Fiscal Decentralization: how to harden the budget constraint

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1. Introduction

The title of the present paper is somewhat misleading. I am not sure that there are general solutions to the problem of the soft budget constraint in intergovernmental relationships, in the sense of ready-to-make recipes which work for any country and any period. There are some reasonable suggestions, which will be detailed in what follows and that an organization such as the European Commission may want to advocate among member countries. But at the end, each country will have to find its own way, on the bases of its own institutions. Also, international comparisons tend to be misleading and must be treated with care. What works in a country may not work in another, and what seems it could not possibly work, it may actually manage to function in some cases. I will discuss this point more explicitly with reference to the Italian case, because it is the one which I know best, but the problem is more general. Political institutions, especially those linked to intergovernmental relationships, are ripe with contradictions and hard-to-follow commitments. In this nth best world, practical solutions are often very different from what one would like to advice in a first best world, where laws and political commitments are promptly followed by all the institutions involved.

But before entering into the details of the argument, let me step back and start by defining the problem I will discuss in this paper. Intergovernmental relationships around the world seem to be going through some common process. On the one hand, there is a clear and marked tendency towards the formation of international unions, or confederations, across countries. On the other hand, there is also a clear tendency toward decentralisation within national borders, which in some cases has gone so far to induce a dissolution of previously existing national communities. This double process, of upwards and downwards devolution, is so widespread to have led several authors to look for a common culprit, generally identified with the process of “globalisation” of the economy (e.g. Alesina and Spolaore, 2004).

In Europe, which is the focus of the present analysis, we have evidence of both tendencies. On the one hand, the last decade has witnessed the strengthening of the powers of the European Union, its enlargement to 10 new countries, the formation of a monetary Union and the draft of a new Constitution. On the other hand, all the main European countries have gone thorough some decentralisation process, strengthening the legislative and fiscal powers of sub-central jurisdictions (e.g. Darby et al., 2003). As we will see, in some cases this process has taken the form of a simple devolution of powers inside the existing constitutional framework (UK); in other cases, it has also involved truly constitutional reforms, transforming previously unitary countries in decentralised or
federal ones (e.g. Spain, Italy, Belgium, France). Even where the Constitution has not been changed, as in Germany, the traditional financial relationships among different levels of government are currently under review.

It is hard to find a common theme in this decentralization process. Pre-existing linguistic and ethnic cleavages have played a role only in some limited cases (Belgium, Spain); in all other examples, these tendencies have more often represented an attempt to reach more efficient decision making in the provision of local services and in the financing of local governments. Increased levels of competition certainly played a role. There is a large theoretical literature and some empirical evidence which suggest that decentralization increases economic growth in advanced economies (Thiessen, 2003).

Possibly, the European countries are just attempting to re-position themselves in the aftermath of the Common Market. Another important factor has been played by the European Union itself. With the increasing powers assumed by the Union with respect to planning, legislation and transfers to the sub-national territories, it has become important to create political organizations able to communicate directly with Brussels. Hence, the increased role assumed by regional and local governments.

Whatever the cause, this process worries observers and international institutions alike (e.g. Tanzi, 1995; Prud’Homme, 1994). Upwards devolution of powers raises new issues of co-ordination, monitoring and control on the behavior of member countries; downward devolution may make it more difficult to ensure that these policies are effectively implemented, by threatening national governments’ sovereignty. Fiscal discipline in the Euro zone is a clear example. With a common currency, fiscal policy of member countries must be somewhat controlled to avoid negative externalities and contrast free-riding incentives. But national “stability pacts” can be made ineffective by the behavior of sub-central authorities. Nor is a simple transposition of stability pact at local levels necessarily a sufficient solution. For, pacts must be respected, which means that state authorities must have the incentives and the powers to keep local finance in check, and devolution of powers may undermine both.

One of the reasons why this may occur is the so-called “soft budget constraint” problem (SBC from now on), a term originally proposed by Janos Kornai for productive firms in transition economies (Hungary) and then extended to a number of different institutional settings (banks, financial markets, etc.), including intergovernmental relationships. According to SBC theory, the inability of a Principal to commit dynamically to a budget constraint may induce Agents to misbehave, distorting financial and productive choices in expectations of a rescue by the Principal in the case of trouble. In the contest of intergovernmental relationships, the SBC disease may surface in the form of excessive expenditure at a local levels, distortions in local public expenditure, bailing out of local debts, excessive transfers and
rent seeking behavior by local politicians. As a result, the overall efficiency of public expenditure and the fiscal sustainability of the community at large may be jeopardized. As the problem has come to be perceived as serious, a quite large literature has developed. This now includes both theoretical and empirical works, ranging from detailed institutional case-studies to broad comparisons across countries and institutions (e.g. Rodden et al, 2003).

When applied to the European context, this approach raises a number of questions. What does theory suggest in terms of SBC problems in intergovernmental relationships? Is decentralization conducive to fiscal indiscipline? More on the point, is the current process of decentralization in Europe likely to increase the risk of SBC phenomena in the future? Is there hard evidence of SBC being at play in intergovernmental relationships, in particular in Europe? For instance, how well have the Euro-zone countries managed so far to decentralize the Stability Pact at local level? And if the local budget is soft, what can be done to harden it? Which are the implications for the fiscal surveillance of national fiscal policies at the EU level?

To answer these questions, the paper is organised as follows. We start by discussing the theory of SBC as applied to the intergovernmental context. This effort of clarification is important because I feel there is still some confusion going on concerning what SBC exactly is in this context and which are its consequences. We then briefly summarize the main elements of the decentralization process in Europe, asking if theory suggests that the SBC problem is likely to become more important in the future. Finally, we briefly review the empirical evidence concerning the stability pact adopted in Europe, discussing their efficacy. In the last section, using the evidence accumulated in the previous sections, we discuss policy recommendations.

2. Theory

The aim of this section is not that of providing a complete, or even a partial, survey of the literature. Excellent surveys already exist (Kornai et al., 2003), and there is even an entire book dedicated to the SBC problem in the context of intergovernmental relationships (Rodden et al., 2003). Rather, the aim of this section is to assess critically some general themes developed in the literature and use them as a guidance for the discussion. I believe this exercise is worth doing for at least two reasons. First, because the literature on SBC was originally developed in the context of nationalised firms and the banking system and only later extended to the intergovernmental context. But some crucial differences remain and it is important to focus on them to understand the extent at
which the SBC literature (and proposed remedies) can be applied to the intergovernmental context. Second, because I feel that there is still some confusion going on in the literature and an effort of clarification may be useful.

There are then at least three important questions one would wish to ask theory:

*What exactly is a SBC’s problem? When can we say that we are facing a genuine SBC problem and not some other problems linked to intergovernmental relationships?

*Which are the testable implications of the SBC? How can we identify on empirical grounds the existence of a SBC phenomenon?

*Which are the motivations behind the problem and how can we intervene to solve it? In particular, is decentralization bound to increase the likelihood of SBC’s problems?

2.1 What does SBC mean?

For the first question, the literature makes it clear that there at least three identifying elements in any SBC kind of problem.

First, there have to be at least two separate agents or organizations with at least partly contrasting objectives and instruments. In an intergovernmental context, these two agents may be taken as being two levels of governments, a higher level and, one or more, lower levels of governments. To focus on the essential, from now on I will discuss the issue as if there were only two levels of governments, a central and a local one, without considering more complex institutional structure or internal composition of governments. Notice that typically there is also a hierarchical structure between these two levels of governments, with the central level being able to support the lower level, say, because the former can rely on a larger pool of resources than the latter.

Second, there has to be a dynamic structure to the problem. The SBC’s disease is fundamentally a time inconsistency problem; the central government may not wish to take some actions ex ante (say, rescuing the local level), but ex post, after some other actions have being taken by the local level (say, running a high levels of debt), it might find itself unable to resist (it is not
any longer in its interest to do so). The central government thus may be forced to take some actions that it wanted to avoid in the first place. Understanding why the central government cannot commit ex ante, and why its incentives ex post are different from its incentives ex ante, it is the real crux of the matter.

Third, this behaviour on the part of the central level must be expected by the local government. The latter has to know that at least with some positive probability by taking some actions it may force the central government to come to its rescue. These expectations are the heart of the problem. If the local government believed that central government’s actions would not be affected by its behaviour, there would not be perverse incentives for the local government to start with, and therefore there would not be a SBC problem.

2.2 Empirical consequences

This simple list is enough to show how difficult it is to answer the second question, the empirically observable consequences of the SBC problem. First, clearly not all ex post interventions by the central government are examples of SBC problems. For example, if these ex post actions by the central government depend on circumstances outside the control of the local government (say, a natural disaster), then clearly ex post financing does not constitute evidence of a SBC problem. But even if these ex post interventions are a consequence of actions taken at a local level, this does not imply that we are facing a SBC problem. The local government may simply have been unlucky (and then ex post financing is just an example of a proper fiscal co-insurance role among governments), or there may be some other aspects of intergovernmental relationships which do not work properly.

To illustrate. In Italy, most of the debts accumulated by the regions in the provision of health services are routinely bailed out by the central government (Emiliani et al., 1997; Bordignon et al., 2002). But this cannot be taken as conclusive evidence of the existence of a SBC problem in the Italian health sector. It might well be, as Italian regions have always claimed, that the ex ante funding attributed by the central government to the regions to finance health services, which in turn are largely mandated by the central government itself, is not enough. Regions might then run in trouble simply because they do not have enough funding. In order to conclude that there is a SBC problem in the health care sector in Italy, one needs to show something more; namely, that regions
have accumulated those debts (or at least part of them), exactly because they were expecting a bailing out from the national government, and that they would not have done so otherwise.

In other words, the SBC problem is the result of expectations. To show that a SBC problem is in place, one needs to show that expectations have played a role in determining local government behaviour. But since expectations can not in general be observed, this creates a very difficult problem for any attempt of serious empirical analysis. But there is more. A typical problem in the existing analysis of the SBC disease is the persistent confusion which is made between bailing out of local debts (or more generally, ex post funding to local governments) and the existence of a SBC problem. We have just argued that the presence of a bail-out episode does not necessarily imply the existence of a SBC problem; we now claim that the converse is also true. One might well have a serious SBC problem in intergovernmental relationships, without no ex-post intervention or bailing out episodes from the center.

The reason is simple. Local and central governments are generally linked together by a complex web of legislative and financial relationships. Legislative decisions taken at the central level affect the tax bases of local taxes and more generally the financial conditions of local governments; local and regional governments are also typically financed partly trough grants by higher levels of government. Having a SBC problem in the intergovernmental context basically means that local governments receive, directly or through some generous act of national legislation, more funding that they would need according to some efficiency criterion. But this does not imply extra funding necessarily takes place ex post, say as a consequence of an excessive accumulation of debts at local level. Knowing it will be forced to give up ex post if it does not offer extra funding to local governments, the central government may simply decide to give up immediately rather than wait until a later date. For example, because an explicit bailing out of local debts may be more damaging for the credibility of the country that an increase in ex ante funding thorough transfers. Hence, the SBC problem may surface into the form of excessive transfers ex ante, rather than in explicit baling out ex post (Inman (2003) and Bordignon et al. (2002) make this point formally; see also Rodden (2005)). Summing up, the SBC disease introduces inefficiencies in the financial relationships across different levels of government; these inefficiencies may appear in many different forms and not necessarily only as bailing-out episodes or ex post financing. Unfortunately, most of these forms are not clearly discernible on empirical grounds, which further adds to the difficulty of detecting SBC problems in empirical analysis.
2.3 Motivations and the technology of committing

We have then reached the third question; why there should be a SBC problem in intergovernmental relationships? As Kornai et al. (2003) rightly argue ‘it takes two to tango’. If there is a SBC problem, there have to be at least two agents willing to participate to the SBC game; some organisations willing to receive the extra money and some other organisations willing or forced to give this extra funding. Understanding the motivations behind these acts is then the most important issue to address.

2.3.1 The Local government

As for the local government (the receiving organisation in our context), these motivations are not too difficult to understand. Receiving extra funding from the center, either in the form of ex post bailing out of local debts or in the form of extra transfers, basically means footing (part or all) the bills of local services at the expense of the residents of some other jurisdictions. As these residents do not vote for the local government, while local residents do vote and are presumably happy to receive public services without having to pay for them, a local government should only be eager to engage in the SBC game. It then follows that if by taking some actions the local government perceives that it can force the center to give in more money, it will take them.

Still, even this intuitive explanation is too simple, for at least two reasons. First, local politicians may have national ambitions; and forcing the hand of the center in providing extra money may not be the best way to pursue these ambitions. A local politician who damages his party at the central level may find it more difficult to be promoted at the national level. Ceteris paribus, one would then expect that the tendency to misbehave for the local government would be the higher the more adversary is perceived the national government to be, that is, the less likely is for the local politician to pursue his national ambitions under the present political system. And indeed, it is interesting to note that in our own analysis of the SBC problem in the Italian context (Bordignon and Turati, 2003), we found out that regional governments of the same political orientation of the national government received more transfers ex ante and produced less problems ex post (they run less health deficits) than regional governments of different political orientation.
Second, the advantages for local governments to misbehave strongly depend on the reactions of their own citizens. Running a high deficit and being bailed out by the central government, even if it does not imply any other sanctions by the central level, may attach a negative stigma on the local administrator. If local residents perceive the financial difficulties of the local community as an indicator of a lack of competence on the part of the local politician, the latter may be jeopardising his future political carrier by running in financial trouble. He will then refrain from doing so. And indeed, casual observation and empirical evidence (Rodden et al., 2003) show that in those countries where local communities have a strong notion of independence from the center and a strong feeling of identity, episodes of bailing out are more rare and local public finances are more in order.

2.3.2 The Central government

Understanding why the center may instead be willing to participate to the SBC game, offering extra funding to local governments who misbehave, is more difficult. It is useful at this stage to distinguish between two different sources of the problem. As we noticed above, the SBC syndrome is fundamentally a dynamic problem. The ex ante incentives of the central government are different from its ex post incentives; that is, the incentives after some actions have been taken at the local level. But since ex ante the central government knows that it would have these different incentives ex post, a natural question to ask is why the central government does not take actions ex ante to force itself not to accompany the behaviour of local governments in the case the latter misbehave. Indeed, there is a huge economic literature which focuses on the possibility for public authorities to pursue “tie own hands” strategies in the context of commitment problems. In our case, this means that if we have a SBC problem in intergovernmental relationships, this may only be the result of a failure in the technology of commitment of the central government. Either the central government is not fully employing its technology to commit ex ante, or this technology is not available. Hence, the first part of the problem of understanding why central government may want to play the SBC game concerns the technology of commitment.

The second part concerns instead the incentives of the central government ex post. Why is it that ex ante and ex post incentives are different for the central government? Why is it that when faced with a local government in trouble, the central government may wish to step in and rescue it?
2.3.2.1 The technology of commitment

Let us begin with the first part of the question. Here there is an important difference between the usual SBC games in the private sector and the context we are discussing here. The private sector generally can commit ex ante, although there may be problems (generally induced by the incompleteness of contracts) which may make this difficult in practice. The private sector has access to this technology exactly because there is a public sector which offers the services which allow the private sector to commit; the juridical system and the sanctions for the agents who break the contracts.

A government, and in particular the central government, finds it much more difficult to commit. This, for the same nature of governments, the fact they are sovereign political bodies. The very idea of sovereignty has to do with the possibility of changing pre-existing rules. Hence, it is difficult to introduce rules which cannot be broken ex post, if the central government changes his mind and wishes to do so. For example, laws can be passed ex ante which forbids the central government from helping local governments; but the same laws can also be changed ex post. External technical bodies to monitor and control the behaviour of local governments can be introduced; but these bodies can also be overruled if there is the political willingness to do so. Sanctions may be threatened and written down in official documents; but they may not be applied ex post. The story of local finance in Italy, and undoubtedly in many other countries, offers plenty of examples of these commitment failures.

In this light, an extreme form of commitment device are represented by constitutional rules, that is, rules that regulate the financial relationship among different levels of government directly at the constitutional level. The new Italian Constitution, approved in 2001, for example, explicitly forbids the central government from helping the local governments in case of financial trouble, and many other Constitution contain similar norms (e.g. Giarda, 2001). In principle, constitutional rules offer the advantage of making it more difficult for the current government to change its mind. Voting rules and procedures to change constitutional laws are usually more restrictive than rules and procedures to change ordinary legislation, and this adds to the commitment ability of governments.

This, in principle. In practise, at least for the case at hand, intergovernmental financial relationships, one can be rather sceptical that these constitutional rules may play a very important role. Constitutions are very incomplete contracts: the contingencies upon which the constitutional
rules apply are only very vaguely described, and there is a fundamental problem of lack of verifiability of the explicit contract written at the constitutional level. Furthermore, constitutional laws need to be interpreted; and as no constitution forbids the possibility for the central government to help local communities and their citizens in trouble because of external factors (this insurance role of governments is one of the fundamental reason for being part of the same country), constitutional rules can be circumvented. The empirical evidence on constitutional rules at the budget level (e.g. Von Hagen and Eichengreen, 1995, Poterba, 1994) adds some fuel to this scepticism.

Finally, in the context of the technology of commitment, one should also raise the issue of sanctions. Here is another important difference with SBC problems as applied to the private context. In the case of a firm or a bank, the ultimate sanction is the “exit” option. Government or other giving institutions may threaten the receiving institutions with the possibility of bankruptcy and exit from the market, if they do not fulfil some obligations in exchange of extra money (e.g. Li and Minsong, 1999). And “exit” may play an efficiency role in a market economy, as it frees resources which can be used more effectively in other sectors of the economy.

But a region, or a town, cannot “exit” from the market. The most serious sanction which can be imposed on a local government, in exchange of financial rescue, is a temporary suspension of local sovereignty. That is, the substitution of local politicians and administrators with central government officials to take care of the finance of the local community. Similar rules (e.g. bankruptcy procedural) exist in any country and local governments are routinely threatened by the center with a strengthening of these sanctions. However, in practise, at least in democratic countries, these sanctions are very rarely used and always as extreme solutions only.

The reason has to do with politics. Local governments are democratic bodies elected by citizens; and suspension of the sovereignty of political bodies democratically elected is a delicate matter in any democracy. It may create alarm in the media and in the public opinion, it might raise suspicions on the true motivations of the central government, especially if this is of a different political orientation of the local government, and so on. It is not an option that any central government would take easily, whatever the law says. But this also means that some of the options to harden the budget constraints in the private sector are not really available in the public one.

2.3.2.2 The difference between ex ante and ex post incentives
The second part of the question concerns the motivations for the central government to help the local government ex post, that is, the source of the difference between ex ante and ex post incentives. Here, the literature offers two basic insights.

First, central government may be forced to intervene ex post because of *externalities*. Financial troubles in a community, say, may affect the welfare of individuals living in other jurisdictions; and as the central government is interested in the welfare of the national community at large, it must be worried about these spillovers effects. Hence, if the cost of the intervention for the central government is lower than the welfare loss on the communities at large, then the central government is induced to intervene to rescue the local community in trouble. But knowing this in advance, the local community under question has no incentives in preventing the trouble in the first place. In equilibrium, then, the situation is sub-optimal with respect to the first best case in which the central government can commit not to intervene ex post.

In a nutshell, this is the fundamental insight of the seminal work by Wildasin (1997; 2004). To be precise, these papers do not consider financial issues; in the model, there is an unspecified locally provided good (Local transportations? Water cleaning?) with spillovers effects to other jurisdictions. Furthermore, the model only considers welfarist governments. That is, both local and national governments are only interested in maximizing the utility of citizens, with the only difference that local governments are interested in the utility of the residents of their jurisdictions, whereas central government maximises the welfare of the residents in all jurisdictions. But the model could be easily extended to take into account political considerations and different types of goods, including financial ones. This is also to say that the central prediction of Wildasin’s model, that large communities should more easily get help from the central government as they produce larger welfare costs on the residents of other jurisdictions (the usual “too big to fail” argument), should not be taken too seriously. Larger communities presumably also carry a larger part of the extra cost the central government has to pay to finance his intervention; and the importance of spillovers effects does not necessarily depends on the size of the community producing the trouble. It clearly depends on the type of the local public good under consideration. A small community which controls the provision of a good which is very important for the rest of society (say, Water cleaning) may be able to blackmail the central government in offering financial help much more than a larger community which offers local goods which only affect its own residents.
The importance of Wildasin’s argument depends on the existence and the magnitude of these spillovers effects across jurisdictions. Financial markets are a good example at hand. If a financial crises at the local level has the potentiality of affecting the general credibility of a country, say, by increasing the risk of default of national debt and therefore raising the risk premium foreign investors ask to hold the national debt, then central government may be forced to intervene to rescue local governments to avoid further troubles. This, in turn, justifies the introduction of ex ante rules aiming at reducing the probability that a financial crisis occurs at the local level (e.g. Ter-Minassian and Craig, 1997).

Another point to be noted about Wildasin’s argument is that it implicitly points to, or takes for granted, the existence of some serious mis-allocation of functions across governments. According to normative fiscal federalism theory, the optimal allocation of functions to the different levels of government should reflect a “correspondence principle”; local governments should only be assigned the responsibility for the provision of goods and services that affect their residents and not the residents of other jurisdictions. To be sure, this principle can never be fully respected in practise. To apply it properly, we would basically need a different level of government for any different service being offered, with exponentially increasing administrative and coordination costs. Furthermore, the organization of territorial governments in any country reflects more history and geography than abstract economic reasoning (e.g. Oates, 1972).

Still, for Wildasin’s argument to carry some force in the real world, one must presume the existence of some very serious violations of the correspondence principle. Going back to our example above, the solution to the problem of the small community being able to blackmail larger communities does not lie in introducing ex ante committing devices on the central level; it lies in avoiding giving this power to the local community in the first place, assigning the responsibility of the provision of that key service to some larger community, possibly to the central government itself.

To put it differently, Wildasin’s argument raises the fundamental issue of the allocation of functions to different levels of government. To ask if there is a SBC problem lurking forwards, it means asking if the attribution of powers to different levels of government is properly done. This takes us directly to the second argument offered in the literature to justify the existence of a difference between ex ante and ex post incentives for the central government. This argument has
yet to be fully developed formally (see Goodspeed (2002) for a start), but I believe it to be important, surely more important, at least for the case of Italy, than the externality argument.

Another reason why the central government may not allow a local government to run in serious trouble is that the central government itself may be blamed for this trouble. Even though there are no externalities of any sort at play, if the central government itself suffers politically for the difficulties of the local government, this may offer a powerful argument for ex ante, or ex post, intervention. There may be many different reasons why this could happen. Perhaps, the political colour of the local government is the same of the political colour of the central government, and the inability of the local government to cope with local finances may be taken by voters at large as a signal of the incompetence of the national government, thus threatening the latter’s chances of re-election. Perhaps, the local jurisdiction in trouble belongs to some important marginal electoral district for national elections, and the lack of satisfaction of the voters in that district may undermine the political fortunes of the national government if this fails to intervene. Mostly important, the political responsibilities of the different levels of government may not be clearly assigned in some key functions, so that local voters do not know whom to punish for the financial difficulties, as local and central governments keep blaming each other for the responsibility of the trouble.

This is, for example, the situation for health care supply in Italy (but also in Spain and in several other European countries; see next section). Italian regions are in charge of administering the supply of services and of running public hospitals; but the standard of the health services are defined at the central level, who also partly finances the services. In general, health care (like education) is too important an issue for national parliaments and national governments to accept to leave it entirely in the hands of regional or local governments. It does not happen anywhere, not even in old and consolidated federations such as the US, Canada or Australia, where in principle health care and education are exclusive competencies of local and regional states. In all these cases, standard for services are contracted at the central level, which also attempt to influence the characteristics of these services through the “power of the purse”, that is, by transferring earmarked money to regions and local communities in exchange of the meeting of some standards. Clearly, however, these pressures and transfers tend to blur the allocation of responsibility across different levels of governments and make it easier the formation of SBC problems.
Again, this too points towards the constitutional allocation of functions to different levels of government as one of main possible “cause” of the insurgence of SBC problems. Notice further that this may become an important issue in future Europe. As we discuss below, several European countries are in the process of decentralising responsibility to local levels in exactly these functions, in search of administrative efficiency and political accountability. But because these are also examples of shared responsibility, they raise the issue of creating potential for the insurgence of SBC phenomena.

2.3 Other issues

There are at least two other aspects which are worth mentioning briefly, as they are specific to the intergovernmental context. One of these is the presence of vertical imbalance across different levels of government (Pisauro, 2003; Von Hagen and Eichengreen, 1996). If local governments are not financed by local money, they might not perceive the existence of a binding budget constraint, and this in turn may push them to attempt to increase public expenditure (one version of the “fly-paper effect”, e.g. Pola et al., 1996). Moreover, if local governments do not have enough tax resources of their own to meet unexpected shocks in cost or demand conditions, they do not have any way to adjust their resources so as to keep their budget in equilibrium. Hence, any budget constraint set up ex ante is a-fortiori not credible and may foster expectations of future intervention by the central government. This suggests that a necessary condition to reduce SBC problems is that local governments have some flexibility in the use of their resources, including tax autonomy.

It is not a sufficient condition, though. In the presence of SBC problems, local governments may simply decide not to use these resources or to divert them to other uses. We have examples of both types in behaviour in Italy. Even when equipped with tax resources of their own, after the decentralisation process of the beginning of the 90’s and in spite of their mounting health deficits, Italian regions preferred not to use these tax resources, waiting instead for central government’s intervention. And even when they actually increased their regional taxes, they used only part of these resources to finance health expenditure, preferring to use most of them for financing other services, where central government’s ex post financing was less likely.

This is also worth noting, because it shows that SBC problems may not only induce excess expenditure or excess transfers but also a diversion of resources, thus reducing the efficiency properties of (local) public expenditure. Local governments may prefer to invest their revenues in
the provision of the services which are politically rewarding for them, if they expect the central government will take care of the other services where the reputation of the central government is also at stake.

Second, transparent and objective rules for determining transfers to local authorities may help to create a climate which reduces the likelihood of the insurgence of SBC problems. For the reasons already stressed (the political difficulties to implement harsh sanctions on mis-behaving local governments), the financial stability of local finance may largely depend upon the existence of consensual relationships between different levels of government. In a consensual equilibrium, the central government finances properly the local governments, and the latter reciprocate by avoiding to create unnecessary financial problems to the former. In order to create this consensual climate, it is important that transfers are given to local governments according to clear-cut and fully understandable rules, rules which are as much as possible perceived as fair by the local levels themselves. To this aim, the availability and reliability of the data upon which transfers are computed are also an important component of the building up of this consensual climate.

2.4 Is decentralisation more conductive to SBC problems?

Let us then finally consider the question of the relationship between decentralization and the insurgence of SBC problems. Clearly, the ultimate answer must be sought on empirical grounds; it will have to be seen, for example, if the decentralisation process in Europe will produce more or less SBC problems in the future. But since an implicit affirmative answer is what lies behind the worries I referred to in the Introduction, it is worth to investigate what theory has to say on the question. Thus, is decentralisation a possible cause of SBC problems in the intergovernmental context?

At a first glance, the answer would seem to be affirmative. Delegating functions to local levels means creating a new organisation that takes decisions on its own, and for the reasons I have already stressed, it is much more difficult for the central government to control the behaviour of politically elected bodies than say, its own administrative offices, which presumably were in charge of those services before the decentralisation process took place. But it is also important to stress

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1 Rodden et alts (2003:11) make the opposite point that “..only as the municipality becomes a body of its own…the central government might credibly commit to let it face the consequences of its actions”.
that decentralisation itself produces effects which work in the opposite direction of hardening the local budget constraint.

In an interesting recent theoretical analysis, Treisman (2004) explores two of these effects. First, decentralisation may reduce the willingness of the central government to offer financial support to local governments in trouble, because it makes it more likely that the extra resources given to them may be used for the financing of services the center is not interested in. To understand the argument, suppose to offer an extra “move” to local governments after a bailing out has taken place. Suppose that local governments can now decide to divert at least part of the extra resources given by the center away from the financing of a public good the center cares about (say, Health), to the financing of some other services (say, Tourism) which local governments care about, but which are not perceived as particularly important by the center. Anticipating this move, the center would now be less and not more willing to give extra resources to local communities, because its political returns from the extra financing would be reduced. As a consequence, the local budget would be hardened, not softened, by decentralisation, if decentralisation also implies more local autonomy on the spending side. On these grounds, notice that unconditional grants would be more useful to avoid SBC problems than conditional grants, because the former maximise the spending autonomy of local governments.

Second, decentralisation may also increase the role of local governments themselves in deciding about the likelihood of a bailing out. In turn, as the objectives of the different local governments are partly conflicting, this may harden and not soften the local budget constraint. In other words, if the local governments themselves are asked to participate to the decision about if bailing out or not another local government, and if this means that directly, or indirectly through the national budget constraint, the other local governments are also asked to finance the bailing out of a particular government, they may oppose it more than the central government alone would do.2

3. Evidence

So far, theory; what about evidence? Unfortunately, strong evidence in this context is hard to come by. The best work on the subject, the book by Rodden et als. (2003) is a clear example of these

2 This also depends on how local governments are financed; some of the possible structures for local financing may have the opposite and perverse effect to make these more willingly to support a bail-out, as the bail-out would increase and not reduce their own resources. See for instance, Kohlscheen (2003) work on Brazil.
difficulties. The book is a collection of very interesting case studies, tied up together by a general framework. But there is no serious attempt to test if in the various countries the SBC disease finds confirmation in the data. At several stages in the book, the different authors say that there is, or there has been, a SBC problem in the intergovernmental relationships in the country under analysis, quoting anecdotic examples, but no formal model which stresses the empirical observable implications of the theory, or any serious attempt to test that theory, is actually produced.

If anything, the book impresses for the variety of solutions and mechanisms employed in the different countries to keep local governments’ finance in check. Some countries use hierarchical mechanisms; strict regulations, decided by the central government, which constraint the behaviour of local governments, in particularly for what concerns access to the credit markets, but also expenditure caps, hiring constraints, ear-marked transfers, and the like. Others use instead more market oriented mechanisms; local governments are free to borrow and spend, but the ratings attributed by national and international agencies to local debt issues are used as a disciplining device (e.g. Lane, 1993). Some others use constitutional mechanisms; various forms of constraints on the amount of current deficits or debts which can be run at local levels or various forms of budget balanced rules (“golden rules”, typically) written in the federal or state constitutions (e.g. Poterba, 1994).

But even more impressive is the variance in results. Canadian Provinces are basically free to do what they wish, with no hierarchical control from the center and no hierarchical or constitutional limits to borrow; yet, there is no evidence of SBC problems being in place. On the contrary, strict hierarchical regulations are in place, and seem to work, in Norway. There are pressures to increase public expenditure, but not bailing out or risks of financial crisis. Similar mechanisms are in place, but do not seem to work in Brazil or India or Argentina, all countries which present an uninterrupted history of financial instability at local level (e.g. the case studies chapters in Rodden et al, 2003). In Germany, the main problem has not to do with intergovernmental relationships per se, but with the Constitution (Rodden, 2000; Seitz, 2002). The US presents a larger variety of instruments (market and constitutional tools) at the state and cities levels; interestingly, with some well known exceptions, everything seems to work, and SBC problems are basically absent (Inman, 2003; Wollf, 2004). So, perhaps the best way to read the book is in terms of a healthy warning on the difficulties of exporting mechanisms to control local finance across countries. The relationships between different levels of government are deeply ingrained with the history and the tradition of the country, and simple comparisons of instruments may be misleading.
Some more robust econometric analysis is available, although these studies too are plagued by unsolved methodology problems and technical controversy, concerning in particular the problem of how modelling and testing convincingly bailing out expectations. Furthermore, while most authors seem to find evidence of SBC problems being in place in their respective case-studies, the difference in the institutional setting among countries is such that it is difficult to generalize these findings. For example, for Europe, Bordignon and Turati (2003)’s work on Italy suggests that is in political sensible fields such as health care that one is most likely to find SBC problems, but also that a sudden change of regime, as that due to the Maastrict Treaty, may do marvels to eradicate SBC expectations. Petterson-Lidbom and Dahlberg (2003)’s study on Sweden, on the contrary, suggest that it is the history of past bailing outs which is most determinant in shaping expectations of future bailing out. Both Rodden (2000, 2005) for Germany and Bordignon and Turati (2003) for Italy find strong evidence that increasing vertical imbalance matters in increasing expectations of SBC; but this is not confirmed in Sweden. Lago-Penas (2003) finds evidence for the Spanish regions which is compatible with SBC theory, but he also makes the point that this evidence could be compatible with alternative models. As already mentioned, Bordignon and Turati (2003) also finds some support to the idea that political affinity between central and local governments matters in determining SBC behaviour, although in the opposite direction from what is usually assumed. Ceteris paribus, local governments of the same political colour of the central government receive more ex ante transfers, but control more their expenditure ex post, than local government of different political orientation. Finally, Rodden (2003) suggests that “too small to fail” may be more relevant than “too big to fail” for SBC expectations, contrary to Wildasin (1997)’s main result. The other studies, on the contrary, did not find any evidence that size matters for SBC problems.

4. European decentralization processes

European countries are characterised by a large variety of political settings and intergovernmental relationships (e.g. Ter-Minassian, 1997; OECD, 1999, 2002, 2003). To illustrate, the next tables present a number of selected indicators, collected from different sources, on local governments’ structure, competencies and financing in several European countries. As can be seen by the following

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3 This is not the place for technicalities; see Bordignon and Turati (2004) for a more detailed discussion of the econometric issues involved.
tables, European countries vary greatly in terms of structure of local governments, allocation of functions, local governments expenditure, means of local financing etc.

INSERT TABLE 1 ROUGHLY HERE

\footnote{Measuring the effective degree of decentralization in a country (rather than the formal one) is a difficult task. It requires answer questions on who actually takes the decisions on the spending and financing sides. Another reason to treat international comparison with care. See Ebel and Yilmaz, 2001 for a discussion.}
As table 1 shows these differences do not reflect differences in the form of the state; indeed, local governments in the unitary Nordic countries spend much more (with respect to both GDP and general government expenditure), and are much more autonomous, than the regional governments in federal countries such as Germany or Austria. Differences in expenditure levels reflect mainly differences in the allocation of functions across levels of government. This is illustrated in table 2. Roughly speaking, countries where local governments are allocated fundamental functions in the Social Welfare System such as Denmark, or competencies in Health care (Sweden and Italy) or in Education (Belgium) spend much more than countries where these functions are mainly a responsibility of the Central government (the UK, France, Netherlands).

INSERT TABLE 2 ROUGHLY HERE

Conversely, on the financing side, the level of autonomy on the revenue side does not reflect so much difference in expenditure or allocation of functions; it mainly reflects the way in which sources for local taxation are allocated in the different countries. For example, taxes on housing are a common source of revenue for municipalities in all countries, but are exclusively so for the UK, which explains the low level of own financing of its local governments. On the contrary, local governments are almost exclusively financed with the income taxes in the Nordic countries, who also enjoy a large autonomy on the tax rates, and Spain is now going in the same direction (Govecor, 2003). Local governments are financed with a combination of tax shares to the income tax and the VAT in Belgium and Germany, with some tax autonomy in Belgium. Italy, France (and less so, Germany) also use taxes on business activity (the “taxe professionelle” in France, Irap in Italy), which explain, for example, why French local governments enjoy high tax autonomy in spite of their low level of spending.

INSERT TABLE 3 ROUGHLY HERE

Yet, in spite of all these differences across European countries, there seems to be some underlying common trend (Darby, 2003, Bernardi and Gandulia, 2004). First, during the ‘90’s, decentralization has been on the rise almost everywhere in Europe, involving in some cases truly

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5 Where the dual income tax model is in use, meaning that the income tax base only considers labour income.
constitutional changes (Belgium, Spain) and in the others, a devolution of functions and/or of tax resources in substitution of transfers. To quote just the most extreme case, Italy moved from 3% in 1985 to 16% in 2000 in terms of the percentage of local taxes on total tax revenue (see table 4). Second, decentralization and more generally the search of new equilibria between the center and the periphery, is still on the political agenda everywhere, except perhaps in the already very decentralized Nordic countries. In Spain, the process of devolution of competencies (health care and social welfare) to the Autonomous Communities has been recently completed (2003), and their system of financing has also been changed, substituting transfers with taxes, either autonomous or shared. In France, a new Constitution has been approved (2003), and although its main characteristics are still unclear, it plans to transfer to regional departments and regions competencies in health, education, infrastructure, local development etc. In the UK, a devolution process of functions to Scotland, Wales and Ulster has started, and now the debate is how to accompany this process on the financing side, giving these governments also more own resources. In Italy, the Constitution was reformed in 2001, giving shared competencies to regions in a number of subjects as well as new exclusive competencies in others, and the constitutional change is still going on. In Germany, the strong redistributive system across regions has been reviewed, by reducing the amount of horizontal redistribution and by introducing a system of incentives for Lander who manage to increase their tax revenues.

INSERT TABLE 4 ROUGHLY HERE
How are these processes going to affect future SBC incentives? Answering the question would require detailed country-cases analyses which are well beyond the aims of this work. However, one can at least point out some common features. First, most of this decentralization process is taking place in (nationally) politically sensible fields, such as education, health care or social welfare. In Italy, for instance, the most important function which is going to be transferred to regions following the 2001 constitutional reform is education, and there is some risk that the same SBC problems we still have with health care supply may spread to this field (Bordignon et al, 2002). Similar processes already took place in Spain and they will in France. Second, such a profound decentralisation process on the expenditure side may also create problems on the financing side, and in particular to the amount of tax autonomy which can be given to regions and other local governments.

When the amount of decentralization is limited, one can cope with specific taxes and tariffs. But when decentralization goes beyond a given threshold, local expenditure needs to be linked to some more robust tax bases, typically large ad valorem national taxes such as the income tax or the VAT (corporate and capital taxation being obviously out of question). The problem is that the degree of local tax autonomy which can be offered on these tax bases looks rather limited. It is currently none for the VAT, subject to strict European rules (pending VIVAT type of innovations, see Keen and Smith, 1999), and looks problematic for the income tax. First, because over some thresholds, varying regional and local governments rates on the personal income tax may induce inefficient fiscal allocation of labour and of place of residence. Second, because in continental Europe (differently from the Nordic ones), the personal income tax is still playing an important redistributive role at the individual level, which could be jeopardised by different regional tax rates. It is then quite likely, as indeed the available empirical evidence suggests, that these forms of financing will mainly take the form of tax sharing, with limited or zero tax autonomy for local governments.

But extensive use of tax sharing for financing local governments is problematic under several respects. First, it may severe the perceived link between expenditure and financing at the local level, reducing accountability and responsibility for local politicians. Second, it may make the revenues of local governments dependent of choices made by another level, again weakening accountability at local level. Third, it may induce the perverse incentives we discussed above concerning the advantage to other local governments of a single bail out, as in the Brazilian case (see note 2). Fourth, sharing of taxes such as the VAT or the income tax tend to make the regional budget strongly procyclical. Revenues fall in a recession, while social welfare expenditure increases, or stays constant. When
accompanied to limits to borrowing capacities, this may make difficult for the regions to keep a balanced budget over the cycle, so undermining the credibility of balanced budget rules at local level.

Finally, it should also be noted that regional autonomy in fields such as health, education, social welfare do not go very well together with unconditional transfers and interregional redistribution system based on the fiscal capacity of regions. Again, conditional or ear-marked grants reduce accountability at local level and facilitate the intergovernmental responsibility shifting games which are conductive to SBC problems.

5. Internal stability pacts

But are there true signals of a loss of control of local finances in Europe? Here, the answer is more doubtful. Several scholars, for example, noticed the potential conflict from the European Stability Pact for the countries in the Euro area and the decentralisation process which is actually taking place (e.g. Balassone et. Al., 2003, European Commission, 2003). This conflict is due to an asymmetry in the Pact: the fulfilment of the Stability Pact at national level depends on the fiscal behaviour of the general government (including therefore both central and local levels), but only the central level is legally responsible for deviations from the Pact and may be sanctioned as a consequence. There are therefore fears that this asymmetry may jeopardise the fulfilment of the Pact, inducing free-riding behaviour on local levels.

Reacting to these fears, several Euro countries have attempted to decentralise the European Pact at the local level, reinforcing hierarchical controls on local finance which in most of the cases were already in place. This process has taken mainly two forms. In countries such as Austria, Belgium, Germany the approach has been mainly co-operative, the attempt being that of finding a consensual agreement between different levels of government which led to a general fiscal behaviour in line with the Pact. In other cases, such as Italy, France, and Spain, the approach has been mainly that of the fiscal rule, requirements imposed by law by the central government on local governments’ fiscal behaviour, usually obligations not to run current deficits supported by various incentives and sanctions (e.g. OECD, 2003, European Commission, 2003). Spain, with the recent approval of General Law of Budgetary Stability, has moved towards a more co-operative approach, based on an agreement reached

6 Strictly speaking, this is not actually true. First, because the European Stability Pact makes reference to cycle-adjusted public finance figures, while these information are usually not available at local level. Second, because there are differences in accountancy rules between local and national budgets on the one side, and the European accounting rules, on the other.
by all levels of governments to maintain a balanced budget over a multi-annual framework, a time setting consistent with the European Pact.

In all these cases, the ability of the central government to effectively decentralise sanctions at local level has appeared problematic. In Germany, for example, for several years the attempts to introduce an internal Stability Pact by the Bund has been blocked by Laender (whose consensus is necessary for constitutional reasons), who did not want sanctions to be imposed on them in case of failures to satisfy the national pact. But even in Austria, the country where the European Stability Pact has been probably more successfully decentralised, sanctions (detailed in the Internal Pact) require the unanimity of all governments, including the sanctioned ones. In many other cases, sanctions appear vague and open to various disclaimers.

Yet, it does not appear that at least so far this has been conducive to fiscal irresponsibility at local level. The evidence of the 90’s, for example, tell us that the fiscal consolidation process in Belgium, Italy and Spain has not been hampered by the decentralisation process. With the possible exception of Germany, the recent problems to meet the Maastricht rules by several European countries too do not seem to depend on the behaviour of local governments. Italy is a good example at hand. In Italy, Internal Stability Pacts were firstly introduced in 1999, and have been applied, at least apparently, very poorly since. The definition of the objectives to be followed by local governments have been changed basically all years, moving from debt ceilings and expenditure caps to reach a definition of balanced local budget, to go back to a cap on expenditure levels in the recent years (see table 5). However, monitoring has been poor, and sanctions, while draconian on paper, have never been applied.

INSERT TABLE 5 ROUGHLY HERE
Yet, the general results of the National Internal Pact appear broadly satisfactory. With the exception of health expenditure (which has been taken away from the regional side of the Pact since the year 2000), all other items of local expenditure and the local budgets have more or less met the objectives. As shown in table 6, 100% of Regions, and between 70 to 90% of all other local governments have respected the National Internal Pact or its main elements in its various versions during the last 5 years.

![INSERT TABLE 6 ROUGHLY HERE]

Hence, even a weak fiscal rule such as the Italian national pact has played a role in co-ordinating local governments efforts to meet and maintain a balanced budget. Indeed, intergovernmental consulting bodies have been directly involved in the writing and the monitoring of the Pact. Intergovernmental conflicts have been somewhat solved in this interactive process. Thus, in spite of its legal form, the Italian national pact has worked more as an instrument for “moral suasion” than anything else.

**6. Policy suggestions**

Summing up, SBC problems in an intergovernmental context are potentially a very serious threat for the fiscal stability of a country. They may provide an incentive for local governments to inflate the level of public expenditure and to distort its uses, reducing overall efficiency and generating structural imbalances at the national level. For fundamental reasons, national governments have access to a poorer technology for committing ex ante than the private sector, and are therefore more prone to SBC problems. Also, enforcing sanctions on mis-behaving bodies in the public sector is more difficult than in the private one. There is no necessary link between decentralization and SBC; indeed, there are plausible cases where decentralisation hardens the local budgets. However, a poorly done decentralisation does increase the risk of SBC phenomena. If functions are badly allocated across levels of governments, the likelihood of the insurgence of SBC phenomena is bound to rise. On the same token, situations where local governments are largely financed by transfers - above all, conditional transfers- are more likely to produce SBC problems. Tax sharing rules may also produce perverse
incentives as well as make it more problematic keeping the local budget in equilibrium along the cycle. The available empirical evidence roughly supports these general theoretical indications. However, it also warns against easy generalizations; intergovernmental relationships are embedded in the history of the countries and similar intergovernmental institutions may produce different results in different countries.

Which are then the implications of the analysis for fiscal surveillance of national fiscal policies at the European level?

First, the decentralization process in Europe should be monitored with care. Our cursory glance to data does not suggest that there is at the moment evidence of a loss of control of local finance in Europe. But in many cases decentralisation is taking place in (nationally) politically sensible fields and local financing may not be up to its new task, a situation which may generate SBC problem in the future.

Second, although decisions about the internal organization and financing of governments belong to national sovereignty, some suggestions may be made. For instance, decentralization in fields such as education and health, which are particularly sensitive from a political and social standpoint, probably requires ear-marked transfers, as incentives for sub-national governments to ensure adequate quality standards in the provision of such services need to be offered and these require conditional money. But one can insist on having transfers to local communities being based on reliable data, transparent and objectives indicators of regional costs and needs, clear-cut procedures for determining total resources and the like. This should reduce political discretion in the determination of the transfers and thus reduces the insurgence of the responsibility shifting games which are conductive to SBC problems.

By the same token, one could suggest that a reasonable amount of tax autonomy, at least at the margin, be left to local governments. As argued above, large amount of decentralization probably requires to be accompanied by local financing based on large ad valorem national taxes; but there are institutional innovations (such as the Vivat system for VAT) which if introduced would still allow for some local autonomy even on these tax bases.

Third, there is a need of a better coordination between national and local finance, in particular but not exclusively for the Euro group countries. As the experience of national stability pact in Europe proves, sanctions on democratically elected bodies are difficult to impose; fiscal rules and draconian punishments written on paper are ex post difficult to apply. This suggest to advocate instead for a consensual approach in intergovernmental relationships. Among the elements of this approach, one
should consider a multi-annual framework for defining the respect of the rules and some form of insurance against the economic cycle (as in the recent Spanish experience).

Fourth, one can also suggest that *too strict hierarchical controls on local governments* (e.g. expenditure ceiling, conditional transfers, hiring limitations etc.) *should as far as possible be avoided*. This not only because they often do not work ex post, but also because they might undermine the efficiency advantages of decentralisation, including the effects in terms of hardening the local budget constraints. Hierarchical controls reduce the responsibility of local governments about their expenditure levels and composition, and make it more likely to force central government to intervene ex post.

Finally, a partial exception to this prescription may be in terms of the *imposition of rules to manage sub-national borrowing*. This, because of the strong externality effects which may be caused by a loss of control of borrowing at local level, especially in countries with still unsettled public finances and huge levels of pre-existing debts. But also because reliable alternatives seem to be rather poor. For example, despite the fact that they seem to work in countries with sophisticated financial markets such as Canada or the US, one should rather sceptical that market controls alone may be very useful in controlling local finances. The controls imposed by the financial markets on local finances tend to be sudden and abrupt, rather than smooth and continuous. Adjustments in the financial markets tend to occur with a time lag and dramatically, imposing costs on citizens which would be better to avoid.
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Table 1  **Sub-national governments in selected EU member States**

<table>
<thead>
<tr>
<th>Country</th>
<th>Regional Government</th>
<th>Intermediate level</th>
<th>Local Government</th>
<th>Sub-national expenditure as % of total public expenditure</th>
</tr>
</thead>
<tbody>
<tr>
<td>Belgium</td>
<td>3 Regions</td>
<td>10 Provinces</td>
<td>589 Municipalities</td>
<td>23.18</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>3 Communities</td>
</tr>
<tr>
<td>Denmark</td>
<td>14 Counties</td>
<td>275 Municipalities</td>
<td></td>
<td>57.33</td>
</tr>
<tr>
<td>France</td>
<td>26 Regions</td>
<td>100 Departments</td>
<td>36.763 Municipalities</td>
<td>21.69</td>
</tr>
<tr>
<td>Italy</td>
<td>15 Ordinary Regions</td>
<td>100 Provinces</td>
<td>8.100 Municipalities</td>
<td>29.70</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>5 Special Regions</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>2 autonomous provinces</td>
</tr>
<tr>
<td>Netherlands</td>
<td>12 Provinces</td>
<td>548 Municipalities</td>
<td></td>
<td>28.97</td>
</tr>
<tr>
<td>Spain</td>
<td>17 Regions</td>
<td>50 Provinces</td>
<td>8.078 Municipalities</td>
<td>40.16</td>
</tr>
<tr>
<td>Sweden</td>
<td>21 Counties</td>
<td>289 Municipalities</td>
<td></td>
<td>38.54</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>4 Nations</td>
<td>34 Counties</td>
<td>263 Councils</td>
<td>28.36</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>8 English Regions</td>
</tr>
</tbody>
</table>

*Source: OECD (2002)*
Table 2  Sub-national expenditure by function, as a percentage of sub-national government expenditure

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1 General public services</td>
<td>21.1</td>
<td>3.98</td>
<td>10.61</td>
<td>6.09</td>
<td>9.41</td>
<td>6.88</td>
<td>2.00</td>
<td>3.95</td>
<td>6.4</td>
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<tr>
<td>2 Defence</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>0.02</td>
</tr>
<tr>
<td>3 Public order &amp; safety</td>
<td>0.34</td>
<td>2.29</td>
<td>3.36</td>
<td>4.24</td>
<td>12.28</td>
<td>8.1</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>4 Education</td>
<td>34.6</td>
<td>13.39</td>
<td>19.65</td>
<td>1.19</td>
<td>17.93</td>
<td>18.27</td>
<td>4.00</td>
<td>28.69</td>
<td>17.9</td>
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<tr>
<td>5 Health</td>
<td>6.2</td>
<td>16.46</td>
<td>2.29</td>
<td>68.35</td>
<td>2.56</td>
<td>20.54</td>
<td>87.00</td>
<td></td>
<td>10.6</td>
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<tr>
<td>6 Social Security &amp; Welfare</td>
<td>4.1</td>
<td>56.69</td>
<td>17.67</td>
<td></td>
<td>22.61</td>
<td>5.14</td>
<td>32.54</td>
<td></td>
<td>20.1</td>
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<tr>
<td>7 Housing &amp; community amenities</td>
<td>0.76</td>
<td>24.11</td>
<td>1.27</td>
<td>19.98</td>
<td>10.69</td>
<td>5.42</td>
<td>8.6</td>
<td></td>
<td></td>
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<tr>
<td>8 Recreational, cultural &amp; religious affairs</td>
<td>13.2</td>
<td>2.80</td>
<td>7.68</td>
<td>1.38</td>
<td>5.83</td>
<td>5.55</td>
<td>3.05</td>
<td></td>
<td>3.5</td>
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<tr>
<td>9 Fuel &amp; energy</td>
<td>4.22</td>
<td></td>
<td>0.47</td>
<td>0.07</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>10 Agriculture, forestry, fishing &amp; hunting</td>
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<td></td>
<td>1.68</td>
<td>0.03</td>
<td>3.49</td>
<td>0.14</td>
<td>2.2</td>
<td></td>
<td></td>
</tr>
<tr>
<td>11 Mining, manufacturing &amp; construction, except fuel &amp; energy</td>
<td></td>
<td></td>
<td>1.14</td>
<td>0.46</td>
<td>0.99</td>
<td>0.02</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>12 Transportation &amp; communication</td>
<td></td>
<td></td>
<td>3.64</td>
<td>5.69</td>
<td>6.73</td>
<td>7.16</td>
<td>4.86</td>
<td></td>
<td>5.8</td>
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<tr>
<td>13 Other economic affairs</td>
<td>6.1</td>
<td>4.95</td>
<td>1.77</td>
<td></td>
<td>2.73</td>
<td>1.01</td>
<td>4.3</td>
<td></td>
<td></td>
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<tr>
<td>14 Other functions</td>
<td>14.7</td>
<td>7.85</td>
<td>11.45</td>
<td>10.62</td>
<td>14.24</td>
<td>7.00</td>
<td>8.01</td>
<td></td>
<td>13.9</td>
</tr>
<tr>
<td>15 Total</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100.00</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td></td>
<td>100</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Total government expenditure. Consolidated % of GDP</th>
<th>Total sub-national government expenditure. % of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>47.58</td>
<td>n.a</td>
</tr>
<tr>
<td></td>
<td>53.20</td>
<td>30.50</td>
</tr>
<tr>
<td></td>
<td>46.16</td>
<td>10.01</td>
</tr>
<tr>
<td></td>
<td>46.50</td>
<td>13.81</td>
</tr>
<tr>
<td></td>
<td>45.94</td>
<td>13.31</td>
</tr>
<tr>
<td></td>
<td>41.23</td>
<td>16.56</td>
</tr>
<tr>
<td></td>
<td>58.9</td>
<td>22.7</td>
</tr>
<tr>
<td></td>
<td>36.85</td>
<td>10.45</td>
</tr>
<tr>
<td></td>
<td>47.0</td>
<td>17.6</td>
</tr>
</tbody>
</table>

Table 3  **Sources of local financing**

<table>
<thead>
<tr>
<th>Countries (1997)</th>
<th>Tax revenue</th>
<th>Non tax revenue</th>
<th>Grants</th>
<th>Share of sub-national tax revenue on total national tax revenue</th>
<th>Share of sub-national revenue on GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Denmark</td>
<td>50.6</td>
<td>8.4</td>
<td>41</td>
<td>43.9</td>
<td>30.9</td>
</tr>
<tr>
<td>Sweden</td>
<td>79.2</td>
<td>5.1</td>
<td>15.7</td>
<td>31.1</td>
<td>19.9</td>
</tr>
<tr>
<td>Netherlands</td>
<td>9.6</td>
<td>14.4</td>
<td>76</td>
<td>23.2</td>
<td>13</td>
</tr>
<tr>
<td>France</td>
<td>47.0</td>
<td>19.0</td>
<td>34.0</td>
<td>18.7</td>
<td>10.0</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>13.1</td>
<td>12.8</td>
<td>71.1</td>
<td>22.8</td>
<td>10.4</td>
</tr>
<tr>
<td>Spain</td>
<td>37.1</td>
<td>8.9</td>
<td>54.0</td>
<td>18.2</td>
<td>15.7</td>
</tr>
<tr>
<td>Italy</td>
<td>22.9</td>
<td>11.4</td>
<td>65.6</td>
<td>21.7</td>
<td>12.5</td>
</tr>
<tr>
<td>Belgium</td>
<td>78</td>
<td>3.1</td>
<td>18.88</td>
<td>32.9</td>
<td>16.3</td>
</tr>
</tbody>
</table>

*Source: OECD (2003)*

Table 4  **Recent tendencies in selected EU member countries**

<table>
<thead>
<tr>
<th>Countries</th>
<th>Sub-national taxes as a % of sub-national revenue, 1998</th>
<th>Some recent changes in sub-central taxes as a % of total sub-national revenue</th>
<th>Sub-national taxes as a % of GDP, 1998</th>
<th>Some recent changes in sub-national taxes as a % of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Belgium</td>
<td>78.5</td>
<td><em>Up from 26.0 in 1980</em></td>
<td>13.0</td>
<td><em>Up from 1.8 in 1980</em></td>
</tr>
<tr>
<td>Denmark</td>
<td>51.2</td>
<td><em>Up from 38.7 in 1980</em></td>
<td>15.8</td>
<td><em>Up from 13.3 in 1980</em></td>
</tr>
<tr>
<td>France</td>
<td>47.0</td>
<td><em>Up from 40.9 in 1980</em></td>
<td>4.7</td>
<td><em>Up from 2.9 in 1980</em></td>
</tr>
<tr>
<td>Italy</td>
<td>30.0</td>
<td><em>Up from 22.9 in 1996</em></td>
<td>5.0</td>
<td><em>Up from 2.9 in 1996</em></td>
</tr>
<tr>
<td>Netherlands</td>
<td>9.6a</td>
<td><em>Up from 5.3 in 1980</em></td>
<td>1.3</td>
<td><em>Up from 0.8 in 1980</em></td>
</tr>
<tr>
<td>Spain</td>
<td>37.1a</td>
<td><em>Down from 52.4 in 1980</em></td>
<td>5.8</td>
<td><em>Up from 1.1 in 1980</em></td>
</tr>
<tr>
<td>Sweden</td>
<td>74.5</td>
<td><em>Up from 57.0 in 1980</em></td>
<td>15.8</td>
<td><em>Up from 15.2 in 1980</em></td>
</tr>
<tr>
<td>United Kingdom</td>
<td>14.0</td>
<td><em>Down from 29.6 in 1980</em></td>
<td>1.4</td>
<td><em>Down from 3.7 in 1980</em></td>
</tr>
</tbody>
</table>

* Source: OECD (2002)
<table>
<thead>
<tr>
<th>Main objective</th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Regions</strong></td>
<td>Improving the budget (computed net of capital expenditure and interest payments) by 0.1% with respect to local GDP.</td>
<td>As in 1999, but excluding health revenues and health expenditure from the computation of the budget deficit.</td>
<td>Improving the budget by 3% as computed in the Stability Pact for 1999 (net of health care revenues and expenditures).</td>
<td>Ceiling on the growth rate of current expenditure (net of health care and interest payments); no more than 4.5% of the current expenditure of 2000.</td>
<td>As in 2002, but the rate of growth of current expenditure (with respect to the 2000 figure) must be below the planned rate of inflation between 2000-2003 (5.9%).</td>
<td>As in 2003.</td>
</tr>
<tr>
<td><strong>Provinces</strong></td>
<td>As Regions same year.</td>
<td>As in 1999.</td>
<td>Improving by 3% the budget as computed in the Stability Pact for 1999.</td>
<td>Current budget surplus can deteriorate up to 2.5% with respect to 2000. But constraints are imposed on current expenditure, (it cannot grow by more than 6% with respect to 2000).</td>
<td>Expenditure constraints are abolished, but the budget deficits must improve by at least 7% with respect to 2001.</td>
<td>Deficits cannot worsen with respect to 2003, augmented by planned rate of inflation (1.3%). No rules for Provinces in surplus.</td>
</tr>
<tr>
<td><strong>Municipalities</strong></td>
<td>As Regions same year. If data on local GDP not available, improving with respect to primary expenditure.</td>
<td>As in 1999.</td>
<td>As Provinces, same year¹.</td>
<td>As Provinces, same year¹.</td>
<td>As Provinces, same year¹.</td>
<td>As Provinces, same year¹.</td>
</tr>
</tbody>
</table>

¹. Municipalities with less than 5,000 inhabitants are exempted.

Source: Ambrosanio et al., 2004
Table 6 **Percentage of Italian Local Governments who comply with the Internal Pact**

<table>
<thead>
<tr>
<th></th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
</tr>
</thead>
<tbody>
<tr>
<td>Regions</td>
<td>n.a.</td>
<td>100%</td>
<td>100%</td>
<td>80%</td>
</tr>
<tr>
<td>Provinces</td>
<td>81%</td>
<td>99%</td>
<td>92%</td>
<td>76%</td>
</tr>
<tr>
<td>Municipalities</td>
<td>67%</td>
<td>54%</td>
<td>68%</td>
<td>71%</td>
</tr>
</tbody>
</table>

*Source: Corte dei Conti (2004).*