Why to keep taxes at the centre during decentralization? Some analytical guesses in the framework of the Italian present reform

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Introduction

Since early 1990's Italy has embarked on a process of transformation of its system of intergovernmental relations into a quasi-federal one. The process culminated – at least temporarily – with the constitutional review of 2001 that sets up a multilayered system of territorial government based on three autonomous spheres: Regional, Provincial and Municipal. The new constitution extends to education and social protection and a number of other areas the range of basic responsibilities assigned to regional governments. It introduces, at the same time, an asymmetrical system if devolution, meaning those regional governments can decide the new functions they want to be assigned with.

Most of the constitutional mandates have still to be implemented. A huge workload is still pending on the revenue side, where the constitution is rather hesitant. A recent law (n.42 of 2009) sets up the legal framework and authorizes the government to issue the decrees that will define the new revenue system of regional (and local) governments. The drafting of this law has been quite lengthy and has been ridden by deep divergences between the Regions of the Centre-North that asked initially for a revenue system based on the derivation principle - the taxes stay in the territory where they are generated - and the Regions of the South that asked for a system based on the redistribution of centrally collected taxes.

 Law 42 pays only lip service to the regional tax autonomy, making a vague reference to the future introduction of regional and local taxes, whereas it details the new system of equalization grants. The law explicitly mandates that IRAP, which is the most productive of regional own taxes (ensuring approximately 30 % of total regional current revenue and 70% of the collections of own taxes) will be eliminated as a soon as the general conditions of the public finances will allow. The law also does not reverse the recent trend towards the shrinking of the base of the property tax, which is the main tax handle of Municipalities.

This is somewhat surprising. Despite initial vociferations in favor of tax autonomy the richest Regions and Municipalities of the North seem to be happy to live with a system that will give them presumably very modest tax handles. There are, however, reasons for the acceptance on behalf of the governments of the rich areas that have huge own revenue potentialities of a revenue system that aligns them to the poorer areas making them largely dependent on central government transfers. Singling out these reasons is main goal of this paper that intends to contribute to the literature on the centralization/decentralization of taxes.

The paper is articulated into four main sections, plus the conclusions.

After the illustration of Law 42 in the first section, the paper focuses on centralization of taxes. In section 2 a summary of the relevant literature is presented, while section 3 develops a model aimed at explaining centralization of taxes. The model builds on the existing literature and adds to it by including consideration of the expense of the revenue from central government transfers. Section 4 focuses on the commitment issue. It assumes that even in highly

decentralized systems the central government is politically accountable for decentralized policies. This helps to solve the typical commitment problem of tax centralization, whereby the central government could renege the bargain struck with subnational governments and reduce (or eliminate) the transfer that replaces the revenue from taxes that have been centralized.

2. The new Italian revenue system for subnational governments

The new system emerges from the constitutional provision, namely of article 117, referring to expenditure responsibilities.

The article assigns to the exclusive competence of the central government the definition of "essential levels of service provision" for a set of basic services that are considered "necessary to guarantee equality of basic individual and social entitlements across the whole nation".[1] These services include health, education and social protection, plus a still undefined set of services provided by local governments (Municipalities and Provinces). According to prevailing estimates, these services will account for at least 70% of subnational expenditure. In view of their overwhelming importance the paper will focus on them.

The framework law 42 for subnational government financing- also referred to as the "Fiscal Federalism" mentioned in the introduction - defines the main characteristics the system by which these basic functions will be funded. The system will be based on the following steps.
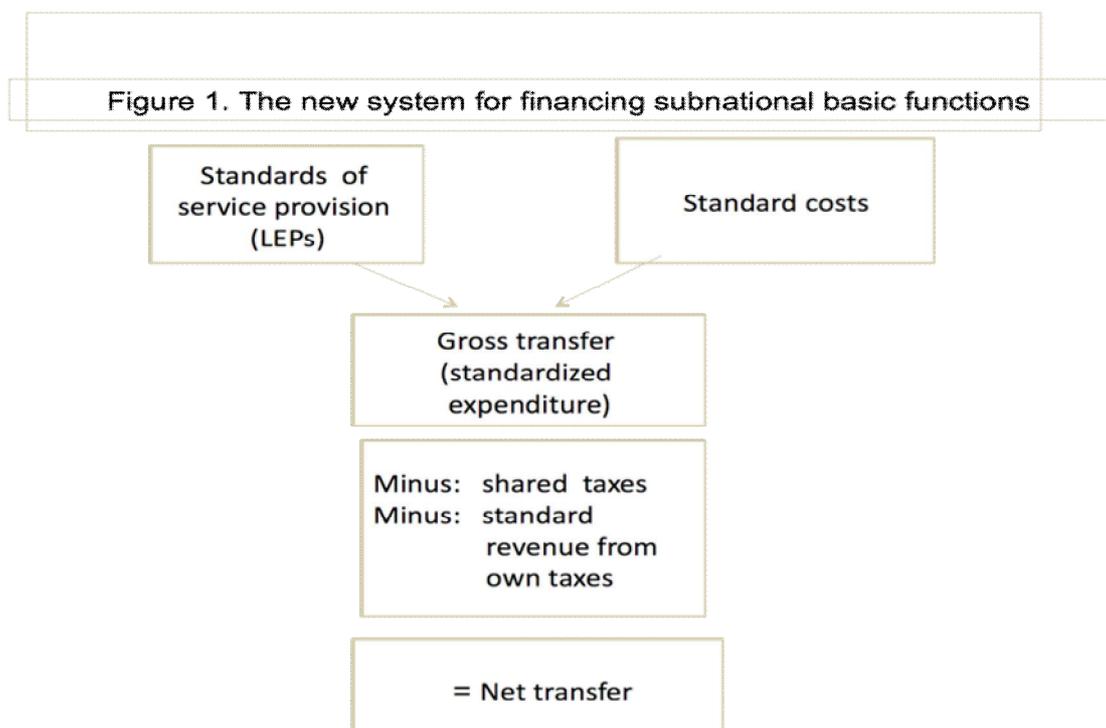
   a. Definition for each local function of the essential level of service provision (LEPs). There is no clarity about the concept and content of LEPs. Clearly they are standards. According to the prevalent interpretation LEPs are more than standards ensuring minimum levels, otherwise the constitution would have termed them *minimum* levels of service. They have also to be standards ensuring *sustainable* levels of service provision, compatible with keeping financial equilibrium (Buratti, 2008).
   b.
   c. Estimating for each subnational unit and for each service the standard cost corresponding to the essential level.
   d. Summing the cost for all the concerned services.
   e. Calculating the revenue deriving from levying, at a standardized rate, the own taxes notionally assigned to fund these functions[2], the revenue from the surcharge of the Personal Income Tax, and the revenue from a still to be determined share of the VAT and other shared taxes notionally pre-assigned to these services.
   f. Determining the net transfer through the difference between d. and c.

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[1] Article 117 is difficult to understand and even more to translate into English. The official translation of the constitution made by the Italian Parliament reads as follows: "determination of the basic level of benefits relating to civil and social entitlements to be guaranteed throughout the national territory".
[2] Since the constitution and the Law 42 mandate the introduction for the other (non basic) functions of equalization grants based on fiscal capacity, it becomes necessary for avoiding double counting to assign to each set of functions the revenue sources meant to finance them.

In principle, own subnational taxes are still on the stage and their effective role has to be specified by government decrees. However, they are and will be clearly overshadowed by the sharing of central government revenue and are likely to play a residual role in a system that is based in essence on a system of block grants with strong equalization content (being based on levels of standard provision of services).

May be, this interpretation is, or will reveal to be, wrong. This does not reduce, however, the attempt made in this paper to explain centralization of taxes.

Figure 1. The new system for financing subnational basic functions

Standards of service provision (LEPs)		Standard costs

Gross transfer (standardized expenditure)

Minus: shared taxes
Minus: standard revenue from own taxes

= Net transfer

2. Centralization of taxes in the literature

In the very long term centralization of taxes is a clear feature of the evolution of federal and decentralized systems, if this is taken to mean simply that present day federal governments have taxing powers that are much larger than those reserved to them in the original constitution. Also, transfers from federal to local governments were totally absent in the initial stages of all federations and even in unitary states, meaning that federal/central government have now more tax resources than they need for their direct expenditure, while subnational governments have now lesser tax resources compared to their expenditures (the so-called vertical fiscal imbalance). However, centralization of taxes is neither a necessity nor a continuous trend. Rather, we can observe extensive fluctuations over time in the assignment of taxes between the national and the subnational governments.

There are two main branches in the literature trying to explain, or to influence this process. The largest body of the literature is the normative, or prescriptive theory of fiscal federalism [Oates, (1972), Inman and Rubinstein (1997), and Ambrosanio and Bordignon (2006) for an excellent updating]. The primary concern of the normative literature is not to explain trends but to lay down the conditions for reaching economic efficiency. While initially (in the classical federal constitutions) the main criterion for assignment was avoidance of tax exportation, more precisely the minimization of tax impediments to the smooth working of the domestic market (thus tariff duties were assigned to the centre, and sales taxes as well in most cases, such as Canada), the literature has later focused on the mobility of the tax bases, more specifically on the elasticity of the tax bases with respect to the changes of their tax rates.

Most of the normative literature stresses the efficiency advantages of centralization, particularly for the collection of taxes, but for a small number of them (such as the property tax). The prescriptions of the normative literature bear, however, a pale resemblance with the real world.

Turning to positive theory, Breton (1996) presents a general explanation for the assignments of powers between levels of government. His analysis does not refer specifically to taxes, but rather to all government functions. Breton's argument is that assignment derives from competition among layers of government. In the case of taxation economies of scale in administration and collection would make the federal government a most likely winner because it can better exploit these economies. However, other factors, such as difficulty of coordination, may constrain the bargaining power of the central government. However, as for the other functions, Breton points out that there is no prevailing trend in favor of centralization, or against it. This conclusion is also maintained by the all the positive literature. This literature is mostly the work of political scientists [Riker (1964); Filipov, Ordeshook and Shvetsova, (2005); and more recently Diaz-Cayeros (2006)] and addresses specific cases and derives conclusions that do not go usually much beyond them. The authors stress the importance of the structure of political parties and of their capacity of make commitments for the striking of federal bargains concerning the allocation of taxing powers.

Filippov, Ordeshook and Shvetsova (2005) are amongst the most widely quoted authors on the issue. However, their focus is on the design of stable federalism systems and on overall (de)centralizing trends in federations and not on (de)centralization of taxation *per sè*. Clearly, proper tax arrangements contribute to stability and derive from proper institutions ensuring negotiations among levels of governments. These include: 1) fundamental constitutional principles designing the basic rules, such as the right to secession (their Level 1 constraints); 2) constitutional principles regarding the amendment of the constitution, the structure of the separation of powers, and the principles guiding the legislation process, 3) political institutions that impact on the implementation of the rules and on the agreements reached through bargaining, such as electoral systems, the structure of party systems and of political parties.

Levi (1988) provides a very careful account of the process by which Australian states relinquished their substantial taxing powers and were left almost completely dependent on transfers from the federal government. There is no formal model of this process, but Levi stresses three factors. They are: a) the superior tax administration capacity of the federal government; b) the capacity of the latter to keep commitments with the states due to strong national structure of political parties; and, c) the increasing unpopularity of widely diverging state tax systems. As in other federal systems, such as Canada, wars and demand for social protection policies facilitated the task of the federal government that Levi views essentially as a revenue maximizer (page 150).

Winer (2000) compares accurately the Australian and the Canadian cases and stresses the lack of evidence on definite centralization trends. In Australia the States have given up most of their taxing powers accepting a centralization of intergovernmental relations that goes much further the constitutional prescriptions. In Canada the evolution of fiscal assignment between the federal government and the provinces is far from linear. Epochs of intense centralization have been succeeded by epochs of equally intense decentralization of taxes. In both cases, also, the constitutional discipline bears no resemblance with actual assignments in the various phases (see, especially, indirect taxation)

Diaz-Cayero's work (2006) is focused primarily on Mexico and Latin America. He also provides a stylized model of the bargaining process between the federal and the state governments. Mexico is, possibly, the most tax centralized federation. Centralization in Mexico is explained by Diaz-Cayero by the one party (PRI) regime that prevailed for half a century and that allowed the federal government to make a credible commitment *vis à vis* the regional politicians concerning the payments of the transfers that replaced the taxes administered by them. In turn, tax centralization brought advantages to regional politicians by reducing the intensity of competition from their possible challengers.

3. A model for explaining centralization of taxes

The model focuses on commitment issues. On the one hand, to accept centralization of   taxes the subnational governments have to be sure that the central government will keep its promises over time and abstain from cutting its transfers once the bargain is made. On the other hand, for the sake of its own political accountability the central government has to ensure that subnational governments will effectively fulfill their commitment to spend the money for the functions for which they the transfers are paid. This may introduce a weak budget constraint that makes centralization of taxes more palatable to regional governments.

The choice strategy by subnational governments

Building on the bargaining approach by Diaz-Cayero by introducing also expenditures into the picture, let's consider the negotiation over tax (de)centralization between a federal government and a Region, or a number of Regions all of equal size and characteristics (which will amounts to the same), when a Region considers taking on a policy responsibility, namely

education, that is presently assigned to the central government. We later relax the equality of Regions by assuming that they differ by income conditions.

To simplify the things, let's assume that there is only one earmarked tax for funding this function, the education tax. The tax base and tax rates are determined in the constitution. Variations in the volume of tax collections depend only on the efficiency of administration. Skills and effort capacity can vary between levels of government and scale economies can play a crucial role[3]. Thus assignment of tax administration variable can lead to different amounts of collections. The assignment of education and the assignment of the administration of the tax to either level of government are the objects of the negotiation. We assume that all governments are revenue maximizers - more specifically, they maximize the difference between the revenue they receive and the expenditure needed with reference to the minimum level of services they consider they are forced to provide for keeping themselves in power, or because of legal/constitutional obligations. [4]

Let's start with the choice of the Region. It is split into a two stage process. Namely, the Region has to decide if it wants to take on the new responsibility. Secondly, the Region has to decide the system with which the new responsibility will be funded. There is no obvious hierarchical relation between the two stages of the decision process, but being a revenue maximizer the Region will first decide about the revenue system: own taxes or transfers. Then, it will decide if it is worth proceeding with the new policy assignment. The choice process is illustrated in figure 2.

The first alternative is between:

1. Centralization of administration of the tax with expected collections of C, accompanied by expected transfers to subnational governments of T, leaving revenue equal to C - T to the federal government.

2. Administration of the tax by the Region (Regional tax autonomy), amounting to an expected revenue of L for the Region.
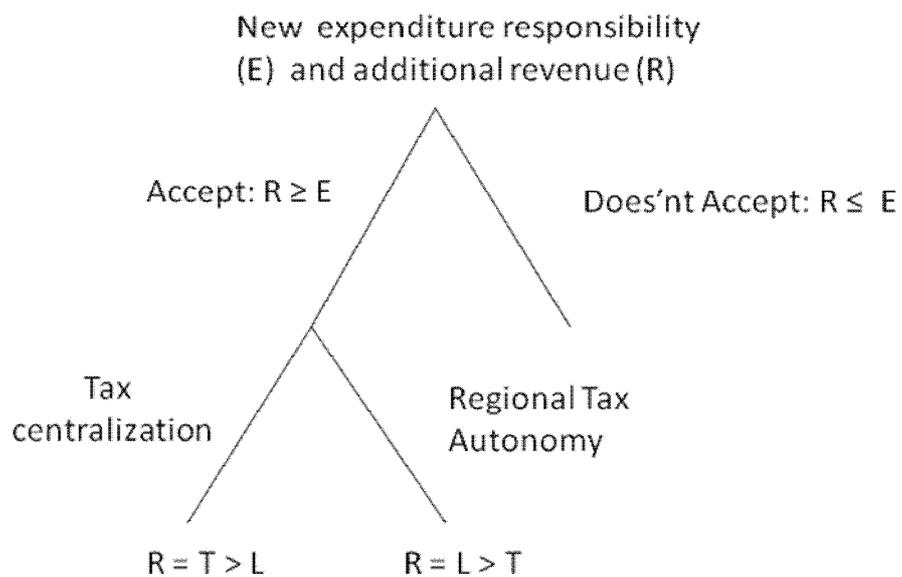
The Region will receive T with tax centralization and L with tax decentralization. It will thus prefer tax centralization when T > L. It will prefer decentralization, at the contrary, when T < L, that is when the transfer it expects from the central is lower than its own expected tax collections.

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[3] We do not consider variations in tax rates or in the tax bases that are the essential ingredients, along with tax administration, of subnational own taxes. The main reason is that within a revenue maximization model it is impossible to distinguish between central and local governments in terms of the choices on tax rates and tax bases that maximize revenue. Their consideration would require another assumption on the decision-making process, such as a median voter model.

[4] The obvious reference is to a less extreme version Brennan and Buchanan (1980), that takes into account the electoral constraints on politicians that prevail in present day industrial democracies.

In the second step the Region has to check whether its preferred choice for revenue - R = max (T,L) - is enough to cover the expected new expenditure, E.

Figure 2. Decision tree of the Region

New expenditure responsibility
(E) and additional revenue (R)

Accept: R ≥ E   Does'nt Accept: R ≤ E

Tax
centralization   Regional Tax
                                  Autonomy

R = T > L   R = L > T

That is the Region will ask for the assignment of the new function and will choose the transfer if
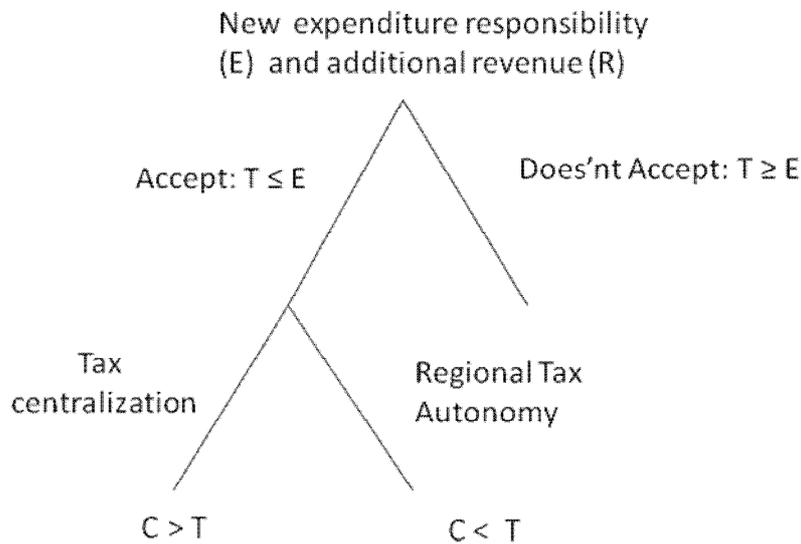
T > L   (1)

and

T ≥ E   (2)

Let's turn now to the federal government. Again, it is faced with a two stage choice process. It has to decide, first, whether to accept the devolution of education to the Region and, second, the way it will be financed: tax centralization meaning that it will keep the administration of the tax or to accept it devolution to the Region. The choices are illustrated in figure 3.

Figure 3. Decision tree of the State

New expenditure responsibility
(E) and additional revenue (R)

Accept: T ≤ E   Does'nt Accept: T ≥ E

Tax
centralization   Regional Tax
Autonomy

C > T   C < T

The federal government will prefer tax centralization if the expected transfer it has to pay to the Region is lower than the expected collections of the tax. Secondly, it will accept the devolution of the function if the grant is lower than, or at most equal to, the expenditure it is presently making for education. Otherwise, there will be no gain for it from the change.

That is the federal government will accept the whole package provided that

C >T   (3)

 and

T ≤ E   (4)

When we combine the four constraints we get that an agreement can be reached if

C > L   (5)

and

T = E   (6)

That is, the agreement will be reached, if tax centralization of tax brings in higher revenue than decentralization, implying better administration or economies of scale with centralization, and if the size of the transfer is equal to size of expenditure.

While it is in the realm of the possible to expect economies of scale and better administration with centralization, the bargain entails that, *rebus sic stantibus*, that is under the existing

conditions, no level of government is going to gain in terms of revenue from the bargain. This is because the Region will get exactly what is needed to fund the new expenditure and the central government will have to pay a transfer that is equal to the foregone expenditure.

There are, however, other possible reasons for the bargain and they derive from future actions by both levels of government. For example, the Region can believe that it will be able to spend with greater efficiency on education than the federal government, saving part of the grant for other purposes. This in fact one of most claimed motives advanced from those Italian Regions, which have asked for devolution of new policy responsibilities according to the asymmetric framework inserted in the constitution.

On the other hand, the central government could believe that there are substantial possibilities of improving the tax administration process, or to reform the tax.

In the reality, past and present Italian tax reforms give some support to this last argument. The last and comprehensive national tax reform of 1970, which was enacted on the eve of the regionalization of the country, centralized all the taxes. The Regions were born without any taxing power and were financed (until the 1990's) entirely out of transfers from the central government (and did not complain).

The present government has announced recently – again on the eve of a likely intense devolution of policy responsibilities to Regions and Local Governments - that it will proceed from next year to a new comprehensive tax reform. The likely strategy is that through tax reform it will be able to satisfy the claims for resources coming from subnational governments and to expand at the same time its reins on the whole tax system.

Presumed higher central government tax administration efficiency can also explain why in some Latin American countries tax reforms have reduced the role of subnational taxes despite concomitant, or perspective decentralization processes.

Tax centralization with differences in income and fiscal capacity between Regions

Clearly this is a more realistic case, but with less straight conclusions, because redistribution comes to the fore and it is quite difficult to model. With tax decentralization the revenue available to each Region is related to its income conditions. The choice between the tax and the transfer will thus depend, *prima facie,* on the existing level of central government expenditure for education (centralization does not imply *de jure* or *de facto* homogeneity of levels of service provision across the country). If education expenditure is the same (percapita) across all the country, L > T for the rich Regions, and L < T for the poor ones, making the former less incline to accept the grant and to ask for the devolution of the expenditure responsibility, unless they fear they will have a weaker capacity in their tax administration or big expectations on their capacity of shrinking the expenditure.

At the same time, the choice will depend on present levels of expenditure made by the central government in the function going to be devolved. If present levels are higher in the rich Regions

than in the poor ones – this situation is actually observable for a range of services in many countries- the propensity of rich Regions to choose the transfer will increase. Paradoxically, but not too much, tax centralization can be easier in more (expenditure) decentralized federations.

Propensity for tax centralization can become stronger when we look at commitment issues, to which we come now.

4. Dependence on transfers and commitment problems

Intended future actions - savings on expenditure and higher tax administration effort – introduce naturally to the consideration of commitment problems.

Intergovernmental long-term contracts are subject, as any other contract, to them. Once the Region has accepted the centralization of the education tax and the compensating transfer, it is potentially at the mercy of the central government. This government could in subsequent years renege the agreement and reduce the size of grant. One does not have to think to extreme situations, where future transfers are set to zero, to stress the importance of the commitment problem. Once the Region has given up its taxing powers, resuming them will take time – especially when they consist of tax administration –and even a modest reduction in real terms, or and worse in the money value, of the grant will do a lot of harm to its finances.

Clearly, both the literature and the observable experience provide more or less effective solutions to the commitment problem, depending on the context where they apply. There are basically three of them. The first solution is to increase the initial size of the transfer, to take care of the fact that the Region applies a discount factor to transfers in future years. In other words, the central government posts a bond. This is an elegant analytical solution in a typical two period time frame. The federal government will pay in the first period $T_1 = T(1+d)$, where d is the discount rate to assuage the fear of the Region that the transfer will be reduced in the second period. This solution becomes more problematic in a more realistic multi-year time frame.

The second solution is to act with legal provisions. The commitment problem can be eased/solved through the insertion in the constitution, on in a law with higher hierarchy than ordinary laws when this kind of law exists, of a protection clause about the size of the transfer.

The third solution refers to the structure of political parties. This is the major argument advanced in the political science literature on tax centralization. In essence, commitment is firmer when parties have a national structure at both levels of government and, especially, when the same party governs at both the federal and the subnational level. It is still firmer when the same party stays unchallenged at power for a lengthy period, as it happened in Mexico with the PRI for 70 years (Diaz-Cayero, 2006).

Political interactions between levels of government as a major source of commitment

Political/electoral interactions are in our view the main player in ensuring commitment. The argument starts with considering that in (or almost) every present day intergovernmental system the various spheres of government are never completely separated, in even in extremely decentralized systems. One implication of this missing separation is that the policies and services provided by subnational governments impact also on the popularity, and thus the probability of re-election of the central government. On the basis of this consideration we use construct an index of centralization/decentralization (Brosio, with meaningful properties that adds to the literature that measures the meaning and the intensity of decentralized systems [see Treisman (2000) for a review].

Essentially, this index maintains that (de)centralization of a service, or of a policy, does not refer to the institutional assignment of it to the central government, but to the probability of re-election for the central government deriving from the level of provision of this service. For example, education can be constitutionally decentralized and thus provided by subnational governments, but it will still be to a varying extent centralized if the probability of re-election for the central government also depends from the level of provision of education .

Suppose a country with a central government, G, and another sphere of, local, government. There are only two publicly provided goods, namely, defense, D, a national good, and education, E, a local one. Both goods can be provided under different institutional arrangements.

The probability of re-election depends on the level of service provision for the publicly provided goods, that is,

$$P_g(\alpha D, \beta E) \qquad\qquad (7)$$

where P_g is the probability of re-election of the central government and α and β are the discount factors, assigned to the arguments, with $0 \leq \alpha , \beta \leq 1$. This probability is related to the probability that each voter will grant his/her consent to the incumbent politician. In turn, this probability is a function of the utility of each voter. [Muller (1989) provides a good summary of, and references to, the literature on voting under conditions of uncertainty]. For simplicity, we assume that voters' utility function has only two arguments, namely defense and education provision.

The degree of decentralization can be inferred – according to this approach – from the value of α and β. When $\alpha = \beta$ the system is completely centralized, since voters consider that the central government only is responsible for both goods. In fact, in a purely centralized system the two arguments are discounted equally by the central government. This is because, independently from constitutional and/or other legal regulations voters consider that the central government has the full and exclusive responsibility for their provision. When $\alpha > \beta$ the system is decentralized. When β equals zero, the system is completely decentralized and the central government bears no responsibility whatsoever for the provision of the local good. A completely decentralized system with two levels of government assigned with the provision of one good each implies that the

probability of re-election depends for each level/unit of government from the single good for which the voters hold them responsible.

The interest of this approach lies also in the fact that it accounts for different degrees of decentralization for different sectors. A country may, for example, be quite decentralized for health, but very centralized for education. With the devolution of a function comes inevitably also the commitment on the transfers for that function if voters consider that this is also a central responsibility and hold the national government accountable for it.

These considerations can help to understand why Canada, which is considered as a highly decentralized federation, finances the provision by the Provinces of health, education and social assistance with a system of block grants, whose allocation is based on population. According to our index of decentralization, health, education and social assistance are in that country to some extent centralized functions, although surely as not centralized as in Italy.

Coming back to the Italian case, Italian Regions are clearly betting on this commitment when they show they are all ready to accept to be funded with a central government transfer. In fact, they are betting on the basis of past experience – the central government has constantly intervened with supplementary grants to those Regions that showed a weak budget constraint. They are also betting on the future, in view of the constitutional mandate on essential levels of service provision that makes education and all basic functions quite centralized in our meaning, tying the electoral fortunes of the central government also to what regional (and local) governments will provide in these sectors.

Furthermore, the national government dependence on regionally provided education could enhance the role of federal government as an insurer against asymmetric shocks. This role is increasingly discussed and tested in the literature, although with no unanimous results [Hepp and Von Hagen (2000), Rodden and Wibbels, (2010)].

Possible excess of commitment

One can also guess that the Italian constitutional mandate will ensure not only commitment about the agreed size of the transfer, but could even be exploited by Regions to obtain additional resources from the central government.

Let's try to imagine for a while the likely future scenario. The Italian constitution and Law 42 mandate both efficiency, by introducing standard costs for the determination of the gross transfer for the basic functions and uniform provision of services across the whole country with the introduction of LEAs. Assuming that the level of efficiency is the same everywhere and that each Region that has been devolved with the new function is providing a level of service that corresponds precisely to the legally mandated LEAs, then each Region would spend exactly the total amount of the gross block grant it receives and there would be no problems. But this will be a very rare occurrence. Regions are more likely to be over or, and especially, under

performing in terms of efficiency and/or compliance with essential levels of service provision, as is the present case. Figure 4 illustrates the four possible combinations.

Figure 4. **Combinations of Regions by efficiency and service delivery levels**

4. Efficient, but not compliant with levels	1. Efficient and compliant
3. Non efficient and non compliant with levels	2. Non efficient, but compliant

Case 1 creates no problems. An efficient a compliant Region can even spend less than the grant and reduce levels to the essential norm and redirect the savings to other functions. This can be what rich Regions presume they will to do when they accept the transfer. Case 2 is a problem for the concerned Region, since it has to spend more than the grant. Problems arise for the central government with case 4: efficient Regions provide less than essential levels and, especially, with case 3 – likely to be   the most common case - Regions that are non efficient and non compliant with levels.

It is quite likely that non-complaint and inefficient Regions will ask for more transfers and that the central government will find it difficult to impose discipline on them considering their numbers. Acceptance of transfer by Regions in an effectively centralized system becomes like buying an insurance policy against not only misfortune, but also misbehavior.

Conclusions

The paper originates from observation of a somewhat startling choice by the Italian Regions to accept a quite likely dependence on central government transfers *in lieu* of own tax instruments in the midst of a decentralization process. The explanation we offer, while constructed with reference to the Italian case, aims at contributing to the branch of literature

that tries to explain centralization of taxes by taking into consideration also the expense of the revenue of centralized taxes. This consideration has been left out in most contributions to this literature.

To this purpose we present a very simple bargaining model between the federal/central government and the Regions that illustrates the main choices open to both levels of government.

The main results are that transfers will prevail on subnational taxes when substantial efficiency gains in centralization of tax administration are expected. Regions will also ask for decentralization of new policy responsibilities- *cum* transfers when they expect to be able to reach substantial efficiency gains in the expense of their revenue. In other words, Regions expect to be less efficient with tax and more efficient with expenditure than the central government.

However, the main contribution of our paper lies, we believe, in the commitment issue. Basically, we maintain that even after devolution of a task to subnational governments, the federal/central government can be still considered by voters as, partly, responsible for the devolved task. In other words, the effective degree of decentralization of a system does not depend only on the quantitative importance of devolved functions, but also on voters' views about the responsibility of each level of government concerning the effective provisions of the service. When voters hold the central government politically, or better electorally accountable for a devolved function, the latter has to keep its commitment referring to the size of the transfer. Regions can also exploit the central government electoral accountability to get increases of their transfer in case of asymmetric shocks, or even of lack of revenue due to their sheer inefficiency.

Although our analysis is referred to the Italian case, its findings may also be applied to other systems. For example, to fiscally centralized federations, such as Australia, where centralization of taxes and the extensive role of equalization grants may be explained by the fact that the federal government considers that it is held electorally responsible also for the policies of the states.

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