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► **To cite this version:**

Céline Du Boys, Emanuele Padovani, Rebecca L Orelli. ASSESSING FINANCIAL HEALTH OF LOCAL GOVERNMENTS: GOING BEYOND ACCOUNTING STANDARDS: A COMPARATIVE STUDY BETWEEN FRANCE AND ITALY. EGPA Annual Meeting, EGPA (European Group for Public Administration), Sep 2014, Speyer, Germany. hal-01470282

HAL Id: hal-01470282

<https://amu.hal.science/hal-01470282>

Submitted on 17 Feb 2017

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ASSESSING FINANCIAL HEALTH OF LOCAL GOVERNMENTS: GOING BEYOND ACCOUNTING STANDARDS

A COMPARATIVE STUDY BETWEEN FRANCE AND ITALY

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ABSTRACT

Context. The issue of fiscal sustainability has affected not only central governments but also – and in some instances with more severe impacts – local governments (LGs) especially in contexts with high autonomy. This has exacerbated, at both the operational and scientific level, the issue of having effective measurement systems and assessment methodologies to detect, and therefore to prevent, financial defaults. Accounting plays an important role to understand the financial health of local governments. Yet, not only the debate about which system of accounts is more suitable for this purpose is still open, but also the growing development of overlaps and linkages within governments and private-sector organizations to provide local services in the era of the so-called “network governance” (e.g., outsourcing, public-private partnership, and, in some countries, the increasing phenomenon of public owned enterprises) and the intertwining of fiscal rules provided by central governments as well as the differentiated effects of local economies have tangled further.

Problem. A greater need for cross countries comparative financial health analysis has emerged for several years, not only to compare central governments, but also LGs, especially in those supra-national settings like the EU. The work on international accounting standards is a great move toward more accurate cross country comparisons. However, the cultural background, the risks and protections offered by each country to LGs may lead to different financial health analysis’s objectives and to various methodologies and focuses, that cannot be taken into account by accounting standards only.

Objective. The paper offers to identify and discuss practitioners’ visions of LGs’ financial health and their objectives when assessing LGs’ financial health. What do they consider to be a “bad financial situation”? It aims at understanding the perceived influence of national environment (legislation, accounting reliability, LG perimeter...) on financial analysis objectives and methods, and operates a comparison of Italian and French situation on these issues.

Method. To do so, we use a qualitative methodology. Several practitioners in France and in Italy will be interviewed: financial managers in local governments, public auditors and bankers that work in the context of LGs’ economies (factoring services to LGs’ providers, dealer of LGs’ bonds, borrowing to LGs). The content of interviews will be analyzed through a thematic analysis. The main themes that will emerge in France and Italy will be compared and discussed. The qualitative methodology aims at identifying the practitioners’ views, without measuring their representativeness. How LGs’ “financial health” and “financial risk” is shaped, the methodology used to assess financial health, and issues such as LG perimeter, accounting reliability and country specificities will be discussed.

Originality and value. The study aims at giving an overview of elements that should be taken into account for cross cultural financial health analysis, beyond issues of accounting harmonization. Usual cross cultural financial analysis methods neglects differences in risk vision, and in LG’s perimeter. The paper aims at giving insights to decision makers of how to interpret and understand the financial situation of foreign LG

1. Introduction

The issue of fiscal sustainability has affected not only central governments but also – and in some instances with more severe impacts – local governments (LGs) especially in contexts with high autonomy. This has exacerbated, at both the operational and scientific level, the issue of having effective measurement systems and assessment methodologies to detect, and therefore to prevent, financial defaults. Accounting plays an important role to understand the financial health of local governments. Yet, not only the debate about which system of accounts is more suitable for this purpose is still open, but also the growing development of overlaps and linkages within governments and private-sector organizations to provide local services in the era of the so-called “network governance” (e.g., outsourcing, public-private partnership, and, in some countries, the increasing phenomenon of public owned enterprises) and the intertwining of fiscal rules provided by central governments as well as the differentiated effects of local economies have tangled further.

A greater need for cross countries comparative financial health analysis has emerged for several years, not only to compare central governments, but also LGs, especially in those supra-national settings like the EU. The work on international accounting standards is a great move toward more accurate cross country comparisons. However, the cultural background, the risks and protections offered by each country to LGs may lead to different financial health analysis’s objectives and to various methodologies and focuses, that cannot be taken into account by accounting standards only.

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The study aims at giving an overview of elements that should be taken into account for cross cultural financial health analysis, beyond issues of accounting harmonization. Usual cross cultural financial analysis methods neglects differences in risk vision, and in LG’s perimeter. The paper aims at giving insights to decision makers of how to interpret and understand the financial situation of foreign LG.

The paper is organized as follow. Part 2 proposes a literature review on financial health and on the sources of financial risks for local finance, also giving raise to importance of studying financial health assessment under a contingency approach. Then, the paper offers to discuss the differences between French and Italian vision of LG’s financial health. The methodology is presented in Part 3. Part 4 and 5 give an overview of the French and Italian institutional and financial contexts. Part 5 presents the results of the qualitative analysis. Part 6 offers a discussion on the main differences between French and Italian visions on LGs financial health analysis, while Part 7 tries to draft a conceptual framework of contingency approach to financial health analysis. In Part 8 our conclusions are portrayed.

2. Literature review of financial health concepts in LGs

At the international level, the literature concerning financial health in LGs is quite limited in number and, with a few exceptions, is restricted to the U.S. and Australian contexts and to municipal government types. This literature tends to highlight the negative side of financial health by studying the concepts of “fiscal distress”, “financial risk”, “fiscal crisis”, or “fiscal strain”.

Most of this literature concerns the way and techniques used to measure financial health. Some authors have focused their research on LGs’ credit ratings measurement and solvency assessment (López et al., 2003; Alijarde and López, 2001; Manes Rossi, 2009), while others have emphasized the measurement of short-term solvency, represented by a LG’s ability to meet its payroll and generally make payments in a timely manner. Still other have focused on the long-term, where the point of view is more on the trends in a LG’s tax base relative to its expenditures and commitments (Kloha et al., 2005).

Broadly speaking, financial health can be seen as the condition in which a LG is regularly able to meet its payroll, pay its current liabilities, meet its debt service (Downing, 1991, p. 323), and undertake

service obligations as demanded by constituents (Falconer, 1991, p. 812; Krueathep, 2010, p. 224); the American Governmental Accounting Standards Board uses the word “economic condition” to summarize a composite situation of financial health and ability and willingness to meet financial obligations and commitments to provide services (Mead, 2006). Groves & Valente, 2003 have singled out four generally agreed upon sub-concepts of financial health, i.e. cash solvency, budget solvency, long run solvency, and service level solvency. They are defined as follows:

- Cash solvency measures a local government’s liquidity and effective cash management, and its ability to pay current liabilities.
- Budgetary solvency refers to the ability of the government to generate sufficient revenues to fund its current or desired service levels.
- Long run solvency refers to the impact of existing long term obligations on future resources.
- Service level solvency refers to the ability of the government to provide and sustain a service level that citizens require and desire.

Designers of local government fiscal health systems face a difficult dilemma in choosing among which indicators to select. The dilemma is embodied in the definition of financial health, mostly in its core notions of fiscal health and fiscal stress.

Fiscal health refers to a local unit’s overall ability to maintain services respond to an emergent situation. It emphasizes indicators such as economic and population change, revenue and expenditures per person, debt per person. For example, with reference to the American context, some authors have written that municipal governments’ financial health is defined or determined, and therefore measured, by socioeconomic forces (Peterson, 1976) or, under a more limited approach, by the municipal bond market (Petersen, 1974). In this definition, fiscal health appears related to long run solvency and service level solvency.

Fiscal stress, on the other hand, is associated with the ability of a local unit to meet short and long term financial obligations and avoid State takeover or even municipal bankruptcy. Downing has demonstrated that situations perceived by urban counties’ public officials “to have the highest validity as indicators of fiscal stress are (1) inability to meet payrolls when due and (2) default on repayment of bonded debt” (Downing, 1991: 323). This latter point of view has been predominant for some European authors, who have focused their research onto LGs’ credit ratings and solvability assessment (López et al., 2001; Alijarde and López, 2001; Manes Rossi, 2010). Fiscal strain has also been defined considering its dynamic nature as an “incomplete adaptation to changing resources and problems confronting a municipality” (Clark, 1977: 55). Others have discriminated short-term, represented by a LG’s ability to meet its payroll and generally make payments in a timely manner, from long-term, where the point of view is more on the trends in a LG’s tax base relative to its expenditures and commitments (Kloha et al., 2005). In fiscal stress measures, there is a general emphasis on indicators such as fund balance, cash availability, deficits, and property value losses. In this context, it tends to be a correlation between cash and budgetary solvency and fiscal stress type measures.

This wide array of options has determined a diversity of approaches to LGs’ financial health assessment by audit bodies throughout the world (Padovani and Scorsone, 2011). It is generally accepted that several measures can be used to assess LGs’ financial health (Andersen and Mortesen, 2010). These techniques range from basic approaches such as accounting information and financial reporting analysis (e.g. Kleine et al., 2003), eventually added of qualitative analysis by reviewing audit reports, LG reporting, or information gathered from discussions or regional workshops (Honadle, 2003), to more sophisticated statistical modelling approaches (e.g., Murray and Dollery, 2005). An important aspect of these quantitative works is the proxy used in order to discriminate financially unhealthy LGs from the healthy ones. Several variables have been proposed for this purpose such as ratio indicators (Clark, 1977; ICMA, 2003), the incidence of mergers or amalgamations, the quantity or quality of service delivery and the cost of restoring infrastructure assets to satisfactory condition (Jones and Walker, 2007; López et al., 2001, Zafra-Gómez et al., 2009). In essence, the differences in the set of indicators used to assess financial health reflect the variances of sub-concepts in which it can be broken out.

The problem of measuring financial health is tightly intertwined with accounting information available. Internationally, there has been a growing pressure about the implementation of accrual accounting replacing or adding to the traditional budgetary cash-based or modified accrual accounting

(Guthrie et al., 2005). This has been in answer to the call for suitable accounting systems to generate information to feed the need of tools to measure and monitor economic quantities. At the local level, fiscal autonomy has acted as the utmost affecting driver, since the object of control has moved from the “correct use of governmental grants” to the “efficient and effective use of local citizens taxes” (Caperchione and Mussari, 2000). Not only the traditional cash-based accounting information versus the ‘new’ accrual accounting information availability is crucial, but also the quality of the information matters. This is made clear by a recent study within the field of LGs by Pinnuck and Potter (2009), which supports that financial reports based on accrual accounting are economic goods whose quality is determined by market demand. In Europe, with the exceptions of UK and some Nordic countries, municipal governments have introduced accrual accounting without being pushed by a factual market-oriented management style (Pina et al., 2009), therefore the demand of high-quality data seems to be poor and so ought be the accrual information produced, originating a loop where accrual accounting information is poor, therefore it is not used for performance assessments, therefore nor for financial health evaluations. In a resolution approved on 22th June 2011 by the European Parliament which decided that member States – including LGs – should adopt International Public Sector Accounting Standards (IPSAS) in their financial statements, within three years, while the European Commission is working on its own European Sector Accounting Standards (EPSAS).

In another part of literature on financial health, some studies have also tried to explore the causes of distress in financial health. One set of causes often identified is internal, and concerns the lack of organizational resources and managerial skills (Carmeli & Cohen, 2001); others emphasize the incapacity to adapt to economic downturns, particularly when some responsibilities are shifted to municipalities without any financial compensation or equal ability to increase revenues or, in general, external forces, mostly socioeconomic, that could heavily affect a LG’s financial equilibrium (Peterson 1976; Falconer 1991; Beckett & Camarata, 2004). While internal causes are subjected to a great deal of variances amongst different LGs, external forces – such as economy trends, institutional context, level of autonomy, etc. – might reveal some similarities amongst LGs falling in specific area, e.g. within the same State.

In conclusion, while the current knowledge in the area of financial health of LGs has already debated the discussion of the basic concepts of financial health, its indicators, the accounting information that should be used, and the approaches of assessment, it is evident that there is a multitude of perspectives for financial health assessment. This may suggest a contingency approach. The cultural background, the risks and protections offered by each State to LGs may lead to different financial health analysis’s objectives and to various methodologies and focuses, that suggests that a unique approach for assessment by imposing standards across countries may not fit.

3. Methodology

The paper offers a discussion of the differences between French and Italian vision of LG’s financial health assessment. It compares the main financial risks incurred in each country. In order to have a complete vision, the paper presents the legal and institutional contexts, and looks forward catching the vision of practitioners, by interviews and by literature review.

Part 4 presents the French and Italian institutional and financial environments. The topical issues of local public finance are introduced to better understand the financial risks. To do so, we mobilize official documents and reports such as reports from observatories of local finance, or from Court of auditors. In Part 5, we use a qualitative methodology to catch practitioners’ visions. It is based on open-ended interviews of eight practitioners in France and seven in Italy (see Table 1). The interviews were concerned with financial risks in LGs: What do they consider to be a “bad financial situation”? In their opinion, what are the financial risks incurred by LGs? What are the risks stemming from LGs’ subsidiaries or partners? What do creditors, suppliers or citizens have to fear? These interviews were added by the analysis of official documents concerning the financial health of LGs issued by public institutions (court of auditors, ministries, public agencies, etc.).

Table 1 – Interviewees’ profile

	France			Italy		
	N	Position	Type of Organization	N	Position	Type of Organization
Auditors	1	External auditor	Regional Court of auditors “ <i>Chambre Régionale des Comptes</i> ”	9	External auditor	Court of auditors (<i>Corte dei conti, sezione autonomie</i>)
	2	External Auditor	Regional Court of auditors “ <i>Chambre Régionale des Comptes</i> ”	10	External auditor	Court of auditors, regional branch of Lazio (<i>Corte dei conti, sezione regionale di controllo del Lazio</i>)
	3	Internal auditor - Manager in charge of Local sector	Public Finance Regional Head Office “ <i>Direction Générale des Finances Publiques (DGFIP)</i> ”	11	Internal auditor, former consultant for the Court of auditor	Internal auditor of several municipalities of various dimensions
				12	External auditor	State general accounting office (<i>Ragioneria generale dello stato</i> -
Managers and administrators	4	Chief financial officer (CFO)	Municipality of more than 100.000 residents	13	CFO	Municipality of more than 1 million residents
	5	CFO	Municipality of more than 100.000 residents	14	CFO	Municipality of about 60.000 residents
	6	CFO	Departement	15	Former Mayor	Municipality of about 10.000 residents and now head of a municipal association
	7	CFO	Departement			
	8	Manager – former CFO	Intercommunality of more than 100.000 residents			

Thanks to those elements, we discuss the differences between Italian and French local public financial situations, and the way managers and public institutions see and analyze financial risks.

4. LGs’ context in France

4.1 Institutional framework

Historically, there are in France three levels of local governments: Region, Department and Municipalities. Their legal system is very similar. The large number of municipalities (over 36,000), specific to France, has pushed to the development of public institutions for the cooperation of municipalities. These intercommunalities now form a fourth stratum of LG.

France is a unitary state and not a federal one. Equalization arrangements help to promote equality between local authorities.

Each LG has specific competences. The municipality manages the services and equipment related to everyday life: water, sanitation, garbage, town planning... The department is oriented towards solidarity missions and rural equipment. The region is involved in economic development. But they also share some competencies related to transportation, education or culture...

These services can be managed directly by the LG or be delegated to external public or private organizations. LGs are also responsible for settling local affairs, which justifies a so-called general competence clause.

The French decentralization took place in several stages (Girardon, 2011) :

- In 1982, a law organized a transfer of competences and power from the State to the 3 levels of existing LGs. The State supervision is replaced by an a posteriori review of legality.
- In the early 2000s, decentralization and LGs financial autonomy are registered in the Constitution. The transferred competences are extended and intercommunalities are strengthened.
- A third wave of decentralization took place in the late 2000s. A reform of local taxation has been initiated with the removal of the main local business tax: the “*taxe professionnelle*”.

Many debates still agitate the decentralization process in France (Girardon, 2011). One is the reduction of the number of LGs stratum. Projects are underway for creating “métropoles” aiming at merging some LGs. The parliament is also currently debating a proposal to reduce the number of Regions.

The removal of the general competence clause is also discussed: it would allow LGs to focus their resources on their legal attributions only.

Since 2003, the Constitution guarantees the autonomy of local authorities. They can freely dispose of their resources, under the conditions stipulated by law.

Tax revenues and other own resources must represent a significant part of their resources. The cost of transferred competences must be fully offset by the transfer of fiscal resources and / or endowments. The State no longer exercises a prior supervision, but the LGs budget is only enforceable after the local representative of the State approved it.

Despite these elements, after 30 years of decentralization, LGs’ autonomy is still questioned (Girardon, 2011). Financial compensation of transferred competences is often regarded as too low. Some LGs, as departments, presently suffer from a lack of resources.

LGs revenues are still largely determined and paid by the State. The parliament determines the local taxation system and LGs vote the rates of some major direct taxes. However this power on rates has been reduced by the successive suppressions of local taxes decided by the State, even if they have been compensated financially (Mouzet, 2011).

Another obstacle to LGs autonomy is their obligation to deposit all their available cash to the national public Treasury¹ account (Mouzet, 2011).

In France, the role of the State remains important and its influence on LGs is strong. It is at the same time a controller, an advisor and a partner for local authorities (Girardon, 2011).

4.2 Local public finances

LGs budget is the central element of local public finances. LGs can act on the amount of their revenues, and thus spending. The budget aims to forecast resources and expenditures, but it is also an act of authorization. Only budgeted expenditures and revenues can be implemented. It is voted by the deliberative local assembly and must be validated a posteriori by the Prefect.

The budget is split in two sections: operating and investment activities.

Local finances are governed by the rule of balanced budget, which dates from the 19th century but was confirmed in 1982 (Mouzet, 2011). No deficit can be forecasted.

Operating section can generate a surplus, which will permit to finance the investment activities. The balance of the investment section is achieved through borrowing resources. Debt repayment must be done from own-resources : LGs cannot borrow to repay debt (Girardon, 2011).

The budget implementation may still give rise to a deficit, in the event of adverse economic conditions or overestimated revenues. In that case, measures to restore equilibrium must be implemented in the following budget. The Prefect and the Court of Auditors monitor or impose measures to return to the balance.

The budget shall be implemented in accordance with the principle that the authorising officer and the accounting officer are different individuals. This principle ensures a secure implementation of the budget (Girardon, 2011).

The accountant establishes the LG’s accounting on an accrual basis.

LGs perimeter and off-balance sheet risks

LGs have financial links with several satellites and dependant organizations. The growing awareness of the associated financial risks has led to establish internal monitoring processes. These satellites are also a constant priority of audit institutions, especially semi public companies (Adam et al., 2007). LGs must produce a statement of their off-balance sheet commitments and the list of funded organizations (Adam et al., 2007). However, no consolidation of accounts is required.

¹ « Trésor Public »

LGs' resources and expenditures

Operating expenses of LGs consist mainly of three types of expenses (Observatoire des finances locales, 2014):

- *Personnel costs* (about 35% for all LGs, but up to 43% for municipalities),
- *Intervention expenditures* (about 40%, but up to 70% for departments, because of social expenditures and regions),
- *Purchases and external costs* (19% in average).

LGs' resources have three sources: internal, external and borrowing.

- *Internal resources* mainly come from taxation, but also from assets and from service fees. Tax represents about 50% of local resources. LGs collect direct and indirect taxes from citizens and companies.

The way taxes are collected provides cash facilities to LGs, and thus limit their risk of cash deficit (Mouzet, 2011). Indeed, local authorities do not take part in the collection of local taxes. The State ensures that LGs receive the amount of taxes they have voted and bears the non payment. In addition, the State pays the expected taxes in advance, by twelfth at the end of each month. This service to LGs is often seen as the counterpart of the cash deposit obligation to the Treasury account (Mouzet, 2011).

The successive reforms of local taxation have had several consequences (Girardon, 2011). The share of taxes in LGs' revenue tends to decrease. The State is now the first local taxpayer because of compensations paid: EUR 20 billion in 2010. Moreover, the power of determining rates tends to disappear for Regions and Departments, reducing their financial autonomy. At last, the tax burden was partially moved from businesses to citizens.

- *External resources* are mainly coming from the State. Even EU funds are distributed through it. They can also come from other LGs.

The main State grant is the General Operating Grant²: more than 40 billion of the 75 billion external revenues. The amount has been frozen since 2011 to participate in the recovery of public finances (Mouzet, 2011). Other State grants and subsidies exist to finance investment, as for example a fund³ that allows LGs to recover part of the VAT paid on their investment.

Equalization mechanisms are associated with State grants to reduce territorial inequalities.

- *Borrowed resources*. LGs' debt has tripled between 1980 and 1995. Then, from 1997 to 2002, there was a debt reduction due to an increase in tax revenues. Since 2003, the debt has increased again for all LGs due to a recovery in investment spending (Mouzet, 2011).

Table 2 and Table 3 give an overview of the main LGs' resources and expenditures and their evolution since 2009. The current economic environment weighs on the state of local finances (Observatoire des finances locales, 2014) :

Resources increase very slightly due to the freeze of State grants (*State grant* and *Investment resources*). This have led to an increase in local taxes and thus in the fiscal burden, and to a growing debt. For the first time in 2013, all type of LGs used their cash to finance their investments expenditures.

Current expenditures remain dynamic: increase in personnel costs for all LGs, and in social spending for departments. Investment spending also continues to increase at the municipal level.

LGs still show a need for funding rather low compared to other jurisdictions, but in 2013 it deteriorates for the second consecutive year. This trend should continue in the years 2015 to 2017, as LGs will participate up to EUR 11 billion to the national cost reduction plan.

² « *Dotation globale de fonctionnement (DGF)* »

³ « *Fonds de compensation pour la TVA (FCTVA)* »

Table 2 – Overview of main municipal and intercommuality accounts evolution

<i>In Billion euros</i>	Municipalities					Intercommunalities				
	2009	2010	2011	2012	2013	2009	2010	2011	2012	2013
Total expenditures	91,8	91,1	94,1	96,4	100,8	34,6	35,7	37,5	39,4	41,1
Personnel costs *	31,9	32,6	33,2	34,1	35	5	5,4	5,8	6,3	6,7
Debt interest *	2,2	2	2,2	2,3	2,3	0,6	0,6	0,6	0,7	0,7
Investment expenditures **	24,1	22,9	24,3	25,2	27,4	8	8,1	8,9	9,5	10
Total receipts	92,6	92,4	95	97,2	98,4	35,2	36	38,2	40	40,6
Taxes*	42,5	44,3	46	46,9	48	18,7	20,2	20,1	21,1	22,1
State Grant *	19,5	19,5	19,5	19,3	18,9	7,3	7,6	8,8	8,7	8,7
Investment resources **	13	11,5	11,4	11,6	11,9	3,5	3,1	3,5	3,4	3,5
Cash flows from operating activities *	10,7	12,1	13,2	12,9	11,9	4,1	4,8	5,1	5	5
Need or capacity for investment before debt **	-0,4	0,68	0,27	-0,65	-3,61	-0,36	-0,19	-0,35	-0,97	-1,36
Debt variation	1,1	0,6	0,6	1,5	1,2	0,9	0,5	1,2	1,7	0,8
Cash variation	0,7	1,28	0,87	0,85	-2,41	0,54	0,31	0,85	0,73	-0,56

* Operating activities ** Investment activities Source : (Observatoire des finances locales, 2014)

Table 3 - Overview of main departments and Regions accounts evolution

<i>In Billion euros</i>	Departments					Regions				
	2009	2010	2011	2012	2013	2009	2010	2011	2012	2013
Total expenditures	68,5	68,4	69,6	71,6	72,4	28	26,5	27,2	28	28,7
Personnel costs *	10,7	11	11,2	11,5	11,8	2,7	2,8	2,9	3	3,1
Debt interest *	0,8	0,8	0,9	0,9	0,9	0,5	0,5	0,6	0,6	0,6
Intervention expenditures including social action *	33	34,6	35,8	37,1	38,3					
Investment expenditures **	14,5	12,5	12	11,9	11,9	10,1	8,6	8,8	8,8	9
Total receipts	68,3	68,8	70,4	71,3	71,8	27,8	26,7	27,2	27,9	28,2
Taxes *	37,4	40,4	41,4	42,2	42,5	12,2	12,4	12,1	12,3	12,6
State Grant *	13,4	13,7	15	15	14,9	8,5	8,6	9,3	9,3	9,3
Investment resources **	4,6	3,4	3,3	3,2	3,3	2,7	2,2	2,2	2,3	2,3
Cash flows from operating activities *	6,2	7,7	8,9	7,7	7,1	5,5	5,5	5,5	5,3	5,3
Need or capacity for investment before debt **	-3,66	-1,34	0,13	-1,02	-1,54	-1,92	-0,92	-1,07	-1,18	-1,47
Debt variation	3,5	1,8	0,6	0,7	0,9	1,6	1,1	1,1	1,1	1
Cash variation	-0,16	0,46	0,73	-0,32	-0,64	-0,32	0,18	0,03	-0,08	-0,47

* Operating activities, ** Investment activities Source : (Observatoire des finances locales, 2014)

4.3 Local debt

Debt legal framework

New loans cannot cover operating expenses or help to repay a previous loan. It is exclusively reserved to finance equipment (Girardon, 2011). The local assembly determines the conditions of the loan

(lender, rate, duration, terms of repayment...). New loans are not subject to prior state authorization (Mouzet, 2011).

The loan agreement with a bank is a matter of private law, but includes a commitment to increase taxes if necessary to fulfill the annual repayments (Mouzet, 2011).

Debt structure and evolution

Since 2011, LGs are facing a reduction in loan offers: less volume and duration and an increase in bank margin. Today, LGs' loans seldom exceed 20 years (Girardon, 2011). But the European Investment Bank and the Caisse des Dépôts et Consignations initiatives have offered to cover LGs long-term investments with loans from 20 to 40 years (Observatoire des finances locales, 2014).

Local authorities mainly use bank financing (over 97% in 2011), but they have the right to issue bonds. In 2012, bond issues went up to € 2.3 billion, three times more than in 2011. 15 issuers and a program involving 44 LGs were recorded. But nearly 30 LGs have obtained a credit rating over the same period, mainly of good level (Cour des Comptes, 2011)

Bond market will be more open to LGs, thanks to the creation, in 2013, of a dedicated financing agency: « *Agence France Locale* ». Its mission is to borrow directly on the financial markets and to grant loans to its shareholders (Observatoire des finances locales, 2014).

Due to zero cash management practices, LGs also use short term bank financing, such as cash lines, but also, more seldom, treasury bills (Cour des Comptes, 2011).

Over the past years, the LGs' debt level has increased (Table 4). But it remains lower than the EU average (Table 5), and appears under control (Observatoire des finances locales, 2014).

Table 4 - French Local Governments Debt in 2013

	Municipal Sector	Departments	Regions	Total
Debt stock at 31/12* <i>in billion Euros</i> <i>(Variation 2013/12)</i>	84,7 (2,5%)	32,2 (3,6%)	20,1 (5,3%)	137,0 (3,2%)

* Non consolidated : only debt form principal budget.

Source : (Observatoire des finances locales, 2014)

Table 5 – Amount of local governments' debt in % of GDP

	2002	2003	2004	2005	2006	2007	2008	2009
<i>Belgium</i>	11,3%	10,6%	10,7%	9,6%	9,0%	8,5%	8,3%	10,9%
<i>Denmark</i>	5,2%	5,3%	5,3%	4,5%	5,3%	5,6%	6,3%	7,1%
<i>Germany</i>	23,0%	25,2%	26,0%	26,8%	26,4%	25,2%	26,2%	29,1%
<i>Ireland</i>	2,3%	2,3%	2,3%	2,3%	2,2%	2,5%	3,0%	3,5%
<i>Spain</i>	8,7%	9,1%	9,0%	9,1%	8,7%	8,5%	9,3%	11,5%
France	7,1%	7,2%	7,2%	7,0%	7,1%	7,2%	7,6%	8,2%
Italy	6,2%	6,5%	6,8%	7,5%	8,1%	7,9%	8,1%	8,6%
<i>Hungary</i>	1,6%	1,5%	1,7%	1,9%	2,5%	3,1%	3,6%	N.D.
<i>Holland</i>	8,2%	8,2%	8,1%	8,0%	7,6%	7,1%	7,3%	8,0%
<i>Austria</i>	5,3%	4,7%	5,0%	5,3%	5,0%	5,1%	5,2%	6,3%
<i>Poland</i>	1,8%	1,9%	2,3%	2,4%	2,7%	2,6%	2,1%	3,4%
<i>Portugal</i>	3,0%	3,3%	3,3%	3,5%	3,4%	3,4%	4,5%	5,0%
<i>Romania</i>	0,1%	0,2%	0,3%	1,2%	1,2%	1,5%	1,7%	2,3%
<i>Finland</i>	4,1%	4,5%	4,9%	5,3%	5,4%	5,3%	5,4%	6,6%
<i>Sweden</i>	6,0%	5,9%	5,7%	5,8%	5,8%	5,3%	4,8%	6,1%
<i>UK</i>	4,9%	4,5%	4,4%	4,6%	4,8%	4,3%	4,0%	4,8%
Average UE 27	9,6%	10,1%	10,2%	10,3%	10,2%	9,7%	10,1%	11,6%

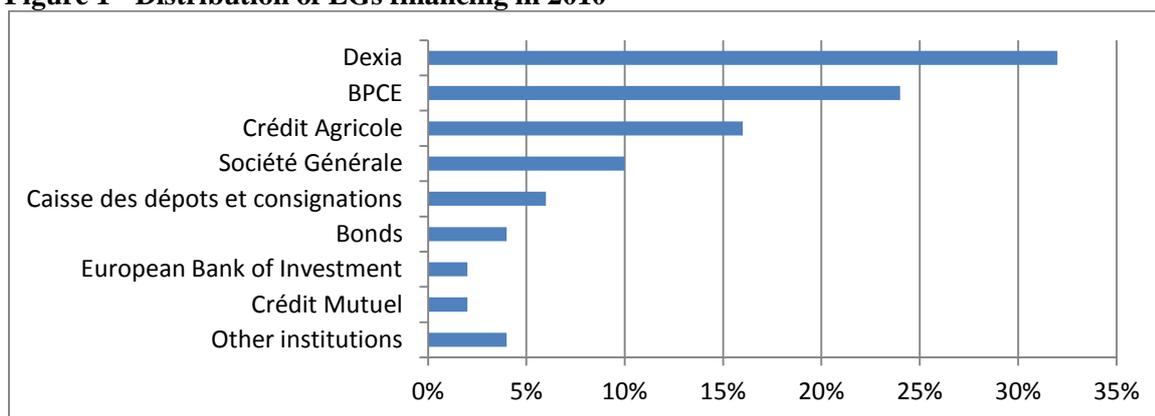
Sources : EUROSTAT - (Cour des Comptes, 2011)

The main present risk on French LGs' debt is not an excessive level of debt, but the existence of toxic loans. A large part of LGs' debt includes toxic loans via structured debt⁴. There seems to be no systemic risk (Observatoire des finances locales, 2014), but many French LGs are affected, and some suffer from high increase in their financial charges.

The State has established an overall framework to limit the use of these risky products and to support LGs in their transaction with banks. Moreover a support fund has been set up by the State, but it is often considered as insufficient.

Dexia is heavily implicated in this case. Despite this and despite its difficulties due to the 2008 crisis, the bank now partially nationalized, remains one of the major players in the financing of French LGs (see Figure 1).

Figure 1 - Distribution of LGs financing in 2010



Beyond services to LGs, many banks offer to discount public debt, enabling companies that work with LGs to get cash loans. The BPI “*Banque Publique d’Investissement*”, a new public investment bank, provides such funding.

4.4 Bankruptcy and default in LGs

Theoretically, LGs' solvency problems may go from an excessive debt, close to bankruptcy to simple cash flow problems causing delays in payment, from the loss of autonomy toward the State or creditors, to the difficulty to raise funds.

In the French law, the bankruptcy procedure does not apply to LGs and their assets are exempted from seizure.

Specific procedures are designed to protect creditors:

- Debt repayment is a mandatory expenditure that is automatically inserted in the budget.
- In case of financial difficulties, the LG is placed under the supervision of the local State representative, the prefect. Under the guidance of the regional court of auditors, the prefect elaborates the budget that will ensure the payment of debt. It sets the level of revenues and expenditures, usually causing major cuts in services and tax increases.
- Constraints on the LG's management can also be imposed, such as forbidding new loans.

Thanks to these mechanisms, the risk of insolvency does not seem to exist in LGs. Even in the worst examples of French LGs difficulties, there has been no debt write-off. The debt has just been extended to enable the payment.

For LGs' creditors, the risk of a bad solvency is mainly a risk of a late payment.

In French LGs, the payment delays are regulated and limited to 30 days after having recorded that the service is done. Any delay gives right to interest payment.

⁴ Loans combining a traditional bank loan and one or more derivatives.

The French Payment Periods Observatory shows that the overall payment delay for LGs is less than the prescribed period of 30 days, with disparities across LGs (see Table 6). It is largely better than B to B delays : 52 days on average in 2012 (Lorenzi & Villetelle, 2014).

Table 6 – Local public sector global payment delay in days (2012 – 2013)

	Average		Median		Last decile	
	2012	2013	2012	2013	2012	2013
Regions	32,6	39,6	32,9	33,0	52,7	79,3
Departments	23,1	23,5	21,8	22,0	33,8	34,5
Municipalities over 10 000 inhabitants	29,0	29,2	26,2	26,4	43,1	44,7
Municipalities under 10 000 inhabitants	21,8	22,1	17,1	17,6	30,9	31,2
Intercommunalities with own tax resources	25,4	25,6	19,6	20,3	34,2	34,4

Source : Annual report from Payment Periods Observatory 2013 (Lorenzi & Villetelle, 2014)

The legal global delay appears to be respected. But there might be some hidden delays due to the time necessary to record that the service is done. According to a survey from CGI⁵ quoted by Lorenzi & Villetelle (2014) and based on 4 economic sectors, there is a gap between the official payment delay and the delay felt by partners. Moreover, nine out of ten public purchasers do not pay interest compensation.

These delays can be a threat for companies with few cash. Hopefully, most of the time, these situations are resolved through a dialogue with LG's representatives. However, it is difficult to verify this information, and to identify bankruptcy that could have been caused by late payment from LGs.

Our qualitative analysis highlighted those reflexions on default and bankruptcy. Our respondents unanimously dismiss the risk of insolvency or bankruptcy. All creditors and suppliers are paid, even if payment delays can be observed.

According to them, the various legal mechanisms effectively protect LGs. In particular, regulation on balanced budget and risk of State supervision work well. The fact that bankers limit new loans in case of difficulties is also an element of protection. Finally, in case of extreme difficulties, our respondents remind the potential State intervention.

All these mechanisms result in mobilizing financial margins. The main margins cited by our respondents are:

- *Increase in taxes.* This margin depends on the possibility for the LG to modify tax rates. Regions, and to a lesser extent departments, have recently lost a part of this power. They are therefore more dependent on a decision of the State to increase their tax revenues. Recently, the State has been forced to increase a real estate tax rate in order to help departments, who collect it. Municipalities and intercommunalities still can use this margin, which has the advantage of having rapid effects on financial resources.

- *Reduction of investment.* This is one of the first measures taken by the LGs in trouble. According to our respondents, most investments can be cut quickly.

- *Reduction in operating expenses.* The scope of this margin will depend on the rigidity of charges. Our respondents agree with qualifying personnel expenses as rigid in the medium term. For departments, social spending is also very rigid. Subsidies to large associations are also politically difficult to cut, as they often create jobs.

In case of problem, personnel costs only suffer slight decrease, while some incidental expenses are cut. Depending how bad the situation, a LG can stop small grants to associations or communication expenses, not replace retiring employees or interim staff, reduce the duration or magnitude of a cultural event, reduce the level of social services, or operate a shift in cultural or sports policies ...

Usually, reduction in operating expenses does not have rapid effect on budget balance.

⁵ CGI : Confédération Française du Commerce de Gros Interentreprises et du commerce International

When the LG falls under the supervision of the prefect, it often leads to clear cut decisions that don't take into account political considerations. All margins are therefore exercised. It is a major fear for elected representatives.

Our qualitative study suggests that thanks to protection mechanisms and to mobilization of the numerous margins, the risk of insolvency is avoided.

According to our respondents, bankers are fully protected: no delay in payments and no debt write-offs. In the most extreme cases, negotiations may intervene to spread payments.

With regard to suppliers, the risk is that of a late payment. Our qualitative study reinforces the idea that the payment delays in the local public sector are not generally problematic. The majority of our respondents note periods not exceeding 45 days. However, they report that a few LGs pay with more significant delays. The payment of interest tends to compensate for damages related to delays, even if this payment seldom occurs. In case a company has financial difficulties because of delays, respondents say they act quickly to pay.

If the poor financial situation of a LG does not expose creditors and suppliers, it is because the margins are quickly mobilized. Thus, the citizen / taxpayer / user endure alone all the risks: increase in the tax burden, and deterioration of public services.

4.5 Internal and external audit structures

LGs' management and financial situation are monitored through internal and external mechanisms.

The external control institutions: the Prefect and the Regional Courts of Auditors

The local state representative, the prefect, reviews a posteriori the legality of all LGs' acts. In case of non compliance with the budgetary rules, he may request the assistance of the Regional Courts of Auditors that will make proposals to restore the balance. The prefect will impose the budget if the LG does not.

Regional Courts of Auditors audit LGs' accounts to check their compliance. They also examine the management of LGs and their satellites (Mouzet, 2011).

The internal control mechanisms

The accountants' network and the General Direction of Public Finance (DGFIP) also monitor LGs' accounts. They have set up a warning system to anticipate difficulties (Mouzet, 2011).

5. LGs' context in Italy

5.1 Institutional framework

The Italian Constitution recognizes federalism and localism. Italy has a highly fragmented regional and LG pattern, with three main governmental levels: 1) the State level, 2) the regional level – which can be seen as a sort of intermediate level –, and 3) the local level (provinces and municipalities). In common they all have a territorial basis of action (state, regional, provincial, municipal jurisdiction). The Constitution provides regions and LGs with a certain level of autonomy in terms of ability to raise taxes and service fees, decide on the organization and performance of their functions and offices, and allocate resources to different functions and services provided⁶. There are 20 regions (*regioni*), among which 5 are provided with special statutes, that have legislative and policy powers over specific functions, such as healthcare (which represent most of the regional budget), regional and local transportation, environmental protection, education and economic development. On the local administrative level the term LG summarizes a quite large range of public administrations provided with executive powers. Primarily this government level is represented by 109 provinces (*province*) and 8.105 municipalities (*comuni*), but there also are second-tier LGs (*enti locali di secondo livello*), i.e. local government whose representatives are not elected directly from citizens but are appointed by

⁶ [Italian Foreign Ministry](#), retrieved 04-03-2014; United Nations Public Administration Network UNPAN, [Republic of Italy, Public Administration Country Profile](#), retrieved 04-03-2014.

LGs' representatives (i.e. a sort of consortiums): 211 mountain/archipelago/island communities (*comunità montane, isolane, di arcipelago*) and 377 unions of municipalities (*unioni di comuni*). 10 metropolitan cities (*città metropolitane*) have been established in 2009 then modified in 2014, but this administrative division, which basically incorporates the functions of municipalities and provinces in metropolitan areas, is not yet operational. Provinces and municipalities have not only important general functions, such as local transportation, waste collection and disposal, social services, road and school infrastructure and maintenance, but are also interesting because of their characteristic as laboratories of administrative innovation programs of the last decades towards the so-called New Public Management approaches of public administration management.

Starting from the 1990s, there have been widespread creations of organizations which are directly controlled or indirectly influenced by provinces and, especially, municipalities. The large outsourcing dynamics of services, offices and activities by LGs let become them "LG holdings". Nowadays LGs act within the range of total privatization and total in-house keeping of services, where most of the governments are situated somewhere in between, acting through licenses (*concessioni*) or specific administrative deeds (*affidamenti diretti*), where administrations are full or major stockholders (public owned corporations) or minor stockholders (controlled public agencies).

Differently from the French context, regions are excluded from the analysis since they still present several non-homogeneities (they also include special statute entities). More importantly they represent that intermediate level between genuine LGs and State level of government, so as they represent a sort of hybrid government.

5.2 Local public finances

With the exception of the recent reform of the accounting system, the most important structural reforms that have affected public finance over the last 25 years have been addressed mainly to LGs. First, starting from early 90s, LGs can get loans with private banks and institutes in addition to the public bank Cassa Depositi e Prestiti. Second, in the middle 90s LGs were given the possibility to use such form outside of typical financing methods as municipal bonds and real estate investment trust. Third, the municipal property tax (*Ici*, then *Imu* and now *Imu* and *Tasi*) and the municipal additional income tax (*addizionale imposta sui redditi delle persone fisiche*) were introduced, in 1993 and 1998 respectively, with the aim to give to municipal governments the power to raise their financial autonomy for current revenues. After these new local fiscal reforms, property tax represented the most important source of revenues for most municipal governments (especially those situated in Northern and Central Italy) and have been recently subjected to a major revision whose effects are still uncertain. Fourth, the reform introduced by Legislative Decree 77/95, now contained within the unified body of law for LGs (TUEL), provided a set of new managerial tools to support managerial control systems, which became mandatory for provinces, municipalities and second-tier LGs. Even though several years have passed since their inception, it is agreed that these NPM-like reforms have not been fully implemented in all regional and LGs. Fifth, Law 42/09 is the cornerstone of the fiscal federalism reform of Italian public administration, by defining the principles and steering criteria to execute fiscal federalism by delegating the government to reframe the financial relationships between the central State, regions and LGs, with the general aim to foster regional and LGs' autonomy and accountability. This is an all-encompassing, still on-going reform. Sixth, starting from 2009, the Italian public sector accounting has been challenged by an all-encompassing reform called "harmonization of accounting systems and reports". The goal of this harmonization is to favour a horizontal reading of public financial reports, overcoming the current fragmentation caused by the adoption of different criteria between different levels of Italian public administration, and fostering the development of an integrated accounting system suitable for the consolidation of public accounts satisfying the economic and financial demands of the EU. Accounting rules frameworks currently adopted in the different sectors of the Italian public administration varies considerably. Regions and autonomous provinces have an accounting system similar to the central government, with a cash/modified cash basis of accounting, coupled with a modified accrual accounting; accrual accounting is not provided, but the balance sheet statement is required by law and derived by cash- and modified accrual-based accounting plus further non-accounting information. LGs (i.e. provinces and municipalities) and second-tiers LGs (i.e. mountain/archipelago/island communities and unions of municipalities) are

provided by the same cash/modified cash plus modified accrual bases of accounting of regions, accompanied by an accrual basis-like set of documents.

The Italian Constitution provides for financial autonomy of LGs, which is regulated by specific laws, decrees and regulations, according to self-sufficiency, financial autonomy, equalization and state intervention principles. Nevertheless, today the system appears contradictory since even though LGs have been provided by a pronounced financial autonomy, the central government is conferred a high power over local finances, particularly during economic crises.

Table 7 and Table 8 report the cumulated structure of revenues and expenditures of, respectively, provinces and municipalities. It must be recalled that municipal taxation has been and still currently is subjected to a strong renovation within the fiscal federalism reform therefore the composition of municipal revenues will be substantially changing starting from 2013 financial reports.

Table 7 – Revenues and expenditures structure in provinces

Revenues	2010	2011	2012	Expenditures	2010	2011	2012
Titolo I – Local tax revenues	4,7	5,0	5,1	Titolo I – Current expenditures	9,0	8,3	7,9
Titolo II – Current grants from other governments	4,3	3,6	3,2	Titolo II – Capital expenditures	3,4	2,1	1,7
Titolo III – Current non-tax own revenues	0,7	0,7	0,8	Titolo III – Loan repayments	0,7	0,7	1,0
Titolo IV – Disposal of fixed assets, capital grants from other governments and private entities	2,3	1,3	1,3				
Titolo V – New borrowing	0,5	0,4	0,2				
Total	12,5	11,0	10,6	Total	12,4	11,1	10,6

Source: Ministry of the Interior, retrieved 25-04-14.

Table 8 – Revenues and expenditures structure in municipalities

Revenues	2010	2011	2012	Expenditures	2010	2011	2012
Titolo I – Local tax revenues	21,8	33,1	35,4	Titolo I – Current expenditures	53,3	53,5	51,8
Titolo II – Current grants from other governments	23,1	11,4	9,5	Titolo II – Capital expenditures	18,0	15,8	12,3
Titolo III – Current non-tax own revenues	11,8	12,4	12,6	Titolo III – Loan repayments	6,8	7,7	7,5
Titolo IV – Disposal of fixed assets, capital grants from other governments and private entities	14,2	13,5	10,9				
Titolo V – New borrowing	7,2	6,4	5,1				
Total	78,1	76,7	73,6	Total	78,1	76,9	71,5

Source: Ministry of the Interior, retrieved 25-04-14.

Table 9 contains the main features of municipalities' own revenues. As it is evident, local revenues (esp. municipal revenues) are subjected to several limits by the central government and their computations are based on factors highly outside LGs' decision power and dependent by local socio-economic forces and central government's decisions.

Table 9 – Features of the most important own-revenues (local tax and current non-tax own revenues) in municipalities

Own revenues	% of Titolo I for 2012	Description	Calculation	Tax rate fixation process	Ability to increase the tax rate	Max rate allowed	Collected by	Dedicated to cover specific expense
<i>ICI Imposta comunale sugli immobili</i> (property tax)	27,8%	Due by householders and trade facilities proprietors (Legislative Decree 504/92)	Tax rate applied to the value of the property; the value is a theoretical value that does not correspond to market value	Municipal council decision	Municipalities can set the tax rate between 0,04 and 0,07%	0,07%	Municipality	No
<i>TARSU Tassa rifiuti solidi urbani / TARI Tariffa rifiuti solidi urbani</i> (tax or fee on collection and disposal of solid waste)	16,4%	Due by residents and trade and industrial activities as tax for the provision of waste collection and disposal services (Legislative Decree 507/1993).	Fees applied on the basis of the area occupied and number of persons living in each house	Municipal council and supra-municipal agency decision	Yes	--	Municipality	Waste collection and disposal service expenditures
<i>Adizionale IRPEF Imposta sui redditi delle persone fisiche</i> (additional regional tax on actual persons)	9,1%	Tax due by actual persons with residence for tax purposes in Italy as of December 31 of the fiscal year of reference (Legislative Decree 360/98)	It is calculated on the taxable amount consisting of the total income as determined for income tax, net of deductible expenses	Municipal council decision	Municipalities can increase the rate, starting from 2012; for the list of municipalities' rates see here	0,8% (Legislative decree 360/98, art. 1, co. 3)	Municipality	No

5.3 Local debt

LGs' borrowing is subjected to specific restrictions by Constitution, national and regional laws with the aim to guarantee financial sustainability. Regulations are evolving towards stricter limits in answer to regulations imposed by the EU after the recent increasing attention over public financial balances. In that regard, an important reform, effective from 2014 and that is part of the so-called "fiscal compact", provides that regional and local administrations can take out loans only to finance investments must be accompanied by amortization scheduling, and the "consolidated" financial balance is guaranteed at the regional level; the regional branches of the Court of auditors verify the observance of this rule and, in general, debt sustainability.

LGs can use the following six main forms of debt, being the first the most widespread: loans, bonds, securizations, building leases, "strong" letters of comfort, loans without pre-amortization supplied with a single payment or with multiple payments. LGs (especially those located in the South) may also have benefited of debts repaid by the State to finance specific infrastructures. Revenue factoring or other forms of credit lines that allow to overcome temporary lack of cash to pay for expenses already covered by budgeted resources, are temporarily possible and not accounted as public debt.

The Italian law has provided the prohibition for LGs to borrow money to finance expenses not related to investments but, in fact, long term debt has been used to cover financial imbalances (not caused by

investments) in case of off-balance debt until August 2001. Article 119 of Constitution now provides the constitutional relevance of the so-called “golden rule” for regions and LGs, i.e. the possibility to take on loans exclusively for investments. The Constitution has further been recently modified in 2012 in answer to the EU “fiscal compact” rule that provides a strict control over public finances. According to law borrowing procedures will be organized at the regional level by agreements amongst region and LGs (as outcome of negotiation processes that follow different rules decided at the regional level) that guarantee “consolidated” annual financial balance, under the cash method of accounting of governments (region and LGs) within each regional jurisdiction. LGs will be able to take out new loans up to the limit of the previous year debt repayment amount, i.e. the debt repayment of the new level of debt cannot exceed the old debt repayment amount. If at the end of the year an imbalance appears, it will be then returned to the new year and is allocated to those governments that have not abide by the agreements. While this new rule will drastically reduce the possibility to get new debts, this provision will somewhat increase the level of autonomy of regions and LGs since it is at the regional level that regions and LGs will agree upon the distribution of the allowances for new debt.

In general, there are three important general restrictions to local public long-term debt.

- 1) It must be addressed to investments (capital expenditure) only.
- 2) Each LG must compulsorily allocate a portion of its long-term budget to debt repayment, so as to guarantee its financial balance in the long run, and the time horizon of amortization scheduling cannot exceed the economic life of the investment (to prevent any deadline extensions).
- 3) Each LG can take on loans only in case the condition of budget balance has been respected in relation to the “consolidated” financial performance of all governments falling into the regional jurisdiction. Therefore, long term loans for LGs is not a financial resource to finance the budget that can be decided by each LG under its autonomy. Instead, the recourse to debt is now restricted and specific, since it represents a funding source just for specific and restricted projects agreed with other governments (region and LGs).

The law imposes also further quantitative limits to borrowing related to annual revenues. LGs can take out new debt in case the new annual amount of expenses for interests (of any form of past and new debt and guarantee) does not exceed the amount of 8% (12% up to 2011), deducted any central government or regional grants covering interest expenses, of current revenues of the second to last previous fiscal year.

While a 2011 law (Law 183/11) has provided for a specific cut of local public debt with specific terms (specific thresholds over which regions and LGs would have acted to reduce the stock of debt, annual percentage of debt reduction, modalities to reduce the stock of debt) that should have been provided by issuing specific non-regulatory decrees, this has not happened yet, probably due to the new constitutional reform of 2012 already discussed above.

A systematic regulation of conditions and limits of access to capital markets by regions and LGs has been imposed in 2001, with which the possibility to use derivatives has been introduced for the first time. Derivatives are not accounted as liabilities, since their aims should be to limit the cost of debt and control public finance trends, providing their insurance as opposed to speculative function. This principle has further been strengthened in 2006 according to which derivatives are used to reduce the cost of debt as well as the financial risk exposure. The temporary window between the law that has opened to derivatives and the issue of the ministerial decree has been decisive for the raise of several derivatives contracts that, in fact, have been considered not only inappropriate with the general aim of the law, but they have exposed local public finances to high financial risks. After several scandals occurred especially in 2007, a new set of rules have been issued with specific reference to derivatives of regions and LGs. Starting from 2009, it is forbidden to issue bullet bonds or similar debt forms. The length of any debt operation (even for renegotiations) is between a minimum of 5 to a maximum of 30 years. The stipulation of new derivative contracts is subordinated to a regulation to be issued by the Ministry of Economic and Finance that has not been issued yet. Transparency has also been strengthened, imposing the transmission of new derivative contracts to the Court of auditors.

Another important element of regulation of public finances that reflects on LGs’ budget decisions and that is intended to decrease local debt, is the Internal stability pact (ISP). Some EU countries are faced with the necessity of adjusting relations between central and local government within the European framework of the Stability and growth act (SGP). Measures for budgetary co-ordination between the various levels of government are under study in Austria, Belgium and Germany. Italy has taken a first

step in this direction with the ISP instituted in 1999. This measure was introduced in answer to the decentralisation process begun in the early 90s. The emerging trend in institutional arrangements implied not only a comparatively high degree of decentralisation, but also a higher sensitivity of regional and LGs revenues to the economic cycle and relatively lax constraints on local debt. Consequently this would have raised the risk of noncompliance with EU budget rules. The ISP is thus designed to involve regions and LGs in the national effort to attain the objectives for general government budget under the European SGP. The ISP mirrors the SGP by requiring regions and LGs to adopt specific measures with the final aim to reduce their deficits and, thus, stock of debt.

The measures to keep under control deficits and debts of regions and LGs by ISP are different for the two types of governments (regions on one side and provinces and municipalities on the other) and have changed over time, in terms of ways to implement the financial efforts and their level. This latter characteristic has substantially introduced a certain level of uncertainty amongst LGs in their financial planning, especially considering that the ISP has widely been considered not an agreement between the central government and regions and LGs, but a unilateral deed.

In terms of composition of local debt, the municipal debt is mainly represented by loans (84,4%), while the remaining part is composed by municipal bonds (13,8%) and other marginal forms (1,8%) (see Table 10). Provinces reflect a similar proportion, with 73,6% of loans, 26,2% of provincial bonds and 0,2% of other forms (see Table 11).

Table 10- Municipal debt, 2011 (in thousands of Euros)

Debiti di finanziamento 2011 (da conto del patrimonio 2011) (in migliaia di euro)

Aree territoriali	N. Enti	Popolazione	mutui			Obbligazioni			altro (fin.ti pluriennali e a breve termine)			Totale Stock debito accertato	
			5	inc. %	inc. %	6	inc. %	inc. %	7	inc. %	inc. %	8	inc. %
Piemonte	1.067	4.198.142	4.757.271	11,87	81,60	1.026.061	12,62	17,60	46.978	7,88	0,81	5.830.310	11,95
Lombardia	1.428	9.566.587	7.557.155	18,86	77,47	2.120.474	26,07	21,74	77.867	13,06	0,80	9.755.496	19,99
Liguria	189	1.514.981	1.596.505	3,98	74,01	553.919	6,81	25,68	6.611	1,11	0,31	2.157.034	4,42
Trentino Alto Adige	115	741.396	1.251.336	3,12	97,10	0	0,00	0,00	37.310	6,26	2,90	1.288.646	2,64
Veneto	528	4.734.289	3.094.592	7,72	79,63	774.709	9,53	19,94	16.716	2,80	0,43	3.886.016	7,96
Friuli Venezia Giulia	207	1.208.320	1.561.307	3,90	93,51	91.957	1,13	5,51	16.376	2,75	0,98	1.669.639	3,42
Emilia Romagna	325	4.298.337	2.309.538	5,76	71,35	887.145	10,91	27,41	40.116	6,73	1,24	3.236.799	6,63
Totale Nord	3.859	26.262.052	22.127.703	55,23	79,53	5.454.265	5,79	19,60	241.973	40,58	0,87	27.823.941	57,02
Toscana	268	3.595.037	2.855.596	7,13	83,37	470.986	5,79	13,75	98.729	16,56	2,88	3.425.311	7,02
Umbria	83	887.466	650.906	1,62	77,24	190.537	2,34	22,61	1.297	0,22	0,15	842.740	1,73
Marche	190	1.409.065	1.235.711	3,08	93,43	86.564	1,06	6,55	316	0,05	0,02	1.322.591	2,71
Lazio	288	4.991.326	2.421.468	6,04	92,83	161.121	1,98	6,18	25.888	4,34	0,99	2.608.477	5,35
Totale Centro	829	10.882.894	7.163.680	17,88	87,37	909.208	11,18	11,09	126.231	21,17	1,54	8.199.120	16,80
Abruzzo	236	1.144.087	1.013.249	2,53	82,08	218.395	2,69	17,69	2.761	0,46	0,22	1.234.404	2,53
Molise	91	205.804	86.061	0,21	86,81	0	0,00	0,00	13.077	2,19	13,19	99.138	0,20
Campania	433	5.194.282	4.280.689	10,68	87,06	609.428	7,49	12,39	26.915	4,51	0,55	4.917.033	10,08
Puglia	219	3.801.452	1.694.154	4,23	76,06	480.145	5,90	21,56	53.116	8,91	2,38	2.227.415	4,56
Basilicata	103	484.684	287.820	0,72	78,54	78.633	0,97	21,46	0	0,00	0,00	366.453	0,75
Calabria	301	1.442.754	984.994	2,46	84,41	101.455	1,25	8,69	80.503	13,50	6,90	1.166.952	2,39
Sicilia	327	4.275.041	1.821.964	4,55	89,16	187.129	2,30	9,16	34.382	5,77	1,68	2.043.475	4,19
Sardegna	312	1.501.949	605.135	1,51	84,48	93.802	1,15	13,10	17.365	2,91	2,42	716.302	1,47
Totale Sud-Isole	2.022	18.050.053	10.774.066	26,89	84,36	1.768.987	21,75	13,85	228.119	38,25	1,79	12.771.171	26,17
Totale	6.710	55.194.999	40.065.449	100,00	82,11	8.132.460	100,00	16,67	596.323	100,00	1,22	48.794.232	100,00

Notes: Translation: Aree territoriali = regional jurisdictions; N. Enti = number of municipalities; Popolazione = total residents; Mutui = loans; inc % = percentage out of total; Obbligazioni = bonds; altro (...) = other; Totale stock debito accertato = total amount of debt.

Table 11 – Provincial debt, 2011 (in thousands of Euros)

Debiti di finanziamento 2011 (da conto del patrimonio 2011)

(in migliaia di euro)

Aree territoriali	N. Enti	Popolazione	mutui			obbligazioni			altro (fin.ti pluriennali e a breve termine)	inc. %		Totale Stock del debito accertato	inc. %
			5	5/Tot.	5/8	6	6/Tot.	6/8		7/Tot.	7/8		
Piemonte	8	4.457.335	926.430	11,84	76,80	279.321	8,69	23,15	577	0,47	0,05	1.206.328	10,81
Lombardia	12	9.917.722	1.629.065	20,83	66,63	806.130	25,09	32,97	9.726	7,94	0,40	2.444.921	21,91
Liguria	4	1.616.788	129.669	1,66	61,14	82.361	2,56	38,83	52	0,04	0,02	212.083	1,90
Veneto	7	4.937.854	384.152	4,91	42,22	437.535	13,62	48,08	88.259	72,07	9,70	909.947	8,16
Friuli Venezia Giulia	4	1.235.808	184.943	2,36	79,04	48.795	1,52	20,85	244	0,20	0,10	233.982	2,10
Emilia Romagna	9	4.432.418	636.472	8,14	69,88	261.295	8,13	28,69	13.016	10,63	1,43	910.783	8,16
Totale Nord	44	26.597.925	3.890.732	49,74	65,74	1.915.438	59,61	32,37	111.873	91,35	1,89	5.918.043	53,04
Toscana	10	3.749.813	500.175	6,39	81,99	107.314	3,34	17,59	2.583	2,11	0,42	610.072	5,47
Umbria	2	906.486	142.714	1,82	78,00	40.258	1,25	22,00	0	0,00	0,00	182.971	1,64
Marche	5	1.565.335	236.291	3,02	66,97	116.170	3,62	32,93	366	0,30	0,10	352.827	3,16
Lazio	5	5.728.688	818.431	10,46	77,41	238.846	7,43	22,59	0	0,00	0,00	1.057.277	9,48
Totale Centro	22	11.950.322	1.697.611	21,70	77,05	502.588	15,64	22,81	2.949	2,41	0,13	2.203.148	19,75
Abruzzo	4	1.342.366	190.505	2,44	52,93	169.411	5,27	47,07	0	0,00	0,00	359.916	3,23
Molise	2	319.780	40.125	0,51	100,00	0	0,00	0,00	0	0,00	0,00	40.125	0,36
Campania	5	5.834.056	341.319	4,36	56,74	260.180	8,10	43,26	0	0,00	0,00	601.499	5,39
Puglia	6	4.091.259	337.785	4,32	77,41	95.223	2,96	21,82	3.351	2,74	0,77	436.360	3,91
Basilicata	2	587.517	57.603	0,74	62,30	34.859	1,08	37,70	0	0,00	0,00	92.462	0,83
Calabria	5	2.011.395	812.544	10,39	85,23	140.761	4,38	14,77	0	0,00	0,00	953.305	8,54
Sicilia	9	5.051.075	265.018	3,39	73,32	92.161	2,87	25,50	4.287	3,50	1,19	361.466	3,24
Sardegna	8	1.675.411	188.817	2,41	98,58	2.711	0,08	1,42	0	0,00	0,00	191.528	1,72
Totale Sud-Isole	41	20.912.859	2.233.716	28,56	73,56	795.306	24,75	26,19	7.639	6,24	0,25	3.036.661	27,22
Totale	107	59.461.106	7.822.059	100,00	70,10	3.213.332	100,00	28,80	122.461	100,00	1,10	11.157.852	100,00

Notes: Translation:

Aree territoriali = regional jurisdictions;

N. Enti = number of municipalities;

Popolazione = total residents;

Mutui = loans;

inc % = percentage out of total;

Obbligazioni = bonds;

Altro (...) = other;

Totale stock debito accertato = total amount of debt.

In terms of trend, the introduction of all the severe limits described above has constantly reduced local debt, even during the last three years of financial crisis, going from 8,8 billion Euros in 2012 to 8,3 billion Euros in June 2014 for provinces and from 48,7 billion Euros in 2012 to 46,6 billion Euros in June 2014 (Bank of Italy, 2014).

5.4 Bankruptcy and default in LGs

In Italy the law provides three typologies of situations of financial distress for provinces and municipalities, from the most serious default (*dissesto*) to the intermediate pre-default (*pre-dissesto*), which is a sort of condition in which the LGs is subjected to a series of central government controls, and the recently introduced, least acute imbalance that occurs in the rebalancing procedure (*procedura di riequilibrio*). The default for Italian provinces and municipalities has been introduced in the legal system in 1989. According to law a province or a municipality is considered in default condition when (a) it is not able to continue its functions and essential services, or (b) it cannot pay creditors with regular resources (i.e. insolvency). This default circumstance may arise either gradually, when the financial management presents some flaws that degenerate year by year, or abruptly, when an unexpected debt arises (e.g. paying a creditor after a judgment has passed, or covering losses of provincial/municipal-owned agencies, consortiums or enterprises). The default status can be declared by the LG's council or by the local Prefect on the basis of analyses done by the Court of auditors. According to the Court of auditors the main causes of default are:

- 1) High amount of non-collectable receivables of local taxes and service fees.
- 2) Irreversible crisis of liquidity with regular recourse to factoring/short-term bank facilities that are not reimbursed and thus become an improper structural, long-term debt.

- 3) High off-balance debts arising from off-balance expenses.
- 4) Overestimation of revenues and underestimation of expenditures in the annual budget.
- 5) Negative trends of derivatives stipulated on long-term debt.
- 6) Inappropriateness or incompleteness (irregularities) of accounting information.

When a provincial or municipal government declares its default status, there is a cut-off of short term bank facilities, payables and receivables before the declaration of default. These are then separated from the ordinary accounting and management system, and managed by a settlement committee appointed by the President of the Republic after the opinion of the Ministry of the Interior has been obtained, that provides to the payment of payables through a regular or a simplified procedure. The settlement committee is usually composed by three members, chosen among magistrates of the Court of auditors, ordinary magistracy, State council's magistracy, officials of the Ministry of the interior, officials of the Ministry of economic and finance, officials of other State administrations, provincial and municipal accounting experts, and professional accountants listed in specific national registers. All debts and credits concerning constrained funds, long-term bank loans and bonds, and all receivables and payables starting from the default declaration date onwards are excluded from this special procedure and remain managed by ordinary institutional bodies. The ordinary institutional bodies are in charge of putting in place a series of measures with the aim of increasing receipts and reducing expenses, in order to restore a balanced financial situation. The law provides for the duty to increase all LG's own revenues to the maximum levels allowed by law for five fiscal years. In case of need, i.e. when resources available do not cover the exposure at default and in place of assets sales, the LG must use part of its liquid resources available at the ordinary institutional body side to finance the exposure at default managed by the OSL. The procedure of default impacts also on suppliers and short-term creditors who are paid with high delays (the settlement procedure may last up to a maximum of 99 months) and might also loose up to a maximum of 60 per cent of their credits.

Every three years, the Ministry of the Interior defines a list of indicators and related thresholds, in order to identify municipalities and provinces which are in structural financial distress and their situation is likely to turn into default. Thus, the status of these LGs is defined as “pre-default” (*pre-dissesto*) and, as consequence, LGs are verified in terms of their personnel expenditures, that cannot overcome specific thresholds, and service fees are required to raise so as to get a minimum level of coverage of fee-paying service costs.

Starting from 2012, in case a LG is not able to provide measures to recover on its own financial imbalances, that are likely to turn into default, and before the Court of auditors ascertains its imbalance status, local administrators may demand to adhere to the rebalancing procedure (*procedura di riequilibrio*) presenting all measures the LG intends to punt in place, with the aim to access a special anti-default revolving fund that should be paid back along years.

5.5 Internal and external audit structures

The legal principles governing audit in Italian public sector can be summarised as follows:

- 1) Monitoring public finances;
- 2) Comparing the results of different administrations;
- 3) Achieving public finance objectives defined in terms of financial balances that comply with the European Monetary Union limits following Eurostat criteria.

These principles are pursued performing external and internal controls, that have been particularly strengthened in 2012, following the fiscal crisis. Each LG has the capacity to establish its own internal control. Simultaneously, the role of external audit has changed over years by the gradual removal of “ex ante” legal audit—considered detrimental of local autonomy—and by introducing a “cooperative” audit by the Court of audit, which represents the most important external auditor in the Italian legal framework. Nevertheless, recent dynamics have fostered an acute strengthening of internal and external audits with the aim to better coordinate public finances in order to steer and control all public entities in view of the fulfilment of EU financial commitments.

The actors of external audit are the Court of auditors (*Corte dei conti*)—with its two coordinating sections (*Sezione delle autonomie* and *Sezioni riunite di controllo*) at the central level and 21 Regional

audit units (*Sezioni regionali*)—and the Ministry of economy and finance’s State general accounting department (*Ragioneria generale dello stato - RGS*)⁷.

The Court of auditors (*Corte dei conti*) is the constitutional body that has the role of safeguarding public finance and guaranteeing the respect of jurisdictional system by auditing the acts of executive and public authorities. The Court of auditors pursues these two aims through two functions: the audit function—i.e. the activity that ascertains the validity and reliability of accounting information, internal control effectiveness, financial health and level of efficiency—and the traditional jurisdictional function—the activity of judgement on issues related to public finance and accounting. The Court of auditors is responsible for the traditional function of “a priori” audit of the legality of central government’s acts and also for the “a posteriori” audit of the central government’s budget management (i.e. evaluation of the efficient and economic character of the administrative action in accordance with the objectives set by law). From 1994 the a priori audit has been limited to a small group of government acts giving more emphasis on the a posteriori audit function (related to public finance regulations and accounting) that have been extended to every government department and agency, including LGs. In general, the a posteriori audit has the aim to foster good governance of public action in terms of effectiveness, efficiency and cost-effectiveness.

The Court of auditors has 21 Regional audit units (*Sezioni regionali di controllo*) to carry out its activity at the local level . In particular, they provide for:

- Audit of internal audit systems of governments within their jurisdiction;
- A posteriori audit reporting to LGs’ councils;
- Verification of financial balancing, achievement of internal stability pact objectives, and, in general, the respect of the set of rules related to the fulfilment of EU financial commitments.

In case Regional audit units ascertain financial imbalances, non-achievement of internal stability pact objectives, serious anomaly in accounting procedures/information, and, in general, a misconduct that may deteriorate financial health, they issue a special verdict that is addressed to the government’s council that needs to recover the concerns highlighted; then the Regional audit unit monitors that corrective actions are actually and effectively taken. All regional audit units’ reports can be consulted online.

At the central level, the Local governments section (*Sezione delle autonomie*) represents and coordinates the Regional audit units. The Local governments section reports to the Parliament, at least yearly (for 2014 this will happen between July and October), on the status of local public finances of LGs. The annual and (if any) infra-annual reports are focused on financial balance, the internal stability pact, and analyse them in respect to the fulfilment of EU financial commitments. In view of its coordination powers, it also examines issues that are common to more Regional audit units and relate to comparative investigations. An important role is also played by the Assembly of audit sections (*Sezioni riunite di controllo*), that decides over conflicts of jurisdictions and main questions that may arise in the activity of Regional audit units .

As to LGs, amongst other tasks Regional audit units are required to verify the following specific aspects of annual budgets and annual financial reports:

- Achievement of internal stability pact objectives;
- Compliance with debt restrictions;
- Absence of irregularities that may affect financial health.

The ascertainment of imbalances or non-compliances has inhibiting effects for LGs that are required to remove irregularities and to restore financial balance, else expenditures cannot be carried out. In the most serious situations of financial imbalances and when irregularities or non-compliances ascertained are not removed, the Court of auditors can declare the status of default.

The State general accounting department (*Ragioneria Generale dello Stato*, RGS hereinafter) is one of the four departments of the Ministry of the economy and finance. It is a central body that supports and verifies policies, processes and budget implementation for the Parliament and central government; its main institutional objective is to ensure correct programming and good management of public

⁷ There also is the National anticorruption authority for evaluation and transparency of public administrations (*Autorità nazionale anticorruzione e per la valutazione e la trasparenza delle amministrazioni pubbliche - ANAC*) but their inspection tasks are related to the nonfinancial side of performance.

resources. One of the main duties of RGS is the supervision and control of public financial management. The control and supervision functions are conducted through an integrated system of public finance controls that operates over the entire country. This system comprises the accounting inspections conducted by Central accounts offices (*Uffici centrali del bilancio*) at the central level, those provided by Territorial accounts units (*Ragionerie territoriali dello Stato*)—located in each provincial capital—on local state administrations, the inspections conducted by the Public finance inspection services (*Servizi ispettivi di finanza pubblica*, SIFIP hereinafter) and the supervision and control of non territorial public bodies by representatives of the treasury appointed in the audit boards of public entities. SIFIP exerts a further form of legal, accounting and financial audit in addition to the Court of auditors. Its legal basis is dated back to 1939 and provides an “inter-institutional” inspection power with the aim of public finance audit. The deliberate aim of SIFIP’s audits is to foster value-for-money policies, inspect for legitimate, and suggest measures for management improvements. SIFIP acts with centralized offices plus five decentralized districts where several supervisors work directly in the field. Differently from the Court of auditors, RGS’s reports on the several inspections made every year are not published online; there only are occasional reports that summarize annual activity . Starting from 2009, the law on accounting “harmonization” attributes new powers to RGS-SIFIP. In particular, RGS-SIFIP intervenes with audits on accounting and financial management when a LG, through the centralized information provided by SIOPE (a centralized accounting system which provides a permanent flow of information about cash inflows and cash outflows of all LGs), shows financial imbalances, especially with reference to a specific set of indicators.

The actors involved in the internal audit and control are the Internal audit body (*organo di revisione* or *collegio dei revisori*), the general manager/city manager, the secretary-general, the chief financial officer or accounting/budget department (*ufficio ragioneria/bilancio*), the management control department (*ufficio controllo di gestione*), the human resource management department (*ufficio personale/ufficio risorse umane*), or other assimilated departments. LGs have been the first set of governments for which an internal audit body (called *organo di revisione* or *collegio dei revisori*) was compulsorily provided. In municipalities with less than 15 thousands inhabitants, unions of municipalities, mountain/archipelago/island communities, it is composed of one auditor; in the other cases and when unions of municipalities manage all fundamental functions of municipalities, three members are in charge. Starting from the second half of 2011, internal audit body members are selected at random from a list of professional accountants and auditors with specific skills in public accounting and financial management managed by the Ministry of the interior. Since this method of selection his effective starting from the renewal of internal audit bodies starting from September of 2011, currently it might be possible to find internal audit bodies still in charge with the old rule, i.e. appointed by the mayor of the municipality or the province’s president. They are in charge for three years with the possibility to be procrastinated for another three years. The audit body performs the following tasks:

- Cooperation with the council body, as the internal audit body suggests corrective actions so as to foster a higher responsibility over results, efficiency, productivity, economy, effectiveness.
- Issuance of compulsory advices on the following issues:
 - 1) Financial planning and control;
 - 2) Budget bill, check of financial balances and budget variations;
 - 3) Outsourcing and shareholding in government owned organizations;
 - 4) Proposal of indebtedness claim;
 - 5) Proposal of use of derivatives and other innovative financial instruments;
 - 6) Proposal of acknowledgement of off-balance debts and settlements;
 - 7) Proposal of internal regulations on accounting, provisions, assets, and implementation of local taxes.
- Surveillance on:
 - 1) Internal stability pact,
 - 2) Revenues collection,
 - 3) Expenditures realization,
 - 4) Contractual activities,
 - 5) Asset management,

- 6) Documentation completeness,
- 7) Fulfilment of fiscal duties,
- 8) Bookkeeping.

- The audit report on annual financial report represents the most important result of the audit body's functions of surveillance, cooperation and validation of accounting information.
- Every three months and when the legislature changes (new mayor or new president), the internal audit body proceeds to cash verification audits; it also verifies the treasurer's reports.
- Commitment to report serious management irregularities to the LG's council and the regional prosecutor's unit of the Court of auditors.

Internal audit bodies cooperate with the Court of auditors and, for this reason, they represent the link between internal and external audit. As a matter of fact, they represent the body that are asked by the Court of auditors to fill in the annual questionnaire on budget and financial report and, together with the LG's council, are the body to which the Court of auditors addresses its audit reports. Auditors are subjected to both administrative and criminal liabilities.

In 2012, new internal controls have been issued and extant ones have been reinforced. As consequence, the current framework of audit and of control is composed of the following types of internal audit and control:

- Compliance with law and accounting standards of administrative acts and accounting documents, which has been reinforced after several scandals caused by misuse of financial resources by politicians or civil servants;
- Balance between revenues and expenses and cash inflows and outflows; this control has been strengthened in order to secure compliance with EU requirements;
- Management control, to ensure higher efficiency and effectiveness;
- Strategic control, which has been re-launched and whose aim is to steer the fulfilment of strategic plans; management control and strategic control requires the implementation and usage of an effective performance measurement system;
- Control of service quality, with particular emphasis on customer satisfaction evaluation;
- Control of consortiums, subsidiary corporations and agencies.

It is also compulsory to send the Court of auditors a detailed report on the status of implementation of internal audit and controls and imposes to draw up a consolidated financial report of LGs and their subsidiaries.

6. Vision from the field: perspectives on financial health assessment

6.1 The French vision

The first point that emerges from our qualitative analysis of the French field is the lack of fear concerning the overall LGs' solvency. Interviewees seem to have confidence in the safety mechanisms imposed by the French system, such as budgetary rules, regulations around debt and State assistance in case of stronger problems.

All interviewees think that the LGs' financial situation is good, but they do not exclude specific problems in some local authorities.

Thanks to our qualitative study, we present a vision of the risks that could affect a LG financial health and their consequences on its financial situation. Highlighting these risks and their consequences permits to discuss the objectives to set to financial analysis.

Interviewees highlight internal risks and external risks. These risks can affect LGs directly or by the means of its satellites.

External risks

Among the external risks, the majority of our respondents obviously feared the consequences of the current economic situation. It causes volatility in tax resources, reductions in State grants and increases in some expenses. It first affects the poorest LGs.

Volatility of tax resources

The LGs' tax resources are fairly stable, as they are often based on stocks. However, some LGs also benefit from volatile tax revenues:

- After 2000, the tax, which replaced the former business tax ("*taxe professionnelle*"), is based on companies' added value, which is directly dependent on economic growth.
- The departments have, as an important resource, a tax directly impacted by the health of the real estate market.
- Some cities benefit from taxes on Casinos' activities which are highly cyclical.

Moreover, departments and regions suffer from a decrease in their power to determine local taxes rates. It prevents them from offsetting tax revenues decrease by an increase in rates.

Decline in state grants and endowments

The fiscal crisis has also led to a decline in State grants. This strongly tightens local budgets. This global cyclical downturn in LGs' resources also causes a reduction in subsidies provided by the departments or regions to municipalities. The equalization mechanisms imposed by the State to help the poorest LGs have a strong impact on the finances of the richest municipalities. Thus, according to our respondents, all LGs suffer from this decrease in State resources.

Increase in incurred expenditures

The economic situation also has an impact on LGs' spending. In particular, the departments in charge of social action have seen their expenses explode under the effect of the crisis. Their situation is delicate and has needed emergency State grants.

Thus, respondents of our qualitative study have noted a scissors effect because of the economic crisis. The three effects, quoted and described above, deteriorate the LGs' self financing cash flows and their overall financial situation.

Internal risks

Respondents also emphasized internal risks that can deteriorate the situation of a LG. For them, they are the result of poorly appropriate decisions by elected officials or managers.

Bad investment choices are often mentioned as a damaging cause: poor anticipation of future operating costs or revenues, bad equipment sizing...

Toxic loans are also frequently cited as a damaging cause for financial situation. The signing of these contracts appears, in the eyes of our respondents, as the result of poor financial decisions. They can cause strong increases in the financial expenses.

For our respondents, the poor decisions listed above can deteriorate the financial situation of a LG by reducing its cash flows, and increasing its debt.

Off-balance sheet risks: at the border of internal and external risks

Beyond the risks mentioned above, our respondents stressed the importance of off-balance sheet risks that are linked to LG's shareholders: semi public companies, private partners, associations ... The deterioration of a partner's health may impact the LG's one. Legal constraint, but also political pressures often force LGs to assume their partners difficulties.

When these partners are not public bodies, they do not benefit from the same legal protections: no balanced budget rule, potential bankruptcy...

According to our respondents, the quality of internal control systems and monitoring of these partners becomes essential for the LG good health.

Semi public companies

The risk most cited by our respondents is linked to semi public companies. If a semi public company faces difficulties, the LG may be required to provide financial support or to recapitalize the company.

There is a strong political pressure not to let those companies go bankrupt, and the cost would anyway not be nil.

The risks are stronger when these companies are subject to significant business risks. This is the case of companies in charge of town planning: housing construction, conference hall ... A decline in the real estate market, or a decline in the territory economic activity can quickly deteriorate the financial situations of these companies. The risk associated with these companies is even stronger as it is difficult to comprehend. Several French LGs have already suffered serious difficulties because of such situations.

Loan guarantees

Another risk mentioned by the respondents is loan guarantees granted to partners: primarily social housing offices, but also semi public companies or, more seldom, associations...

These loan guarantees, generally granted to safe organizations, are rarely implemented. But in case of difficulties or embezzlement, bankers quickly turn against LGs to recover their money.

Intercommunalities

According to our respondents, there are few risks of risk transfer between municipalities and their intercommunalities. They may result from financial difficulties of the intercommunality or from modification in the intercommunality perimeter that would lead to changes in political relations.

In those cases, the intercommunality may reduce its investments or lower tax repayments made to the municipality.

Partners providing public services

The failure of a private partner that provides a public service may also have financial consequences for the LG: obligation to increase subsidies, or in case of bankruptcy, obligation to manage internally the provided service.

The obligation to assist the partner or to replace the service is primarily political, because of pressures on employment or pressure from users...

According to our respondents, off-balance sheet problems remain rare. Nevertheless, semi public companies and loan guarantees represent a risk. So, most large LGs have established internal control systems and performing financial analysis.

6.2 The Italian vision

Basically the vision of Italian respondents about what is considered a bad financial health status reflects the definition provided by the local government act (the *Testo Unico Enti Locali* law) which states that a LG is in default condition when it cannot guarantee basic services to its community or it is insolvent. More specifically, the law establishes a set of indicators and their relate thresholds; if at least one half of them go beyond these limits, the LG is considered in default status. These performance indicators, whose last release was issued in 2013, have basically remained the same during the last ten years:

- Annual total deficit / total current revenues;
- Credits related to local revenues / annual local revenues;
- Debts related to current expenditure / annual current expenditures;
- Enforcing judgements amount / current expenditures;
- Personnel expenditures / current revenues;
- Long term debt / current revenues;
- Past expenditures not covered by appropriations / current revenues;
- Treasury overdraft not reimbursed.

The interviewee from the State General Accounting Department has also reflected what is contained in a report that summarize the inspections upon 116 municipalities (State General Accounting Department, Ministry of Economic and Finance, 2009), that has highlighted five critical factors of municipal finance:

- Current expenditure increasing trend;
- Current imbalance;
- Cash imbalance;
- High short term credits;
- Amount and truthfulness of total surplus.

According to the Court of auditor's respondents, the main symptoms of default are listed in a recent document issued to the Parliament⁸. They are the followings.

- High amount of non-collectable receivables specifically with reference to those revenues under direct responsibility of the LG, such as local taxes and service fees. Since the accounting system mechanism provides that expenditures can be covered by revenues accounted when the right to collect arises there are several LGs that accounts non-collectable receivables in their budgets and reports to support expenditures that will not then be paid because of lack of liquidity.
- Irreversible crisis of liquidity with regular recourse to factoring/short-term bank facilities that are not reimbursed and thus become an improper structural, long-term debt. This is against the Constitutional principle that allows public debt for investments reasons only. The lack of liquidity is a consequence of the first point (high amount of non-collectable receivables) and is mostly related to LGs' incapacity to collect local taxes and service fees revenues.
- High off-balance debts (*debiti fuori bilancio*) arising from off-balance expenses usually carried out to bypass the basic local public finance rules of (current) financial balance and Internal stability pact, and/or to defer financial impacts of expenses decisions. Off-balance debts may also arise as consequence of judgment resolutions and losses of provincial/municipal-owned organizations to be covered. In all these cases, this new expenditures might be of such a magnitude that room of manoeuvre for revenues increases or expenditures cuts may not be possible, bringing the LG into a structural imbalance status. Since, by definition, off-balance debts are not accounted before they appear and may cause imbalances, differently from points 1) and 2) they cannot be foreseen by analysing official accounting information, even if it can be asserted that LGs with a regular appearance of off-balance debts are likely that will have the same trend in the future.
- Overestimation of revenues and underestimation of expenditures in the annual budget (*bilancio di previsione*), is another cause that might bring to a structural imbalance status. Differently from point 3), this can be easily ascertained by comparing the trend of revenues and expenditures over years, especially by comparing the estimates of revenues and expenditures in the previous year annual budget with actual revenues and expenditures in the annual financial report (*rendiconto*).
- Negative trends of derivatives stipulated on long-term debt. This requires an in-depth analysis that can be done only by analysing each contract stipulated. In its external audit activity, the Court of auditors gives special emphasis on these issues by asking specific questions in the questionnaire to internal audit body (i.e. *collegio dei revisori*) for the annual financial report.
- Inappropriateness or incompleteness (irregularities) of accounting information.

These aspects are essentially the same discussed in an in-depth analysis by Cimbolini and Moriconi (2009) on the pathologies of LGs' finances. These authors also give a specific emphasis by highlighting the issue of government-owned organizations (GOOs). This is also at the centre of specific analyses by the Court of auditors (2009, 2013, 2014) and is also considered pivotal by interviewees from the Court of auditors and the chief financial officers, since the growing of the phenomenon of financial relationships between LGs and their government-owned organizations (GOOs, *partecipate pubbliche*). Italian economy is characterized by a widespread presence of GOOs held by the different levels of government, especially LGs. According to some analysts, government-owned corporations (i.e. that part of government-owned organizations in the form of *società per azioni* or *società a responsabilità limitata* corporations) with majority of shares by the public sector held some € 208 bln. of assets; most of this value is owned by the central State, but municipal-owned corporations prove to manage € 8 bln. of assets and a "municipal current expenditure" of € 34,8 bln. or

⁸ See also Corte dei Conti, [Audizione sul DDL Disposizioni urgenti in materia di finanza locale, nonché di misure volte a garantire la funzionalità dei servizi svolti nelle istituzioni scolastiche A.C. 2162, Commissioni riunite bilancio e finanze – Camera dei Deputati](#), 21 marzo 2014, retrieved 03-04-14.

2/3 of the amount managed within the boundaries of municipal budgets⁹. To date, according to the most recent analysis provided by the Court of auditors (2014), regions and LGs have 7.472 GOOs, of which 6.386 in activity. GOOs can be totally or partly (either majority or minority) held by public organisations. They produce services or goods for the market or, as it has happened and increased especially for LGs in the last 25 years and despite operating as private organisations, they pursue general interests carrying out duties and functions of a public nature such as to configure them as real public organisation, public agencies or public bodies.

LGs have extensively used GOOs not only with the aim to foster efficiency and economies of scale, but mainly to bypass the increasing financial constraints of public finance central government controls and, in general, to overcome the public law rules concerning several areas of activity, such as procurement and public employees hiring. In recent years evidence has proved that financial distress at the municipal level might be caused by financial problems that arise in GOOs, which financial situation and performance are not consolidated in the municipal financial reporting system. For this reason, the Court of auditors has started to put a specific emphasis on GOOs, especially those held by municipalities.

While the Court of auditors has clearly stated the need to extend the Internal Stability Pact (ISP) limits provided with reference to each LG to *aziende speciali, istituzioni*, and private-like corporations with (directly or indirectly) public majority (minority GOOs are excluded) under a consolidation of accounts approach¹⁰, practically the complexity of ISP computations together with the lack of any specific rule for consolidation has de facto brought GOOs as means by public entities to bypass ISP rules. Currently these GOOs concur indirectly to public finance objectives of ISP, but problems of coordination of accounting systems continue to be reported by the Court of auditors.

Recently a new reform occurred in 2012 has profoundly reformed the internal audit and control systems especially for LGs. Starting from 2013 (for LGs with more than 100.000 inhabitants, 2014 for LGs with more than 50.000 inhabitants, 2015 for LGs with more than 15.000 inhabitants) GOOs' (not listed in stock exchange markets) internal audit and control is exerted by LGs' internal audit bodies and controllers. The LG council is responsible for strategic planning and control. The focus of the legislator is especially on the need to have a consolidated financial situation and performance view (LGs and GOOs) but there currently is a total lack of consolidated financial statements for LGs. Furthermore, starting from year 2012, provinces and municipalities must reconcile credit/debit relationships with GOOs and provide a report (attached to the annual financial reporting) where they give notice of relevant discrepancies and their motivations. This is particularly relevant since the Court of auditors has revealed that in several instances there are significant differences, usually more credits on GOOs' balance sheets and less debits on regions and LGs' financial reports, and these may be relevant for the assessment of the real government's financial health situation¹¹, causing possible shocks when consolidation of accounts will be compulsory.

Table 12 tries to summarize and give an overview of the relevant characteristics of GOOs that affect risk assessment of local public finances.

⁹ For more information see [Padovani E. \(2013\), “#PagamentiPA il fenomeno dei debiti commerciali”, presented at Rapporto Dexia Crediop 2013 sulla Congiuntura della finanza locale on 28-11-13](#), retrieved 12-06-14.

¹⁰ [Corte costituzionale \(2013\), “Sentenza n.46”](#), retrieved 19-06-14.

¹¹ See for example, [Corte dei conti - Sezione di controllo della Puglia \(2013\), “Deliberazione n. 124/2013/PARI”](#), retrieved 17-06-14.

Table 12 – Relevant characteristics of GOOs that affect financial health risk in LGs.

Type of entity	Ownership regulation	Type of public service provided	Regulations and audit	Financial impact on LGs/regions	Consequence of a default/bankruptcy on regions/LGs
Private-like corporations – totally public (in house provision)	Civil code apply (same rules as private corporations) but they are assimilated as a department (“in house provision”)	Any local public service and “pertinent” intermediate service	Several special measures (regulations) apply for procurement, transparency, types of activity that can be provided, board of directors, personnel, internal stability pact, internal audit, consolidated financial report, balancing deficit, recapitalization and divestment/liquidation	Not only governments transfer money to pay the service GOOs provide, but also provide grants, balance losses, recapitalize; as receiving profits from totally public GOOs is less frequent, more often this category produces a net outflow of financial resources from regions and LGs	They are separate entities, therefore if they go to bankruptcy they have no effects on regions or LGs; but this might not be always the case, since “strong” letter of comforts or other guarantees might be present
Private-like corporations – listed in stock exchange markets	Civil code apply (same rules as private corporations) plus rules for listed corporations	Mainly local public services (multiutility corporations)	Civil code apply (same rules as private corporations) plus rules for listed corporations	Usually cash inflows (profits) from these types of GOOs	No effects
Private-like corporations – other	Civil code apply (same rules as private corporations)	Any local public service and “pertinent” intermediate service	Same as private-like corporations – totally public	Same as private-like corporations – totally public, but as provided by evidence, losses could be less likely	Same as private-like corporations – totally public
Public entities (<i>aziende speciali</i> and <i>istituzioni</i>)	These entities are disciplined by the LG act law; they operate more like autonomous departments than separate entities	Any local public service and “pertinent” intermediate service; <i>istituzioni</i> can only manage social services	Same as private-like corporations – totally public	Same as private-like corporations – totally public, but as provided by evidence, losses could be less likely	No special bankruptcy rules are provided for these public entities; while more investigation is needed, we are inclined to confirm that in case a public entity goes to bankruptcy the region or LG is required to bail it out
Consortia and foundations	Civil code apply (same rules as private corporations) and there are some limits for foundations	Any local public service and “pertinent” intermediate service	Same as private-like corporations – totally public	Same as private-like corporations – totally public, but as provided by evidence, losses could be less likely	Same as private-like corporations – totally public

It should also be noted that all the aspects discussed in this section are subjected to a specific annual scrutiny by the Court of auditors through a specific questionnaire addressed to LGs’ internal auditors. This gives further evidence that all these elements describe how financial health is conceptualized by professionals.

7. Comparative analysis

The presentation of the institutional and financial contexts and the interviews of practitioners coupled with the analysis of domestic literature and official reports, highlight the priorities of LGs financial analysis. They differ from one country to the other. In this section we sum up and compare what described above for the two countries, trying to combine the contextual elements and the components of financial health in each country.

First of all our analysis has allowed to understand that in the two countries the sub-elements in which the concept of financial health is traditionally subdivided received a different level of attention by respondents and literature. In France, where there has recently been an increase of financial autonomy, the central aspects of financial health analysis are self financing and cash flow, supplemented by margins available. Debt analysis is also related to cash flow. But following the problems of toxic loans, regulation binds LGs to detail their outstanding debt stock. This is precious for analysis and monitoring financial health. On the other hand, liquidity risks are very little analysed and remain of secondary importance in the analysis. Liquidity or solvency ratios, traditionally based on balance sheet data, seem less used. This can be explained by the low liquidity risks in France and the doubt concerning the reliability of the balance sheet. Furthermore, and more importantly, payments are done within the limits permitted, due to a regular attention on cash flows, let alone that the State ensures the payment of voted taxes resources anyway. Also, while in French LGs there might be the take over by a national commissioner in case of bad financial health, there is not a default procedure for LGs. This means that all providers (workers, providers of goods and services, banks and financial institutions, etc.) are guarantee by the State which intervenes in case of need.

On the other side, in Italy cash solvency represents one of the most important financial problems, that has also caused the strengthening of LGs' accounting system with a new reform that will be applied starting from 2015 together with several urgent measures to pay outstanding commercial debts. Italy, where the level of financial autonomy has been changeable in the last years, LGs have a bankruptcy procedure, and other two pre-default procedures, based on the concept of inability to continue its functions and essential services and pay creditors with regular resources, embracing all traditional concepts of financial health. All aspects of financial health seem to be relevant.

Our analysis has also found further two components that current literature on LGs financial health have not considered under an integrated perspective. First, the level of financial health of GOOs, that seems to be extremely important in both countries. The financial relationships between LGs and their shareholdings may have band implications due to negative spillovers into the public budget. In France, the analysis of satellite organizations is carried out through internal control mechanisms. Large LGs consolidate their data to better assess this risk. Analysis of French LGs implies to have an interest in those stakeholders. However, to assess LGs' financial health from an external point of view is complicated because of the low availability of accounting and financial data. Balance sheet data and elements on satellites are hard to find. This often limits the analysis to cash flow and margins of the principal budget. In Italy GOOs have been extensively used to bypass the increasing financial constraints of public finance central government controls and, in recent years, evidence has proved that financial distress at the municipal level might be caused by financial problems that arise in GOOs. LGs do not consolidate GOOs in their financial reporting system and, as it is for France, it is very difficult to collect financial information on these entities from external side.

Second, the failure of external organizations to which some activities or complex services are outsourced might negatively reflect on LGs financial health. This aspect has been highlighted only for the French case, where it is seen as a major financial risk, especially in the case of semi public companies in charge of town planning. Risks also come from private partners that provide public services. Political pressure to ensure public services' continuity or preserve local employment may drive to an increase in LGs' expenditures. The former additional element has already been discussed within the accounting literature under the consolidated financial report in LGs (for example see Grossi, 2007; Grossi & Mussari, 2008; Mussari & Grossi, 2009) in the mainstream of research of the Whole-of-Government approach (Christensen & Lægheid, 2006), while the latter has received attention by the literature concerning privatization, when it discusses of the effect of in-sourcing in case of failure of

outsourcing (for example see Savas, 1987). Here, we give evidence that the specific context also originates further separate elements of financial health, namely the “government-owned organizations’ financial health”, that refers to the level of financial health of external organizations for which LGs have some levels of responsibility as shareholders, and the “successful level of external providers”, that refers to the level of probability of insourcing of currently outsourced activities, and the following financial shocks that this may cause.

8. Conclusion: toward a contingency model of financial health assessment

By studying the two cases of France and Italy, we found that the level of autonomy, not only in terms of financial autonomy but also in terms of presence or not of default procedures and level of external controls, is profoundly linked to the dimensions selected to assess the financial health. Furthermore, we have found that GOOs’ financial health and the successful level of external providers, in terms of probability of insourcing of currently outsourced activities and the negative financial repercussions that this may cause, are further components of financial health. These elements have not been taken into due consideration by financial health literature in the past, perhaps because the analysis is usually focused within the legal boundaries of LGs. This let half-view of a contingency model of financial health assessment, where the different components of this polyhedral concept are more or less important based on contextual elements linked to the level of autonomy of LGs. This requires further study so as to frame a theoretical framework that might be extended by further analysis.

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