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EFFECTS ON THE FINANCIAL AUTONOMY OF LOCAL AND REGIONAL AUTHORITIES RESULTING FROM THE LIMITS SET AT EUROPEAN LEVEL ON NATIONAL PUBLIC DEBT

Local and regional authorities in Europe, No. 71

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Report by the Steering Committee on Local and Regional Democracy (CDLR)
prepared with the collaboration of Professor Laura Castellucci

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I. INTRODUCTION

A crucial issue in macroeconomic policy is what are, within a given context, the features of a sound budgetary and fiscal policy, that is, what budgetary and fiscal policies are to be implemented, or may be implemented in order to foster sustainable economic development?

Fiscal discipline may be greater in member states of unions than in sovereign countries, as several studies have shown. However, no agreed theory exists on whether strict rules on fiscal policy necessarily produce better economic results than does their absence.

At the very least, a certain “flexibility” (and therefore the existence of a mechanism guaranteeing flexibility) seems necessary. The question of flexibility is indeed highly controversial in theory. In practice, in countries with high levels of debt, the use of flexible fiscal policy in a recession is impaired if the interest rate is higher than the rate of growth.

In fact, the sustainability condition is necessary to stabilise the debt/gross domestic product (GDP) ratio; this result can be reached either by running a primary surplus or by money creation. Resorting to money creation leads to inflation, as shown by the experience of Latin American countries in the 1980s and as confirmed by the experience of east European countries in the 1990s; therefore, the running of a primary surplus appears to be necessary in a high debt/ratio scenario.

This means that the use of fiscal policy to counterbalance economic shocks is practically ruled out. In other words the “flexibility” is lost in a high debt/GDP ratio scenario even when there is not the explicit target of stabilising the debt/GDP ratio.

One may therefore consider that control over the level of overall public sector debt and the annual deficit constitutes a key element in any economic policy. This explains why, in the framework of the European Union, but also on a worldwide scale, specific targets have been set up which impose restrictions on national budgetary policies, in order to reduce or at least stabilise the debt/ GDP ratio.

The aim of this report is to assess the effect on local authorities’ autonomy when such restrictions are imposed at national level. The analysis needs to be carried out on several levels; this is why the scope of this report is rather wide.

The discussion will start with a brief presentation of the Maastricht criteria. These will be considered not in isolation but in the context of similar criteria enforced for analogous reasons by international organisations such as the International Monetary Fund (IMF).

In conjunction with this, the report will attempt to discuss the problem of distinguishing between current expenditure and investment capital expenditure, as there is evidence that under fiscal constraints the latter is the first to be reduced.[1] The classification of public expenditure within the two categories from a "true" economic perspective may be different from the "book-keeping" classification that commonly prevails when arguing about the best way to finance different types of public expenditure.

The analysis will then move on to institutional aspects and practical schemes (in use or under discussion) for co-ordinating budgetary policy among central and lower authorities.

The last section deals with the issue of how restrictions on national economic policy impact on the financial autonomy of local authorities.

The 1990s seem to have been characterised by the belief that lower-tier authorities know better than central government which services their people need and want. Moreover, the direct and closer relationship between the local electorate and local representatives is commonly considered to be an element that fosters efficiency and effectiveness in the provision of local services. These seem to be (almost) definitive arguments in favour of the process of decentralisation, which is in fact prevailing in the political debate.

Nevertheless, the idea that too much decentralisation is "bad" still seems to be quite widespread, as lower-tier authorities cannot cope with the macrostabilisation policy or with the redistribution of income among different areas of the country.

It is not an easy task to decide between these views, or to reconcile them. In practice, much depends on the situation of the specific country under consideration. The balance achieved may be reflected by the solutions retained for ensuring the compliance with the Maastricht – or similar – criteria.

The findings of the study may be applicable to any country, which for several reasons, has to comply with budgetary rules either imposed from outside or self-imposed. A sound budgetary policy is fundamental to economic growth; in other words the problems of the relations between central government and lower-tier authorities are fairly general and their proper solution is important for the welfare of any country, whether it belongs to a monetary union or not.

1 See, among others: N.Roubini and J.D.Sachs, "Government spending and budget deficits in the industrial countries", in *Economic Policy* (1989), pp. 99-132; H. Oxley and J.P.Martin, "Controlling government spending and deficits: trends in the 80s and prospects for the 90s", in OECD *Economic Studies*, 17, pp.145-89.

II. RESTRICTIONS ON NATIONAL BUDGETARY POLICIES

The third phase of monetary union started on schedule on 1 January 1999, with the "irrevocable" fixing of exchange rates for national currencies with the quotation of 31 December 1998.[1] As is well known, the decision to transform a multi-currency Europe into a single-currency area was based on a choice of "gradualism".

Such gradualism implies agreements on some criteria of convergence, which were actually agreed upon by all the participating member countries (eleven countries are participating while two others are member countries not participating in the union from the start).[2]

It was believed that smooth monetary unification would have taken place if every single country involved had satisfied certain conditions. Three of these conditions are particularly relevant for the purpose of this study:

– an annual total nominal deficit no greater than 3 per cent of GDP (in case the ratio was greater than 3 per cent; this condition was considered to be satisfied either if a situation could be deemed exceptional and temporary or if the ratio was steadily declining);
– a cumulated debt no greater than 60 per cent of GDP (or, if a country had a greater one, it should be seen to be decreasing and thus capable of bringing the ratio to the expected value within a reasonable period of time);
– an inflation rate not exceeding the average of the three lowest EMS countries' inflation rates by more than 1.5 percentage points.

When phase three started, all the above conditions were fulfilled by the eleven countries, while for the countries who want to join the union at some later date, the assessment of whether they fulfil the conditions for the adoption of a single currency has been postponed.

The condition concerning the rate of inflation does not give rise to great debate, since its significance is straightforward. The two others are at the centre of a wide debate. The Maastricht Treaty and the Stability Pact refer to "excessive" deficits, to a "sufficiently declining" debt/GDP ratio, to a debt/GDP ratio that approaches the reference value at a "satisfactory pace", and to a deficit/GDP ratio that has to "remain close" to the reference value. Differences in interpretation are therefore inevitable. Besides problems of interpretation, the debate is very important for gaining a better understanding of the functioning of the economies in the monetary union and for assessing its consequences both in terms of policy instruments and benefits for the people.

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1 The first stage, which began on 1 July 1990, involved the complete abolition of any kind of capital control. The second stage, which started on 1 January 1994, involved the creation of a new temporary European institution, the EMI (European Monetary Institute); it was only in operation during this second stage and was then replaced by the ECB (European Central Bank).

2 The eleven countries are: Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, Netherlands, Portugal and Spain. Denmark and the United Kingdom are exercising their right to opt out.

1. Budgetary convergence: the requirement of 3 per cent for annual deficit over GDP and of 60 per cent for debt over GDP

The requirements of reducing annual deficits and debts imposed on countries that intended (or intend) to enter the union, can be justified by several arguments (although they also can be criticised by others). Certainly they raise questions concerning the figures that were chosen: why 3 and 60 per cent?

One possible theory which comes easily to mind, that could explain those two magnitudes and their possible links is embodied in the following formula: $d = gb$,[1] where:

d stands for the ratio of debt to GDP;
g stands for the growth rate of GDP; and
b stands for the ratio of new bonds to GDP.

The theory says that with a steady state (when the rate of growth of newly issued bonds is nil by definition) a given budget deficit is necessary to stabilise government debt. Such a deficit is obtained by the product of *g* and *b*. Therefore, given an expected growth rate of 5 per cent GDP, a deficit of 3 per cent allows for government debt to be stabilised to 60 per cent of GDP (0.03 = 0.05 x 0.6).

This formula shows that the relation between the three magnitudes is precise, but cannot explain why the figure 60 per cent has been retained as the annual deficit ratio.[2] It has been said that: "the only reason why 60 per cent seems to have been chosen at Maastricht was that at that time this was the average debt/GDP ratio in the European Union".[3]

2. The requirement of converging inflation levels

The Maastricht strategy has been greatly affected by an anti-inflationary attitude quite similar to the one prevailing at the IMF. The main concern for the IMF seems to be to secure anti-inflationary policies in countries receiving its financial help (see below). The Maastricht attitude appears to be analogous to this. In fact, restrictions on countries' deficits and debts are simply added to monetary restrictions called for by the deflationary policy.

The importance of recalling the IMF strategy derives from the fact that it can face similar problems to the ones at stake at Maastricht. The IMF sets down conditions on the conduct of national economic policy to help the country cope with its imbalances in the balance of payments.

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1 The derivation of this formula can be found, among others, in L Bini-Smaghi and S. Vori, "Rating the EC as an optimal currency area: is it worse than US?", Bank of Italy Discussion Paper, 187, (1993).

2 If the figure given were, for example, 50 or 75 instead of 60 per cent, this would result in a different figure for the annual deficit (namely 2.5 or 3.75 per cent). This would also imply differences when adjusting other economic magnitudes, not least the rate of employment.

3 P. De Grauwe, *The economics of monetary integration*, 3rd edn, (Oxford University Press, 1997), p. 133.

In setting such conditions the IMF should not impair the future growth of the country, but growth is not its concern. Growth is the concern of the World Bank.

Although in the recent past there have been problems of overlapping between these two international organisations, the dividing line is still that economic problems must be “temporary and exceptional” for the IMF to intervene, while for the World Bank they must be of the longer-term growth type.

The IMF therefore has to deal with short-term financial imbalances, similar to those prevailing in the European Community during the transitional period leading up to monetary union (the third stage of the Maastricht Treaty) and afterwards.

Although the precise conditions concerning loans that are decided on a case-by-case basis have not been publicly disclosed, the fund’s philosophy seems to be clear. It relies on monetary policy and global demand restrictions for short-term adjustments, while in the long term it relies on the law of the competitive market and price mechanisms.

In the IMF approach, the restriction on monetary policy takes the form of a reduction in domestic credit. The stress on the reduction in domestic credit has sound theoretical roots in a model that the fund still seems to adhere to and that is in line with the monetarist approach to the balance of payments. According to this model, monetary restrictions are capable of producing balance of payments adjustments and that is why they are imposed. Indeed, the basic idea is that a deficit in the balance of payments can exist only in the presence of positive domestic credit creation and therefore the solution to the deficits in the balance of payments implies a reduction in the growth of domestic credit.

3. The Stability and Growth Pact and the problem of public investment

The stability and convergence programmes, which must be submitted by the participating and non-participating countries, are fundamental for applying the European Union multilateral surveillance mechanism. In these programmes the economic targets should be fixed, the way of pursuing them specified and the macroeconomic hypothesis on which the probability of success rests made clear.

The basic principle is to achieve a (virtually) balanced budget in the medium term (this target should be reached by 2002) and possibly, in the long term, to run a surplus. The reason for this requirement (apart from the theoretical interpretation of a “sound” fiscal policy in terms of a balanced budget, which is open to question) is to be found in the limit of 3 per cent for the annual deficit, to be satisfied even during the slowing down periods of the economy.

In order for a country to comply with the 3 per cent ceiling on actual deficit (defined as the difference between total current receipts and total outlay) it should have a structural (or cyclically adjusted) deficit of 1 per cent or be close to the balance. This is why a debate on the methods of assessing the structural budget is also flourishing.[1]

In principle, countries enjoy complete formal autonomy in setting up their own budget. However, since the deficit/GDP ratio cannot diverge too much from the reference limit ("excessive deficits" must be avoided), the degree of freedom is, quantitatively, fairly limited. Moreover, as mentioned above, when budget restrictions are imposed a reduction in investment is likely to be the first and/or largest reduction to occur. As a consequence, instead of achieving the targeted future rate of inflation, the country in question may experience a lower growth rate.

In fact, it emerges from both empirical observation and theoretical studies that the "close-to-balance" budget produces a reduction in public investment.[2]
In other words, to assess the inflationary effect of a budget deficit, it is necessary to know not only its magnitude but also its composition. Several scholars and some policy makers (the Dutch for

1 See for instance: *Indicators of structural budget balances*, Bank of Italy, produced for the Research Department's public finance workshop, (1999). This publication presents the methods adopted by the European Commission, the IMF and the OECD.

2 Empirical studies: Roubini N., Sachs J.D. "Government Spending and Budget Deficits in the Industrial Countries", in *Economic Policy*, 1989, p.99-132; De Haan J., Sturm J.E., Sikken B.J., "Government capital formation: explaining the decline", in *Review of world economics*, 1996, p.55-74; Theoretical studies – Balassone F., Franco D., "Public investment in the Stability Pact Framework", in *Concorrenza fiscale in un'economia internazionale integrata*, Bordignon-Da Empoli (eds), Angeli, 19.

Between 1986 and 1996 in Italy the deficit to GDP ratio went down from 12.3 to 6.7 per cent and the public investment to GDP ratio went down from 3.7 to 2.3 per cent. In the same period nine European countries reduced their deficit but also their public investment expenditures. De Haan (and others) also found that the ratio of investment to GDP in twenty-two OECD countries in the period 1980-1992 followed a trend of reduction.

In other words, the introduction of a ceiling to the deficit produces a reduction in the investment level according to the prevailing theory. On the other hand what happened in the countries of the Maastricht Treaty in the period 1992-1997 may be interpreted as an empirical support to the theoretical view. While in 1992 nine countries had a deficit greater than 3 per cent, in 1997 they all (but Greece) had been able to reduce their deficits within the 3 per cent limit but they all had a reduced share of investment in GDP. (See the following table by Balassone-Franco, "Investimenti pubblici e patto di stabilità e crescita: è opportuno introdurre la 'golden rule'", *Politica Economica*, *1998*, p. 345-376.

	Net deficit (percentage of GDP)	Net deficit (percentage of GDP)	Investment (percentage of GDP)	Investment (percentage of GDP)
	1992	1997	1992	1997
Italy	9.6	2.7	3	2.4
France	3.9	3.	3.5	3.1
Germany	2.6	2.7	2.8	1.9
United Kingdom	6.2	1.9	2.1	1.1
Spain	3.8	2.6	4.1	3.1
Belgium	6.9	2.1	1.5	1.4
Denmark	2.1	-0.7	1.7	1.8
Greece	12.8	4	3.5	3.3
Ireland	2.5	-0.9	2	2.2
Luxembourg	-0.8	-1.7	5.4	4.9
Netherlands	3.9	1.4	2.1	1.9
Portugal	3	2.5	3.8	4.3
Austria	2	2.5	3.3	2.6
Finland	5.9	0.9	3.5	2.7
Sweden	7.7	0.8	2.7	2.4

instance) would have preferred to see investment expenditure excluded from the ceiling on deficit (the so-called golden rule). The problem, however, is fairly complicated mainly because it would require a definition of current and investment (capital) expenditure in a true economic sense and not in a formal, book-keeping sense.[1] The aim of avoiding a cutback in investment expenditure is, in some countries, somehow transferred to local level by imposing restrictions on current expenditure only, as is the case with the internal stability pact in Italy.

It is necessary to have both sound fiscal policies at national level and real co-ordination between such policies in order to avoid external effects and to guarantee a low inflation rate in the area covered by the union. It is, therefore, quite natural to start with a common definition of the public authorities' current deficit.

The problem is that the use of 1995 SEC does not guarantee that the formal distinction between current and investment expenditure produces the expected results in terms of future rates of inflation. There are indeed sound reasons to believe that public deficits can be inflationary. However, it is not convincing to rely on the formal distinction between current and investment expenditure for the assessment of their inflationary or non-inflationary effects.

In particular, when looking at the composition of expenditure in the budget in connection with its potential inflationary effects the aspect to keep in mind is whether the specific expenditure will increase the country's productivity. It is appropriate to regard as "public consumption" those forms of expenditure that do not have a productivity component and as "investment", in the true economic sense of the term, those forms of expenditure that have a productivity component. On the other hand, it does not seem appropriate to regard all physical expenditure as investment.

Nevertheless, the formal distinction incorporated into SEC between current outlay and investment outlay corresponds to the nature of the expenditure itself, whether services (i.e. non-physical) or physical.

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1 The golden rule was not introduced in the Maastricht Treaty because it raised the following problems: i. it is difficult to distinguish between investment and non-investment expenditure since the book-keeping definition does not coincide with the true economic one; ii. the golden rule may boost "creational accounting" practices and iii. it requires a specific definition of budget measures.

A simulation exercise was carried out on the basis of the ISPE macroeconomic model (ISPE 1998 and F. Padoa Schioppa, "Conti pubblici e le loro prospettive dopo l'euro", in Paganetto L. (ed), *Oltre l'euro*, Istituzioni, occupazione e crescita, CEIS-Il mulino, 1999) to enquire about what would have happened in terms of the convergence path of the debt to GDP ratio if the golden rule had been in use. The hypothesis of an increase of public investment of 3 500 billion in 1999, of 4 500 in 2000 and of 9 600 in 2001 was made and tested. A significant increase in the rate of growth of GDP (and in the rate of employment) emerged and a faster speed of adjustment to the targeted debt to GDP ratio of 60 would have followed. One can say that excluding investment expenditure (i.e. using the golden rule) from the balancing of the budget in the medium term would have accelerated the process of convergence.

To sum up, the main concern behind the Maastricht Treaty (and that is explicitly at the basis of the Stability and Growth Pact) is to prevent national fiscal policies from being inflationary, control of inflation going hand in hand with control of public budget deficits, although the inflationary effects of a public deficit are not so easy to predict.

The same fundamental aim of controlling inflation can be recognised in the IMF strategy; the IMF directives to curb temporary imbalances in the balance of payments have always been associated with controlling inflation through monetary restrictions, following a monetary approach to the balance of payments deficits. Thus, while the IMF takes inspiration from a consistent view or model of the effects of balance of payments deficits, the Maastricht policy's theoretical bases are less clear.

In fact, from an economic point of view, one may notice several theoretical shortcomings in a policy that imposes figures that are, to a certain extent, arbitrary, and which do not take into consideration the "qualitative" aspects of the budget. But of course the Maastricht approach is not to be judged from an economic perspective alone.

III. DECISION-MAKING MECHANISMS WHICH ALLOW OVERALL PUBLIC SECTOR RESTRICTIONS TO BE TRANSPOSED INTO RESTRICTIONS ON THE VARIOUS LEVELS OF GOVERNMENT

1. Reasons for imposing restrictions on local and regional financial autonomy

There are both political and economic advantages relating to the financial and decision-making autonomy of lower tiers of government.

The political advantages are those commonly linked to the implementation of the principle of subsidiarity. The allocation of substantial public responsibilities to authorities that are closest to the citizens should lead to citizens' empowerment (additional opportunities for the individual citizen to exercise his/her democratic rights) and ensure more effective accountability of public managers and service providers to the population and more responsive provision of services.

Economic advantages result from sound competition between the institutions that can be generated by a decentralised system. This competition can be of two different types depending on the institution involved: vertical (i.e. between central government and decentralised authorities) and horizontal (involving lower tiers). Thus fiscal decentralisation fosters efficiency in the allocation of resources and, in this way, leads to increased social welfare. The works of Musgrave, Oates and Tiebout support this idea.[1]

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1 See in particular: R. Musgrave, "Theory of fiscal federalism" in *Public Finance*, 24, 4, (1969), pp. 521-32; W.E. Oates, *Fiscal federalism*, (New York, Harcourt Brace Jovanovich, 1972); C.M. Tiebout, *An economic theory of fiscal decentralization in public finance needs, sources and utilisation*, (Princeton, New Jersey, Princeton University Press). Oates's "decentralization theorem" shows how centralised decisions produce welfare loss. Tiebout's model, also known as "voting by feet" shows how competition among local tiers produces efficiency in allocation.

When analysing the consequences of fiscal decentralisation, there is also evidence that governments' deficits actually grow faster in centralised countries than in decentralised ones.[1]

Nevertheless, in European Union countries the imposition of restrictions on the financial autonomy of lower levels of government and, in particular, on the possibility of running deficits, appears to be a concern for a number of countries. This attitude may be explained (at least partially) by the following reasons.

Firstly, local indebtedness over a certain level can lead to a decrease in the proportion of the local budget that goes to running public services and may, eventually, jeopardise the financial situation of local authorities.

Secondly, it is widely acknowledged that local authorities are not suitable for playing a large part in the stabilisation activities of the public sector. Economic theory suggests that the stabilisation function should be attributed to central government as central rather than local government can meet stabilisation targets more efficiently.

The third and yet perhaps most relevant reason is complementary to the second one. Within a context of budgetary restrictions imposed at national level, it seems normal that every public authority should contribute to the achievement of macroeconomic targets. This implies a certain degree of co-ordination between the different levels of governments (and between the lower-tier authorities). The higher the level of financial autonomy of the lower tiers of government, the greater the need for co-ordination; nevertheless, it is often difficult to ensure adequate co-ordination of fiscal policies between the lower tiers of government. As a consequence policy on public debt should also be centralised.

There is another reason which is closely linked to the previous ones: local authorities (and their staff) may still have to improve their financial and managerial capability, and central government may not be entirely convinced that local authorities are able to implement sound financial and budgetary policies.

The question is therefore how to decide on the extent to which lower tiers of government will contribute to the achievement of the targets set for the overall public sector. In a number of countries decision-making mechanisms exist (or are being considered) that entail the participation (at least to a certain extent) of the lower levels of governments in setting goals. Several examples follow.

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1 See in particular M. Wrim and P. Van Rompuy, "The growth of government size and fiscal decentralization", in R. Prudhomme (ed.), *Public finance with several levels of government*, proceedings of the 46th congress, (IIPF, Brussels, 1990), pp. 113-24.

2. Mechanisms set up by federal states

Austria

Following the Maastricht Treaty, all three levels of territorial authorities in Austria agreed on a new form of co-operation to ensure that the country meets European Monetary Union criteria.

In order to prevent new legislation from putting too much financial pressure on the budgets of *Länder* and municipalities, an amendment to the federal constitution was made by the federal parliament and subsequently by decisions of the *Länder* parliaments, setting up a consultation mechanism.

According to this mechanism, the costs of new regulations have to be clearly calculated and if they exceed a certain level negotiations have to be started. A small body consisting of representatives of the three levels of government – the local level being represented by the Austrian Association of Towns and Cities and the Austrian Association of Municipalities – has to deal with the proposed legislative act and should try to find a solution for funding the financial implications.

If the negotiating body fails to agree on who should cover the financial implications of the new piece of legislation, the cost is to be borne by the level of government which adopts it – at least for a certain period of time (until the next period to which the Financial Equalisation Act applies). This is a very powerful tool for avoiding excessive financial pressure on municipalities resulting from decisions of other authorities and for securing a certain part of the budget to be decided upon and used locally. The consultation procedure applies to regulations passed by the Union and the *Länder*.

On the other hand, all three levels of territorial authorities have agreed to avoid excessive deficits and have decided how to share the financial sanctions in the event of consolidated public deficit exceeding 3 per cent of the GDP.

Belgium

At the time of Belgium's accession to the Maastricht Treaty, the government set a number of strict objectives for financial and budgetary policy. Review and monitoring of these objectives, listed in detail in the "Convergence Plan for Belgium" and – from 1999 – the "Stability Programme for Belgium",[1] were assigned to the public sector financing needs section of the Higher Finance Council. Half of the members of this section are from the federal government, while the other half are proposed by the governments of the regions and communities.

1 The government set itself objectives for 1999 concerning the net financing needs and primary balances of the public sector as a whole and of "Entity I" (federal government and social security) and "Entity II" (communities, regions and local authorities): the public sector as a whole must not run a primary surplus exceeding 6 per cent of gross domestic product (GDP), and its net financing needs must not exceed 1.3 per cent of GDP. In terms of debt levels, the objective of a consolidated gross rate of 114.5 per cent of GDP should be achieved by the end of 1999. The government has also undertaken to ensure that the primary surplus is stabilised at 6 per cent, if necessary by taking corrective measures as part of the budgetary review conducted at the beginning of the year. Similarly, in accordance with the political undertakings given at the European Summit on 1 May, the government has defined its budgetary strategy for 2000 to 2002: it plans to maintain the primary surplus for the public sector as a whole at a level of approximately 6 per cent of GDP in the medium term.

The tasks of this section include:

- giving an annual opinion on public-sector financing needs;
- the possibility, either on its own initiative or at the request of the Minister for Finance, of giving an opinion on the desirability of limiting the capacity to borrow of a community or region, so as to avoid disturbing domestic and external monetary balances, and/or of making provision against a structural deterioration in financing requirements.

The Budget Act authorises the king, on the basis of such an opinion and on the proposal of the Minister for Finance, to limit the borrowing capacity of a community or region for up to two years by means of a cabinet order, following consultation with the government of the region or community in question.

In practice, this section of the Higher Finance Council acts as the co-ordinator and guardian of the budgetary policy pursued both by the federal government – which includes social security – and by the communities and regions. In this way, it seeks to ensure that the federal government, regions and communities make equivalent contributions to the stabilisation of overall public finances.

The federal state, communities and regions have the opportunity, and indeed an obligation, to co-operate in certain areas of common interest.

Several agreements have been concluded on public finances and budgetary matters. Reference should be made at this point to the co-operation agreement on the 1996-1999 budgetary objectives, which was concluded on 19 July 1996.

Under this agreement, the parties took note of the recommendations put forward by the Higher Finance Council in the 1996 annual report of the public sector financing needs section, and decided to make every effort to achieve the recommended 1999 objectives for federated entities (regions and communities) and local authorities. The parties also defined acceptable net financing needs for each federated entity and for local authorities in billions of Belgian francs and as a percentage of GDP. The acceptable overall debt level was also stipulated.

Although the agreement does not provide for penalties in the event of non-compliance, it is binding on the signatories. Should one of them fail to make every effort to fulfil its obligations, this would probably provoke a major political crisis.

Each central government entity retains the right to impose stricter rules than those proposed by the public sector financing needs section, stipulated in co-operation agreements or arising from international political undertakings.

Opinions of the Higher Finance Council are by no means binding on local authorities, since the latter are not represented in the public sector financing needs section, and are not signatories to the co-operation agreements concluded by the various central government entities. They are indirectly concerned, however, as a result of their “status” as public authorities.

The co-operation agreement on the 1996-1999 budgetary objectives expressly provides that the regions shall encourage municipalities to give priority to debt reduction in the allocation of any exceptional proceeds from financial asset sales.

In practice, therefore, the undertaking given by the regions may result in limits on the financial autonomy of subordinate authorities. The fact that the regions oversee local authorities means that they have a degree of control which may extend to overriding decisions by the latter, including those concerning budgetary and financial matters.

Over the period 1995-1997 the public sector deficit decreased (-49 per cent for the whole period) while public debt was kept at a constant level.

Germany

In Germany, in order to meet the goals set by the Maastricht Treaty, the Fiscal Planning Council voted a recommendation that the increase in public expenditure should not be greater than 2 per cent each year. This applies to each level of government.

With regard to the deficit requirement, the Federal Ministry of Finance has proposed to set, by legislation, the share of the permitted deficit for the Federation (including statutory social insurance) and the share for the *Länder* (including local authorities). This would clarify the respective responsibility if the deficit limit of 3 per cent of GDP is exceeded or is likely to be exceeded.

From the point of view of the Federal Ministry of Finance, the deficit share for the *Länder* might be distributed between the individual *Länder* and their local authorities on the basis of the number of inhabitants or on the basis of the average deficits during a reference period. A mixed system, taking both criteria into consideration, would also be possible.

For the time being, the *Länder* are seeking a harmonised position on the national procedure to ensure compliance with the deficit criterion. In particular the horizontal distribution of the deficit at *Länder* level can only be settled in agreement with and among the *Länder*. In this respect, the Federal Ministry of Finance is open to the proposals of the *Länder*.

The local authorities and associations of local authorities are subject to the supervisory power of the *Land* and it is for the *Land* to ensure compliance with limits set for local authorities. The *Land* may influence the development of local authority indebtedness by using the instrument for approving local budgets, and by fixing upper limits for borrowing.

It is left to the individual *Land* how they will involve the local authorities in order to comply with a given deficit limit. Should the need for action arise for the *Land* parliament, in the context of monitoring compliance with the convergence criteria, the central association of local authorities will be involved at *Land* level in the framework of the legislative procedure. The high number of delegates in the *Land* parliaments who are at the same time involved in local politics also promotes co-operation between the *Land* and the local level.

The data for Germany shows a small increase in overall public sector debt for the period 1996-1998, and a decrease in public deficit (-17 per cent from 1997-1998). It is important to highlight that over the last few years (from 1997-1998) the municipalities have had a budgetary surplus.

Switzerland

In Switzerland, balanced public accounts and the ensuing stable tax burden are important elements in establishing a climate conducive to development and economic growth.

Swiss public-sector accounts were balanced from 1980 to 1990, but public debt more than doubled between 1990 and 1999. In order to improve the deteriorating financial situation, a transitory constitutional provision was passed in 1998, which should make it possible for the Confederation to achieve virtually balanced accounts by 2001.

In particular, this new provision – known as budgetary objective 2001 – stipulates that the deficit must be reduced to an amount not exceeding 2 per cent of revenue by the end of the 2001 financial year (approximately one billion francs). Prior to that, the 1999 deficit must not exceed 5 billion francs, and the 2000 deficit must not exceed 2.5 billion francs. These deadlines are mandatory, with one exception: in the event of an economic recession, parliament may postpone them by two years.

Stabilisation measures taken at all levels have led to improvements in the budgetary situation; the planned 1999 budgets show a deficit equivalent to 1.9 per cent of GDP, with a debt ceiling of 54 per cent of GDP.

The considerable financial autonomy enjoyed by cantons and municipalities makes it difficult to pursue an overall budgetary policy for the public sector. Nonetheless, previous efforts to combat deficits in local and cantonal finances were based on co-operation between the Confederation and the cantons, in the form of agreements and budgetary recommendations. Such agreements, which also applied to municipalities, stipulated – for example – acceptable growth rates for public expenditure, staff expenditure and so on. Deficits were also limited by means of quotas for public sector loans raised on the financial market.

At present, co-operation between the cantons and the Confederation consists of regular meetings between the Head of the Federal Department of Finance and the Conference of Cantonal Finance Directors. At the operational level, a meeting is held at the beginning of each year between representatives of the Federal Department of Finance (responsible for the federal budget) and the heads of all the cantonal finance departments to discuss topical budgetary issues.

A special department within the canton usually oversees municipal budgets. Municipal budgetary trends are controlled by means of the following measures: a requirement of preliminary cantonal authorisation for investments; maximum municipal tax rates set by the canton; compulsory instalments for the repayment of investments; and refusal by the canton to approve the budget.

3. Mechanisms set up by other states

Denmark

In spring 1997, the Danish government set down a number of objectives for the development of the public sector until 2005, to prepare the Danish economy for the future ageing of the population, which will, in the long term, pose a major challenge for the public sector. The reduction of public debt and hence interest expenditure are high priorities when preparing for this demographic pressure on public finance.

The Ministry of Economic Affairs is monitoring the development of public sector debt and public sector deficit. In 1997, public debt as a percentage of GDP was at 65 per cent. The aim of the Danish Government is to reduce public debt to a maximum of 40 per cent of GDP by 2005.

Because the local and regional government sector forms a substantial part of the overall public sector in Denmark budgetary co-operation between the state and local and regional authorities is a major factor in managing the public sector economy. However, local and regional authority borrowing is not, as a general rule, open for negotiation, but is managed by central government.

Annual negotiations are held between the Danish Government and the associations of local and regional authorities, at which the Ministry of Finance and the associations agree on limits for growth in expenditure, investments and tax increases for local and regional authorities.

In connection with the annual negotiations between the government and the associations the government can make recommendations on developments in expenditure and taxes and thus the need for borrowing, but the agreements between the parties are not legally binding on the individual municipality or county.

Central government rarely imposes conditions for local and regional authorities' economies, as guidelines on the economy, negotiated as part of the agreements between the government and the associations of municipalities and counties, are in general, followed by local and regional authorities.

Spain

In Spain, the system functions on three different levels: central government, the regions (autonomous communities) and local authorities (including municipalities and provinces). The financial autonomy of the lower tier authorities has to be consistent with the principles of co-ordinating public finances.

The debt policy of the autonomous communities is co-ordinated with that of the state by the Fiscal and Financial Policy Council. This body is made up of financial advisers from the autonomous communities and an equivalent number of government representatives (Ministry of Economic Affairs and Finance and Ministry of Public Administration).

In response to the convergence programmes proposed by the government, the council drew up "budgetary consolidation frameworks" for 1997 to 2000, stipulating debt ceilings and setting objectives for the budgetary deficits of the central government and the autonomous communities.

Act 50 of 30 December 1998 on Fiscal, Administrative and Social Measures (passed at the same time as the 1999 General State Budget Act) provides that by the end of 1999, the relevant departments at the Ministry of Economic Affairs and Finance and the Spanish Federation of Municipalities and Provinces (FEMP, the largest association of local bodies) shall prepare draft regulations on budgetary and accounting activities, aimed at unifying and harmonising the requirements to be fulfilled and measures to be taken in order to ensure that the local public sector complies with the Maastricht criteria.

The laws and regulations passed by the government in order to oversee local and regional authority debt (see Chapter IV) were subject to preliminary political negotiations within the National Committee on Local Government. This is a standing body responsible for co-operation between the state and local government. It is chaired by the Minister for Public Administration and made up of local authority representatives (designated by the FEMP) and government representatives, in equal numbers.

IV. RESTRICTIONS ON LOCAL AND REGIONAL BUDGETARY POLICIES

1. Different types of restrictions on local government financial autonomy

Restrictions set by central government on the financial autonomy of lower tiers of government (and sanctions following breaches of imposed restrictions) may substantially reduce local authorities' room for manoeuvre. These restrictions mainly aim at reducing or at least keeping under control the level of local expenditure; they may operate directly on the expenditure side, but can also concern local revenue (or sources of revenue).

The most typical restrictions on local revenue relate to:

– raising taxes and setting tax rates or tax bases (fiscal decentralisation);
– the size of state grants;
– borrowing.

The most typical restrictions on local expenditure relate to:

– the amount of expenditure ("capping");
– the use of state grants;
– the use of loans.

Direct limitations of expenditure and ceilings on local taxation seem to be less consistent with the principle of local self-government than measures that rule out the possibility of indebtedness or operate through the grant system. These measures may be stricter according to the targets and situation.

As, in general, some redistribution among local authorities takes place through the grant system; the simplest way to force local authorities to comply with ceilings or restrictions on their budget could be to cut back state grants.[1]

Budgetary rules and in particular those that prevent an unbalanced budget being voted are to be taken into account, in conjunction with other restrictions. Of course, the various restrictions may be (and actually are) used together, or combined in different ways. The mechanisms of financial supervision and auditing also play an important role.

In its two last reports on local finance,[2] the CDLR presented and analysed the situation in the Council of Europe member states concerning in particular:

- restrictions on local taxation and on the level of fiscal decentralisation;
- the methods for calculating general state grants (including the possibility of linking state grants to the local tax effort or tax revenue);
- the use of earmarked grants.

A more recent study has been carried out by the CDLR on the supervision and auditing of local authorities' action;[3] this publication also deals with the financial and budgetary supervisory mechanisms.

The present study can therefore focus more on other restrictions.[4] Examples from the countries in the sample are given in the following paragraphs.

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1 Reviewing the grant system to control local government spending has been greatly investigated. Generally speaking the following formulae can be used to address these problems in a simple way:

$Gi= Ei - t^*.Rvi$ or $Gi=Ei - (t^*- x).Rvi$

where *Gi* stands for grants (transfers) to authority *i* from central government, *Ei* for expenditure, *t** for a conventional rate and *Rvi* for the rateable value and *x* stands for the "disincentive" to expand expenditure introduced by central government.

It appears from the formulae that it is possible for central authority to indirectly control both expenditure and local taxes. When calculating its transfers (or grants) to local authority it can consider either actual expenditure by local authority *i* or what it should be spending to supply local citizens with local services in a standard quantity and quality (*Ei*); then it considers a conventional rate *t** (centrally assessed) to be applied to the taxable value of local authority; finally it can discourage overspending by reducing its transfer by a coefficient *x* linked to the excess of expenditure. The amount of grants is therefore determined once the targeted expenditures are set and after having equalised for spending needs (when *Ei* represents standard services) and resources. According to the theory, the proper assessment of grants (transfers) from central government to local authorities would produce the desired limitation of local expenditure.

2 *Local finance in Europe*, *No. 61* and *Limitations of local taxation, financial equalisation and methods for calculating general grants*, *No. 65* study series "Local and regional authorities in Europe".

3 *Supervision and auditing of local authorities' action*, *No. 66*, study series "Local and regional authorities in Europe".

4 With regard to restrictions on revenue, it is useful to mention the experience of the USA because it represents a successful example of the reduction of local expenditure when upper level authorities set limits. The main way of limiting expenditure has been through limiting local tax rates, or through the growth of local tax revenue or the local tax base. No accounting mechanism (of the type introduced in Italy) or direct restriction on expenditure seems to be in use. The efficacy of the restrictions can be seen from numerous empirical studies: a reduction of 6 to 8 per cent can be expected in the per capita local expenditure in states subject to federal limits.

2. Restrictions on budgetary imbalances

The requirement of a balanced budget in Belgium

In Belgium, the Municipal Act of 24 June 1988 lays down budgetary principles applicable to municipal finances, including the procedure for drafting and implementing municipal budgets. It also states that municipalities should balance their budgets.

Section 252 expressly provides that "from the 1988 financial year at the latest, on no account may municipal budgets for revenue and expenditure show an ordinary or extraordinary deficit, or a fictitious balance or surplus". Section 253 sets out measures to be taken against municipalities showing a deficit.

The requirement of a balanced budget in France

In France, no restrictions are imposed on local and regional authorities for macroeconomic considerations. There is no ceiling for debts or the debt service. However, the debt may only be used to cover investment expenditure.

The main protection against excesses is the obligation for local and regional authorities to vote a balanced budget. The balance must be a true one: if the prefect acknowledges that compulsory expenses have not been included or that estimated revenue is manifestly unrealistic, he may modify the budget adopted by the local authority. It must be noted that the reimbursement of debt (interest plus capital) is included among compulsory expenses.

If the budgetary year closes in deficit, the deficit must be carried on to the next year. If the deficit exceeds certain limits, the prefect may take the place of the local authority in order to insure the revival of the local authority's finance.

The requirement of a balanced budget in Norway

In Norway, the "balanced budget rules" (BBRs) in force until 1 January 1993 required current revenue to cover current expenditure, including interest and regular instalments, at the very least. The revised Local Government Act (LGA) implied more flexible BBRs from the point of view of the municipality. The most relevant provisions in the present LGA are the following:

- the annual budget is split into two parts: a current (operating) budget and a capital budget; the BBR refers to the current budget;
- the budget must be realistic. It must include all the financial means that are available for the year and the destination of these funds;
- the budget must provide for an operating surplus that should at least be sufficient to cover interest, ordinary repayments and necessary allocations;
- when setting up the budget the municipal council and the county council must ensure that there are at any time adequate funds to cover current expenditure. Certain flexibility is given by the "rainy day fund", which can be awarded, in the form of grants, for smoothing the current deficit;
- funds remaining at the end of the fiscal year are carried over to the next.

Any deficit in the annual accounts not covered in the budget in the year in which the accounts are presented is to be carried over to be covered in the following year's budget. In special circumstances, the municipal council and the county council, having made the necessary amendments to the finance plan, may resolve that the deficit be covered over a further period not exceeding two years.

The requirement of a balanced budget in Sweden

In 1998, a statutory requirement to maintain a balanced budget was introduced for municipalities and county councils, with effect from the year 2000. It aims at preventing the continuous undermining of the finances of municipalities or county councils and should provide the conditions for stable, long-term financial development.

The balance requirement means that municipalities and county councils draw up their budgets so that income covers (or even exceeds) expenditure. If expenditure in the final accounts exceeds income, the deficit has to be cleared over the following two years.

Current income should cover current expenditure. The balance requirement consequently implies that current activities will not need to be financed through borrowing. There is, however, no ban on raising loans for operational purposes. Capital gains are not to be included in the balance requirement, but capital losses can, in the main, be counted in the balance requirement.

The balance requirement can be overridden if there are special reasons,[1] but exceptions must be consistent with good financial administration.

The requirement of good financial administration means that the net income should normally be at a level that enables the consolidation of the municipalities' and county councils' finances in real terms. A desirable requirement for net income is that long-term reinvestment can be made without financing through new loans.[2]

After investigating whether the balance requirement should also extend to municipal companies, the government has come to the conclusion that this should not be the case. The requirement of good financial administration does, however, mean that these companies should also operate sound finances.

1 Such special reasons may be considered to exist if a municipality or county council has consciously and clearly made provisions and built up substantial equity for the purpose of meeting temporary falls in income or increases in expenditure in the future. What constitutes a special reason is a matter for local political judgment, and should, therefore, be decided within the framework of the political system. Accordingly, where imbalances are not handled in accordance with the law, the responsibility rests with the politicians.

2 The meaning of good financial administration cannot be defined solely from a financial perspective. Other important factors which must be taken into account are the municipality or county council's future investment plans, population trends, exposure to risk and so on.

The requirement of a balanced budget in Switzerland

The cantons and most municipalities apply a harmonised accounting model. According to this model, which divides administrative accounts into an operating account and an investment account, the annual operating account must be balanced. Ongoing surpluses or deficits should be eliminated by regulating taxation.

The rules on investment repayment rates stipulate that at least 60 per cent of annual investments should be self-financed. Some cantons have introduced binding legislation which limits the level of deficits and imposes immediate corrective measures.

In St Gallen canton, for example, the Act of 17 June 1929 on Cantonal Finances provides that "the budget must be drawn up according to the principle of balancing revenue and expenditure". In practice, this condition is deemed to be satisfied when the budgetary deficit does not exceed revenue by more than three percent of the cantonal tax yield. The act also provides that "where expenditure from the administrative account exceeds revenue, the surplus expenditure shall be carried over to the budget for the following financial year". In practical terms, this means that the cantonal council has to reduce expenditure and/or increase revenue, either by drawing on reserves or by raising the tax rate, if the current rate is not sufficient to achieve a balanced budget.

Restrictions on local budget deficits in Bulgaria

In Bulgaria the budgetary position of the public sector has improved considerably over the last three years. Nevertheless, in the global framework of the difficult transition to a market economy, the financial position of the communes has worsened since the recession of 1996.

As a result, since the 1998 Law on Municipal Budgets was passed, municipalities may have a deficit, but this cannot exceed 10 per cent of their revenue. This deficit can be financed as the municipal council decides (by bonds, loans, extra-budgetary funds or other sources).

Restrictions on local deficit related to national public debt in Poland

In Poland, the constitution itself restricts national public debt to a maximum of 60 per cent of the GDP. A monitoring system has been created in order to ensure that this limit is respected.

The 1998 Law on Public Finance imposes certain restrictions on local and regional budgets' deficit; it introduces a relation between the overall national debt and local and regional authorities' budgetary deficit. When the national public deficit is between 50 and 55 per cent of the GDP, local and regional authorities may not increase their budgetary deficit in relation to the past year. When the above-mentioned ratio is between 55 and 60 per cent, local and regional authorities must lower their deficit to an amount which varies proportionally from 100 per cent of the previous year's deficit (when the ratio public deficit/GDP is 55 per cent) to nil (when this ratio is 60 per cent). No public deficit is allowed and no new guarantee may be granted when national public debt exceeds 60 per cent of the GDP. These provisions do not apply to deficit which is financed from the previous year's surplus.

The state budget is subject to similar restrictions.

Procedures for clearing local deficits in Spain

Borrowing by local authorities whose accounts show a deficit is subject to prior authorisation from the central government (Ministry of Economic Affairs and Finance) or the relevant autonomous community (where the latter has competence for such matters).

The local authorities in question must approve a financial stabilisation plan, to be completed within three years, in order to absorb the deficit. This plan must indicate the management, taxation and other measures envisaged in order to achieve at least a balanced budget and must be submitted with an application for authorisation of the anticipated loan.

For local authorities with over 200 000 inhabitants, authorisations for individual loans may be replaced by a "budgetary consolidation framework", which is approved, depending on the circumstances, either by the Ministry of Economic Affairs and Finance or by the autonomous community.

This budgetary consolidation framework stipulates the non-financial deficit ceiling and the maximum debt allowed for each of the three subsequent budgetary years.

The balanced budget amendment in the United States of America

In the United States of America, it has been said that one of the reasons why states are able to balance their budget is that the federal government does not.[1] The balance can be achieved by using four mechanisms:

– issuing short and long term debt;
– relying more on federal grants while giving less to lower local government;
– increasing tax rates;
– lowering capital spending.

States which do not balance their budget can carry over their deficits. This "carryover provision" is in force precisely "to prohibit the state from issuing debt to finance a shortfall". Carrying over surpluses is allowed in all states; forty-five states have some extra "rainy day" funds; twenty-one states carry over deficits.[2] Thus the carryover provisions both with respect to deficits and to surpluses are successfully in use in a true federal state.

1 L. McGranahan, "State budgets and the business cycle: implications for the federal balanced budget amendment", *Economic Perspectives*, Federal Bank of Chicago, 1999.

2 See C. Eckel, "States broaden the scope of rainy day funds", Washington D.C. National Association of State legislature, 1998; available on the Internet at www.ncsl.org/programs/fiscal/rdf97.htm.

3. Restrictions on the overall amount of local expenditure

The "domestic stability pact" in Italy

Law No. 448 of 1998 known as the "domestic stability pact" established guidelines to be followed by regional and local authorities (Article 28). According to these guidelines, local authorities should have reduced their total expenditure by 2 200 billion lire, corresponding to roughly 1 per cent of total local expenditure for 1999.

The first year (1999) of recommendation by the central government to local authorities to participate in the reduction of debt to meet the Maastricht criteria ended without full compliance from local authorities, especially regions. With the new year central government did set up other "saving targets" for regions, provinces and municipalities, to participate in the reduction of debt but it also allowed for the carry over of the unmet balance requirements for 1999. At the same time it confirmed that the internal stability pact is indeed based on the implementation of a golden rule in that the calculation of the actual balances exempts investment expenditure. The golden rule is in fact even enhanced by the exemption of interest expenditures (and some others in year 2000).

Italy is therefore using the carry over provision and (a version of) the golden rule. It is instead impossible to resort to "rainy day funds" because they are incompatible with the accounting rules of SEC 95.

Local authorities are supposed to act on a voluntary basis, in order to contribute to the sustainability of public finance (i.e. to the reduction of financial deficit and public debt). Law No. 448 of 1998 does not establish how local authorities should accomplish their task but it does mention the possibility of resorting to sanctions. It is not clear yet how central government will make local authorities paying for not complying with rules and recommendations. It only says that in case of a pecuniary sanction by the European Union it will make local authorities pay for it in proportion to their distance in not meeting their targets.

The reference figure for judging whether local authorities are following the guidelines is the financial deficit, defined as the difference between own revenue (exclusive of receipts from the sale of financial assets) and current outlay (exclusive of interest). The notion is linked to the net total deficit, as opposed to primary deficit, in the national accounts, because this is the reference figure in the treaty. With respect to the net total deficit, the financial deficit is calculated with reference to current outlay only (exclusive of interest), in order to avoid restrictions on investment expenditure, which may be financed through loans.[1]

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1 The question, raised earlier, about the distinction between current and investment expenditure emerges again. What is important is whether expenditure is self-financing or not. If it is, it is quite possible to finance it through loans; if not, even if it has a physical dimension, it is questionable whether financing through loans is acceptable.

Other guidelines refer to the next three years and lay down the way of calculating the "planned balance" according to a complex mechanism equally based on accountancy principles. As is usually the case when confronted with the necessity of reducing expenditure, the government tries to impose a "proportional" reduction without attempting to carry out an economic analysis. However, it has to be added that while the proportionality rule appears to be objective and as such is not open to dispute by the lower tiers, any other form of restriction would give rise to large debate.

The former "capping" system in the United Kingdom

In the past, the United Kingdom Government annually set a "cap", or budget requirement limit, for each council, and announced capping principles in advance. The practice was introduced in 1984, when legislation empowered the government to cap the expenditure of local councils in England and Wales. There is evidence that capping would have reduced local authority spending by a figure equivalent to 2 per cent of GDP (over eight years) if capping at that time had applied to all authorities. In practice, it only applied to a handful of councils. The macroeconomic framework of the time meant that higher council spending would not have translated into higher GDP. It would have crowed out other public spending. Emerson, Hall and Ridge,[1] in a study focusing on the period 1983-1990, found evidence that capping could reduce council expenditure by almost 8 per cent the impact being different depending on the type of local service.

It is important to stress that the capping system may result in different reductions for different types of expenditure, as opposed to the proportional one which is based on accountancy criteria.

This crude and universal capping has ended. Local authorities in the United Kingdom are now able to make up their own minds about their budgets, taking account of their local circumstances and the views of local people. Recent legislation has replaced previous capping powers in England with more flexible and discriminating reserve powers to protect local people from excessive increases.

The government has also introduced the Council Tax Benefit Subsidy Limitation Scheme. Its aim is to protect the national taxpayer from the council tax benefit costs arising from local decisions to make large increases in council tax. In Scotland, the Scottish Executive issues local authorities with an expenditure guideline, as an indication of the level of spending it considers prudent.

1 C. Emmerson, J. Hall and M. Ridge, "The impact of expenditure restrictions on local government spending: evidence from the UK", (Institute of Fiscal Studies, 1998), working paper No. 98.

4. Restrictions on borrowing and the use of loans

Restrictions on local borrowing are frequent, but vary as to their nature and the extent to which they are carried out.

Fixing a ceiling on local borrowing is a widespread practice. Nevertheless, different criteria may be used for fixing the ceiling. Among other methods, it may be determined according to the capacity to repay loans (annual payment as a percentage of annual revenue), by reference to the permissible annual deficit for the authority considered, by the government through general and/or specific credit approvals, and so on. Moreover, in limiting the amount of borrowing, loans may be considered in isolation or together with the other local authorities' liabilities.

Other restrictions are related to access to the market and concern, for example, the possibility of issuing bonds or negotiating foreign loans.

It is very common to find restrictions on the type of expenditure that may be deficit financed. These restrictions refer to the distinction between capital expenditure (i.e. investments) and current expenditure. This point is worth examining in detail, before presenting some examples of restrictions on borrowing from the countries in the sample.

It has already been said that when fiscal restrictions are imposed a reduction in investment expenditure is likely to occur first and/or to involve the largest amount of money. It is therefore reasonable to introduce restrictions that do not impair investment, based on the idea that investment expenditure is not inflationary. Unfortunately, the formal distinction between current expenditure and investment expenditure made in the accountancy classification does not coincide with the economic distinction between inflationary and non-inflationary outlay. If outlay increases a country's productivity then they are economically self-financing and can be financed through loans without risk of breaching the Maastricht criteria. If they do not, whatever the accountancy classification might say, they should be financed by tax in the same way as current expenditure.

To give a precise idea of an economic perspective as opposed to a purely book-keeping angle, let us suppose that a public authority decides to build a useless bridge or road. Since it is classified as investment expenditure it can be financed through loans; but since it is economically useless its effects on the economy do not differ from public consumption or current expenditure.

Moreover, the idea that only investment expenditure (according to the formal definition) is to be deficit financed is mainly based on an intergenerational equity consideration, which is not entirely convincing.

The argument is that the present generation shifts the burden of the provision of present public goods when resorting to deficit financing. For this reason it is considered unfair with respect to future generations to finance current expenditure through loans. Although the argument has immediate appeal, it is, however, incomplete.

What the present generation will pass on to the next is not simply the burden of public debt and the physical dimension of public goods. What is passed from one generation to the next is public goods in all their complexity, this surely includes the state of knowledge, technical progress and other non-physical goods.

If intergenerational links were the main concern when setting up the budget and estimating its effect on current and future GDP (as an acceptable proxy for the welfare of the people), then our accounting rules would have to be greatly adjusted to perform this task. In fact, distinguished economists have been working at producing an intergenerational accountancy system that goes far beyond the simplistic view of stopping current expenditure from being financed through loans.[1]

These considerations do not lead to a refutation of the importance of a balanced operational budget and of stringent rules concerning borrowing for current expenditure, but could justify a certain flexibility and help to clarify the reasoning behind the argument which stresses the importance of the flexibility rules to be found in a balanced budget system.

Within the same framework of the search for flexibility, it is interesting to note that excessive debt of one local authority could be compared to an "externality" which affects the others and as such it could be rectified by issuing "permits to borrow" very much on the line of correcting externalities in a polluted environment.[2]

The theoretical framework supporting the idea of using tradable permits to borrow in order to control the deficit of lower tiers can be found in the works by Coase concerning the correction of externalities through the market. In the presence of external effects, an efficient allocation (an optimum or socially desired level of the externality) can be reached just by the appropriate assignments of property rights.[3]

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1 See L.J. Kotlikoff, *Generational accounting – knowing who pays and when for what we spend*, (New York: The Free Press, 1992); L.J. Kotlikoff, "From deficit delusion to the fiscal balance rule: looking for a sensible way to measure fiscal policy", in *Journal of Economics*, Supplement 7, (1993). A.J. Auerbach, L.J. Kotlikoff and J. Gokhale, "Generational accounting: a meaningful way to evaluate fiscal policy", in *Journal of Economic Policy*, vol. 8, 1, (1994).

The distinction between current and investment expenditure (and the idea that only investment expenditure should be deficit financed) may be questioned for other reasons too.

Although it may seem easy to draw a dividing line between the two types of expenditure this may be the case only in terms of a book-keeping definition, because conceptually it is rather arbitrary. This arbitrary component gives way to misguided book-keeping practices (which have been described as "creative accountancy") in the sense of producing formally correct accounts, which are substantially, or economically, incorrect. The importance of misguided bookkeeping practices should not be undervalued.

Moreover, if the various possible forms of financing public expenditure are to be taken into consideration when setting up the budget, one cannot completely disregard the large tradition of study in the field. Leaving aside the over-rational opinion that even denies the possibility of different forms of financing (each of them boiling down to taxation at present or in the future) the standard Keynesian tradition teaches that a comparison of effects stemming from tax or alternative debt financing must be carried out on the basis of the same composition of expenditure.

2 See A. Casella, "Tradable deficit permits: efficient implementation of the Stability Pact in the European Monetary Union", *Economic Inquiry*, (1999).

3 The well known Coase theorem asserts that, under certain circumstances, whenever there are externalities, the parties can get together and reach some sort of arrangements by which general efficiency is ensured.

In the case of excessive debt, the permits to borrow represent the assigned property rights. Once a total amount of permits to borrow has been identified, they can be distributed to lower tiers which can use them to finance specific programs. In this case, the basic idea is that the market incentives can lead to a more efficient output regarding the financial needs of lower tiers, compared to the use of uniform or proportional restrictions.

The main difficulties arising from the use of permits to borrow regard:

– the determination of the initial distribution of permits, which should be decided only on the basis of objective criteria. If the system is not well tuned, it can lead to equity problems; here one could apply, *mutatis mutandis*, the principles which are to be used for the distribution of grants.
– the necessity to have a sufficiently large number of bodies operating in the market (local bodies), and ideally of a similar dimension, in order to ensure the efficiency of the system.

The theoretical suggestions on the use of permits to borrow seem to indicate that the system can be successfully applied to finance capital expenditure because this expenditure can be planned and distributed over several years in accordance with the financial needs of local government. This is the case, for example, of the British credit approvals that are allocated to individual local authorities considering their needs on capital spending and their usable capital receipts.

Fixing a loan bracket: the Danish example

In Denmark, the general fiscal framework designed by central government aims to reduce public debt to 40 per cent of GNP by 2005. In this respect, as the budget of lower-tier authorities forms a substantial part of the overall budget, there is great co-operation between the different tiers of government in trying to reduce public debt.

Nevertheless, local and regional authority borrowing is managed by central government. Restrictions on borrowing were introduced in the 1970s. Therefore, they are not a result of the limits set at European level on national public debt to meet the requirements for monetary union.

Central government fixes a “loan bracket” for each municipality, which represents the extent to which the municipality can raise debt. Municipal debt includes debt from the public utilities and the bracket is equal to the sum of the municipal investments in the user-financed public utilities (water supplies, electricity and heating supplies, etc.) energy-saving measures and urban renewal expenses. The definition of the municipal loan bracket reflects the fact that municipalities are allowed to raise loans only for the above-mentioned purposes.

Since 1996 local authorities have been allowed to raise loans within an annual bracket corresponding to 25 per cent of net investment on construction in the county.

Furthermore, legislation sets forth precise rules concerning the terms and other conditions for loans. It is important to note that access to loans for financing current expenditure is not allowed. However, the Ministry of the Interior can grant exemptions from the loan brackets within an annually fixed pool. In 1999, the pool for the municipalities is DKK 500 million (0.1 per cent of the total debt of local and regional authorities).

Credit approval: the United Kingdom example[1]

In the United Kingdom, once national priorities on public expenditure have been considered along with the spending needs of the local authorities, budgets for the central government service department are agreed by the ministers collectively. Central government then allocates part of its budgets to the local authorities in two specific forms: grants and credit approvals. Credit approvals are approvals for borrowing. Each local authority can only borrow up to the level of those approvals.

Basic credit approvals, which local authorities can use as they wish, are allocated to individual local authorities taking account of their general need to spend on capital and their usable capital receipts. Specific credit approvals are issued in response to a specific spending requirement and the borrowing that they permit has to be used for the specific purpose for which they were issued.

Borrowing to finance current expenditure is not permitted. Measures also exist to prevent local authorities from circumventing the borrowing controls. Thus credit arrangements, such as finance leases, also require the cover of credit approvals.

Restrictions on borrowing in other countries

Bulgaria

In Bulgaria, local authorities are only able to raise loans to a value of 10 per cent of the estimated revenue but there is no restriction on the destination of loans. Nor is there a limit on total debt. However, the different debt instruments are rarely used, and when they are it is almost exclusively by municipalities with financial revenue above the average, which may be explained to a certain degree by the high interest rates of loans in Bulgaria.

1 The following is a very brief outline of the way local authority borrowing in England is controlled within the wider framework of maintaining sound public finances. Arrangements are very similar for local authorities in Scotland and Wales.

Croatia

In Croatia the Budget Act regulates borrowing by both central government and local authorities. Local and regional authorities may only borrow, issue securities and grant guarantees up to a limit of 20 per cent of their budget revenue (excluding state grants) and only finance capital expenditure which is considered to be necessary for financing reconstruction and development programmes (buildings and equipment, utilities, social infrastructure, etc.).

They may raise loans from other local authorities, from the state budget and from the non-banking sector (including the population) but only subject to government approval.

Estonia

In Estonia rural municipalities have access to loans and other debt instruments but only for making investments as prescribed in the municipal development plan.

The total amount of financial obligations arising from debts may not exceed 75 per cent of the estimated revenue for the coming year. At the same time, total repayments related to these financial obligations (for both capital and interest) are limited to 20 per cent of the estimated revenue. These limits apply neither to short-term loans aimed at covering running expenses and repayable the same year, nor to loans for which a state guarantee has been obtained.

Local authorities' loans and other debt instruments may be raised subject to prior approval from the Ministry of Finance which only checks compliance with these limits when granting approval.

Hungary

In Hungary, the maximum annual limit of new obligations increasing the debt of a municipality is set at 70 per cent of the municipality's estimated own income (local taxes, duties and levies, interest, etc.) minus the short-term loan and the repayment of debts due for the year in question.

At the request of creditors, the court may establish the insolvency of the local authority and nominate a financial trustee who will take decisions on behalf of the local authority and supervise municipal activities. However, official and basic services for the population may not be suspended.

Latvia

In Latvia, the total amount of municipal loans and guarantees cannot exceed the amount determined by the annual law on the state budget after negotiations between the cabinet and municipalities.

A municipality has the right to apply for a loan only after receiving the approval of the Municipality Loan and Guarantee Control and Supervision Board, which examines the necessity of the loan as well as the existing financial obligations of the municipality in question.

Lithuania

In Lithuania, municipalities' overall debt must not exceed 20 per cent of the budget income of the year (30 per cent in Vilnius). The total annual limit for raising new loans is set at 10 per cent of the adopted budget revenue while the limit for short-term borrowing is 5 per cent. Compliance with borrowing restrictions is supervised by the Ministry of Finance.

Poland

In Poland, total local and regional authority debt and loan repayment (principal and interest) must not exceed 60 per cent and 15 per cent of the authority's annual income respectively.

Slovenia

In Slovenia municipalities are allowed to incur debts by issuing securities or borrowing only for an amount not exceeding 10 per cent and if repayment of principal does not exceed 5 per cent of the income of the previous year. The limit on total debt becomes irrelevant if debts are incurred through investments in housing construction, water supplies and purification of sewage as long as repayment of principal for these investments is limited to 3 per cent of actual municipal income. Debts may be raised subject to the prior approval of the Minister for Finance.

Spain

In Spain, restrictions on the terms and conditions governing regional authority debt are laid down in Act No. 8 of 22 September 1980 on the Financing of the Autonomous Communities.

Autonomous communities may take out short-term loans (for a period of up to one year) to cover temporary cash-flow problems. Longer-term loans are authorised where the loan is raised solely for the purpose of financing investment expenditure, provided that total annual repayment instalments (capital and interest) do not exceed 25 per cent of the autonomous community's current revenue.

Authorisation from the Ministry of Economic Affairs and Finance is necessary for loans raised outside the European Monetary Union.

The financial autonomy of local authorities is governed, in particular, by the annual General Budget Act. This act determines the proportion of the state tax yield allocated to local authorities (the largest transfer to local budgets); it may also set limits on access to credit by local authorities, where such a measure is justified on grounds of overall economic policy.

As stated above, loans raised by local authorities whose accounts show a deficit require prior authorisation.

V. CONCLUSIONS

1. General remarks

In an integrating world, where there is increasing globalisation, the economic convergence of European countries is both a necessary and a beneficial process. It is not only the result of the political will of governments but equally the result of the new global economy.

In a context where economic and monetary policies may decisively influence commercial exchanges and hence economic development and growth, public authorities must observe rules on financial caution that were once ignored. New restrictions are being imposed on states' budgeting policies in Europe. These restrictions may result from strong formal requirements linked to the adoption of a common currency, from agreements concluded with international organisations such as the IMF or the World Bank, but also simply from the governments' need to follow the path of a sound public spending policy. This is because public authorities which do not strive to follow the example given by the European "champions" of sound public finance will need to face the fact that macroeconomic results in their countries may be poor. Indeed, in a global world where the circulation of information, capital and people becomes more and more fluid, any excess will quickly be sanctioned.

Central government is responsible for designing, implementing and monitoring macroeconomic policies. They may therefore take into account local and regional budgetary policies which may have a serious impact on the country's macroeconomic situation and to monitor their evolution.

In the framework of their macroeconomic policies, central governments set objectives and must make the means available to achieve them, including restrictions on the financial freedom of national, regional and local public authorities.

However, these restrictions are rarely shared between the different levels of government and between the local and regional authorities of the same level in a clear-cut and well-defined way.

One can see that limitations to local and regional authorities' financial autonomy are being imposed practically everywhere by central government, even though the nature and harshness of these limitations may vary considerably from one country to another. This is hardly surprising; however, questions may be raised as to the reasons why most often the authorities concerned are scarcely consulted (or not at all) when defining these restrictions. This is mainly the case in less decentralised countries, where the political role of local and regional authorities is less important. However, from a macroeconomic perspective, as the share of local and regional authorities in public spending is low, limitations imposed to them may be less stringent without any significant impact on macroeconomic indicators.

Each time the decision is taken to set limitations on local and regional authorities' financial autonomy, one major question is how to adjust the restrictions according to the situation of the different local authorities. It is indeed difficult to find good indicators, as this situation may vary greatly even among authorities of a similar population and area. Moreover, the same authority may find itself in new circumstances and with new requirements from one year to the next.

2. Guidelines

The guidelines presented in this section are addressed to governments which have chosen to impose restrictions on local and regional authorities in order to achieve the macroeconomic policy objectives they have set. These restrictions must not be considered as unavoidable. In some countries it might indeed be unnecessary to impose supplementary financial efforts to local authorities. However, if such restrictions are considered to be useful, they must be designed and implemented in such a way as to minimise their impact on local autonomy.

a. Criteria to guide the sharing of the financial burden

The financial effort required at state level should be equally shared between central government and the local and regional authorities. Restrictions that are too stringent should not be imposed on lower levels of government. Central government should not request local and regional authorities to make efforts that they themselves are unable to make.

The method for sharing the burden is not necessarily based on mathematical principles alone. While quantitative data is important, it must not conceal the need to deal with the diversity of situations and needs.

When the decision is taken that nationally defined financial restrictions should be shared by the different authorities, the sharing of the financial burden should be based on:

- sound knowledge of the economic/financial situation and targets of the authorities concerned, mainly through monitoring and information exchange systems, impact studies and econometric analysis;
- clearly defined goals;
- discussion or even negotiations between the different authorities concerned; this is very important in order to avoid limitations imposed on local and regional authorities jeopardising local autonomy; these discussions should be, as far as possible, of a permanent nature; in this way, local and regional authorities may compensate the loss in financial autonomy by an increase in their political weight.

The criteria used when defining the limitations imposed to each authority should be clear and objective. "Creative accounting" tricks and other dishonest or simply undesirable adaptation mechanisms should be banned.

b. Nature and scope of limitations

Local authorities must take responsibility for their buying or spending decisions. State measures may be justified by the need to ensure sound macroeconomic policies; or to counteract financial difficulties or specific emergency situations of given authorities (in the case, for instance, that an authority has poor management systems, or is acting in a financial imprudent way) to protect the local taxpayer. These measures should be taken according to the legal regime of state intervention and should be withdrawn as soon as possible.

Normally, measures of general applicability which have a major impact on local and regional authorities' financial autonomy, such as direct limitation on all authorities' expenditure or tax rates, should be avoided. Measures such as these should only be used when it is proved that less severe measures may not succeed.

More generally, central government should refrain from imposing limitations on local and regional authorities which are excessive when compared to the goals to be achieved. The impact the imposed limitations have on local economic development should be periodically assessed in order to be able, if need be, to make changes to the system.

c. Flexibility of limitations

Systems should be favoured which make it possible to adapt restrictions to the situation of the different local authorities. There are indeed important variations between the needs an authority may have from one year to the next, as well as between the needs of different authorities.