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# Fiscal Rules for Sub-National Governments: What Lessons from EMU Countries?

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## Summary

*The paper analyses the interaction between fiscal rules applying to European Union (EU) member states and fiscal decentralisation, a process which has gained momentum in some European countries since the early '90s. Three critical areas are identified. First, while compliance with European rules depends on the behaviour of all levels of government, it is the central government that is held accountable at the EU level; this asymmetry increases the need for rules applying to lower government tiers. Second, European rules demand that the overall budget (both current and capital) be balanced over the medium term; applying this rule at the sub-national level may unduly reduce capital outlays. Third, European rules allow margins to deal with the budgetary effects of the economic cycle; replicating this feature at the sub-national level, although desirable, may prove difficult. The paper examines the solutions available in principle to deal with these problems and compares them with those actually adopted by five European countries. It is argued that since European rules call for clear accountability and rapid adjustment, in theory the introduction of explicit domestic rules, mimicking the European ones, has marked advantages over purely co-operative mechanisms. However, in practice the strengthening of consensus-based institutions and procedures has been privileged, with little recourse to formal rules. While co-operation has proved effective in terms of general government deficit reduction, it may be sub-optimal in terms of allocation of resources and it may not withstand stress-testing in terms of both economic and institutional developments.*

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## 1. Introduction

The fiscal framework of the European Economic and Monetary Union (EMU) is a new historical development<sup>1</sup>. For the first time, a number of sovereign countries have adopted a set of common fiscal rules and a complex multilateral surveillance mechanism<sup>2</sup>. This new institutional setting has extensive implications for the European economies. It affects the conduct of fiscal policy. It has implications for the allocation and distribution of government functions. It influences intergenerational redistribution and the way demographic ageing is dealt with.

This paper focuses on the impact of EMU fiscal rules on the relationships between central and sub-national governments. Three critical areas are identified.

First, as EMU fiscal rules apply to general government balances, compliance depends on the behaviour of all levels of government. However, it is the central government that is held accountable at the European Union (EU) level. This asymmetry weakens the central government position vis-à-vis sub-national governments concerning the distribution of the fiscal effort needed for compliance with the rules and, therefore, increases the need for rules applying to lower government tiers within each country.

Second, EMU fiscal rules demand that the overall budget (both current and capital) be balanced over the medium term. However, the provision of an adequate level of public infrastructure at the sub-national level may be difficult to attain without sub-national authorities using deficit finance.

Third, in order to reconcile fiscal soundness and budgetary flexibility in bad times, thus avoiding pro-cyclical policies, EMU fiscal rules rely on the measurement of cyclically adjusted fiscal balances. At the sub-national level, such measurement may be difficult to obtain, while other devices designed to allow for budgetary flexibility may prove inconsistent with EMU fiscal framework.

The paper examines the solutions that can be adopted to make fiscal decentralisation compatible with EMU fiscal rules and compares them with the approaches of five European countries. The countries considered are an extremely diversified sample in terms of institutional tradition, and also of size, population and economic development. Three countries, Austria, Belgium and Germany, have a federal institutional structure – in Belgium a relatively recent development. Italy and Spain have substantially increased decentralisation in recent years.

It is argued that since European rules call for clear accountability and rapid adjustment, in principle the introduction of explicit domestic rules, mimicking the European ones, has marked advantages over purely co-operative mechanisms. In practice, however, the

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<sup>1</sup> European fiscal rules apply to the fifteen European Union member states. Nevertheless, they are more binding for the twelve countries which joined EMU so far.

<sup>2</sup> For a review of the justifications put forward for this framework and for an analysis of its potential macroeconomic implications see European Commission (1997), Artis and Winkler (1997), Eichengreen and Wyplosz (1998) and Cabral (2001). On the genesis of the framework, see Costello (2001) and Stark (2001). Balassone and Franco (2001b) examine EMU rules against the background of the past debate on fiscal rules.

strengthening of consensus-based institutions and procedures has been privileged, with little recourse to formal rules. This applies, albeit to different degrees, to all five countries considered; the extent to which co-operation is supported by some elements of control seems to decrease with the length of the federalist tradition of a country. The paper stresses that while co-operation has proved effective in terms of general government deficit reduction, it may deliver sub-optimal allocations of resources and may not withstand stress-testing in terms of both economic and institutional developments.

The structure of the paper is as follows: first European budgetary rules and their implications for the interactions between different government tiers are examined (section 2); then the solutions available to make decentralisation compatible with EMU rules are analysed both from a theoretical point of view (section 3) and with reference to the experience of Austria, Belgium, Germany, Italy and Spain (section 4); finally theory and practice are compared and conclusions are drawn (section 5).

## **2. European fiscal rules and fiscal federalism**

The first part of this section describes the European fiscal rules as they were developed in the Maastricht Treaty in 1992 and in the Stability and Growth Pact in 1997. The second part deals with the issue of compatibility between fiscal decentralisation at national level and the rules introduced at European level.

### **2.1. European fiscal rules**

EMU fiscal rules have been designed with the goal of ensuring that national policies maintain a sound fiscal stance while allowing sufficient margins for budgetary flexibility in bad times<sup>3</sup>. On the one hand, fiscal sustainability is a central tenet of EMU: it is a precondition for financial and monetary stability. On the other hand, budgetary flexibility is needed for stabilisation policy: it has become more important in EMU as member states can no longer rely either on a monetary policy tailored to national needs or on exchange rate adjustments.

The Treaty of Maastricht states that budget deficits cannot be larger than 3 per cent of GDP unless (a) under exceptional circumstances, such as deep recessions; (b) they remain close to 3 per cent; and (c) the excess deficit lasts only for a limited period of time<sup>4</sup>. If the deficit exceeds the 3 per cent limit and the three conditions above are not met, the deficit is deemed “excessive” and it triggers a procedure intended to force adoption of corrective measures.

The Stability and Growth Pact specifies what is meant by “exceptional” and “limited period” in the clauses allowing a deficit greater than 3 per cent of GDP not to be considered “excessive”. A recession is exceptional if real GDP diminishes by 2 per cent. A milder recession (where the reduction in real GDP is at least 0.75 per cent) may also be considered exceptional if, for example, it happens abruptly. The excess above 3 per cent must be reabsorbed as soon as the “exceptional circumstances” have expired. The Pact gives no quantitative specification of the concept “closeness to 3 per cent”.

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<sup>3</sup> The economic policy framework of EMU is extensively examined in Buti and Sapir (1998), Buti, Ongena and Franco (1998) and Brunila, Buti and Franco (2001).

<sup>4</sup> These three conditions make the 3 per cent threshold extremely binding. See Buti *et al.* (1997).

The Pact further specifies that each country should aim at a medium term objective of a budgetary position “close to balance or in surplus”. According to the European Council, compliance with the Pact should be assessed by taking into account the cyclical position of the economy<sup>5</sup>. In practice, the Stability and Growth Pact requires that each member state choose a budgetary target in cyclically adjusted terms and let automatic stabilisers or discretionary action operate symmetrically around it. The lower this budget balance with respect to the 3 per cent threshold, the wider the margins for counter cyclical policy without having the risk of an excessive deficit<sup>6</sup>. Compliance with this threshold and with the 60 per cent ceiling for the debt to GDP ratio prevents the public finances of EMU member states from taking unsustainable paths<sup>7</sup>.

The choice of the medium-term target for the neutral phase of the cycle is dictated mainly by three factors: (a) the depth of expected recessions; (b) the elasticity of the budget with respect to the cycle; and (c) the size of the discretionary measures that may be taken to enhance the impact of built-in stabilisers. Past experience suggests that in the majority of EMU countries a cyclically adjusted deficit between 0 and 1 per cent of GDP should make it possible for built-in stabilisers to become fully operative without incurring a risk of overshooting the 3 per cent ceiling (Buti *et al.*, 1998)<sup>8</sup>.

Countries with debt ratios above 60 per cent of GDP should also take into account the need to diminish them, at a satisfactory pace, towards the threshold. An increase in the debt ratio during recessions should be avoided<sup>9</sup>. Other risk factors, such as the effects of demographic trends, are to be taken into account.

Each EU member state must submit its budgetary targets officially in multi-year budgetary documents (stability and convergence programmes). These documents are updated annually and are subject to a review by the European Commission that aims at assessing their consistency with EMU fiscal rules (Cabral, 2001). There is a mid-year examination of public finances and an *ex post* evaluation of results, as compared to the planned targets. The European Council can make recommendations to governments on the need to adopt corrective measures.

Countries with an excessive deficit are required to adopt corrective measures according to a fixed timetable. Failure to comply brings sanctions. Specifically, the country must pay a non-

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<sup>5</sup> Council Resolution on the Stability and Growth Pact, 17 June 1997; Council Regulation n. 1466, 7 July 1997; Council Declaration, 1 May 1998; Opinion of the Monetary Committee, 12 October 1998 as approved by the Council.

<sup>6</sup> According to the guidelines provided by the European Council, the choice of the medium term target should take into account the budgetary risks of recessions and those linked to fluctuations of other economic factors (e.g. interest rates).

<sup>7</sup> The theory of fiscal sustainability and its links with EMU fiscal rules are reviewed in Balassone and Franco (2000a). See also the papers in Banca d'Italia (2000).

<sup>8</sup> These figures are based on European Commission estimates for the period 1960-1997 (a maximum output gap averaging 4 percentage points; average budget elasticity equal to 0.6). The issues related to the choice of the medium term fiscal target are examined in Artis and Buti (2001), Dalsgaard and de Serres (2001) and Barrel and Dury (2001).

<sup>9</sup> Article 104C of the Treaty states that when the ratio is above 60 per cent of GDP it must “diminish sufficiently” and approach 60 per cent “at a satisfactory pace”. If the ratio increases, the excessive deficit procedure begins. It should be noted that, while the Treaty allows exceptions to the 3 per cent deficit criterion, it does not do so for the criterion concerning the debt ratio. See Balassone and Monacelli (2000).

interest-bearing deposit equal to 0.2 per cent of GDP plus one tenth of the difference between the 3 per cent ceiling and the actual deficit (up to a maximum of 0.5 per cent of GDP). For each successive year that the deficit is judged to be excessive only the variable component of the sanction must be paid<sup>10</sup>. Should the excessive deficit persist, the deposit is converted into a fine after two years.

Sanctions may also be associated with a loss of reputation, which can translate into a higher risk premium in yields of government securities. The public nature of the whole procedure can contribute to the effectiveness of the control exerted by the market on budgetary policy.

Overall, the approach taken by EMU can be summarised as follows:

- (a) the rules are defined on the basis of pre-determined numerical parameters;
- (b) *ex post* compliance with the parameters is required each year – overshoots must be rapidly dealt with;
- (c) margins of flexibility are envisaged only in connection with exceptional cyclical events (defined *ex ante* in terms of GDP dynamics) or with events beyond the governments' control;
- (d) no special provision is made for investment expenditure;
- (e) monitoring procedures are envisaged. They include the submission of yearly targets, the assessment of developments during the year and the evaluation of results. Peer pressure is strengthened by the European Council's power to make formal recommendations calling for the adoption of corrective measures and by the application of pre-determined monetary sanctions.

While this framework has so far proved effective in constraining deficit and debt levels, it is too early to draw definitive conclusions as to its effectiveness in shaping the fiscal policy of euro-area members. In particular, EMU rules have not yet been tested in the context of severe recessions or large scale asymmetric shocks. It is not clear that the envisaged "automatic pilot" version of fiscal policy in which automatic stabilisers work freely around a predefined cyclically-adjusted target would provide a sufficient degree of cyclical smoothing, in view of the larger requirements of fiscal stabilisation in EMU (Brunila, Buti and Franco, 2001). The funding of public investment may also prove difficult (Balassone and Franco, 2000b).

Another problematic aspect concerns the consistency of budgetary procedures and institutions at the national level with the constraints imposed by the new EU framework<sup>11</sup>.

## 2.2. The role of sub-national governments

The problem of monitoring the soundness of public finances of lower government tiers arises in all countries which are not highly centralised, regardless of EMU membership (Ter-Minassian, 1997). Within each country, the stability of monetary and financial conditions represents a public good which the central government and all sub-national governments

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<sup>10</sup> The fixed component is intended to discourage excessive deficits, while the variable component is an incentive to limit their amount. If no corrective measures are adopted, the sanctions can be applied in the same year in which the deficit is judged to be excessive.

<sup>11</sup> Budgetary rules in EU countries and their recent evolution are examined in Hallenberg, Strauch and von Hagen (2001) and von Hagen, Hughes Hallet and Strauch (2001).

contribute to by maintaining sustainable budget positions. There is an incentive for each sub-national government to exploit the benefits accruing from the discipline of others without itself complying with the rules (free-riding). This may create a double cost for the other entities: the free-rider's excessive indebtedness can put pressure on interest rates to rise and it can result in bankruptcies requiring bail-outs.

In principle, this incentive problem can be dealt with both via market-induced discipline and via regulations. However, the effectiveness of the market in inducing fiscal discipline requires that certain conditions are met: no government body should have privileged access to the market; the market should have access to all the information necessary to evaluate the financial conditions of each government; bailing-out troubled governments should not be allowed; public authorities should react to market signals (Lane, 1993). These conditions are difficult to attain and unlikely to apply simultaneously. "Creative accounting" and "window dressing" may hinder the assessment of the true conditions of sub-national government finances. The no bail-out clause may not be credible, especially in those countries where the public sector plays an important role in providing public services and goods. The reaction-time of decentralised fiscal authorities may be excessively long (Blondal, 1999). Consequently, in most countries, market rules are widely supplemented by regulations.

Excluding pervasive administrative controls, which by their very nature are incompatible with a federal structure, two solutions may be considered: co-operative management of indebtedness and the introduction of rules and sanctions for non-compliance<sup>12</sup>.

With co-operative solutions, all levels of government must be involved in formulating the objectives of economic policy and be responsible for their attainment. The incentive problem is addressed through moral suasion and peer-pressure. Co-operation may require protracted negotiations, especially when a large number of bodies is involved, to the detriment of the effectiveness of economic policy. Nevertheless, co-operative solutions can permit greater flexibility in dealing with unexpected circumstances.

Rules modify directly the incentive faced by governments. They bring benefits in terms of transparency and speed. They can increase the predictability of governments' behaviour, thereby reducing the level of uncertainty in the economic environment. But they also raise some problems, such as credibility of their rigorous application, in particular for the management of bail-outs, and the possibility of efficient monitoring to avoid forms of "creative accounting".

For these reasons, several countries have adopted eclectic approaches that combine rules with forms of co-operation based on peer pressure (Ter-Minassian and Craig, 1997; Banca d'Italia, 2001b). Some administrative controls are also frequently used. In some countries, fiscal targets are specified by the law; in others, they are the outcome of budgetary procedures in which both co-operation and controls may be present. In federal countries and in countries characterised by a high degree of decentralisation, recourse to debt is generally permitted to any government tier. The rules generally limit the overall size of the deficit (either directly, or indirectly via thresholds for interest outlays) and allow indebtedness for certain purposes only (usually public investment). The constraint on indebtedness generally applies *ex ante*: possible

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<sup>12</sup> Rules may obviously be the outcome of a co-operative decision-making process, but once defined they avoid the need to search for a consensus about each budgetary policy issue. Ter-Minassian and Craig (1997) note that there is some scope for co-operation also in a rules-based approach.

overshoots may be compensated for in subsequent financial years. Further budgetary flexibility is sometimes provided by the so-called rainy-day funds<sup>13</sup>.

In assessing the compatibility between fiscal decentralisation at the national level and the rules introduced at European level, three issues gain prominence: the asymmetric structure of incentives and constraints provided by EMU rules with respect to different government tiers; the absence in EMU rules of special provisions for capital outlays; and the need to avoid inducing pro-cyclical budgetary behaviour.

First, EMU rules may exacerbate the free rider problem as they introduce an asymmetry in the structure of constraints and incentives faced by central and sub-national governments. This feature is related to the fact that the rules apply to sovereign states. While compliance with budgetary rules is evaluated with reference to general government data which reflect the behaviour of all levels of government EMU documents do not assign specific responsibilities to sub-national governments. A representative of the central government of each member state sits on the European Council and commits the government of that member state to the common policies<sup>14</sup>. It is the central government that is held responsible and that primarily bears the costs of non-compliance, both in terms of the monetary sanctions and of the loss of reputation.

Second, perhaps reflecting the lack of a federal authority with the power to enforce fiscal discipline, EMU fiscal rules are tighter than those generally introduced at the national level with respect to the funding of capital outlays and the effects of the economic cycle on the budget.

The adoption of rules which are less flexible than the national ones may imply that the existing equilibrium between the central and the sub-national governments turns out to be no longer appropriate. More specifically, the flexibility allowed to decentralised public governments, in terms of deficit financing in exceptional circumstances or for capital spending, may be inconsistent with EMU fiscal rules. However, reducing this flexibility may be problematic.

The call for close-to-balance or in-surplus balances implies that most capital outlays have to be funded out of current revenues. Hence it is no longer possible to spread the cost of an investment project over all the generations of taxpayers who benefit from it. This implies a disincentive to undertake large projects producing deferred benefits and entailing a significant gap between current revenues and current expenditures. It should also be noted that the disincentive is stronger during the transition towards a balanced budget, when, in order to keep the flow of investment unaltered, the gap between current expenditure and revenue grows. This compression effect may be stronger for sub-national governments, where investment spending can fluctuate considerably over time and the cost of projects may easily exceed available current revenues. "Building a school may be an extraordinary effort for a small town, an ordinary one for a big city" (Einaudi, 1948, p. 318; our translation)<sup>15</sup>. The

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<sup>13</sup> For example, this is the case in the United State of America. For a detailed analysis, see Mc Granahan (1999).

<sup>14</sup> See Articles 145 and 146 of the Treaty establishing the European Community, as amended by the Treaty on European Union of 7 February 1992.

<sup>15</sup> On deficit finance Pigou (1927; p. 717) argued as follows: "This process of anticipating revenue has greater justification in the case of a local than in that of the central government. The former deals with a smaller revenue, on which any extraordinary outlay will have greater effect, and it is restricted in its taxing powers,



available evidence, concerning general governments, confirms the link between fiscal consolidation and cuts in capital spending. In 1992, the year of the Treaty of Maastricht, the deficit to GDP ratio exceeded 3 per cent in nine EU countries. In 1997 for all these countries but Greece the ratio was at or below the threshold; all had reduced the investment to GDP ratio; all but Greece and the Netherlands had lowered the investment to primary outlays ratio. Over the same period, investment ratios increased in three of the six countries that met the deficit criterion in 1992<sup>16</sup>.

Economic theory has long maintained that stabilisation policy should be a responsibility of central government due to externalities and spill-over effects<sup>17</sup>. It has also maintained that sub-national government tax bases should be chosen in such a way as to minimise sensitivity to the cycle, thereby avoiding pro-cyclical policies at the sub-national level. The latter provision is not necessarily followed in practice since flexibility for the effects of the cycle at the sub-national level is frequently provided via mechanisms such as rainy-day funds or the possibility to compensate deficits in one year with surpluses in another. These mechanisms are not consistent with EMU rules, which reconcile soundness and flexibility by reference to a target for the cyclically adjusted budget and to a ceiling for the nominal deficit. The latter is valid not only *ex ante* but also *ex post*. Moreover, EMU rules require estimates of cyclical developments and of their effects on the budgets which may be unavailable at the sub-national level (or, if available, may be biased because of measurement problems due, e.g., to the mobility of factors).

### 3. What solutions are there?

First, we explore the feasibility of a smooth adaptation of the existing fiscal framework for lower government tiers<sup>18</sup>. As for bolder steps that may be taken, we focus on two possibilities: the duplication of European rules at the national level and the introduction of a market for “deficit permits”.

**Adapting existing regulations at the national level.** – As already pointed out, control systems in place in most countries set flexible ceilings for the deficit. The ceilings may exclude capital expenditure (golden rule) or may apply only on an *ex ante* basis (i.e. if the deficit overshoots the ceiling the overrun can be compensated in the following years). In some

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while the national government can more easily distribute its outlay from year to year, and possesses full control over its means of revenue. As a general rule, therefore, it is true that loans are convenient, indeed an indispensable, part of the financial machinery of the smaller bodies.”

<sup>16</sup> See Balassone and Franco (2000b) who also examine the possibility of introducing the golden rule in the framework of EMU fiscal rules. Support for the link between fiscal consolidation and investment cuts is also found by Roubini and Sachs (1989) and by De Haan *et al.* (1996) with reference to different periods and for a sample of OECD countries.

<sup>17</sup> The standard reference here is R.A. Musgrave. See for example Musgrave and Musgrave (1984).

<sup>18</sup> We do not take into account the possibility of the EU directly monitoring the fiscal outcomes of sub-national governments. While apparently appropriate in a context in which the budgetary results of large regions are more relevant than those of some Member States, this solution would be politically problematic as it would radically change the relationship between the EU and the member states. Also, the monitoring of a large number of bodies could hamper the effectiveness of procedures that have been set up to deal with 15 governments at most. Indeed, EMU fiscal procedure may have to be revised to cope with the forthcoming enlargement of the Union.

cases (e.g. some USA States) the deficit overshoot must be financed through recourse to specially constituted rainy-day funds, without going to the market.

Adapting these solutions to the new scenario created by EMU rules appears easier in terms of the asymmetric incentive issue and the financing of investment than with respect to the effects of the cycle.

The incentive problem may be tackled by introducing a rule – possibly with a constitutional rank – that gives equal responsibilities to all government tiers with respect to compliance with EMU fiscal rules. This should be supplemented by a peer-review system – whose feasibility and effectiveness would clearly be sensitive to the number of governments involved – and by the introduction of credible sanctions.

Concerning capital outlays, the adoption of the golden rule for lower government tiers would have to be accompanied by an overall ceiling on investment expenditure by sub-national governments. The deficit thus allowed would have to be compensated by a central government surplus with a generous enough margin to allow for counter-cyclical measures, so as to take into account the need for the overall cyclically adjusted general government budget to be close to balance or in surplus.

Rules should be drawn up to define the criteria for allocating among decentralised bodies the overall deficit allowed for investment programmes. To this end, given the difficulties of defining an adequate reference parameter (population, amount of infrastructure, overall receipts, etc.), a co-operative approach could be contemplated. By involving decentralised governments in the process of defining overall budgetary targets, they would acquire greater responsibility for behaving consistently with the pursuit of the targets set and reaching agreement on the allocation of resources. The peer-pressure incentive for compliance generated in a co-operative framework could be strengthened<sup>19</sup> by allocating any sanction handed down by EMU to the bodies responsible for the overshoot<sup>19</sup>.

Finally, with regard to the absorption of cyclical effects on the budget, the application of ceilings that are valid only *ex ante* is clearly in contrast with European legislation, which is based on *ex post* limits (i.e. budgetary outcomes cannot be compensated over time). On the other hand, setting limits that are valid also *ex post* would have shortcomings too:

- (a) The limits would have to be decided on a case-by-case basis in connection with each government's budget sensitivity to the cycle and to the size of expected downturns. Differences may prove politically difficult to justify. As already pointed out, the necessary information may be unavailable or unreliable.
- (b) Without a target in terms of cyclically adjusted balance (whose definition would pose the same difficulties met in defining nominal ceilings), sub-national governments may tend to target the deficit ceiling also during favourable cyclical phases, in order to minimise fiscal effort. This would result in pro-cyclical policies and distort the allocation of resources.

The establishment of rainy-day funds could lessen the incentive problem, since it would increase the visibility of imprudent budgetary behaviour. However, under ESA95, the rainy-

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<sup>19</sup> The overall ceiling and the sanctions should avoid the risk of a "pork-barrel" effect. See for example Chari and Cole (1993).

day funds would have to be subject to limits, so that, again, the same difficulties concerning the definition of deficit ceilings would arise<sup>20</sup>.

One possible solution is a careful selection of tax bases, with own revenues of sub-national governments properly supplemented by transfers, so as to minimise the cyclical sensitivity of sub-national budgets. This would have to be supported by the requirement to balance the budget in nominal terms. However, this solution may not be consistent with a high degree of decentralisation, which would imply autonomy with respect to the level of public services provided and therefore with respect to the level of resources to be used.

**Extending the Stability and Growth Pact to the national level.** – This would clearly eliminate any asymmetry in the incentives faced by different government tiers. However, the financing of local investment expenditure through local taxation could pose particular problems, especially where unusually expensive projects could lead to expenditure peaks.

Moreover, the high number of bodies involved could make monitoring particularly costly. As already pointed out, the evaluations needed for the cyclical adjustment of budgetary data could be especially problematic.

The extension of European rules to the larger decentralised governments only (i.e. to regional governments) could be a solution, provided smaller governments have only limited autonomy. Otherwise, the cost of adjustment would merely be shifted from the central government to the larger sub-national governments.

**A market for deficit permits.** – The thesis that the problems of externalities might be solved by creating appropriate ownership rights and allowing them to be freely traded was first put forward by Coase (1960). Casella (1999) suggests taking this approach to the question of fiscal discipline within EMU. Comparing the negative externality produced by governments running excessive deficits to that of pollution, Casella suggests using the machinery developed in environmental economics to limit deficit levels<sup>21</sup>. In Italy, the *Commissione Tecnica per la Spesa Pubblica* (an experts' committee on public expenditure) also raised the possibility of introducing a system of deficit permits for sub-national governments<sup>22</sup>.

Once the overall ceiling on permits and their initial allotment is set, market incentives would produce, through free trade, the most efficient allocation in relation to the financial needs of the various governments in any given year. The total volume of permits issued can be related to the national economic cycle, so as to allow both a "structural" margin for investment and a variable margin to absorb the cyclical impact on the budget. Borrowing and bond issues lacking debt permit coverage should be prohibited.

The scheme would apparently answer the three problems we have identified in reconciling fiscal decentralisation at the national level and EMU fiscal rules. However, it is subject to

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<sup>20</sup> In order to avoid this problem, ESA95 would have to be modified. Resources drawn from rainy-day funds would have to be treated as government revenue rather than as proceedings of financial transactions. This would amount to a redefinition of EMU fiscal rules and of the relevant balance for budgetary policy (Balassone and Monacelli, 2000).

<sup>21</sup> An early suggestion of a market in pollution permits is Dales (1968). Later a vast literature has developed. For a discussion of the benefits and limitations of the approach see Baumol and Oates (1988).

<sup>22</sup> Commissione Tecnica per la Spesa Pubblica (1998).

three main difficulties. First, while its effectiveness requires that the deficits of the various governments generate the same externality and are thus perfect substitutes, it must be recognised that the risk of triggering a financial crisis is not uniform across governments. If this risk were the function of a single variable, e.g. the level of debt, then one would merely have to make the value of the deficit permits of the governments inversely proportional to their stock of debt. However, the risk depends on a number of factors<sup>23</sup> and determining the value of the permits held by each government is complicated.

Second, the efficiency of the market for permits would depend on the level of competition. This makes the mechanism ill-suited to situations in which the number of governments is small (within the EMU there would be just twelve players, and vastly different in size at that)<sup>24</sup>.

Finally, there is no easy solution to the problem of determining the initial allotment of permits. The possible criteria (GDP, population, etc.) would produce greatly differing allocations. If the demand for permits exceeded the supply, then the countries with an allotment greater than their requirement would enjoy positional rents.

The first two objections appear more cogent for a permit market among member states at EMU level than for one among sub-national governments within each country. Presumably, the risk associated with each entity's deficit is more uniform within countries than between countries: the size of the governments is smaller, and in many cases they have only recently acquired the power to issue their own debt. Moreover, the number of market operators would be vastly greater. Of course, an extensive market could entail high administrative costs.

The third difficulty, which is strictly political, would be encountered at the national level as much as at the EMU level. It would be compounded, at least initially, by sub-national governments' problems in adapting to the new procedure for the allotment of resources.

Apart from these difficulties, the permit system seems better suited to financing investments than to buffering the budgetary effects of the business cycle. Trading in permits could certainly contribute to greater efficiency in resource allocation in public investments. The financial needs associated with investment projects could be planned, and the realisation of work modulated as a function of available resources. As to the cyclical effects, however, the initial allotment would necessarily be based on forecasts of national economic developments. The emergence of a discrepancy in the course of the year could result in over-demand for permits, which would penalise the governments of areas where cyclical performance was especially poor.

**An overview.** – Each of the three solutions has drawbacks. In light of this, a combination of different approaches could usefully be evaluated.

- (a) For larger sub-national governments, a domestic replica of the Stability and Growth Pact would appear to be a feasible solution to both the asymmetric incentives problem and the need to buffer cyclical effects. As far as relatively large regions are concerned, the

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<sup>23</sup> For instance, the risk may depend on the degree of exposure of the banking system, the degree of international openness, and so on. See among others Eichengreen and Portes (1986), Kharas (1984) and Hernandez-Trillo (1995).

<sup>24</sup> The problem could be attenuated by a continuous double auction market (a system used in many financial markets); see Friedman and Rust (1993).

problem of lack of data is solvable and the small number of bodies involved allows an effective peer-pressure system to supplement sanctions when dealing with the incentive problem. In this context, the need to spread investment costs over a number of years could be addressed by a golden rule with an overall deficit cap to be compensated by a central government surplus. Co-operation may lead to an inefficient allocation of borrowing for investment projects. This would be the case if conventional criteria (e.g. size of population), which do not reflect the returns of the different projects, are used for the distribution of borrowing allowances. In this case, the introduction of a market for borrowing-rights could induce more efficient outcomes.

- (b) As to smaller governments, provided that they enjoy a limited degree of autonomy in terms of revenue, a careful selection of tax bases can largely isolate their budgets from cyclical effects. In this case, the requirement to keep the budget balanced in nominal terms – a less sophisticated rule than the one envisaged in the Stability and Growth Pact – could be used to solve the incentive problem without any risk of inducing pro-cyclical behaviour, thereby avoiding the data problem and reducing the monitoring difficulties arising in a “large number” context. Again, a “compensated” golden rule could be used in order to avoid an undue compression of capital outlays.

#### **4. The solutions adopted by five EMU countries**

The structure, responsibilities and means of financing of the sub-national governments in the 15 countries of the EU are very diversified (Smith, 1996; Fischer, 2001; Tables 1 and 2). They reflect national history, traditions and specific political and cultural features.

Sub-national financial autonomy is relatively high in federal states, such as Austria, Belgium and Germany, and in the Nordic countries, where sub-national government traditionally benefits from a high degree of autonomy. Italy and Spain have been experiencing a shift from a centralised to a decentralised structure over the last quarter of the 20th century. In 1995, the ratio of sub-national governments' expenditure to GDP ranged from 6.0 in Belgium to 32.3 in Denmark. However, a low/high ratio does not imply a low/high degree of financial autonomy. For example, in Italy, in the Netherlands and in the United Kingdom the ratio of sub-national government expenditure to GDP was about 10 per cent, but own revenues were limited (2.9 in Italy; 1.7 in the Netherlands and 0.2 per cent in the United Kingdom); on the contrary, in Belgium and in Germany expenditure was, respectively, about 6 and 12,5 per cent of GDP and own revenues covered respectively about a half and almost all the outlays.

On average, sub-national governments in EU countries balance their budget (Fischer, 2001). Nevertheless, this does not imply that they do not run operating deficits, as their budgets usually include sizeable transfers from central government.

Central governments usually set constraints to sub-national governments' finances. In many cases, a golden rule is in place. In other cases, borrowing at the sub-national level has to be authorised by the Finance Minister. In France, Ireland and the United Kingdom the central government can directly restrict borrowing by lower levels of government (Hallenberg, Strauch and von Hagen, 2001). In Sweden a strong constraint on sub-national government finances was introduced in 2001: sub-national governments are required to balance their budget every year and, when a deficit is recorded, the balance has to be restored within two years. On top of limits to borrowing, EU countries frequently adopt explicit co-ordination agreements between different government tiers. Generally, these agreements are more like

voluntary commitments than legally binding contracts. Only Finland does not have either co-ordination procedures or restrictions from central government.

**Table 1**

**Revenue, expenditure and net borrowing in EU countries in 1995**  
(as a percentage of GDP)

	General government			Local governments		
	Revenue	Expenditure	Deficit	Revenue <sup>(1)</sup>	Expenditure	Deficit <sup>(2)</sup>
<b>Austria</b>	52,1	57,2	5,2	9,1	...	0,7
<b>Belgium</b>	48,6	53,0	4,3	2,7	6,0	-0,2
<b>Denmark</b>	58,0	60,3	2,3	16,2	32,3	-0,5
<b>Finland</b>	56,2	59,9	3,7	10,2	...	-0,6
<b>France</b>	49,7	55,2	5,5	4,4	8,4	0,2
<b>Germany<sup>(3)</sup></b>	46,1	49,6	3,5	12,5	13,7	1,2
<b>Greece</b>	37,7	47,8	10,2	...	...	...
<b>Ireland</b>	39,4	41,6	2,2	0,9	...	-0,1
<b>Italy</b>	45,6	53,2	7,6	2,9	11,7	0,2
<b>Luxembourg</b>	48,4	45,1	-3,3	2,8	...	-0,4
<b>Netherlands</b>	47,3	51,4	4,2	1,7	14,0	-0,2
<b>Portugal</b>	40,4	44,9	4,6	...	...	0,2
<b>Spain</b>	38,4	45,0	6,6	...	11,5	0,7
<b>Sweden</b>	60,0	67,6	7,7	15,9	...	0,2
<b>United Kingdom</b>	40,1	45,9	5,8	0,2	9,8	0,3

Sources: Banca d'Italia (2001a), for general government data; national accounts for German sub-national governments; Eurostat (1997), for the remaining sub-national governments data.

(1) Including only current tax receipts; excluding all transfers.

(2) The deficit is computed considering overall revenue (including transfers).

(3) For Germany, sub-national government data refer only to regions.  
sub-national

This section examines five EMU countries. Three countries (Austria, Belgium and Germany) have a federal institutional structure. In Belgium this is a relatively recent development. The other two (Italy and Spain) have substantially increased decentralisation in recent years. In all the five countries, the problems highlighted in the previous section have received attention. Interestingly, none of them have decided to either replicate the Stability and Growth Pact at the national level or to introduce a market for deficit permits. Four of them have adapted their rules to the new European environment, although to a different extent and in different ways. One (Germany) has long discussed reforms, but in the end has left things unchanged.

The five countries considered in this section represent an extremely diversified sample not only in terms of institutional tradition, but also in terms of size, population and economic development. Population size varies from 8 million (Austria) to 82 (Germany); surface from Belgium's 30.5 thousands square kilometres to Spain's 504.8. Population density goes from Spain's low of 78 inhabitants per square kilometre, to Belgium's high of 335 (Table 3).

Table 2

**Composition of tax revenue and social security contributions  
by sub-sector of government in EU countries in 1998**  
*(as a percentage of overall tax revenue)*

	Central government	Local governments	Social security
<b>Austria</b>	52,7	19,6	27,7
<b>Belgium</b>	36,7	28,2	35,1
<b>Denmark</b>	64,9	32,0	3,1
<b>Finland</b>	52,6	22,2	25,3
<b>France</b>	43,6	10,6	45,9
<b>Germany</b>	26,6	30,4	43,0
<b>Greece (1)</b>	68,6	1,2	30,2
<b>Ireland</b>	86,8	2,0	11,2
<b>Italy</b>	58,7	11,8	29,5
<b>Luxembourg</b>	68,2	6,3	25,5
<b>Netherlands</b>	56,5	3,1	40,5
<b>Portugal</b>	67,0	6,1	26,9
<b>Spain</b>	48,0	17,0	35,0
<b>Sweden</b>	58,0	30,8	11,2
<b>United Kingdom</b>	78,2	3,9	17,9

Sources: national accounts for Germany and OECD (2000) for the remaining countries.

(1) 1997 data.

Table 3

**Selected indicators I**

	Population	Km <sup>2</sup>	Density	Nominal GDP <sup>(1)</sup>	GDP <sup>(2)</sup>	per capita GDP <sup>(3)</sup>
<b>Austria</b>	8,092,014	83,849	97	206.04	188.72	23,321
<b>Belgium</b>	10,221,997	30,513	335	246.00	238.78	23,359
<b>Germany</b>	82,087,035	356,159	230	2,025.53	1,844.90	22,475
<b>Italy</b>	57,645,932	301,323	191	1,165.68	1,256.54	21,798
<b>Spain</b>	39,417,994	504,782	78	606.26	673.13	17,077

(1) Billions of euros.

(2) Purchasing power parities GDP. Billions of euros.

(3) Purchasing power parities GDP. Euros.

Sources: Various national sources; Eurostat, for GDP.

Per capita GDP varies from 17.1 thousands of euros in Spain, to 23.3 in Austria and Belgium. Germany's nominal GDP accounts for one third of the euro-area GDP; Austria's share is three per cent. The economy of four countries, the exception being Austria, is characterised by a large regional division in terms of economic development.

The number of "regional" governments varies from 3 in Belgium to 20 in Italy. In terms of territory, population and GDP, the largest regions are on average those of Germany (Table 4).

Table 4

Selected indicators II

	Number of municipalities	Number of regions	Average population per region	Average Km <sup>2</sup> per region	Min. regional GDP per capita <sup>(1)</sup>	Max. regional GDP per capita <sup>(1)</sup>
Austria	2,400	9	899,113	9,317	14,227	33,398
Belgium	600	3	3,407,332	10,171	17,203	48,298
Germany	15,000	16	5,130,440	22,260	14,369	38,671
Italy	8,100	20	2,882,297	15,066	13,186	28,756
Spain	8,100	17	2,318,706	29,693	10,566	23,197

(1) Purchasing power parities regional GDP per inhabitant. Euros.

Sources: Various national sources; Eurostat, for GDP.

The share of sub-national government taxes in general government revenue is highest in Germany (17.5 per cent in 1999 with reference to regions), and lowest in Belgium (4.4 per cent in 1998 with reference to sub-regional authorities; Fig. 1). During the 1990s, the share was relatively stable in Austria, Belgium and Germany. In the second half of the 1990s, it grew in Italy and Spain.

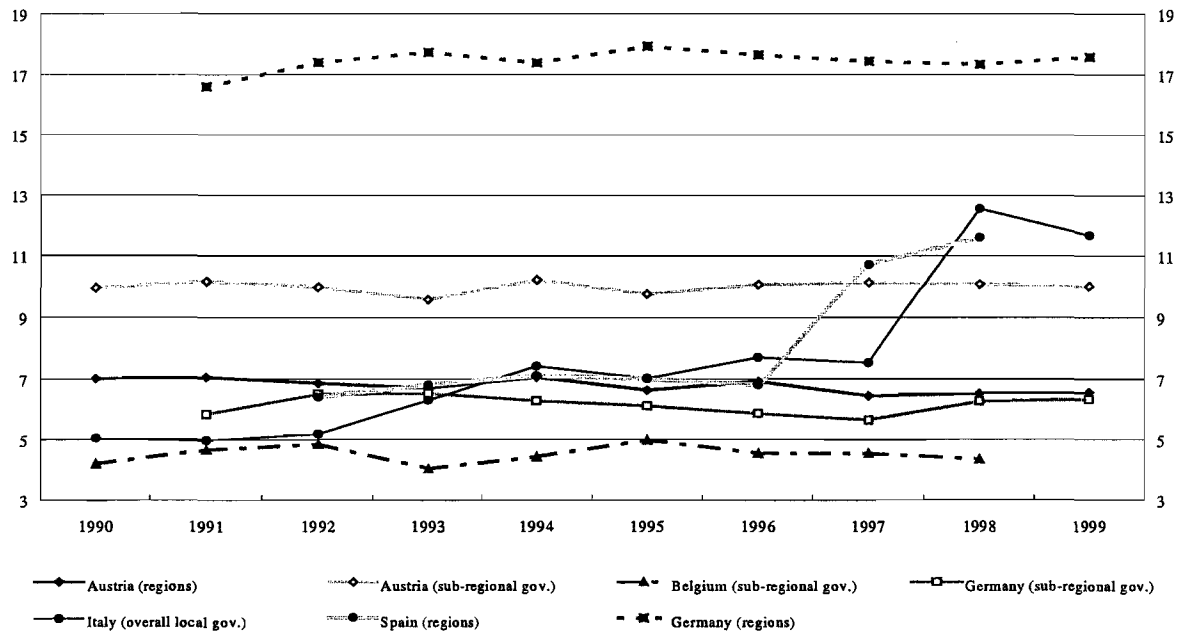
Differences between countries also emerge when measuring the degree of decentralisation in terms of the resources managed by sub-national governments relative to the overall resources managed by general government. The role of sub-national governments in terms of spending is generally much larger than in raising revenues. Indeed, the picture changes when one considers expenditure<sup>25</sup>: in Italy sub-national governments manage a percentage of government outlays which is not much different from that of the German regions (Fig. 2).

As already noted, federalism has the oldest roots in Germany and Austria, the youngest in Italy and Spain. Explicit budgetary rules for sub-national governments were already in place before monetary union only in Germany and Austria.

<sup>25</sup> Data concerning the composition of expenditure by level of government can be to some extent misleading as a measure of the degree of decentralisation in countries where areas of concurrent responsibility between different tiers of government are relevant.



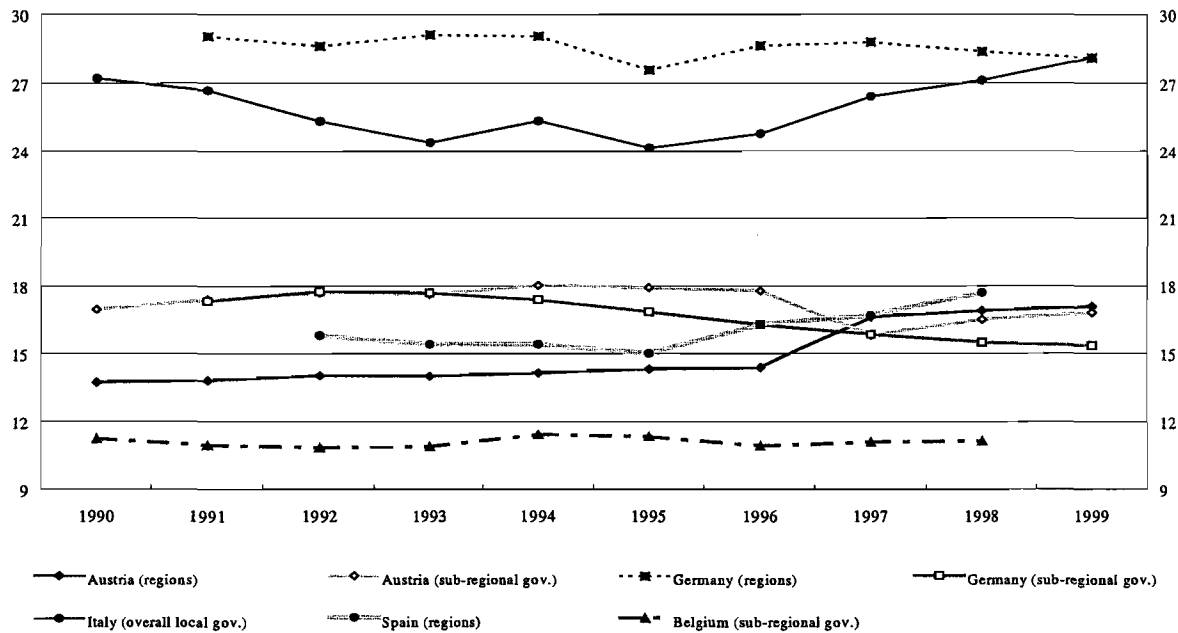
**Figure 1**  
**Local government taxes as a share of general government revenues (1)**



Sources: ISTAT, for Italy; national accounts, for Germany; Gordo and de Cos (2001), for Spain; European Commission (2001), for the remaining general government data; International Monetary Fund (2000), for the remaining sub-national government data.

(1) As a share of general government taxes for Spain.

**Figure 2**  
**Local government expenditures as a share of general government expenditure**



Sources: ISTAT, for Italy; national accounts, for Germany; Gordo and de Cos (2001), for Spain; European Commission (2001), for the remaining general government data; International Monetary Fund (2000), for the remaining sub-national government data.

All countries, with the exception of Germany have introduced some explicit Domestic Pact for sub-national governments<sup>26</sup>. Rules are generally based on agreements between centre and periphery (Fig. 3). The main exception being Italy where rules have so far been largely imposed by central government. This may be due to the relatively short Italian decentralisation experience and to the lack of an institution representing regional governments at the national level (such as the Austrian and the German parliamentary chambers). Nevertheless, Italy also is moving towards a framework where negotiation, co-ordination and consensus between centre and periphery are more important; for example, formal rules are being supplemented by informal procedures to reach agreements in the health sector.

As for flexibility, some margin is generally allowed for investments – with the exception of Austria, Belgium and, only from 2002, Spain – while no explicit mechanism is in place for taking into account the effects of the cycle on public finances (Fig. 4).

**Figure 3**

		<i>Domestic 'Pacts'</i>	
		Imposed	Agreed
Explicit		Italy	Spain, Belgium, Austria
Implicit			Germany

**Figure 4**

		<i>Flexibility for investment</i>	
		No	Yes
<i>Explicit flexibility for the cycle</i>	No	Austria, Spain, Belgium	Germany, Italy
	Yes		

As far as the degree of sensitivity of sub-national governments' budget to the cycle is concerned, there are relevant differences between the five countries considered and, within each country, between the different sub-national tiers. First, the cyclical component of sub-national governments' resources lies primarily within tax revenue; therefore differences in the tax share of total revenue at the sub-national level matter (Fig. 5). Secondly, sensitivity may depend on which taxes are local. Thirdly, sensitivity may depend on the way grants are designed<sup>27</sup>.

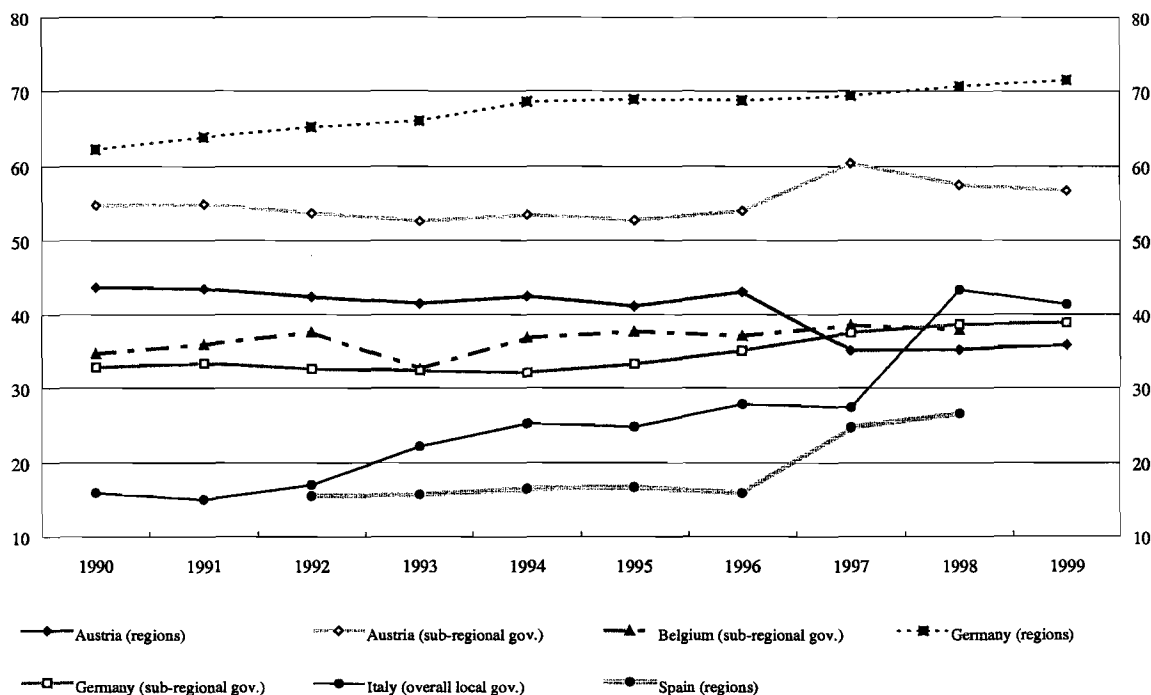
<sup>26</sup> The agreement reached in March 2002 by the federal and regional governments about their joint responsibility for the commitments arising within the Stability and Growth Pact represents a step towards the establishment of a formal domestic pact.

<sup>27</sup> For example, in Germany current transfers from regions to municipalities mainly depend on the level of regions' tax revenues. Moreover, capital transfers from regions to municipalities often depend on the budgetary situation of the regions.

In particular, in Germany, where a relevant share of sub-national governments' revenue comes from income taxes and VAT sharing schemes, both regions and municipalities seem quite exposed to the cycle. In Austria sub-regional authorities seem less exposed to the effects of the cycle than regional ones: even if sub-regional governments' taxes as a share of their resources is higher than that of regions, sub-regional governments are assigned lower shares of taxes which are most sensitive to the cycle. In Belgium, the way grants are designed can partially counterbalance the cyclical changes in local revenues. In Spain, tax revenue as a share of local resources is relatively small so that the effects of the cycle can still be considered limited. Up to the beginning of the 1990s, this was the case for Italy as well. In these two countries the problem posed by the cyclicity of revenues is going to become more pressing as the decentralisation process advances.

Figure 5

Local government taxes as a share of sub-national government overall revenues



Sources: ISTAT, for Italy; national accounts, for Germany; Gordo and de Cos (2001), for Spain; European Commission (2001), for the remaining general government data; International Monetary Fund (2000), for the remaining sub-national government data.

#### 4.1. Austria

Austria has been a federal state since 1920. Government responsibilities are shared between three levels of territorial authority: the central government (Bund), nine federal regions or states (Länder) and about 2,350 municipalities (Gemeinden)<sup>28</sup>.

<sup>28</sup> The public sector includes also professional organisation, social security bodies and public funds. Counties exist only as administrative sub-units of the regions.

The distribution of responsibilities between the central government and the regions is determined by the Constitution<sup>29</sup>. Legislative responsibilities are mostly conferred to the central government. Administrative responsibilities are mostly attributed to regions. The Constitution makes regions responsible for all matters that it does not explicitly reserve to other government levels. Despite the formal dominance of central government, the regions exercise considerable discretion in their relations both with central government and the municipalities.

On the revenue side, sub-national governments largely rely on shared taxes (almost three quarters of their overall revenues in 1994). The sharing mechanism concerns both taxes on income and property (wage and income tax, capital gains tax, interest income tax, inheritance and gift tax) and indirect taxes such as VAT and mineral oil tax.

Austrian federalism is based on co-operation and co-ordination between the government tiers. This feature is apparent when the role of consensus in determining the degree of fiscal equalisation is looked at. The structure of financial provisions is established by the Financial Constitution Law which defines the guidelines for assigning shared and exclusive taxes. The general framework thus defined becomes operational through an ordinary law (Fiscal Equalisation Law) which establishes the details of the rules for tax sharing, intergovernmental transfer and cost bearing between the three levels of government. Before being actually presented to parliament, the Fiscal Equalisation Law is negotiated between the finance minister, the nine regional finance ministers and the representatives of the municipalities. So far, without exceptions, unanimous consensus has been reached on this law. The Fiscal Equalisation Law approved in 2001 covers the period from 2001 to 2004<sup>30</sup>.

More generally, co-operation and co-ordination have been crucial in determining the overall performance of Austrian public finances. In spite of the lack of correspondence between the political responsibilities for spending and taxing, no explicit and binding rule was introduced before the run-up to EMU. In principle, regions and municipalities can use debt-financing only for financing non-ordinary expenditures. Therefore, investment projects should be financed via ordinary revenues, unless investments are such that they can be considered extraordinary. In practice, the distinction between ordinary and non-ordinary budget is rather loose.

In 1999 Austria introduced binding budgetary rules for sub-national governments, which took the form of an explicit Domestic Stability Pact. The main target of the Pact was the stabilisation of general government deficit below the 3 per cent threshold.

In Autumn 2000, a new Domestic Stability Pact was discussed in the context of the negotiations concerning the Fiscal equalisation law for the years 2001-04. In June 2001 the negotiations between central government, regions and municipalities were brought to a positive conclusion<sup>31</sup>. The new Pact sets budgetary obligations and consequences of non-compliance for all levels of government.

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<sup>29</sup> On fiscal relationship between different government levels in Austria see Thoni (1999), and Matzinger (2001a, 2001b).

<sup>30</sup> Previous agreements applied to six year periods up to 1985 and to three year periods thereafter.

<sup>31</sup> As the Fiscal equalisation law, this Domestic Stability Pact covers the period from 2001 (retroactively) to 2004. See OECD (1999).

A budget balance for general government is to be achieved by 2002 as a result of a small federal deficit, surpluses of the regions and balanced budgets by the municipalities. More specifically, according to the Pact:

- (a) Municipalities have to balance their budget over the period 2001-04. This commitment concerns municipalities grouped according to the region they belong to;
- (b) Regions as a group have to reach a surplus of 0.75 per cent of GDP. The Pact allocates the surplus required to each region mainly according to population. However, regions in favourable financial conditions have agreed to have more ambitious targets than the other regions;
- (c) The central government has to reduce its deficit in 2001 and in 2002 and keep the level thus reached thereafter<sup>32</sup>.

The Pact sets up several committees with advisory, co-ordination, supervision, planning and implementation responsibilities<sup>33</sup>. The committees are the main information channel between governments. The Pact requires all authorities involved to provide proper flows of information concerning their budgetary position. Under pre-specified circumstances, sanctions have to be paid in case of failure to deliver necessary information.

During the negotiations concerning the Domestic Stability Pact, a great deal of attention was focused on how to evaluate budgetary outcomes. In the end, an agreement was reached to use ESA95 instead of the Austrian cash-based accounting method. This decision goes in the direction of setting common accounting standards for all levels of government and of harmonising accounting standards in a way which makes national rules compatible with those applied at the European level.

The Pact envisages sanctions only when non-compliance refers to major deviations.. Each year the agreed contribution to the target set for general government has to be achieved not only *ex ante*, but also *ex post*. No specific reference is made to the financing of public investment and to the budgetary effects of the economic cycle.

If the National Statistical Office informs the National Co-ordination Committee about a case of non-compliance, a conciliation committee is set up. The committee asks for an expert opinion on the extent of the shortfall in the contribution to the Domestic Stability Pact. On the basis of the this opinion, the conciliation committee decides the sanctions to be applied according to the Pact.

Sanctions amount to 8 per cent of the contribution to the Pact (i.e. the agreed change in the budget balance) plus 15 per cent of the shortfall but they cannot exceed the shortfall itself. The fine is to be deposited at the Austrian central bank. If compliance is re-obtained within one year the fine is returned; otherwise, the money is allocated across the complying governments. Non-compliance does not lead to sanctions (a) if the general government overall budget is balanced; (b) if non-compliance is due to a change in the interpretation of ESA95 accounting rules; and (c) if there is a revenue shortfall concerning only one level of government due to a Supreme Court decision.

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<sup>32</sup> Austrian Federal Ministry of Finance (2000).

<sup>33</sup> There are a national committee, which represents all levels of government, and eight regional committees.

## 4.2. Belgium

Over the last 30 years, Belgium has been turned from a unitary and highly centralised country into a federal and very decentralised one (Greco, 2000; van Meerhaeghe, 1995; Todman, 1997; Bogaert and Père 2001). The process of the federalisation of Belgium started in 1970 when regions and communities were introduced in the Constitution<sup>34</sup>. In 1993 the federal nature of the country was established and the responsibilities of sub-national governments were extended to their current scope.

The institutional structure of Belgium is particularly complex. It includes the federal government, three economic regions, three linguistic communities<sup>35</sup>, ten provinces and about 600 municipalities. Regions and communities are not subordinate to each other. This structure is reflected in the complex allocation of functional responsibilities<sup>36</sup>. The regions are responsible for infrastructures, transports, agriculture, science policy, foreign trade, employment policy and the environment. They also oversee provinces and municipalities. The communities are responsible for language use and the arts; they have a relevant role in education, social assistance and public health.

Regions and linguistic communities are granted financial autonomy. The federal government remains responsible for raising most of public revenues. An important part of them is automatically transferred to regions and communities<sup>37</sup>. The revenues of central government (VAT and personal income tax) attributed to regions and communities represent about 90 per cent of their overall resources. The VAT share is allocated on the basis of the number of students. The personal income tax share of each region is determined on the basis of the income-tax revenues that can be attributed to each area. However, a solidarity fund provides some degree of redistribution across regions. Regional and community own taxes amount to 8 per cent of total funds, while grants from central government account for less than 3 per cent of their total resources.

The completion of the federalisation of Belgium in the 1990s took place in a context in which fiscal policy was very much affected by the development and the implementation of European fiscal rules. Accordingly, the development of rules and procedures applying to the budgetary decisions of sub-national governments reflected both the pressures stemming from their increasing role and the need to comply with euro-level commitments. The approach taken by the Belgian authorities does not rely on uniform predefined rules (such as the balanced budget or the golden rule), but rather on the consensual definition of yearly targets. In this context, co-ordination mechanisms and the supervisory Council introduced in 1989 (*Conseil Supérieur*

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<sup>34</sup> The new text of the Constitution specified the responsibilities of the federal government and assigned all residual responsibilities to regions and communities. The previous arrangement worked in the opposite way. The legislation enacting the Constitution was passed in 1980 when the territories of the Flemish region and Wallonia were defined and the Flemish and French communities, consisting respectively of all Flemish and French-speaking citizens, were established. In 1983 a German Community was also created. In 1988 the responsibilities of regions and communities were further increased. In 1989 the revenue structure of sub-national governments was modified on the basis of their new responsibilities. The new arrangement was to be fully operational after a transitional period of ten years. In 1989 the Brussels-Capital Region was also created.

<sup>35</sup> Todman (1997) notes that the two types of entities reflect the linguistic nature of the factors determining institutional changes as well as the different objectives of the French and Flemish communities. The Flemish put pressure for the creation of the linguistic communities, the French-speakers insisted for the creation of the economic regions. The Flemish Region and Community are de facto merged.

<sup>36</sup> For instance, four levels of government are involved in the supply of educational services.

<sup>37</sup> The revenue structure of regions and communities is extensively examined in Spinnoy (1998).

*des Finances* – CSF)<sup>38</sup> have a major role. This solution probably reflects the different initial budgetary positions of regions and communities and their limited number. The tensions between the linguistic groups may also have had an influence.

There is no formal rule setting limits to expenditure, deficit and debt levels. However, the CSF sets yearly guidelines for expenditure growth and the deficit level of each institution (federal government, regions, communities, social security authorities)<sup>39</sup>. Primary expenditure is recognised as the control variable for reaching the target set for the overall balance. Sub-national governments are not expected to match expenditure overruns with increases in tax rates. The regions can levy supplements on national taxes, but they have to consult the federal government and the other regions. Regions and communities can issue bonds, but they must have the approval of central government.

There are no provisions for sanctioning procedures. However, legislation enacted in 1989 allows the federal government to limit the borrowing of regions for a period of two years. The restriction would follow a recommendation of the CSF and a consultation with the regional governments.

Over the 1990s, the CSF indicated targets for each region and community. The CSF guidelines were reflected in the convergence programmes of 1992 and 1996 and in the more recent stability programmes prepared in the EMU context<sup>40</sup>. Since 1992 the programmes refer to two groups of public authorities: Entity I, which consolidates the budgets of federal and social security institutions, and Entity II, which consolidates the budgets of regions, communities and sub-national authorities. Targets are set for the primary and the overall balance of the two entities<sup>41</sup>.

In the 1990s, the CSF aimed at gradually reducing the overall deficit of general government and making budgetary balances more homogeneous. In 1999, at the end of the 10-year transitional period for the financing of sub-national governments, the guidelines were revised on the basis of Belgium's fiscal strategy within EMU. For each authority still in deficit in 2000, the CSF confirmed the objective of balancing the budget no later than 2010. A gradual reduction of debt levels was also targeted. The CSF estimated for each government a constant growth rate of primary expenditure over the period 2000-10 consistent with this target.

The early stage of the decentralisation process coincided with a period of sizeable imbalances in public accounts and growing public debt. The final stage, in the 1990s, coincided with a phase of fiscal consolidation and declining debt to GDP ratios. Decentralisation did not hamper the consolidation process. All regions and communities met the CSF deficit guidelines. However, the distribution of the consolidation effort was asymmetric (de Callatay

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<sup>38</sup> The "CSF – Besoins de financement des pouvoirs publics", which is in charge of drafting the reports concerning budgetary targets, includes representatives of federal government, regions, communities and the central bank.

<sup>39</sup> See Conseil Supérieur des Finances (1998). The guidelines of the CSF refer to parameters which do not fully correspond to national accounts concepts. These are not available for each region and community. See Bogaert and Père (2001).

<sup>40</sup> The convergence programmes translated into national accounts data referring to all sub-national governments the budgetary targets set by CSF. On the link between the guidelines of the CSF and the medium-term programmes, see de Callatay and Savage (1998).

<sup>41</sup> The Federal government also asked the CSF to provide an annual report on the achievement of the targets set in the Stability Programme. See Conseil Supérieur des Finances (1999).

and Savage, 1998; Bogaert and Pèrè 2001). The federal and social security authorities largely contributed to fiscal consolidation in the 1990s. The rate of growth of primary expenditure was particularly low for Entity I, while Entity II could benefit from the strong revenue growth guaranteed by the transitional rules. De Callatay and Savage (1999) note that this asymmetry is problematic in terms of resource allocation (expenditure cuts can only be implemented on some budgetary items) and incentives (regions and communities may consider themselves immune from the effects of shocks).

At present, all regions are recommended to maintain or gradually reach a budget balance. The need for borrowing for investment projects is not recognised, in spite of the fact that net public investment has been negative or close to zero in recent years and that regions are responsible for most capital spending. Bogaert and Pèrè (2001) note that, in the Belgian political context, the differentiation of budgetary targets, even on the basis of capital expenditure, could prove difficult. It would raise problematic issues concerning the contribution of each authority to reducing debt levels. For this reason, a uniform deficit threshold for all regions is considered more appropriate.

The effects of automatic stabilisers on the budget are not explicitly taken into consideration in setting the budgetary targets of sub-national governments. The resources transferred to regions are computed on the basis of data concerning the previous year. This implies that sub-national governments tend to be insulated from cyclical factors and that the federal government has to ensure, if necessary with active fiscal measures, the achievement of the target set for general government. Bogaert and Pèrè (2001) note that this issue is now under consideration and that there is some consensus on regulating expenditure growth for each authority on the basis of a structural budget balance.

The CSF suggests that each region or community should produce an internal stability programme covering the same period considered in the programme submitted within the EMU framework. It also advocates that the National Accounts Institute provides national accounts data for each region and community.

### **4.3. Germany**

Germany has a federal structure made up of three main government levels: the central government (Bund), sixteen regions or states (Länder) and 15,000 municipalities (Gemeinden)<sup>42</sup>. While the Constitution confers powers primarily to the regions, these powers have been gradually eroded in favour of central government. This process is related to the importance of concurrent legislation and to the principle of federal law overriding regional law<sup>43</sup>.

Each level of government has its own tasks and is responsible for financing the expenses related to these tasks. As far as budgetary decisions are concerned, in principle sub-national authorities are autonomous. Nevertheless, there are important interrelations and interdependencies between the different government levels. As far as the provision of public goods is concerned, the Constitution establishes the principle of “uniformity of living

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<sup>42</sup> On fiscal relationships between different government levels in Germany see Deutsche Bundesbank (2001), Spahn and Foettinger (1997), Wendorff (2001) and Zimmermann (1999).

<sup>43</sup> Even in areas of primary regional responsibility, region’s tasks have been reduced by increasing joint decision making and sharing of responsibilities.



conditions” (instead of minimum standards). Moreover, the “confederate principle”, which derives from the Constitution, establishes that all governments guarantee for one another. Moreover, the budget of municipalities is subject to direct financial monitoring by the regions and regions largely affect the financial position of municipalities by transferring an important amount of resources. In this sense, the structure of the German decentralisation is to some extent hierarchical.

The strong interrelationships between different tiers of government show up also in the financing system of the sub-national authorities. Most sub-national governments’ revenues come from revenue sharing schemes. Both vertical and horizontal redistribution schemes are relevant (these equalisation schemes mainly aim at achieving the uniformity of living conditions target). Shared taxes were more than 70 per cent of overall taxes in 1999. Wage and income tax, corporate tax and turnover tax are almost equally distributed between the central government and the regions, while municipalities receive 15 per cent of the income tax revenue. Exclusive taxes are not very important. Sub-regional governments benefit from the local business tax and from the property tax; regions benefit from inheritance and motor vehicle tax even if they cannot choose the tax rate or base; the central government benefits from the solidarity surcharge on income taxes and from excises.

Given these basic features of German decentralisation, it is important to stress that German federalism has been based on the co-operation between different tiers of government and between the authorities belonging to the same tier. This is also reflected in the framework of budgetary arrangements applying to sub-national governments. There are explicit rules defined by the Constitution. Moreover, there are implicit rules which are based on consensus rather than on the central government power to impose them.

According to the budgetary autonomy of each level of government, each authority can finance its expenditure through borrowing. A golden rule budget constraint envisages that borrowing is allowed only for investment expenditure<sup>44</sup>. There is also an indirect limit to borrowing which comes from the “confederate principle”: each government has to take into account the effects of its choices on the other governments.

In particular, regions are subject to provisions included in regional constitutions and budgetary statutes, the latter being based on central government regulations. These statutory regulations basically concern investment expenditure (i.e. reference is made to the golden rule) and generally imply only weak constraints on regional borrowing.

Provisions for municipalities are somewhat more binding: borrowing can be used only if other financing is not feasible or appropriate and it is always subject to regional approval. The golden rule is more strictly defined (investments are defined as a narrower concept).

The co-operative nature of German federalism was confirmed after the approval of the Maastricht Treaty. Indeed, the “Act on the Treaty on the European Union” which was approved by both the Bundestag and the Bundesrat at the end of 1992, established that “obligations arising for the Federal Republic of Germany from the legal instruments of the

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<sup>44</sup> In principle, this rule also applies to central government (Constitution, Article 115). Nevertheless, in practice the rule does not really work as a constraint as it can be avoided when the business cycle is not favourable. Moreover, it is valid only *ex ante* and it can be referred to a rather broad concept of investment.

European union [...] are to be fulfilled on the basis of an agreement between the federal government and the Länder”.

In spite of this formal commitment, no provisions acting as a domestic stability pact were introduced in Germany. The federal government proposed to determine a legally binding allocation of the Maastricht deficit limit both vertically between central government and regions and horizontally across regions. This allocation would have been relevant only in the case of an excessive deficit for the general government, as defined in the Maastricht Treaty. The debate which followed this proposal concerned: (a) the extent to which binding deficit allocations are actually required; (b) how to allocate the deficit both vertically and horizontally; and (c) the rule according to which fines set at the European level should be paid by non-complying governments. The debate was non-conclusive, so that eventually no domestic stability pact was introduced.

This outcome may reflect a certain lack of urgency. Up to 2000, the general government net borrowing was well below the 3 per cent threshold and in recent years the deficit of sub-national governments has been relatively limited. More importantly, the outcome also reflects the co-operative nature of the German federalism. Indeed, the central government cannot introduce a domestic stability pact without the approval of the regions. In turn, the regions do not agree on crucial elements of such a pact because they have no interest in undertaking binding agreements which do not provide them with advantages.

With the publication of the most recent estimates on the general government deficit in 2001, the debate on the introduction of a domestic stability pact has gained new importance. Indeed, in 2001 regions seem to have played a role in determining a significantly higher than expected general government net borrowing. Moreover, last December the Bundestag and the Bundesrat agreed on an amendment to the Budget principle act concerning the compliance with budgetary discipline in the EMU framework. This amendment is not a strictly binding rule. Nevertheless, it states that the federal government and sub-national governments shall aim to reduce net borrowing and to achieve a balanced budget and that, if budgetary discipline of the central, regional and local authorities does not comply adequately with the requirements, the Financial planning council shall discuss the reasons and make recommendations on adequate budgetary measures to be implemented. Finally, in Spring 2002, in the context of the Financial Planning Council the central and regional governments stated their joint responsibility for the commitment arising from the Stability and Growth Pact and reaffirmed the objective of balancing their budgets. They also agreed upon the introduction of ceilings to the outlays of the different government tiers.

#### **4.4. Italy**

After World War II Italy retained a centralised structure for a long time. Although the 1948 Republican Constitution placed great emphasis on the role of the Regions, five of which were granted a high degree of autonomy under special statutes, the 15 ordinary statute regions were actually established only during the 1970s. Up to the 1980s the responsibilities attributed to regions have been relatively limited. The decentralisation process gained momentum in the

1990s and culminated in the constitutional reform of 2001 which has substantially extended regional powers<sup>45</sup>.

The transfer of functions to the regions began in 1972. As initially designed, it was completed in 1978 when most of the functions regarding health care were delegated to the regions. During this period the possibility provided for in Article 18 of the Constitution of delegating some regional function to municipalities and provinces was also implemented. However, health policies were effectively defined at the national level. Regions only had administrative powers.

In the 1970s tax collection was even more centralised at the national level than before. Between 1970 and 1990 sub-national government expenditure grew from 11 to 14.8 per cent of GDP. It also increased as a share of total general government expenditure. Over the same period, sub-national governments' own revenue did not change significantly. In 1990 it was still equal to 2.8 per cent of GDP. Transfers from central government increased from 5 per cent of GDP in the mid-1970s to 10 per cent in 1990. During the 1980s four-fifths of regional budget revenue consisted of transfers from central government. Most of this revenue was earmarked for health care.

During the 1980s and the early 1990s, in spite of a rule limiting sub-national government borrowing to capital spending and in spite of an indirect ceiling to overall borrowing (the cost of debt servicing could not exceed 25 per cent of own revenues), sub-national government outlays regularly overshot assigned resources, especially in the health and local transport sectors. The persistence of large public-sector deficits brought growing awareness of the need to increase the responsibility of local administrators with regard to both the management of services and their funding.

In the 1990s, innovations in the electoral system, such as direct election of the regional governors and municipal mayors, created a tighter relationship between sub-national authorities and their electors, which helped to encourage the reform of sub-national government finances.

Between 1990 and 2000 the tax levying power of sub-national authorities increased significantly through the introduction of both new local taxes, such as the regional tax on productive activities (IRAP), and surcharges on central government taxes, as that on the personal income tax. The process involved also lower levels of sub-national governments (municipalities and provinces), which are mainly responsible for local public transport, primary and secondary levels of education and social and cultural services. These sub-national governments were assigned the municipal tax on buildings (ICI) and a personal income tax surcharge. As a result, the ratio of sub-national government revenue to GDP rose from 2.8 per cent in 1990 to 7 per cent in 2000. In 2000 a legislative decree was passed (n. 56/2000) replacing most of the previous State transfers with co-participation in central government tax revenue, the most significant of which is a 38.55 share in VAT receipts.

The need for tighter budgetary discipline in sub-national government finances was reinforced in the run-up to EMU. In 1996 and 1997 mandatory limits were introduced for transfers from

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<sup>45</sup> On fiscal relationships between different government levels in Italy see Arachi and Zanardi (2000), Buglione (1998), Fausto and Pica (2000) and Messina (2001). On the constitutional reform see Fazio (2001), Balassone, Degni and Salvemini (2001), Fossati (2002) and Giarda (2002).

the State to sub-national authorities. In 1999 the so-called Domestic Stability Pact was enacted. The latter is a law of central government, rather than a pact, and its name notwithstanding it does not mimic the European Pact. It is essentially a rule setting maximum ceilings to sub-national governments' deficits growth. Its features hardly make it a binding rule. First, the deficit referred to in the Domestic Pact is not a comprehensive measure as it is computed excluding health, capital and interest outlays. Second, overruns with respect to the ceiling can be compensated in subsequent years; in this respect it is important to note that amendments to the original law introducing the Domestic Pact have retroactively re-defined the budgetary ceilings, allowing higher deficits than would have been possible otherwise.

These features make the Italian pact of little help in disciplining sub-national governments with respect to EMU budget rules<sup>46</sup>. It must also be recalled that the budget deficit referred to for the Domestic Pact is computed according to cash accounting rather than according to accruals accounting as the ESA95 requires. More generally, there is an issue concerning the quality, homogeneity and timeliness of Italian sub-national governments accounting which has so far made it especially difficult to monitor sub-national developments and enforce budgetary discipline.

The Domestic Pact was supplemented by agreements between the State and the regions concerning health outlays. These aimed at constraining expenditure growth, but often proved ineffective due to a lack of incentives on the part of the regions.

These difficulties have become all the more important with the recent constitutional reform, whereby Italy's institutional system has acquired pronounced federalist features. The regions are now the "elements of which the Republic consists" and no longer those "into which the Republic is divided". The change is evident in the reversal of the enumeration of the matters falling within the jurisdiction of the central government and that of the regions respectively. In the 1948 Constitution the matters falling within the legislative power of the Regions were expressly established. In the new text, conversely, the powers of the State are defined.

To fulfil their functions sub-national governments are no longer "assigned" revenues. They now "have independent resources. They enact and collect taxes and enjoy own revenues [...] they share in the revenue from national taxes as generated in their territory".

The new constitutional text gives the central government the power to determine "the essential levels of benefits and services in relation to civil and social rights that must be ensured throughout the national territory". The central government shall establish a redistribution fund for the areas with lesser tax levying capacity and provide additional resources to sub-national governments "to promote economic development, cohesion and social solidarity, to eliminate economic and social imbalances, and to assist the effective exercise of individual rights".

Italy does not have a good track record with respect to financial stability. Its experience with decentralisation is relatively short. It started about twenty years before the Treaty of Maastricht was signed. The rules then enacted have been slowly tightened due to evident shortcomings and in connection with the speeding up of the process of budgetary consolidation during the run-up to EMU. At present, Italy's arrangements can be characterised

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<sup>46</sup> For an analysis of the Italian Pact, see Balassone and Franco (2001a), Balassone, Franco and Zotteri (2001), Balassone and Zotteri (2001) and, for a less pessimistic view, Giarda and Goretti (2001).

as explicit rules imposed by the centre. In principle, a golden rule is also in place for sub-national governments. With the recent reform of the Constitution, this rule has been given constitutional status. Flexibility for unexpected circumstances is allowed in that borrowing limits can be relaxed.

#### 4.5. Spain

The territorial organisation of Spain was changed by the 1978 Constitution which introduced the regional governments. Since then, the regions have played an increasingly important role in the management and financing of public services<sup>47</sup>. This devolutionary process is not yet completed. Own revenues still represent less than 30 per cent of overall regional revenues. Some regions have not yet taken over the responsibility for major public services (such as health and education). The extent of autonomy varies across regions due to both constitutional reasons and the fact that the process of devolution has been based on a co-operative approach with the regions. These were allowed to decide if and when to move to more advanced steps in the process.

Three groups of regions can be distinguished: (a) the Regions with a Special Status (SSRs), that is the Basque Country and Navarra, which enjoyed some degree of administrative autonomy even prior to the 1978 Constitution and had specific Charter Laws since the Middle Ages; (b) the so-called Regions under article 151 of the Constitution (151Rs; i.e. Andalusia, Catalonia, the Canary Islands, Galicia and Valencia); and (c) the remaining ten regions, the so-called Regions under article 143 of the Constitution (143Rs).

SSRs have full autonomy concerning both revenues and expenditures. Indeed, the Basque Country and Navarra regions transfer to the central government some of their resources to contribute to the financing of the services which are left in the responsibility of the latter (such as defence and diplomatic representation). 151Rs and 143Rs have limited financial autonomy, with the first group being characterised by a wider range of responsibilities in the field of public services and by a faster process of devolution than the second.

Decentralisation in Spain conforms to three principles: (a) it should not undermine the unity of Spain, so internal barriers and hidden support are excluded; (b) least developed regions should be supported in the catching up process; and (c) regional governments should have sufficient resources to finance the services in their domain.

The principles of financing for 143Rs and 151Rs were laid down in the 1980 Law for the Financing of the Autonomous Regions. A Fiscal and Financial Policy Council (FFPC) composed of representatives of central and regional governments was set up to discuss the development of financing arrangements. The institutions were to be established and tested over a transitional period lasting up to 1986. After that period, three subsequent agreements on regional financing were reached within the FFPC, applying respectively to the years 1987-1991, 1992-96 and 1997-2001.

During the transitional period, the financing needs of regions were negotiated on the basis of *ad hoc* calculations. The central government retained most of the taxing power, with regional finance being based on transfers. Later arrangements gradually moved towards predetermined

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<sup>47</sup> On fiscal relationships between different government levels in Spain see OECD (1993), Monasterio, Sánchez and Blanco (1999) and Gordo and da Cos (2001).

transfer mechanisms (based on formulas taking into account both cost variables, such as population and dispersion, and distributive variables, such as per capita income and fiscal effort) and larger autonomous financing sources. The last agreement assigned to the regions 15 per cent of personal income tax receipts, with regulatory responsibilities for both the tax rate schedule and the amounts of deductions, allowing for a gradual growth of this share up to 30 per cent<sup>48</sup>.

Tax resources grew from 15.5 per cent of total financing needs in 1992, to 26.5 per cent in 1998. However, the latter percentage masks the fact that the regions which have assumed greater responsibilities for services (151Rs) are relatively more dependent on transfers than the other regions (143Rs). The former obtain only 15.6 per cent of their revenues from own taxes, as against 32.9 per cent for the latter.

At present, the financing arrangements for the regions are extremely articulated. They include both transfer and own resources. The former may come from central government, social security and the EU. They can be general purpose, both cost and distribution oriented, or earmarked, such as those for health. Own revenues are both directly managed, such as wealth taxes and registration duties, and participated, such as the personal income tax.

Due to the relatively low level of own resources and to the negotiation oriented approach taken to first determine regional financing needs, the decentralisation arrangements failed to provide for tight financial constraints. The transfer of responsibilities to regional governments was accompanied by a marked increase in sub-national government employment, probably beyond actual needs, without a commensurate decline at the central level (OECD, 1993). The limits to borrowing, whereby the annual amount of repayments plus interest should not exceed 25 per cent of a region's current revenue, proved ineffective in a context where initial debt was very limited. This in spite of the fact that borrowing should in principle finance only investment outlays (Gordo and de Cos, 2001).

At the beginning of the 1990s it became evident that, given the growing weight of regions, planned budgetary retrenchment, an essential tract of the strategy for the run-up to EMU, could not be achieved without the involvement of regional governments. Improved co-ordination between central and sub-national governments was one of the aims of the 1992-96 financing arrangement, whereby the regions also agreed to participate in the required fiscal adjustment to meet the targets set in the Convergence Programme. The central government made it clear that there was not going to be a bail-out of regions in financial distress.

As from 1992, on the basis of bilateral negotiations with central government, regions agreed to keep deficit and debt below specified targets. These limits were revised twice: in 1995 with the update of the Convergence Programme and in 1998, when the first Stability Programme was presented. The Regions may ask for a derogation from the agreed limits and the State can suspend borrowing by the regions if this were to hamper the Treasury's financial policy.

Borrowing declined from 12.7 per cent of total financing needs in 1992 to 2.6 per cent in 1998. Regional debt grew from 3.6 per cent of GDP to a maximum of 6.5 per cent in 1997, to decline to 6.3 per cent the following year (almost 10 per cent of total general government debt). The most indebted regions are those with larger responsibilities in the field of services (151Rs).

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<sup>48</sup> However, the agreement was not signed by Andalusia, Castile-La Mancha and Extremadura.

In 2001 two new pieces of legislation were enacted: the agreement on Sub-national Government Financing Law (Ley 7/2001 and Ley 21/2001) and the Budgetary Stability Law (Ley 18/2001 and the accompanying Ley 5/2001)<sup>49</sup>.

The former completes the gradual move towards predetermined financing mechanisms and larger autonomous financing sources started in the early 1990s. The agreement is understood to be a final settlement replacing the previous system of periodic negotiations. Financing needs of each region have been determined with reference to a base year (1999). Resources (both own and transferred) corresponding to these financing needs have then been assigned to the regions.

Concerning tax resources, regions can now rely on 33 per cent of personal income tax receipts, 35 per cent of VAT, 40 per cent of special excise duties and 100 per cent of taxes on energy consumption. Regions decide over personal income tax rates (provided the tax remains progressive), while VAT and other indirect tax rates, with some minor exception, remain the responsibility of the Central Government. These tax resources may be sufficient for some regions, therefore a special fund has been set up which redistributes across regions. The resources accruing to the fund will grow at the same rate as the tax receipts of Central Government. The latter no longer guarantees a minimum growth rate of resources available to Regions.

The Budgetary Stability Law replaces the system of bilateral negotiations for the determination of deficit and debt ceilings by a common target for all regions, that of a budgetary position in balance or surplus. In case of non compliance the Law requires the faulty Region to present a financial plan to make up for the deficit over-run (the plan must be approved by the FFPC) and in case the financial behaviour of a Region should cause Spain to breach EMU fiscal rules, that region would have to take care of European sanctions. The Law also provide for an improvement in the statistical standards observed by regions in providing budgetary information.

Spain is a country with an average good record as regards financial stability. Its experience with decentralisation is short. It started little more than ten years before the Treaty of Maastricht was signed and there was no time to set up fiscal rules independently of the process of budgetary consolidation started by the run-up to EMU. Although Spain's rules were developed in the EMU context, there was no attempt to either replicate the Stability and Growth Pact at the national level or to introduce innovative solutions like markets for deficit permits.

Over the 1990s Spain adopted a mixture of explicit and implicit rules largely based on consensus; in principle, a golden rule was in place for sub-national governments and flexibility for unexpected circumstances was allowed in that borrowing limits could be relaxed. As far as the cycle is concerned, being largely based on predetermined transfers, regional finance seemed quite sheltered against revenue losses due to cyclical circumstances.

The recent reform will change the landscape of Spanish budgetary arrangements. Explicit rules for budgetary targets will replace negotiations. Flexibility will be reduced both with

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<sup>49</sup> See Onrubia and Sanchez (2002) and Banco de España (2002) for a detailed analysis and evaluation of the reform.

respect to investment (the target applies to the overall budget) and to the cycle (there will no longer be predetermined State transfers).

## **5. Are the solutions adequate and sustainable?**

In section 2 three critical areas of the interaction between the fiscal rules applying to EU member states and fiscal decentralisation were identified: the incentive problem posed by the asymmetric distribution across levels of government of responsibilities with respect to compliance with EMU fiscal rules; the risk of an undue compression of capital outlays at the sub-national level if borrowing is not allowed; the possibility of a rule-induced pro-cyclical behaviour in sub-national governments policies.

Section 3 examined the possible solutions to these problems and defined a “recipe” suggesting that:

- (a) For larger sub-national governments, a domestic replica of the Stability and Growth Pact, including explicit monetary sanctions, can be introduced to tackle both the asymmetric incentive problem and the need to buffer cyclical effects.
- (b) For smaller governments, a careful selection of tax bases can largely isolate their budgets from cyclical effects. In this way the requirement to keep the budget balanced in nominal terms – a less sophisticated rule than the one envisaged in the Stability and Growth Pact – can be used to solve the incentive problem without any risk of inducing pro-cyclical behaviour.
- (c) To avoid compression of investment outlays, the introduction of a “compensated” golden rule (i.e. a golden rule with an overall deficit cap to be compensated by a central government surplus) together with a co-operative mechanism to allocate borrowing according to the needs of the different governments can be considered. To the latter effect, if co-operation leads to an inefficient allocation of borrowing for investment projects, the introduction of a market for borrowing-rights can be considered as an alternative solution to induce more efficient outcomes.

With respect to the solution identified in principle, the analysis in section 4 highlighted the variety of approaches followed by European countries. Institutions, rules and procedures strongly reflect national history, traditions and specific political and cultural developments. However, the analysis has also shown that:

- (a) No European country has chosen to replicate the Stability and Growth Pact at the national level. Indeed, in most countries there are no predefined sanctions for sub-national governments contributing to a slippage with respect to the targets set for general government (the only exception is Austria). This may reflect technical problems related to the measurement of local GDP and the budgetary effects of the cycle.
- (b) In fact, municipalities and other smaller sub-national governments are usually assigned resources in such a way as to limit the sensitivity of their budgets to the cycle. Indeed, in some countries (e.g. Belgium) this also applies to larger regions. In general, the share of own taxes in sub-national governments revenues is still relatively low. This further contributes to insulate these governments from the cycle.
- (c) All countries rely, albeit to different extents, on co-operative mechanisms to tackle the three identified critical areas. Parliamentary chambers representing regions and advisory councils including representatives of the different levels of government play a crucial role. The major exception is Italy, where effective decentralisation is most recent and



consensual procedures are gradually being introduced. The extent to which co-operation is supported by some elements of control (often in terms of explicit supervision by central government) seems to be in inverse relation with the length of the federalist tradition of a country. The elements of control are stronger in Italy (where the Domestic Pact is in fact a law enacted by the national government) and in Spain (where the involvement of regional governments in the consolidation of public finance was obtained also thanks to a commitment by the central government not to bail-out sub-national administrations) and lighter in Germany (where bailing out is actually foreseen in the Constitution) and in Austria, with an intermediate blend in Belgium (where borrowing by sub-national governments is subject to central government approval).

The budgetary frameworks for sub-national governments adopted by the five EMU member states examined has so far proved successful in terms of deficit control. In Belgium, Italy and Spain the increase in fiscal decentralisation has not hampered the fiscal consolidation process. Between 1993 and 2000, the deficit to GDP ratio has declined from 7.3 per cent to balance in Belgium, from 10.3 to 1.5 per cent in Italy and from 6.8 to 0.4 per cent in Spain<sup>50</sup>. In no country do sub-national governments' finance seem to have put significant pressures on budgetary targets. Furthermore, the Belgian experience indicates that even in a country with significant tensions between the different regions a co-operative approach can be successful.

The question then arises of whether such frameworks can be seen as adequate and sustainable or are there some factors that, while not yet producing effects, may nevertheless require further changes in the future?

The robustness to stress-tests of the co-operative mechanisms used to tackle the incentive problem posed by EMU fiscal rules still needs to be assessed with respect to both economic and institutional changes, the two aspects obviously interacting somehow.

First, one should consider whether the existing arrangements are adequate to deal with relevant shocks, such as a deep recession. Co-operative approaches may require protracted negotiations and prevent rapid adjustment of revenue and expenditure to new circumstances. This may especially apply when a large number of governments is involved, to the detriment of the effectiveness of economic policy.

Second, while at present in most countries (Germany being an exception) sub-national governments' budgets are largely insulated from the effects of cyclical developments, in the future this feature may vanish if more tax bases are assigned to lower government tiers. The choice not to replicate nationally the Stability and Growth Pact may reflect technical problems related to the measurement of local GDP and of the effects of the cycle. The introduction of rainy-day funds can be considered as an alternative.

This takes us to the institutional aspect. It has to be noted that the highly centralised countries which have substantially widened the responsibilities of regional governments have done so mainly in order to cope with political pressures related to the cultural diversity of regions. Economic arguments did not play a primary role. The process is still on course, with relevant changes being introduced in some countries.

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<sup>50</sup> Excluding UMTS receipts.

The current budgetary frameworks are consistent with a limited degree of fiscal differentiation across regions. In most of the countries considered in Section 4, regional governments have actually limited autonomy in setting tax and expenditure levels. In this context, tax-sharing agreements are necessarily complemented by expenditure guidelines, since sub-national governments would not have the possibility of compensating expenditure increases by higher revenue growth<sup>51</sup>.

If a larger degree of autonomy is introduced in the future, which may be the case of Italy, expenditure control would become unfeasible. It may be advisable then to strengthen the role of the rules referring to the budget balance. Moreover, a tight link between revenue and expenditure decisions is important for an efficient allocation of resources. Such a tight link can only work if a budget balance rule is applied.

From an economic point of view, the sustainability of current arrangements may also be questioned on allocative efficiency grounds. If due both to the characteristics of the financing system of sub-national governments, which partly insulate them from cyclical shocks, and to the lack of predefined sanctions, central government ends up systematically compensating for the slippages of other government levels, a misallocation of resources may occur.

The introduction of EMU rules has increased the attention for budgetary outcomes at the regional and local level. At the same time, it has constrained the range of solutions applicable to regulate these outcomes. In particular, EMU rules call for clear accountability and rapid adjustment.

In this respect the introduction of explicit Domestic Pacts, mimicking the Stability and Growth Pact, has marked advantages over purely co-operative mechanisms. The introduction of predefined rules and sanctions may redress the incentive structure facing politicians and induce faster adjustments (Kopits and Symansky, 1998). It may also increase transparency and allow better control of policy implementation on the part of both the electorate and the market.

While all countries are taking steps towards supplementing co-operation with some rules, rules can be especially useful in those countries, such as Italy and Spain, where decentralisation is relatively young and where the number of governments involved is large. Indeed, the reform recently enacted in Spain seem to reflect these concerns. Explicit rules for budgetary targets have introduced to replace bilateral negotiations. Flexibility will be reduced both with respect to investment and to the cycle.

The feasibility of a rules-based approach depends on the adoption of a common accounting and statistical standard. At the European level this was achieved by reference to ESA95. This was also a key element of the co-operatively-defined rules adopted in Austria. Unfortunately, this principle seems to meet harder difficulties in countries whose decentralisation is young. In Italy, for example, it is sometimes claimed that the Constitution gives Regions autonomy also with respect to accounting practices. In Spain the recent reforms explicitly acknowledges the need to improve the degree of transparency of sub-national government finances by requiring

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<sup>51</sup> The introduction of expenditure guidelines for EMU member states to replace the Stability and Growth Pact would be problematic under three respects: (a) institutionally, the question would arise of who is to set the reference growth rate of expenditure for each country (there would be an issue of sovereignty); (b) if the externalities of fiscal policy are determined by deficit and debt levels, rules should refer to these parameters and not to expenditure; and (c) operationally, as member countries can change their tax system the need would still arise to use rules for the budget balance.

that a central statistical archive be set up to ensure that budgetary information of the same standard as that produced by central government is also made available by Regions.

EMU fiscal framework has given new prominence to intergovernmental relationships. However, it is worth recalling that the main issues had been clearly identified and discussed a long time ago. "The extent to which the liberty of experiments in taxation should be conceded to the subordinated bodies must, we believe, be carefully limited. For the smaller units the taxes should be absolutely laid down, and also the maximum to be raised, but the opportunity of economy should not be denied then on the condition that they duly discharge their necessary function. The larger circumscriptions are fairly entitled to greater latitude. A higher standard of intelligence may be expected from their representatives, and their economic resources are more varied. But even with them the need for supervision cannot be said to be absent." (Pigou, 1927, p. 409-10).

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