buildings, and environmental reclamation works.

The Limited Impact of the Innovation

The innovation of deficit permits exchanges between regional and municipal governments was introduced by central government law in 2009, in order to limit the investment crunch that started occurring at the local level in 2008, following the introduction of LG fiscal balances featuring capital expenditure calculated on a cash basis. The investment reduction was related to an "overshooting" of fiscal balance targets (Table 3); LGs were able to achieve a better than expected aggregated result in terms of fiscal surplus/deficit by delaying capital expenditure. Put another way, budget overshooting by LGs resulted in greater levels of balance correction (by delaying capital expenditure) than expected, thus resulting in money behind retained in cash balances instead of being used to fund additional investment.

Table 3- Overshooting of fiscal balance targets by municipalities (million euros)

Fiscal Balance	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017**
(a) Municipal fiscal balance target ('-/+ signals a deficit or a surplus)	-1,606	-359	+500	+2,423	+3,200	+4,262	+4,165	+838	≥0 *	≥0
Adjustments at regional level (vertical and horizontal)		-258	-160	-1,164	-1,398	-1,310	-1,309	-914	-32	-204
Adjustments at national level (' <i>patto di solidarietà nazionale</i> ')					+2	-1	-46	0	0	-759
(b) Total adjustments	n/a	-258	-160	-1,164	-1,396	-1,311	-1,355	-914	-32	-963
(c) Revised municipal fiscal balance target (a+b)	-1,606	-617	+340	+1,259	+1,804	+2,951	+2796	-76	≥0 *	≥0
(d) Actual fiscal balance	-179	+507	+1,153	+1,079	+2,475	+4,252	+4,406	+1,451	+3,931	+4,734
(e) Overshooting (d-c)	+1,427	+1,124	+813	-180	+672	+1,301	+1,610	+1,375	+3,931	+4,734

Source: Authors' analysis on data extracted from *Rapporto sul coordinamento della finanza pubblica*, Corte dei Conti, years 2009-2018, available at (accessed on 10 October 2018):

http://www.corteconti.it/attivita/uffici_centrali/sezioni_riunite_sede_controllo/rapporto_finanza_pubblica/

* Since 2016 the fiscal target has been changed into a balanced budget rule.

** Provisional data.

However, the exchanges of deficit permits did not prevent the overshooting of aggregated LGs' fiscal balance targets, which continued to occur regularly, almost every year, except for a braking in 2010-12, independently of whether the targets were formulated either in terms of deficit, surplus or a requirement to break even.

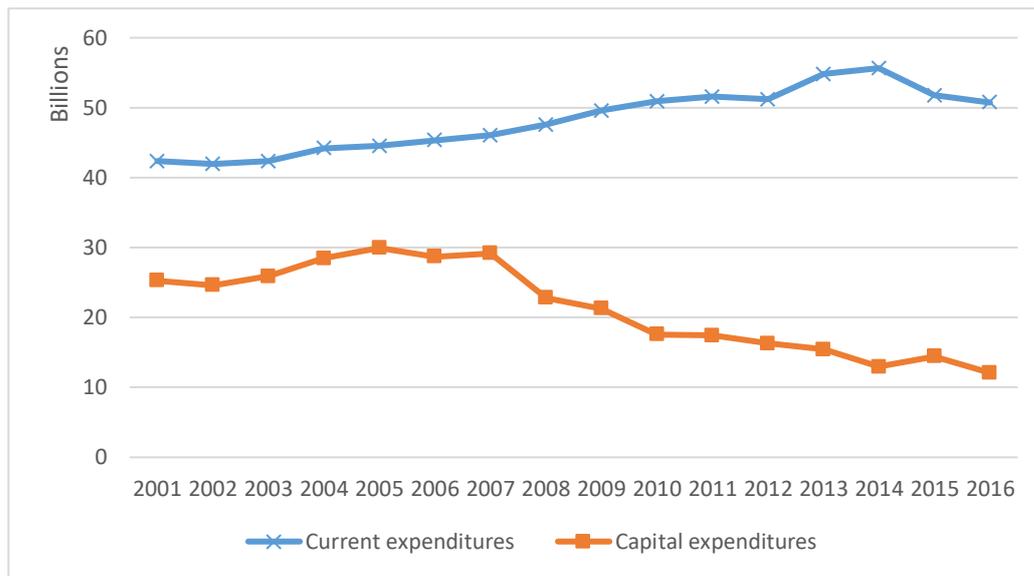
The new mechanism of regional adjustments allowed some flexibility at the local level, because the vertical and horizontal exchanges between municipalities and the regional government in each jurisdiction increased from €258 million in 2009 to €1,309 million in 2014. However, this was not sufficient to prevent the overshooting at the aggregate level, which increased further in 2016–17 (Table 3).

The phenomenon of large amounts of budgetary surplus being made available in deficit permits was not caused by fiscal targets but that were easy to meet, but rather, by the cautious capital spending strategies adopted by municipalities to avoid heavy fiscal sanctions from the central government (Guarini and Pattaro, 2013), or, more generally, to

“the specific financial health conditions of each local government” (Corte dei Conti, 2019). Moreover, the deficit permit system operated at national level since 2012 (“*patto di solidarietà nazionale*”), despite limited amounts of activity (see again Table 3), created problems of coordination between government levels as this parallel mechanism overlapped with regional adjustments (Corte dei Conti, 2012).

As shown in Figure 1, municipalities avoided cutting current expenditures for public services and achieved its budget surplus targets exclusively by cutting capital expenditure (“expenditure switch” case).

Figure 1. Impact of fiscal targets on municipalities’ investments



Source: Authors’ calculations based on data from Bureau van Dijk.

Indeed, since 2008 the growth in current expenditure has been balanced by a corresponding reduction in capital expenditure. These data confirm that “the new mechanism of exchangeable deficit permits has not been effective to prevent the public investment crunch at local level” (Corte dei Conti, 2018, 21); indeed, the investment crunch has significantly increased over the years.

The Governance Model Between Tiers of Government

In this subsection, we analyze the impact of financial innovation in terms of governance relationships between levels of government by attempting to identify the drivers of the described attitudes and effects. Within this perspective, budgetary rules can be considered as the main strategy through which higher-tier government bodies typically control lower-tier government bodies’ spending and borrowing, so the implementation of these rules at different levels of government can shape fiscal governance models in terms of rules, actors, goals, and strategies (Guarini and Pattaro, 2016).

The initiatives of inter-governmental exchange of deficit permits have partially changed the roles of the institutional actors involved. In effect, the regional governments play a central role in the new governance model: they act as enablers and as coordinators of local financial management, or as a clearing house for deficit permits in their jurisdiction. The exchange of deficit permits at the local level can significantly help virtuous municipalities in their compliance with the National Stability Pact and can also incentivize dialogue and collaboration among local governments, enhancing the governance role of regional governments at sub-national level.

Thanks to the use of regional stability pacts, municipalities have the opportunity to exercise some managerial room of maneuver in their compliance with national and regional fiscal balance targets, since they can decide how to use the granted flexibility and can avoid overshooting targets. The necessity for municipalities to exchange deficit permits with the regional government and with other municipalities in the regional jurisdiction can be also positive in terms of creating additional autonomy to address contingent local needs/requirements, exerted in response to central constraints. In any case, in this context the national government still maintains the role of central controller in the fulfillment of financial targets at the local level. Indeed, it set sanctions for individual municipalities in case of non-compliance with their targets even if the regional jurisdiction level financial targets are met. In so doing, the financial coordination role of regional governments in the exchanges of local deficit permits could be undermined. Further, this model of governance of financial coordination and deficit offset among government tiers also has some limits.

First, there is an overlap between mechanisms and rules concerning the National Stability Pact and the regional stability pacts, affecting the local governments. In addition, the rules and targets for LGs are defined by the central government without involving either the municipalities or the regional governments. On the other hand, municipalities are usually involved in the definition of regional stability pacts at the local level, since those rules are often negotiated.

Second, the regional stability pacts rules and targets are defined by the regional governments only after the individual financial targets for local governments are set by the central government. Consequently, regional adjustments of deficit permits come too late to affect central constraints and avoid overshooting at the municipal level. This weakens the potential utility of deficit permit exchanges as instruments of inter-governmental financial coordination.

Last, with this model of inter-governmental financial governance it is difficult to correctly implement a planning, programming, and control cycle. In fact, especially at local level, it is almost impossible to perform long-term financial planning, because there are not certainties on the size of future financial targets, especially because the National Stability Pact rules have often changed over time.

In order to better understand this financial governance innovation, it is also useful to identify the drivers and influencing factors that might have contributed to shape the different attitudes and effects analyzed in this study. The mechanism of deficit exchanges between regional governments and municipalities created, de facto, a quasi-market of

issuing deficit-permits, within and across jurisdictions, under the regulatory oversight of the central government. This innovation could be interpreted as a case of “marketization”, arising in a context highly influenced by the NPFM values, but also by the austerity rhetoric. The central government considered the deficit control system only within a legalistic perspective, with sanctions for LGs in case of non-compliance. This can be explained by the Napoleonic tradition of the Italian institutional system in which laws and formal rules play an important role in shaping the behavior of public entities. In contrast, LGs tried to exercise their managerial autonomy by exchanging deficit permits within the constraints and rules established by law. This feature is important in order to assess the innovative forms of financial governance adopted in different regions, in particular those arrangements inspired by a management control approach that contributed to enhance the coordination role of regional governments (Guarini and Pattaro, 2013). In addition, resource dependence (e.g., Hillman et al., 2009; Pfeffer and Salancik, 1978) could be a useful framework in understanding the logic of the new inter-institutional fiscal governance. According to the resource dependence theory, the resource scarcity (and dependence on the resource), and not necessarily efficiency, motivates organizational action (Pfeffer and Salancik, 1978). In addition, another possible strategy to partially reduce uncertainty and interdependence is to form an inter-organizational alliance with the source of the constraint (Malatesta and Smith, 2014). Finally, through the exercise of political power, organizations actively attempt to influence the conditions (e.g., legislation) of the external institutional environment. Under this perspective, intergovernmental relationships can be interpreted by considering the financial strategies adopted at the central and local levels to reduce resource dependence and uncertainty in a given environment. In particular, the Italian central government developed a deficit control system at the sub-national level to ensure the achievement the EU’s macro-level fiscal deficit requirements and avoid sanctions. At the same time, regional governments developed special arrangements for exchanging deficit permits to ensure flexibility in decision-making at the local level and avoid sanctions from the central government. Also, the neo-liberal political values of the leading national and regional coalitions could have had an influence in shaping the features of emergent regional agreements, the accountability mechanisms, and financial governance models.

CONCLUSIONS

In line with the claim of De Vries et al. (2015), we attempted to “look deeper into the goals and effects of the innovation process,” and also to distinguish between innovation and improvement, which have “often been assumed to be synonymous, [although] this is by no means always the case.”

Thus, in this paper we critically analyzed the financial governance innovations (National Stability Pact, regional stability pacts and the system of exchangeable deficit permits) emerging from the implementation at sub-national level of a deficit control system, from three perspectives: the governance model inherent to this mechanism, the new financial management practices emerging at the local level, and the effectiveness of the mechanism with regard to declared goals and objectives. Our analysis finds that these agreements,

implemented at regional and national levels for the purpose to ensure compliance with the SGP offered some opportunities for innovation in the financial governance models at the sub-national and local level. On the other hand, the effectiveness of the mechanism in relation to declared goals and objectives is only partially satisfied. We also identified some possible drivers and influencing factors of the financial innovation: the neo-liberal political institutional context; the roles played by regional governments; the influence of resource dependence and the progressive marketization consequent to NPFM values and austerity.

We have also identified, and attempted to contribute to filling, a gap in the literature on public sector financial management and public sector innovation. Considering literature on public sector financial management, we identified a gap concerning a systemic dimension the subject: literature and practice consider financial management innovations within individual public sector organizations, but fail to address the governance effects of inter-institutional relationships within and between governmental levels. Considering literature on public sector innovation, we observe that financial reforms are rarely investigated as a subject of study. Nevertheless, financial reforms are deserving of study because: i) they involve several distinct public sector entities affected by a networked-based financial decision-making and coordination instrument; ii) there is a perception of novelty in adoption; and iii) there is a form of discontinuity with the past, and the results of the change may be either intended or unintended, and either positive or negative (e.g., De Vries et al., 2018; Moore and Hartley, 2008). As outlined in the previous paragraph, considering the governance model inherent to this mechanism, we identify some tendencies and management implications related to inter-governmental body financial governance.

First, we observe that re-centralization of controls has increased over years. This highlights that decentralization of decision-making power will inevitably be associated with centralization of monitoring and powers to act in the event of performance failures. This will be especially true where the central power is subject to external pressures or commitments (in this case, the Italian government's obligations under the SGP). In Italy, public sector reforms have generally been focused on enhancement of local autonomy enhancement and decentralization of responsibilities for services delivery, often in collaboration with private (profit or non-profit) local partners. From an institutional and/or financial point of view, this process was driving towards federalism. However, at the same time (re)centralization of management and financial control is also emerging. This tendency towards (re)centralization appears to have progressively spread and intensified at the national level, in consequence of the general economic and financial crisis, as claimed for instance by Coen and Roberts (2012), for example. The new financial management practices emerging in different regional stability pacts have attempted to mitigate central government constraints and to offer sub-national level public entities the innovative opportunity to take autonomous decisions about services to be delivered or investments to be made. Nevertheless, considering the third perspective of analysis, the effectiveness of the mechanism with regard to declared goals and objectives, the impacts of regional financial coordination has still been limited because of the failure of these measures to prevent the investment crunch. This study has shown

that one part of the problem relies on the budgetary target considered for LGs, but the other part is that targets and sanctions have always been defined at the central level. Other countries that have not yet implemented similar deficit exchange systems to Italy's, should consider controlling LGs' deficit by enforcing multi-annual ceilings for capital expenditure rather than for the aggregate budget balance, so mitigating the risk of expenditure switch. This approach could reduce the need for budgetary control at the central level, while allowing the formulation of autonomous targets and sanctions at the regional level.

Second, several levels of accountability for debt and deficit control must be fulfilled by LGs, because LGs have to accomplish to both national and regional fiscal stability targets, set by the central and the regional governments, respectively. However, these constraints must be met at the same time as local governments are trying to improve local management and to answer to local needs through improvement of services. In effect, the accounting and financial rules connected to the domestic fiscal arrangements creates a trade-off between the accountability of sub-national governments for the national fiscal deficit, the enhancement of LGs' autonomy, and the necessity to improve public services at the local level (Guarini and Pattaro, 2017). This issue emphasizes the importance of the role of LGs' managers in finding the right balance in LGs' responsiveness towards citizens, effectiveness requirements, and economic constraints.

Finally, this study suggests that cascading aggregated budgetary targets at the local government level does not ensure that they can be met. A critical element limiting innovation in fiscal governance seems to be connected to the simplistic observation that the overall budgetary position of the country's government results from the algebraic sum of all individual government bodies' financial results. At the core of this understanding are collateral effects that occur when local priorities are distorted by the need to achieve detached fiscal targets set in a top-down manner by the central government, as exemplified by the unexpected investment crunch in Italy induced by fiscal targets calculated on a mixed accrual-cash basis.

To improve the effectiveness of innovations in public sector financial management, future research should investigate more deeply the interconnections between reforms and governance mechanisms in the context of multi-level government. These aspects are in general neglected in the literature on public sector financial management and accounting. On the one hand, it is necessary to focus more on evaluation of the real impacts of innovations in the management of different public sector entities (Damanpour and Schneider, 2009). Academic studies (and practice) of innovations and reforms in public financial management and accounting are usually highly concerned with 'technical' issues and effects, but focus much less on how they impact the everyday management of single public entities and the decisions made by government officials in connection with the provision of public services and the working of organizations. On the other hand, since certain innovations are prescribed by the central government and implemented at

the local level, it might be relevant for future studies to consider the features of multi-level relationships and how local public managers react to that which is new and novel.

NOTES

- 1 This search was carried out between 3-5 July 2018.
- 2 Ratifying member states were required to enact laws requiring their national budgets to be in balance or in surplus within one year of the date the Fiscal Stability Treaty enters into force. The laws must also provide for a self-correcting mechanism to prevent their breach. The treaty also contains a direct copy of the “debt brake” criteria outlined by the Stability and Growth Pact, which defined the rate at which debt-to-GDP levels above 60% should decrease.
- 3 Source: Ancitel 2019. Processed from ISTAT data (<http://www.comuniverso.it/> - accessed June 3, 2019).
- 4 A “deficit permit” here means a revised fiscal balance target, which can result in a higher deficit or a lower surplus being allowed, depending on the initial target.
- 5 Three of Italy’s 20 regions are endowed with a special autonomous statute, Valle d’Aosta, Trentino Alto Adige, and Friuli Venezia Giulia. These regions are subject to different and specific rules negotiated with the central government.
- 6 For example, municipalities who did not utilize a high proportion of the additional fiscal balance permits claimed in a previous year were, in some cases, denied participation in a subsequent year’s clearing house.
- 7 An overshooting of fiscal targets means a better fiscal balance (lower deficit or higher surplus) at the end of a fiscal year, that is some budget capacity to make additional capital expenditure payments existed during the year and was not used.

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