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**Financial difficulties of Italian local authorities:
a financial critical elements analysis to identify
prediction and diagnosis models**

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President
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Abstract

Recently, business management literature has been enriched by numerous contributions on corporate crises and related processes of reorganization or liquidation. The majority of these studies have always been about private sector business. Nevertheless, crisis situations can arise in any type of business (Guatri, 1986; Manes Rossi, 2000), just as the same concept of crisis is intimately related to the notion of company, which is an open system and, therefore, constantly changing (Manes Rossi, 2000).

Based on these considerations, the analysis of crisis situations is particularly interesting, with specific reference to non-profit public companies (Guatri, 1986) and, more specifically, to local authorities, in view of their significant importance within the public field and the abundant existing legislation completely revamped, however, in recent years.

There is one important aspect on which it is necessary to focus our attention about local authorities crisis situations: in fact – given the institutional and public purposes that led to their birth – they cannot dissolve, but they need to live and provide essential community services and goods.

It is therefore paramount to identify the early onset of the crisis, before imbalances and inefficiencies will irreversibly affect the company life.

The primary objective in this direction is to create a performance reporting (Borgonovi, 2009) to provide an adequate response capability in situations of difficulty or crisis, leading to the systematic dissemination, even in public, of real and concrete benchmarking techniques, essential for an effective management of local authorities (Ricci, 1998; Savioli, 1995).

Keywords: Local Authorities; Bankruptcy; Crisis condition; Public Administration Default; Crisis Diagnosis; Crisis Prediction

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From general phenomenon of crisis to Local Authorities Financial crisis.

Recently, business management literature has been enriched by numerous contributions on corporate crisis and related processes of reorganization or liquidation. We evaluated symptoms and causes, with various classifications of different types of crisis, and we investigated the possible developments of the phenomenon “crisis”.

The majority of these studies have always been about private sector business.

Nevertheless, crisis situations can arise, as well as the doctrine has highlighted (Guatri, 1986; Manes Rossi, 2000), in any type of business, just as the same concept of crisis is intimately related to being firm, which is an open system and, therefore, constantly changing.

In fact (Manes Rossi, 2000),

‘the concept of crisis is inherent to being the company that, as a dynamic and open system, is constantly changing and is therefore subject to critical situations, as determined by a non-timely or adequate response to changing environmental conditions or to market demands , and thus to the loss of the economic-financial equilibrium, which ensures its survival over time’.

Based on these considerations, the analysis of crisis situations is particularly interesting, with specific reference to non-profit public companies (Guatri, 1986) and, more specifically, to local authorities, mainly because of their significant importance within the public field and the abundant existing legislation, however, completely revamped in recent years.

During the life of every type of company, as a dynamic system that is open to the market, internal and external factors of influence create a system of risks and uncertainties and, consequently, they may show different series of crises: overcoming them, it is possible to find a new equilibrium. Such situations could be considered as a physiological crisis, inherent to the same conditions of a company life.

In contrast, sometimes the company fails to respond adequately to changing environmental conditions and this situation can affect business sustainability, more or less relevant, more or less severe. This can determine a pathological state of crisis and to face them it may require changes in structure, organs or functions. This crisis is sometimes irreversible and leads to the forced dissolution of the company.

However, there is one important aspect on which it is necessary to focus our attention about local authorities crisis: in fact – due to the institutional and public purposes that led to their birth – they cannot dissolve, but they need to live and provide essential community services and goods (Manes Rossi, 2000).

This situation creates a profound difference in the treatment of local authorities crisis, as well as the need for a specific legal framework regarding local authorities bankruptcy which is distinct from the other insolvency and bankruptcy procedures provided for private companies.

So, if a local authority can never be dissolved, but we should always find its way to a desirable and sustainable recovery, it becomes imperative to understand what are the causes of the crisis, what are the warning signs and, therefore, to identify tools that can monitor the permanent existence of the institution equilibrium. Nevertheless, when crisis situations arise, it is important to look for tools to monitor developments of the next phase of rehabilitation and to ensure the restoration of equilibrium.

At the base of the crisis, are phenomena of imbalance and inefficiency, which may be internal or external source (first stage). If these conditions persist, it may cause losses of varying severity (second stage). With repetition and increasing intensity of the losses, the crisis enters in a third stage, characterized by the insolvency, that is the inability to meet its commitments. At the end, there is the final stage of collapse, defined as the permanent inability to meet liabilities.

However, beyond these observations, the main aspect is that for any type of crisis, the most dangerous threat is represented by possible delay in the intervention. Indeed, history is often marked by belated recognition of the symptoms of crisis, the illusion of excluding the state of crisis or minimize the scope, the fear of adopting measures that are inevitably painful. The net effect of these behaviors is that the process of decomposition and depletion becomes more severe, up to the limit of irreversibility.

Fundamental problem is, therefore, to identify the early onset of the crisis, before the imbalances and inefficiencies will irreversibly affect the life of a company.

In fact the crisis is, apart from rare exceptions, a phenomenon not unexpected, although sometimes it can manifest suddenly. It is a phenomenon that may be present in a latent form, and gradually undermining the financial balance until someone (inside or outside the company) is able to detect it.

Why is it necessary to have the institution of local authorities Bankruptcy Law?

The introduction of local authorities Bankruptcy Law in our legal system has its reasons in an attempt to put a stop to the legal phenomenon of chronic budget deficit of municipalities, provinces and other types of public organizations. With time, this has become absolutely not to be delayed.

The reasons that led to these circumstances are various and of different weights. Among these, we can mention: a steady rise in spending, an increasing pace of deficit (only in small part attributable to investments) and continuous increase of local taxes.

We can identify other causes in:

- political class chronic irresponsibility, regarding financial management of public bodies;
- case law too precautionary against creditors (Romano & Sarracino & Zeoli & Inglese, 1998).

The notion of local authorities Bankruptcy can be deduced analytically from the reading of numerous provisions of Law, covering a wide historical period. The purpose of this research is not to examine the historical evolution of legislation, but it is important to list the main acts of law that have led to the current definition of local authorities Bankruptcy Law:

- a) D.L. 2 march 1989, no. 66 then turned into Law no. 144/1989 (art. 25);
- b) D.L. 18 January 1993, no. 8 then turned (with amendments) into Law no. 68/1993 (art. 21);
- c) D.P.R. 24 August 1993, no. 378;
- d) D.Lgs. 25 February 1995, no. 77 and succeeding amendments (D.Lgs. no. 336/1996 and no. 342/1997).

The end result of this sequence is represented by the D.Lgs. 18 August 2000, no. 267: Text of the laws on the local authorities (TUEL).

Therefore, the current definition of the phenomenon of local authority bankruptcy is provided by Article 244 TUEL, which specifies that:

'State of local authorities Bankruptcy occurs if a local authority cannot guarantee the performance of functions and essential services, or there are against it demandable claims which cannot cope with the arrangements laid down in Articles 193¹ and 194² TUEL³'.

Unlike the bankruptcy of private enterprises, the declaration of bankruptcy of a local authority is a unilateral act not caused by a creditor request.

The state of instability is, thus, a very serious condition of insolvency, which must be denounced. Furthermore, it is not allowable and is not preventable by the ordinary expedient of financial loan.

In fact, the Law establishes that, if the regional body control becomes aware of any condition of instability, it shall appoint a special commissioner for the declaration of bankruptcy, with the further consequence of the complaint and initiation of a procedure by local Prefect⁴ for the dissolution of the local Council.

From the above definition of local authority bankruptcy, is deduced two fundamental conditions (De Dominicis, 2000):

1. the entity's inability to provide essential services (and related compulsory expenditure);
2. inability to honor its debts, especially debts below the line, including those "black debts" contracted in previous years without complying the normal procedure of commitment accounting.

These conditions, as noted above, are due to the structural difficulties that cannot be eliminated by normal recovery tools (provided by Articles 193 and 194 TUEL).

In other words, it is clear that these are conditions or situations that show a certain deficit and serious total financial imbalance, but that may not co-exist and compete simultaneously.

In short, the two aspects of failure – to provide services and to honor debts – which are considered harmful situations disjointed and independent indices of insolvency.

Local authorities Bankruptcy *versus* Pre-Collapse: differences and similarities.

As mentioned earlier, we understand that the financial default does not arise, thus, with a casual deficit, but is related instead to a real and concrete structural imbalance in the local authority financial situation (Mulazzani, 2001).

In this respect, it should be emphasized that in local authorities, while the Budget⁵ is the schedule of activities that each administration plans to implement, the Financial Report⁶ (consisting of three tables graphs) represents the summary of the entire past management, by which local authority shows transactions actually occurred during the reference year.

¹ Art. 193 TUEL

² Art. 194 TUEL

³ Text translated and adapted.

⁴ Local Government Authority.

⁵ *Bilancio di Previsione*, in Italian.

⁶ *Rendiconto della Gestione*, in Italian.

Just in this connection, it must be observed that Article 228 TUEL provides that local authority must set up the Table of Structural Deficits Parameters⁷ and the Table of Performance Management Parameters⁸ for three years.

Therefore, it is only with the Financial Report that we can understand how the budget estimates have been performed and the ability of administrators in treating and managing the public affairs.

More particularly, it should be noted there are tools that may represent, at least, an aid for the measurement of such performance, and they are represented by so-called indicators or parameters.

This system of indicators and parameters is designed to monitor overall activities put in place by local authority, and to direct it toward positive standards, by creating processes of competitive benchmarking.

Such a system of indicators is so important that the Law provides for local authorities not only the need to develop indicators and operational parameters, but - in addition - their inclusion in the Financial Report with the Table of parameters of structural deficits.

To understand the importance of this table, it should be emphasized that, according to the doctrine, when it shows a situation of structural deficit of the local authority, the situation is considered so serious as to talk of “pre-collapse”, thus bringing to light how this precarious situation of deficit may lead, under certain conditions, in a situation of real and substantial bankruptcy.

However, although it is necessary to admit the existence of a physiological link between the situation of structural deficit (or pre-collapse) and a real local authority bankruptcy, it is necessary to highlight that there are important differences between the two conditions.

Indeed, the lack of financial resources may show a deficit situation, but, if promptly addressed (as in the case of local authorities in pre-collapse), it can lead to avoid the extreme situation and the unilateral proclamation of the state of bankruptcy.

Certainly, the situation of pre-collapse, is a condition of emerging structural deficit, and is common to institutions in a state of bankruptcy, but for them the deficit state assumes the objectivity of absolute gravity and solvability, even by the ordinary tools of reorganization and financial maneuvering.

We can argue, therefore, that the difference between situation of bankruptcy and condition of pre-collapse lies in this: in the first case, the declaration of collapse is a starting point and it is aimed to identify specific responsibility on whose basis is then possible to reach a decision of a temporary disqualification for directors responsible, while in the latter case it is not possible any special pronouncement, neither for responsibility nor for disqualification to certain public office due to the facts of pre-collapse.

In particular in a situation of bankruptcy a recent Law⁹ provides that administrators responsible (because judged by the Judicial Organs in charge) of damage in the five years preceding the occurrence of bankruptcy, may not hold significant positions in public and private institutions for a period of ten years, if the Court finds that the circumstances and causes of bankruptcy are derived from acts or omissions of administrator found guilty.

Similarly, mayors and presidents of the provinces that are responsible for the bankruptcy are not candidates for a period of ten years for position of mayor,

⁷ *Tabella dei parametri di riscontro della situazione di deficitarietà strutturale*, in Italian.

⁸ *Tabella dei parametri gestionali*, in Italian.

⁹ D. Lgs. NO. 149/2011.

president of the province, president of the Regional Council and other high offices in the communal, provincial, regional and European level.

However the situation of structural deficit is not without consequences, and involves the sequential subjection to various controls and fulfillments.

Specifically, they are subjected to a series of controls by the Department of the Interior. Moreover, they are obliged to adopt a series of measures in order to allow recovery of deficit and the payment of “black debts” such as:

- hiring freeze;
- reorganization of the staffing plan;
- increase in cost of services on individual demand etc.

Local authorities Bankruptcy Law: the procedure.

Regarding the procedure we must point out that, in previous legislation, the management of events before and after declaration of bankruptcy was assigned within the organization.

This caused many difficulties because the management of pre-existing condition could lead to negative consequences on ordinary activities after the bankruptcy (Danielli & Pittalis, 2010).

For this reason, with subsequent laws we move to a clear separation of powers between the past and the present management. In this way local authority should take care of management of the organization after the bankruptcy, from which to take a new route avoiding to fall back into a new situation of bankruptcy.

Indeed, after the declaration of bankruptcy, all efforts are aimed at enable a balanced management: this phase ends with the preparation of hypothetical balanced and healthy budget which is built by eliminating all causes that led to structural collapse of the situation.

In fact, to ensure that local authority pursues a real and effective rehabilitation, the Law provides for the drafting of this important document which is, basically, a budget for the year following the bankrupt declaration.

Then it must be submitted to the Department of the Interior for his official approval.

As just pointed out, is sufficiently clear that in a state of bankruptcy we have a “dual management”, which two actors involved: the Extraordinary Settlement Body¹⁰ and the Council of the local authority.

The Council should declare the state of bankruptcy but, in addition, it must also evaluate the generating causes, on the basis of a report prepared by the auditors.

This is because the declaration is not a simple aseptic acknowledge, but the first measure of determination and designation of responsibility.

This declaration produces mainly two kinds of consequences.

The first of these concerns local authority’s creditors: in this case, the declaration determines the freezing of some of their rights and guarantees.

The second consequence of the declaration affects management of the organization and introduces several constraints on expenditure and the income management and lasts until compilation of hypothetical balanced and healthy budget.

In other words, management is not based on the budget of next year (as is usual) but takes as reference the last budget adopted before the bankruptcy¹¹.

After the declaration of bankruptcy, local authority is not obliged only to contain costs (as discussed above) but it must take any kind of action aimed at achieving incremental variations of incoming resources. These measures are identified in Article 251 TUEL, and consist, in general, in raising fees and taxes to the maximum extent permitted by Law. This resolution, therefore, is not revocable, and retains its effectiveness for five years starting from the hypothetical balanced and healthy budget.

After approval of hypothetical budget (within 30 days) the next step is to approve the budget for which the hypothesis applies.

This because it is necessary that the hypothetical budget becomes a real budget to legitimate action of the Council.

¹⁰ Organo Straordinario di Liquidazione (OSL), in Italian.

¹¹ Art. 250 TUEL.

The duration of the procedure is five years after approval of the hypothesis. To further facilitate the healing process, the law clarifies that local authorities can get a bank loan only in cases provided by Law (for the duration of the process).

Possible causes of local authorities Bankruptcy.

As noted above, local authority bankruptcy takes place because of a financial imbalance that prevents it to perform its functions and its services.

Regarding this aspect, it is important to remember that since the eighties, local authorities are no longer in a situation of financial dependency by the State. This means that while previously, in situations of budgetary imbalance, the Government intervened with its financial resources to cover the situation, now they must develop an adequate system of financial autonomy to become entirely self-sufficient.

In particular, we can argue that local authority Bankruptcy can be caused by the following internal and external dangerous factors:

- mismanagement (e.g. deficit, “black-debts”, etc.);
- management goals are too ambitious;
- short-term management policies;
- mismanagement of cash flows;
- excessive debt exposure;
- inefficient management control system;
- inability to promptly identify potential causes of damage and/or inability to act promptly to remove them;
- uncontrolled increase of expenditure;
- growing deficit (without making investments);
- continuous increase of certain local taxes;
- discontinuity in management;
- lack of business management tools to support management;
- negative events that involve the market.

From these factors we can argue that most dangerous situations can be found mainly from the lack of a systematic vision of the institution.

Results and Conclusions.

By analyzing statistical data regarding the phenomenon of local authorities bankruptcy up to now, we can show that it involved a relatively small number of institutions.

Specifically, since 1989, were 448 institutions that have approved the state of bankruptcy (in which only one Province: Napoli)¹².

On the basis of different rules apply, we can divide bankruptcy as a function of various external financial resources available to cover debts. It appears that:

¹² The data is updated at June 21, 2011.

- no. 414 local authorities have declared their bankruptcy by November 8, 2001, for which the State has guaranteed costs payment of restructuring loan, unconditionally;
- no. 5 local authorities have declared bankruptcy between November 8, 2001 and December 31, 2003. For five of them, was established a State contribution under Article 5 of Law no. 240/2004;
- no. 29 local authorities have approved the bankruptcy after January 1, 2004. For them it is possible to have an extraordinary contribution of the State (D.L. no. 159/2007 as amended by D.L. no. 248/2007).

One of the most significant considerations - in the opinion of the writer - in analyzing the bankruptcy phenomenon as a function of time. Indeed, as shown in Figure 1, the number of bankruptcies (frighteningly large in the first few years following its introduction) has quickly and steadily reduced over the years, remaining (from 1997 to present) always below the dozen cases reported each year.

In particular, the falling graph shows that bankruptcy Law, in the first five years, has been warmly welcomed by local authorities, when he revealed those with the most difficult financial situations that could lead to a economic and financial collapse of the administrative structure.

Following this “start-up” period, deliberations of bankruptcy (as rightly should be) were taken only in a few cases.

This demonstrates that the aim of transforming this procedure in an exceptional tool (to be applied only when it was impossible to manage the financial collapse) had actually been achieved (despite a discipline, at that time, not fully mature).

However, it is important to point out that the drastic reduction of local authority defaults has another explanation, simple but very persuasive. Until 2001, bankruptcy had its own “convenience” because the deficit was covered by a loan financed directly by the State.

Today, instead, declaration of bankruptcy causes damage to all:

- employees: those who are redundant (compared to the national average ratio employee/population) may lose their jobs;
- suppliers: due to the constraints arising from the declaration;
- citizens (especially): as mentioned earlier, after the collapse there is an obligation to increase local taxes to the legal maximum.

The circumstances outlined above allow us to easily admit that the probability for a local authority in bankruptcy to reach a situation of real and tangible rehabilitation is very difficult without a consistent activity of “support” at State or Regional level.

The problem is that we need to reflect jointly on these two aspects:

- ✓ it is vital to assist local authorities in difficulty by a Regional or State support;
- ✓ it is important to avoid systematic safeguards action, to encourage a real and long-lasting recovery will.

The Italian Local Authorities Bankruptcy Law has tried to reconcile these two conflicting requirements.

In this direction, Article 119 of the Italian Constitution establishes that:

‘To promote economic development, social cohesion and solidarity, to remove economic and social imbalances, to facilitate the effective exercise of the rights of the person, or to provide for purposes other than the normal exercise of their functions, State allocates resources and performs additional special

interventions in favor of specific municipalities, provinces, metropolitan cities and regions.'

It is precisely in the constitutional dictate that we must consider and evaluate rules providing for extraordinary interventions in favor of local authorities in a state of bankruptcy. Thereby, these additional resources would allow, together with the indispensable financial efforts previously described, to reach a real recovery.

Ultimately, we can say that it is not easy to come to a complete and unambiguous conclusion on topic of local authorities bankruptcy law.

If it is true that many are betting on the actual value of the recovery process, considering it capable of producing a true 'cultural revolution and modernization of the bureaucracy' favoring 'the establishment of collaborative relationships between Central Government and local authorities' (Danielli & Pittalis, 2010), we found a widespread view (including that of many "experts") who are opposed to the same evaluation of this tool.

In support of positive evaluation there are mainly empirical findings related to some statistical analysis on bankruptcy phenomenon (Figure 1).

However, many evaluate the effectiveness of the recovery process very differently.

In this case, the most effective argument used is represented by another empirical fact: many entities in bankruptcy are back in a new situation of financial default. For example, Arpaia (in the Province of Benevento), Lungro (in the Province of Cosenza) and Soriano Calabro (in the Province of Vibo Valentia).

The key issue is try to determine whether they are simply exceptional cases compared with a prevalence of stable rebalance, or examples that demonstrate the ineffectiveness of bankruptcy Law to produce a real recovery. In this perspective, the procedure would be seen not as a definitive solution, but as a mere palliative, because it can only provide a temporary benefit, a "breath of fresh air", to local authorities in crisis.

In this way, probably, is more clearly explain the recent trend aimed at making stronger control over local authorities by the Court of Auditors, by widening of documents submitted to it. In fact, the most significant concerns the power assigned to the Court of Auditors to transmit documents to local Prefect in cases in which occur: if differing behaviors emerge from financial management, or there are accounting irregularities or budget imbalances that can cause bankruptcy, local Prefect may appoint a special commissioner for the

In other words: the prevention would be better than cure.

In this sense, we can express a clear appreciation for Italian Constitutional Law no. 3/2001. It established (unlike in the past) that local authority may use a financial loan only for investment: it achieved the intention to remove the connotation of systematic assistance tool (created by the practice), replacing it with the role of special intervention measure.

These considerations highlight the extreme difficulty in expressing an overall opinion on the topic. So, probably the crucial point is another. Perhaps - I believe - we can argue that it is not possible to express an overall opinion.

Of course we can improve this tool but, at the same time, his exceptional character reduces the need of wanting to make it perfect and flawless in every circumstance, because in view of the complex situations that it is facing, it is very difficult to think about its universal effectiveness.

Finally, it is essential a reflection in the international context.

In Italy local authorities Bankruptcy Law (as previously described) provides an essential function: a local authority can never “fail” because it have to provide its essential services to the community. Even temporarily.

In other countries, instead, the situation is quite different.

In the United States of America, for example, the procedure requires the preparation of a restructuring plan. However, if this is not approved by creditors of the City, the situation is particularly confusing, because the Bankruptcy Judge could impose (in theory) a tax increase, cost cutting and asset sales. But this, in fact, never occurred. In very few cases discussed in the literature (White, 2002), U.S. Courts have rejected the restructuring plans by appealing to the coercive power of local authorities to collect taxes.

Indeed, the U.S. framework is more complex.

New York City, for example, has legislation which provides, in case of financial loss, replacement of the mayor with a special commission and the payment of the deficit entirely by the citizens.

Even more “interesting” is the case of the city of Chicago. On August 17, 2009 Mayor Richard Daley has been forced to declare the “closure” of the City. It is undoubtedly an extreme measure, but necessary, because of lack of funds recorded in the budget of the City and that has allowed, through the imposition of a mandatory day off and not paid, a savings of \$8.3 million.

But there are other examples.

In California, in 2010, the debt reached a record \$24 billion, and so were estimated cuts of 4.7 billion, but above all, it was decided the closure of most public offices for three days a month¹³.

Beyond the examples, the comparison with these experiences undoubtedly puts in evidence the social value of the Italian local authorities Bankruptcy Law, capable to guarantee the permanent presence of the Public in providing functions and services to citizenship and, especially, apart from any financial difficulties in which it might incur.

¹³ <http://www.dpa.ca.gov/personnel-policies/furloughs/list-of-furlough-fridays.htm>

Figure 1. Italian Local Authorities Bankruptcy over the years (till 21/06/2011)

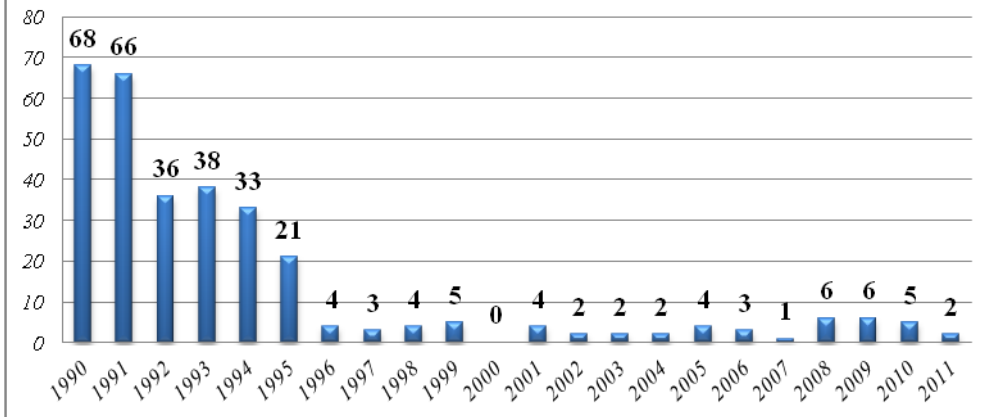
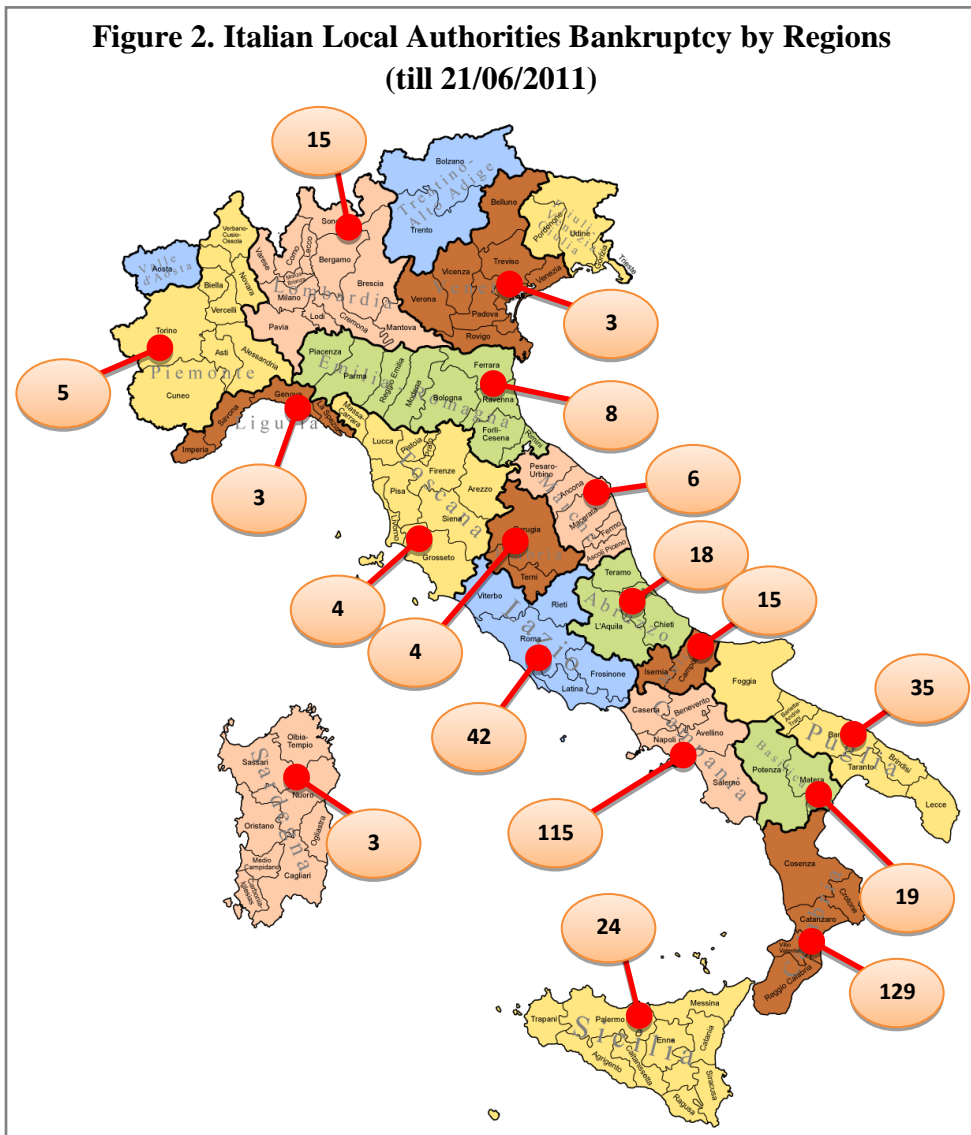
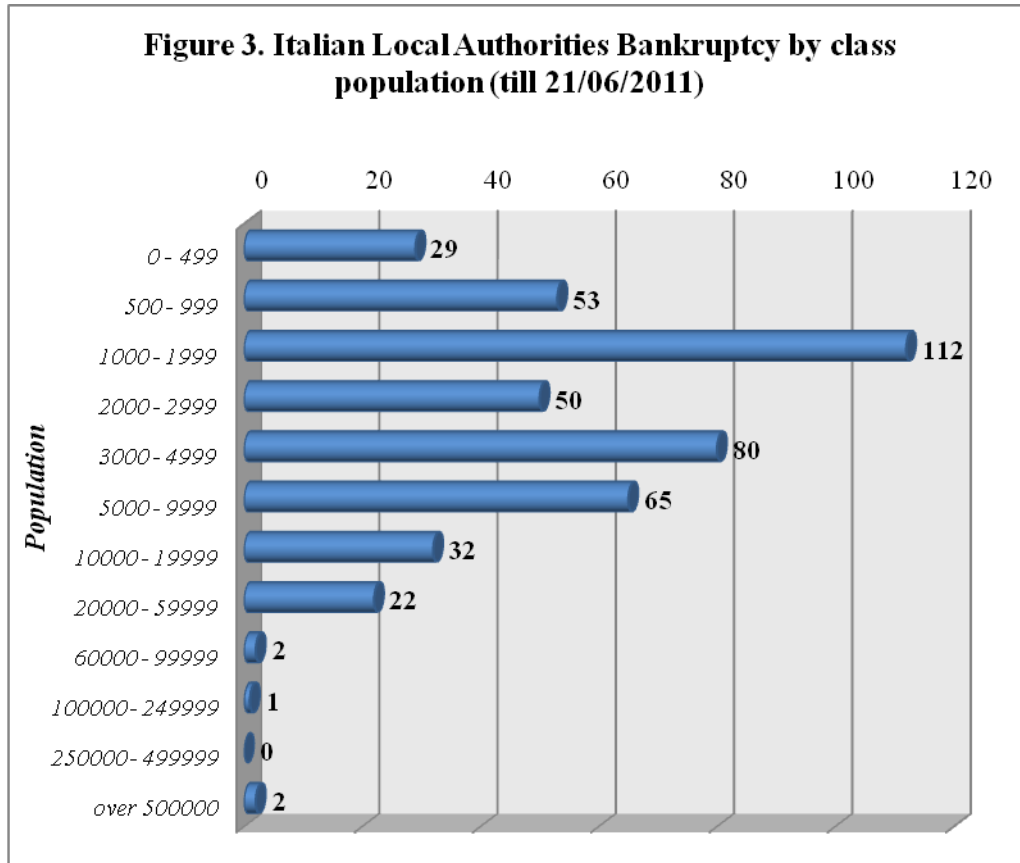


Figure 2. Italian Local Authorities Bankruptcy by Regions (till 21/06/2011)





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