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# Coordination arrangements across government sub-sectors in EU Member States

Georges Tournemire

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## Abstract

Coordination arrangements constitute an essential building block of a budgetary framework. They should ensure that fiscal policy is conducted in a consistent manner across the various public entities and sub-sectors of general government. This dimension has gained in relevance as recent fiscal governance reforms in the European Union, supplemented with the adoption of the Fiscal Compact, have put a premium on sound coordination in order to reach shared fiscal objectives within each EU Member State. Using information from the Commission Fiscal Governance database, the note identifies between hard and soft coordination instruments and discusses their respective design and merits. Overall, it is found that subnational government is being equipped with specific fiscal rules in a growing number of Member States. Soft coordination mechanisms for their part are becoming more structured and results-oriented with in particular improved monitoring procedures. The note finally suggests a number of avenues to improve existing coordination mechanisms to integrate further domestic budgetary timelines and ensure a genuine involvement of subnational government within the annual budget cycle.



**JEL classification:** E02; E61; E62; E63; H77

**Keywords**: budgetary framework; fiscal coordination; fiscal rules; fiscal institutions


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# ABBREVIATIONS

| | |
|---|---|
| ASP | Austrian Stability Pact |
| BFL | (Portuguese) Budget Framework Law |
| CCAA | (Spanish) Autonomous Communities |
| CNAL | (Spanish) National Committee of Local Administration |
| COFOG | Classification of the Functions of Government |
| CPFF | (Spanish) Fiscal and Financial Policy Council |
| DKK | Danish Crown |
| DSP | (Italian) Domestic Stability Pact |
| EMU | Economic and Monetary Union |
| EPC | Economic Policy Committee |
| ESA | European System of Accounts |
| GDP | Gross Domestic Product |
| MTBF | Medium-Term Budgetary Framework |
| MTO | Medium-Term Budgetary Objective |
| PIT | Personal Income Tax |
| TSA | Treasury Single Account |
| TSCG | Treaty on Stability, Coordination and Governance |
| TSGU | (Czech) Territorial Self-Government Unit |
| SALAR | Swedish Association of Local Authorities and Regions |
| VAT | Value-added Tax |

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# FOREWORD

**Coordination arrangements across government sub-sectors in EU Member States**

Coordination arrangements constitute an essential building block of a budgetary framework. They should ensure that fiscal policy is conducted in a consistent manner across the various public entities and sub-sectors of general government. This dimension has gained in relevance as recent fiscal governance reforms in the European Union, supplemented with the adoption of the Fiscal Compact, have put a premium on sound coordination in order to reach shared fiscal objectives within each EU Member State. Using information from the Commission Fiscal Governance database, the note identifies between hard and soft coordination instruments and discusses their respective design and merits. Overall, it is found that subnational government is being equipped with specific fiscal rules in a growing number of Member States. Soft coordination mechanisms for their part are becoming more structured and results-oriented with in particular improved monitoring procedures. The note finally suggests a number of avenues to improve existing coordination mechanisms to integrate further domestic budgetary timelines and ensure a genuine involvement of subnational government within the annual budget cycle.

# 1. INTRODUCTION

The organisation of powers across government levels within the EU Member States cannot be approached through simple criteria. Many different demands have shaped the way government levels are functioning: (i) unity of action, (ii) subsidiarity, (iii) efficiency, and (iv) solidarity. Power-sharing arrangements are often more the result of history or political contingency than the deliberate application of general principles. They have resulted in 27 different equilibriums that take into account national preferences and form a complex grid of arrangements, procedures and rules. As a whole, it provides the necessary legal underpinning for each government level to conduct its accepted share of public policies. As the central government and subnational governments are working side-by-side on the ground, formal and informal arbitration mechanisms settle possible conflicts as established boundaries between sub-sectors cannot fully anticipate new policy developments.

Treaty-based EU fiscal rules have taken this diversity into account. While the Excessive Deficit Procedure refers to General Government in the meaning of the European System of Accounts, Article 3 of Protocol 12 of the Treaty on the Functioning of the European Union stipulates: '*in order to ensure the effectiveness of the excessive deficit procedure, the governments of the Member States shall be responsible under this procedure for the deficits of general government as defined in the first indent of Article 2. The Member States shall ensure that national procedures in the budgetary area enable them to meet their obligations in this area deriving from these Treaties*'. While most fiscal surveillance procedures are applicable to all Member States, it is up to each Member State to ensure that the aggregation of fiscal objectives, plans, budgets and preferably, outturns, reflects a common understanding and a shared vision across general government entities. Going a step further, the Directive on budgetary frameworks adopted in 2011 ([1]) contains a reference to the necessary establishment of appropriate mechanisms of coordination across sub-sectors of general government, putting on the policy agenda the need to involve all public stakeholders against the background of fiscal consolidation requirements.

To that aim, Member States have developed – before and after the launch of EMU-specific mechanisms that aim to ensure a consistent approach between central government ([2]), State government ([3]) and local government ([4]) – the grouping of the latter two called subnational government throughout the note ([5]). After a broad presentation of the subnational government sector, the following paper will describe the various coordination arrangements that prevail in Member States, whether they take the form of subnational fiscal rules or soft coordination arrangements. Recent reforms will be highlighted and tentative guidance suggested.

([1]) Council Directive 2011/85/EU of 8 November 2011 on requirements for budgetary frameworks of the Member States –Official Journal L306/41 of 23.11.2011.

([2]) Defined as 'all administrative departments of the State and other central agencies whose competence extends normally over the whole economic territory except for the administration of social security funds' in ESA95 (S.1311).

([3]) ESA95 defines State government as 'separate institutional units exercising some of the functions of government at a level below that of central government and above that of the governmental institutional units existing at local level, except for the administration of social security funds' (S. 1312).

([4]) The sub-sector local government includes those types of public administration whose competence extends to only a local part of the economic territory, apart from local agencies of social security funds (S.1313).

([5]) The note excludes from its scope the social security sub-sector of general government. However, most policy advice provided in the note could be applicable to the social security sub-sector as well.

# 2. MAIN FEATURES OF THE SUBNATIONAL SECTOR IN THE EU

**The structure of the subnational sector in the EU varies markedly from one Member State to another.** In 11 Member States, there is one level of administration below central government (BG, CY, EE, IE, LV, LT, LU, MT, PT, SI and FI). In 9 Member States there are two levels (AT, DK, EL, HU, NL, CZ, RO, SK and SE) and three levels in 7 Member States (BE, DE, ES, FR, IT, PL and UK). This administrative classification is only indicative as many special districts or entities may exist in Member States, blurring the boundaries between levels of government. The classification does not serve either as a proxy for the level of centralisation or the share of expenditure conducted at the subnational level. From a national accounts perspective, Eurostat considers that 'State government' exists only as statistical concept in 4 Member States (AT, BE, DE and ES), the first three of them being officially labelled as federal states.

**Subnational government accounts for a significant share in total expenditure**. In 2011, subnational government expenditure amounted to 16.7% of EU GDP, similar to the social security sub-sector (16.2%), but lower than central government (26.5%). The largest share of local government in general government expenditure can be found in two unitary States, DK and SE. However, all federal States, when combining State expenditure and local expenditure, rank high in the EU regarding the share of subnational expenditure. State government expenditure, where it exists, represents a sizeable share, with around 25% in total general government expenditure. The share of local and State government expenditure in total expenditure has increased somewhat between 2000 and 2007 before edging down after 2007. In nominal terms, local expenditure increased on average by 6.6% between 2000 and 2011, against 5.2% for central government.

**State and local government expenditure are specialised in few, yet visible areas of public expenditure**. From the COFOG classification State and local expenditure are broadly targeting the same policy areas. Expenditure of these two sub-sectors is generally focussed on education, health, economic affairs and social protection, where proximity with the beneficiaries of such public goods and services may be considered important according to domestic preferences. Only minor differences exist between unitary and federal states (see Table 2.1). However, even within these categories, some differentiation can be found across Member States (see Annex 2).

*Table 2.1:* **Average share in total subnational expenditure (1995-2007, EU15, in %)**

| | Public services | Social protection | Defence | Public order and safety | Economic affairs | Env. protection | Housing | Health | Recreation, culture and religion | Education |
|---|---|---|---|---|---|---|---|---|---|---|
| Federations (*) | 20.4 | 16.4 | 0.0 | 4.5 | 13.6 | 4.1 | 4.3 | 10.5 | 5.4 | 20.8 |
| Unitary countries | 15.7 | 18.0 | 0.0 | 2.6 | 13.2 | 6.5 | 6.7 | 14.3 | 6.3 | 16.5 |

(*) including ES

Source: von Hagen and Foremny (2013) in Economic Paper 501 (July 2013) – Fiscal relations across government levels in times of crisis – making compatible fiscal decentralization and budgetary discipline

**Subnational revenue is heavily dependent on transfers from other government sub-sectors**. Taxes account for a relatively low share of total subnational revenue (40.6% in federations, 32.4% in unitary states, see Table 2.2). Within the category, own taxes account for the majority of tax revenue in unitary states, while the higher share of shared taxes in federations may be linked to practical considerations; in order to match a high level of expenditure, revenue from larger taxes (VAT, PIT, excise duties) has to be partially allocated to federated entities ([6]). A noticeable feature is the significant dependence on transfers

([6]) Tax sharing arrangements are an important revenue source in BE, AT, LV, LT, EE, RO, PL, CZ, SK, EL, HU, PT, SI and LU.

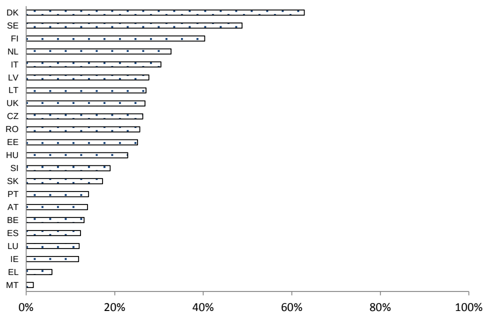
from other government levels, irrespective of the 'nominal' degree of decentralisation. This attenuates to a significant extent the classical legal distinction between unitary states and decentralised ones.

*Table 2.2:* **Average share in total subnational revenue (1995-2007, EU15 in %)**

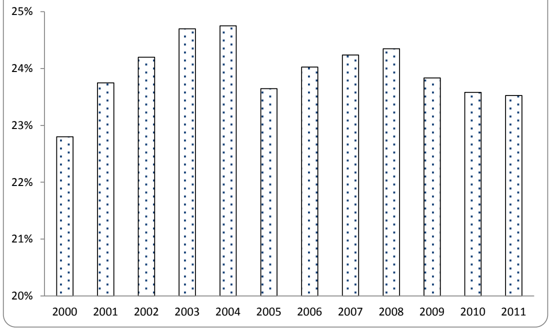
| | Own taxes | Shared taxes | Transfers | Fees | Other |
|---|---|---|---|---|---|
| Federations (*) | 17.7 | 22.9 | 40.9 | 8.8 | 9.8 |
| Unitary countries | 28.4 | 4.0 | 44.4 | 14.4 | 8.8 |

(*) Including ES.
Source: von Hagen and Foremny (2013)

*Graph 2.1a:* **Local government expenditure (as a % of general government expenditure, 2011)**




*Graph 2.1b:* **Local government expenditure (as a % of general government expenditure, 2000-2011)**




**Fiscal imbalances at the local government level have remained contained**. Being balanced in 2007, accounts of local government have deteriorated following the global financial crisis (see Table 2.3). For the aggregate 27 Member States, net borrowing amounted to -0.4% of GDP in 2009. Sizeable deficits, to the tune of 0.5-0.75 GDP points, were incurred around 2009-2010 in BG, DK, ES, FI, HU, NL, PL, PT and SK, but were significantly reduced afterwards in all Member States with the exception of FI. In the first two years of the crisis, the subnational spending increase was financed from central transfers (as part of fiscal stimulus) and higher deficits roughly in equal parts (Eyraud and Moreno Badia, 2013) ([7]). In 2012, local government deficits were back to balance, with -0.1% of GDP for the EU27 on aggregate.

**State government deficit has been more volatile than local government**. From a globally balanced position in 2007, State government deficit rose to -0.7% in BE, and -0.8% in AT and DE. A large and unexpected deterioration took place in ES, where State government deficit increased to -3.8% in 2010 and -5.1% in 2011 before decreasing to -1.8% in 2012.

**The evolution of subnational debt remains contained in comparison with the rapid expansion witnessed at the central government level**. Subnational public debt has remained contained at significantly lower levels than those reached by central government. Still, State government debt is sizeable in Spain (17.6% of GDP) and Germany (25.3%). Local government debt stands at lower levels overall, but numbers are not trivial in the Netherlands (9% of GDP), France (8.6%), Italy (8.4%), and Sweden (7.6%). Unlike central government however (+11.4 GDP points from 2009 to 2012), State and local debt have only marginally increased over the same period (+1 point and +0.3 point respectively).

**Funding of subnational government remains largely bank-based**. Bank borrowings amount to 59% of the total debt. The structure of the debt is predominantly formed of long-term instruments (78%).

([7]) 'Too Small to Fail? Subnational Spending Pressures in Europe' L. Eyraud, M. Moreno Badia – in proceedings of the Public Finance Workshop 'Fiscal Relations across government levels in times of crisis-making compatible fiscal decentralisation and budgetary discipline' - European Economy – Economic Papers 501 (July 2013) pp.24-55.

*Graph 2.2:* **Unconsolidated transfers between all general government sub-sectors in 27 Member States ( as a % of general government expenditure, 2011)**

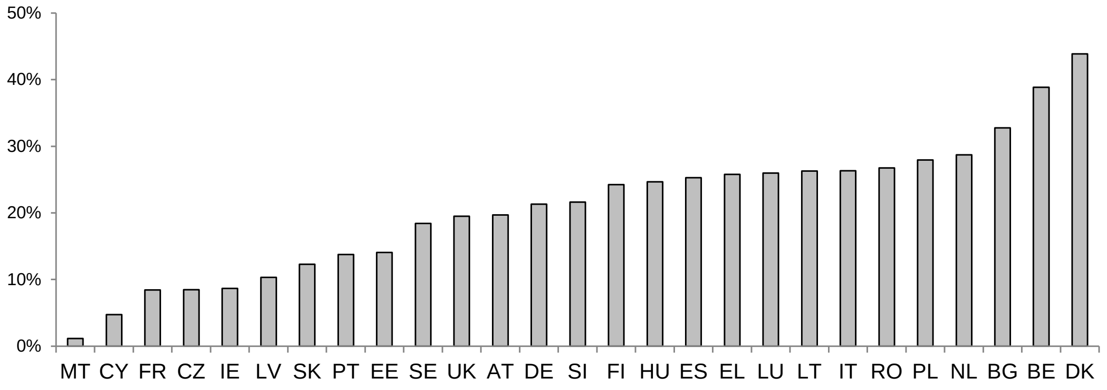


*Table 2.3:* **Net borrowing in % of GDP (2007, 2012)**

| | **AT** | **BE** | **BG** | **CY** | **CZ** | **DE** | **DK** | **EE** | **EL** | **ES** | **FI** | **FR** | **HU** | **IE** |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Central Government 2007 | -0.9 | -1.1 | 1.1 | 0.5 | -1.5 | -0.8 | 5.1 | 2.3 | -6.5 | 1.2 | 1.0 | -2.6 | -5.7 | 0.0 |
| State Government 2007 | 0.0 | 0.4 | - | - | - | 0.1 | - | - | - | -0.2 | - | - | - | - |
| Local Government 2007 | 0.1 | 0.2 | -0.1 | -0.1 | 0.3 | 0.5 | -0.3 | -0.5 | -0.1 | -0.3 | -0.2 | -0.4 | -0.1 | -0.2 |
| | **AT** | **BE** | **BG** | **CY** | **CZ** | **DE** | **DK** | **EE** | **EL** | **ES** | **FI** | **FR** | **HU** | **IE** |
| Central Government 2012 | -2.6 | -3.4 | -1.1 | -7.2 | -4.2 | -0.5 | -3.9 | -0.7 | -9.2 | -7.8 | -3.4 | -4.0 | -2.6 | -7.6 |
| State Government 2012 | -0.1 | -0.1 | - | - | - | -0.3 | - | - | - | -1.8 | - | - | - | - |
| Local Government 2012 | 0.1 | -0.3 | 0.3 | 0.0 | -0.1 | 0.2 | -0.1 | -0.2 | 0.3 | -0.2 | -1.1 | -0.2 | 0.7 | 0.0 |
| | **IT** | **LT** | **LU** | **LV** | **MT** | **NL** | **PL** | **PT** | **RO** | **SE** | **SI** | **SK** | **UK** | **EU27** |
| Central Government 2007 | -2.0 | -0.6 | 0.9 | -2.5 | -2.3 | 0.5 | -3.0 | -3.7 | -3.7 | 2.4 | -0.1 | -1.9 | -2.7 | -1.4 |
| State Government 2007 | - | - | - | - | - | - | - | - | - | - | - | - | - | - |
| Local Government 2007 | -0.1 | -0.3 | 0.4 | -0.7 | 0.0 | -0.2 | 0.0 | -0.3 | -0.2 | 0.1 | -0.1 | -0.1 | -0.1 | 0.0 |
| | **IT** | **LT** | **LU** | **LV** | **MT** | **NL** | **PL** | **PT** | **RO** | **SE** | **SI** | **SK** | **UK** | **EU27** |
| Central Government 2012 | -3.4 | -1.2 | -2.6 | -0.8 | -3.3 | -3.2 | -3.9 | -7.1 | -2.4 | -0.5 | -3.8 | -4.8 | -6.0 | -3.7 |
| State Government 2012 | - | - | - | - | - | - | - | - | - | - | - | - | - | -0.2 |
| Local Government 2012 | 0.2 | -0.2 | 0.1 | -0.2 | 0.0 | -0.4 | -0.3 | 0.5 | -0.4 | -0.3 | 0.1 | 0.1 | -0.4 | -0.1 |
| Source: Eurostat | | | | | | | | | | | | | | |

# 3. EXISTING COORDINATION ARRANGEMENTS BETWEEN GENERAL GOVERNMENT SUBSECTORS

### 3.1 General considerations

**Coordination takes the form of hard and soft arrangements**. The distinction has been established in the EU fiscal policy area (Begg, Hodson and Maher, 2003) ([8]). Hard policy coordination tends to have top-down policy formulation, with the higher level playing the dominant role. Implementation lies with lower-level authorities, but failure to conform may lead to enforcement action. Soft policy coordination takes the form of guidelines, arrangements, meetings, and even at times letters, designed to achieve a balance between policy credibility, stability and flexibility. A further breakdown of hard coordination instruments would distinguish numerical fiscal rules from other rules such as borrowing or recovery rules. Budgetary procedures at the subnational level are often detailed in domestic legislation.

**As an alternative to coordination, market discipline faces a number of practical hindrances**. Theoretically the greater the discipline markets can impose on subnational governments, the lesser the need for coordination. However market discipline is muted for two reasons: (i) the impact of market-based funding matters less for smaller subnational government as non-market funding received from other government sub-sectors often represents a sizeable share in revenue; (ii) market participants may be ill-placed to gauge effective solvency of subnational governments on account of insufficient data or scarce sector-specific expertise. Another shortcoming of market discipline is that it relies primarily on instruments such as interest rate risk premia and credit ratings that do not react smoothly to fiscal developments. They often do not provide much advance warning for the need to restore fiscal discipline (Ahmad and al., 2005) ([9]). This occurred for instance in Spain where ample credit conditions enjoyed by regions have been followed after the onset of the financial crisis by steep increases in funding spread and, eventually, by their crowding out of the market. Due to these limitations, market discipline may not take centre stage in ensuring fiscal discipline at subnational level, but its effectiveness would still benefit from advances in coordination in so far as they improve transparency.

### 3.2. Hard coordination: fiscal rules for subnational governments

According to the seminal definition of Kopits and Symansky (1998) ([10]) and parts of Article 2(c) of the 2011 EU Directive on budgetary frameworks, a fiscal rule is *'a permanent constraint on fiscal policy, expressed in terms of a summary indicator of fiscal performance such as budget deficit, borrowing, debt or a major component thereof'*. Fiscal rules seek to confer visibility, stability and credibility to the conduct of fiscal policy by limiting scope for discretionary intervention.

Fiscal rules for subnational governments are created under two different regimes (Kopits, 2001)([11]):

**Under the autonomous approach**, the initiative for establishing rules arises from individual subnational governments themselves, for instance because of the need to build good reputation with banks or in financial markets. This approach is followed in many US federated States and in federations like Switzerland where subnational governments enjoy a very high degree of autonomy;

**Under the coordinated approach**, subnational governments are subject to uniform rules to ensure a degree of fiscal discipline under the surveillance of higher authority. This approach seems more relevant in the EU context, where central governments have benefited from the historical trend towards bigger

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([8]) '*Economic Policy Coordination in the European Union*' I.Begg, D. Hodson, I. Maher, National Institute Economic Review No.183 January 2003.

([9]) 'Subnational Public Financial Management: Institutions and Macroeconomic Considerations' E. Ahmad, M. Albino-War, R. Singh – IMF Working Paper WP/05/108.

([10]) '*Fiscal Policy Rules*', IMF Occasional Paper No.162, G. Kopits and S. Symansky (1998).

([11]) '*Fiscal Rules: useful policy framework or unnecessary ornament?*' in Fiscal Rules (2001) - Banca d'Italia Research Department.

government and shaped nation-states by ring-fencing the powers previously held by subnational governments.

*3.2.1. Design constraints for subnational fiscal rules*

**The design and functioning of subnational fiscal rules face specific challenges**. Beyond the typical effectiveness issues addressed at fiscal rules in the economic literature, a number of challenges specific to subnational government come mostly from institutional and practical features (see Table 3.1):

*Table 3.1:* **Specific challenges applicable to the design and functioning of subnational fiscal rules**

| *Central Government features* | *Subnational government features* | *Ensuing constraints for subnational fiscal rules* |
|---|---|---|
| Homogeneous | Heterogeneous | Challenge in rule specification |
| Unified | Fragmented | Challenge in rule monitoring<br>Challenge in accountability to the rule |
| In command of its revenue and expenditure base | Dependant on policies/revenues from other government tier(s) | Challenge in accountability to the rule |
| Stronger administrative capabilities | (Poss.) Weaker administrative capabilities | Challenge in rule implementation |
| Timely-available fiscal data | Fiscal data not always available timely | Challenge in rule monitoring |
| Directly accountable to EU fiscal multilateral surveillance | Safeguards as regards its institutional autonomy | Challenge in rule enforcement |
| (Poss.) Strong media coverage | Weaker media coverage | Challenge in rule effectiveness |

- Subnational governments are heterogeneous in size, population and factor endowment, putting constraints on the design of one-size-fits-all rules;

- Subnational governments enjoy –sometimes constitutionally established– legal safeguards at the national level; subnational decision-makers may also wield significant political power at the national level (e.g. through a bicameral system);

- For a given government level, subnational government is fragmented into many different individual entities, each with a unique democratic mandate coming from its constituents. Large resources for monitoring and enforcement (i.e. supervision) may be needed to ensure accountability. To prevent committing too many resources, uniform rules can be set for all subnational government entities, in aggregate. However uniform rules may raise relevance and accountability issues;

- Unlike central government, subnational governments do not have full discretion when preparing their budgets. Centrally-fixed rules govern the provision of standardised public goods and services, sizeable grants originate from central government, and subnational government may have limited powers to reform its own taxes (these powers might be even weaker in the case of shared taxes);

- As subnational expenditure usually provides essential public goods and services funded by transfers, it gives rise to open-ended funding arrangements typical of soft budget constraints; Eyraud and Moreno Badia (2013) find that subnational government do not always fully accommodate negative shortfalls, most likely because central government would be expected to fill the gap. Aggravating factors include improperly-designed transfer systems based on costs rather than genuine expenditure needs (possibly linked to input-based policies). The complexity of the stacked policy-specific funding arrangements framing relations between central government and subnational ones provides little room to adjust public resources to actual needs, barring extensive expenditure reviews. Also due to the different granularity of taxes and expenditure (with the collection of taxes concentrated around few efficient taxes), it is not always possible to set up arrangements where own-taxes would exactly match expenditure needs. Transfers then fill the funding gap for subnational government;

- Other constraints may include weak administrative capacity, insufficient public financial management systems, infrequent fiscal reporting to ensure in-year rule monitoring and enforcement, and patchy media coverage of assessments of the fulfilment of fiscal rules by subnational governments.

*3.2.2. Overview of subnational fiscal rules in the EU*

Covering all 27 Member States and based on their own reporting, the Commission's Fiscal Governance database maintained by DG ECFIN ([12]) lists and assesses the functioning of fiscal rules, including those covering sub-national governments. Looking at its 2011 update, the database released in late 2012 provides a number of substantive findings.

**The number of subnational fiscal rules in the EU has grown over the years**. As of 2011, 38 numerical fiscal rules were specifically applicable to subnational government (see Table 3.2). The number rose mostly between 2000 and 2005 (24 in 2000, 35 in 2005), especially as some Member States set up new budget-balance rules. Overall, balanced-budget rules account for the majority of rules (21 in 2011), with debt rules a distant second (13 in 2011). Local government is more subjected to fiscal rules than State government.

**Expenditure or revenue rules are less frequent**. One-size-fits-all expenditure or revenue norms may struggle to match the wide spectrum of specific subnational cases. Expenditure rules for regional governments in federal states, given their lower numbers and their higher share in general government expenditure, may be easier to envisage. While there is no numerical revenue rule listed in the database, subnational governments are subjected to legal tax requirements, which often lay down in detail tax bases, applicable rates and collection procedures ([13]). Another consideration to recall is that transfers from central government usually account for a significant share of subnational government revenue.

([12]) http://ec.europa.eu/economy_finance/db_indicators/fiscal_governance/
([13]) A limitation of the database is the non-reporting of autonomous rules that some subnational government may impose on itself at the local/regional level (for instance a commitment to keep expenditure or debt below a certain threshold throughout an entire regional/municipal term). Such rules affecting only one local government are not recorded in the database, which gathers uniform rules set at the national level affecting all local or regional governments. Likewise, hypothetical numerical fiscal rules imposed in federal states to the local level by regional government are not reported, as the database focusses on uniform fiscal rules covering all the territory of a given Member State.

*Table 3.2:* **Subnational fiscal rules in EU Member States**

| | Budget-balance rules | | | Debt rules | | | Expenditure rules | | | Revenue rules | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2000 | 2005 | 2011 | 2000 | 2005 | 2011 | 2000 | 2005 | 2011 | 2000 | 2005 | 2011 |
| State govt. | 3 | 5 | 7 | 2 | 3 | 2 | 2 | 3 | 2 | 0 | 0 | 0 |
| Local govt. | 9 | 13 | 14 | 7 | 10 | 11 | 1 | 1 | 2 | 0 | 0 | 0 |
| **Total sub-nationals** | **12** | **18** | **21** | **9** | **13** | **13** | **3** | **4** | **4** | **0** | **0** | **0** |
| p.m Central govt. | 3 | 4 | 2 | 2 | 1 | 3 | 6 | 10 | 12 | 1 | 1 | 4 |
| Source: Commission database on fiscal governance, release 2011. | | | | | | | | | | | | |

**Legal bases of subnational fiscal rules are diversified**. When grounded in law, they are rooted either in ordinary law, organic law or even the Constitution. Recourse to texts of high legal standing is often found in federal states to equip fiscal rules with an equivalent or stronger footing than the principle enshrining the autonomy of subnational government. For a given fiscal rule, high legal standing does not always guarantee effectiveness, as a high legal footing may instead signal the need to overcome well-entrenched institutional hindrances.

**Budget-balance rules appear more effective at the margin**. For each rule, the database features an indicator of its strength based on several criteria ([14]). Scoring is based on reporting from Member States. According to the indicator, budget-balance rules score on average 6.73 while debt rules score 6.28. Quite a few budget-balance rules take inspiration from 'golden rule' principles, where capital investment is excluded from rule constraints (DE, FR, IT, LT, LU, RO and SK). This acknowledges the important share of local investment in total subnational spending (9.7% in 2011) and limits –to some extent– cuts that target investment spending during unfavourable economic times. Most Member States also exclude from the scope of the rules projects involving EU co-financing.

**Visibility of subnational fiscal rules is sometimes perceived as weak**. While media coverage is stronger when rules are created, the functioning of established rules does not seem to receive a lot of media attention. Two conclusions of opposite nature may be drawn. It may reflect the fact that some rules are so ingrained in national life that they barely draw the interest of the public anymore. It may also mean that regional or local media has less resources than national media. As an important vector for accountability to other stakeholders including constituents, the lack of media scrutiny constitutes a serious challenge for rule effectiveness.

**A majority of reported subnational fiscal rules are reported to have an impact on deficit and debt.** Most Member States consider that their rules are conducive to fiscal discipline, although some Member States report lesser effectiveness when it comes to reigning in expenditure. Some rules are not considered effective or that compliance is assessed as difficult (SK, CZ, HU and PT). Despite rules, a number of reasons for overruns are reported by some Member States; they include macroeconomic shocks hitting revenue, unrealistic forecasts and wrong local investment decisions.

**Monitoring and enforcement often involve the collaboration of several administrative bodies**. The Ministry of Finance (or the Ministry of the Interior) often ensures monitoring, sometimes backed up by

([14]) Criteria include: (i) the statutory base of the rule, (ii) room for setting or revising its objectives, (iii) the body in charge of monitoring respect and enforcement of the rule, (iv) the enforcement mechanisms relating to the rule, and (v) the media visibility of the rule. For more information, see http://ec.europa.eu/economy_finance/db_indicators/fiscal_governance/fiscal_rules/index_en.htm.

regular reports from Courts of Auditors (ES, EE, CZ, BG). Local government can be supervised by dedicated bodies, such as municipal supervisory authorities (DE), Regional Chamber of Auditors (FR, PL), state officers appointed by central government (LT), or specific boards (RO, LV, and LU). Self-monitoring exists in SE and HU. Sanctions would normally affect local government and can range from a cut in grants (PT, IT, ES), the referral to courts for mandatory corrective action (FR, LT) or restrictions in borrowing rights (ES, IE). In DE, municipal supervisory authorities can substitute themselves to local authorities to execute corrective measures ('*Ersatzvornahme*'). A less direct approach includes the nomination of an evaluation committee (FI).

*3.2.3 Borrowing rules and other administrative rules*

**Member States have developed regulations aimed at restraining subnational borrowing capabilities**. Short-term borrowing provide intra-annual resources to make up for the mismatch between revenue and expenditure flows, especially where taxes account for a significant share in revenue and their collection occurs later during the fiscal year. Borrowing can also finance capital expenditure or be linked to the rescheduling of current debt. Borrowing restrictions were introduced for several reasons: (i) experience from past subnational indebtedness episodes; (ii) shortage of financial skills in finance in smaller local authorities; (iii) usage of borrowing rules as a substitute to explicit numerical rules. In quite a few Member States, these rules exist for a long period of time. From the 1980s onwards, some administrative controls have been relaxed following financial market liberalisation (lifting of mandatory funding through special financial channels and/or institutions, lifting of prohibition of borrowing in foreign currencies, etc.).

**While outright prohibition seldom exists anymore, various rules aim to constraint borrowing**. The most frequent clause limits borrowing to the financing of investment expenditure in line with 'golden rule' principles. Administrative controls can subordinate the decision to grant a loan to vetting by the Ministry of Finance (or the Ministry of Interior) or the local representative of the State. In Federal States, vetting powers may be conferred to State authorities. For instance in Germany, local authority borrowing is subject to legal provisions of the *Länder* Ministers of the Interior. As a result, the borrowing rule is often part of a wider rule-based system, in particular when it is coupled with a balanced budget rule.

**Some Member States also forbid or limit the possibility for local authorities to provide loan guarantees**. Unchecked loan guarantees are contingent liabilities that can pose a major off-balance sheet threat to the health of local finances, for instance if granted to local businesses. While guarantees granted by the central government are satisfactorily recorded, less statistical material is available on the amount of guarantees at the subnational level. Statistical work under the aegis of Eurostat deriving from the provisions of Article 14 of the 2011 EU Directive on budgetary frameworks should contribute to improving knowledge as to their exact scale.

**Financial innovation increased the potential for rule circumvention**. In recent years, a number of cases arose where the financial position of local authorities deteriorated markedly due to exposure in sophisticated financial products (such as swaps in Italy and France or structured financial products linking borrowing rates to variable financial indexes). In Hungary, municipalities faced financial difficulties because of heavy foreign-currency borrowing, in particular in Swiss francs ([15]). Some anecdotal evidence points to increased recourse to sophisticated loans when local government are highly indebted to obfuscate their financial situation ([16]). Some Member States have recently taken steps to better ascertain the size and use of these non-conventional financial products. In 2008, the Italian government banned the

([15]) '*Franc's Strength Roils European Cities*'– 22 August 2011 –The Wall Street Journal Europe.
([16]) 'Political incentives and financial innovation: the strategic use of toxic loans by local governments' C. Perignon, B. Vallée HEC Paris Research Paper No.FIN-2013-1017.

use of derivatives by Italian municipalities ([17]). It comes down to the issue whether subnational decision-makers could be considered qualified investors or whether they should face specific restrictions.

*3.2.4 Recovery rules*

**Unlike commercial entities, recovery procedures regarding subnational government cannot take the form of liquidation**. In almost all European Member States, it is not legally possible for local authorities to go bankrupt ([18]). Chapter 9 of the US Bankruptcy Code dedicated to municipalities states that there is no provision for liquidation of the assets of the municipalities and distribution of the proceeds to creditors: '*The purpose of chapter 9 is to provide a financially-distressed municipality protection from its creditors while it develops and negotiates a plan for adjusting its debts*' ([19]). Yet subnational government may call for emergency financial assistance. In a study of an US city, Inman (1995) mentions four triggering factors: (i) unfavourable economic developments in the local economy; (ii) unfavourable demographics (erosion of the tax base or expansion of social spending); (iii) unfavourable policies from higher government tiers (reduction in aid or new legally-mandated expenditure); and (iv) local politics. In addition, exceptional events (i.e. natural disasters) provide additional reasons for relief.

**Recovery rules entail significant moral hazard risks**. As a last-ditch measure, recovery rules signal a double failure: existing rules and supervision have failed to avert default and the subnational government failed to administer itself. These risks have been described in the work of Kornai (1980) ([20]) which introduced the notion of 'soft budget constraints' as supporting institutions are unable to commit themselves not to extend funding to a budget-constrained organisation. The need to ensure the provision of essential local public services to the population also increases the bargaining power of local authorities ([21]).

**The response to financial difficulties follows a number of common patterns**. Usually, the distressed entity would hold meetings with higher authorities (either regional or national) and draw up a plan to correct the situation. It is not common that the funding entities fully take over the economic planning of the distressed entity, although the possibility exists in some Member States. In most Member States, exemptions to fiscal rules or borrowing rules can be granted on a temporary basis. Assistance is provided against specific conditionalities and often includes a reduction in expenditure, and to a lesser extent an increase in taxes. In federal States, State government is often the counterpart to distressed local entities.

**Recovery rules can be viable if a number of prerequisites are met.** Given moral hazard considerations, recovery rules may pose a threat to fiscal discipline. The risk is mitigated by the weaker political clout of smaller subnational government when it comes to negotiating the terms of their recovery. Hence recovery rules can provide a frame for compromise between small subnational government and supervising entities, providing a few prerequisites are met: (i) other upstream rules make sure that there are few cases of actual financial distress; (ii) the scope of recovery rules is limited to smaller subnational government, where the asymmetry in powers between the distressed entity and the provider of assistance lessens the risk of abuse; (iii) there are stringent conditions attached to assistance, possibly including personal sanctions against subnational decision-makers.

([17]) '*Four Banks Fined in Italy Swaps Case*' – 20 December 2012 – The Wall Street Journal Europe.
([18]) '*Recovery of local and regional authorities in financial difficulties*' Report No.77 of the Council of Europe Steering Committee on Local and Regional Democracy.
([19]) http://www.uscourts.gov/FederalCourts/Bankruptcy/BankruptcyBasics/Chapter9.aspx.
([20]) '*Economics of shortage*' J. Kornai –North-Holland, Amsterdam (1980).
([21]) '*Subnational Government Bailouts in OECD Countries: four case studies*' IADB Working Paper #399 – J. von Hagen, M. Bordignon, M. Dahlberg, B. Grewal, P. Petterson, H. Seitz.

*Table 3.3:* **Examples of local recoveries in Member States**

| Community | Reason for financial distress | Recovery procedure | Monitoring |
|---|---|---|---|
| 823 local authorities (PL) | Floods | Grants from central government against fulfilment of criteria | |
| Municipality of Steningsund (SE) | Loss on local housing company due to real estate slump | Grant against the establishment of consolidation plan | Regular reporting to MoF |
| Pernik (BG) | Decline of local industries | Central Government provided earmarked grant against stabilisation programme | Continuous monitoring |
| Passau (DE) | Financial obligations towards private company | Regional Government granted bridge loan against conditionalities | |
| Local authority (DK) | Shrinking population | Central Government authorised borrowing against an expenditure cuts plan | Continuous monitoring |
| Hatvan (HU) | Decline in industrial base | Following steps to reduce expenditure, central government approved grant. | |
| Welwyn Hatfield District Council (UK) | Unfavourable court decision in commercial case | Government offered non-financial support and expertise to reduce costs | |
| Reiderland (NL) | Decline in industrial base | Grants from Central Gov. Municipalities Fund following consultations between municipalities, province and Municipality Fund Managers against the implementation of consolidation plan including expenditure cuts and local tax hikes | Continuous monitoring |
| Source: '*Recovery of local and regional authorities in financial difficulties*' Report No.77 of the Council of Europe Steering Committee on Local and Regional Democracy. | | | |

## 3.3 Soft coordination mechanisms among sub-sectors applicable to fiscal policy

### *3.3.1 General considerations*

**Box 3.1: Organic linkages between government tiers**

*A sizeable portion of subnational government revenue derives from transfers, mostly in the form of grants. Grants may be general or earmarked for the provision of specific public goods and services. They can originate from higher authorities or authorities of the same tier. Grants provide funding for either operating expenses or capital expenses. They can be allocated following objective criteria or discretionary ones. Fees and charges collected by subnational government from the provision of public goods and services may be capped or subject to regulation. Rates, upper limits and collection procedures of own-taxes can be regulated by higher levels of government in an attempt to prevent excessive tax competition between subnational governments. Tax revenues can be shared out between different tiers of government and/or between different authorities within a specific tier. The percentage shares allocated to the various authorities for a given tier may be laid down in national legislation. Finally, vertical and horizontal equalisation systems, sometimes grounded into the constitution, aim at limiting disparities in tax capacity or expenditure needs between or within government tiers. These systems are often complex and suggestions for reform are regularly floated.*

**Soft coordination arrangements are common in States with a sizeable share of expenditure delegated to subnational government**. This concern States with a federal structure or unitary States with a large share of expenditure implemented through decentralised levels, as negative externalities associated with uncoordinated fiscal policies are markedly stronger. Therefore the benefits for fiscal discipline to be reaped from increased monitoring are supposed to overcome policy coordination costs.

**Soft coordination arrangements also prove valuable when subnational government enjoys constitutionally-established safeguards**. These coordination arrangements aim at ensuring consistency of fiscal goals at the national level while safeguarding the benefits of decentralisation as perceived through national preferences. The inability of one specific government level to impose its views on others lays the ground for a collaborative or contractual approach involving institutional bargaining to reach common fiscal goals.

**Due to their more flexible nature, soft coordination arrangements can also look at the broader picture surrounding the preparation of budgets**. The economic and legal ties between government tiers are intense (see Box 3.1). Subnational governments implement policies whose terms are decided at national level or are uniform across the country to ensure the equal provision of public services and/or transfers to citizens. Against this background, coordination meetings may facilitate reform by widening the agenda of discussion beyond headline fiscal targets to other legal or policy-based aspects. Broad-based bargaining may concern in particular the revenue and expenditure structure of subnational governments, including vertical and horizontal redistribution schemes. Given the substantial share of transfers obeying to sector-specific considerations, coordination arrangements provide a forum to improve the design of such transfers. This may in particular entail the introduction of performance-based components to incentivise subnational government in the cost-effective provision of earmarked public goods and services.

**Impediments affect coordination involving subnational governments.** The fragmented nature of subnational governments does not facilitate bargaining when coordination aims at more than the top-down provision of fiscal information. The heterogeneity of subnational governments also hinders advanced coordination, given that the outcome of negotiations might not be suitable for all subnational governments at a given level. Finally, subnational interests might also be represented within the national level, blurring responsibilities and impeding the taking of reform initiatives as a result.

*3.3.2 A brief overview of soft coordination arrangements in the EU*

The Commission's Fiscal Governance database contains information reported by Member States on coordination arrangements.

**The preparation of medium-term fiscal plans early in the year provides an opportunity for early coordination** (see Tables 3.4 and 3.5). Around half of Member States report involving in some way subnational governments (e.g. through representative bodies) in the preparation of their medium-term fiscal plans (also called Medium-Term Budgetary Frameworks in the EU Directive on budgetary frameworks). The involvement is reported to be grounded in law in AT, IT, PT, RO and UK. For instance, the Italian MTBF document (Economic and Financial Document) is submitted by 10 April each year to the Standing Conference for Public Finance Coordination for its opinion to be taken into account of during the relevant parliamentary debates and before its submission to the European Commission by the 30 April deadline. The Standing Conference was established as a permanent body for coordinating public finances between different tiers of government by a Legislative Decree. It enacts provisions regarding the autonomy of the ordinary regions and the Provinces in respect of their tax revenues and lays down standard costs and requirements in the healthcare sector ([22]).

**There is less reported involvement of sub-national government when preparing Stability or Convergence Programmes**. Less than half of Member States report taking steps to involve their subnational government. This can be explained if the Stability and Convergence Programme is identical or forms a subset of national medium-term fiscal plans developed under MTBF requirements. The two-pack regulation for euro-area Member States should be conducive to a consolidation of existing arrangements, given that the preparation of Stability Programmes and medium-term fiscal plans may be integrated.

([22]) '*Recent budget reforms in Italy*' paper from the Italian Chamber of Deputies presented at the third annual OECD meeting of PBO officials (28-29 April 2011).

*Table 3.4:* **Reported coordination arrangements in the preparation of national Medium-Term Budgetary Frameworks (2011)**

| | AT | BE | BG | CZ | DK | EE | FI | FR | DE | EL | HU | IE | IT |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Coverage (breakdown of targets by Subnational government) | Y | Y | Y | N | N | Y | N(a) | Y | Y(b) | Y | N | Y | Y |
| Involvement of subnational governments | Y (L) | Y (E) | Y (E) | N | N | Y (E) | Y | Y (E) | Y | Y | N | Y (E) | Y (L) |

| | LV | LT | MT | NL | PL | PT | RO | SK | SI | ES | SE | UK |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Coverage (breakdown of targets by Subnational government) | N | Y | Y | N | N | N | Y | Y | Y | Y | Y | Y |
| Involvement of subnational governments | N | N | Y (E) | N | N | Y (L) | Y (L) | N | N | Y | N | Y (L) |

Y = Yes; N = No; L = coordination arrangement grounded in Law; E = established practice
(a) There is implicit coverage as municipalities are expected to run balanced accounts over a three-year period.
(b) In Germany, each sub-sector prepares its own medium-term planning document.
Source: Commission database on fiscal governance – Update 2011.

*Table 3.5:* **Involvement of subnational government during the preparation of the Stability and Convergence Programmes (2011)**

| | |
|---|---|
| Austria | Established consultation arrangements |
| Belgium | Indirectly, with involvement of subnationals in *comités de concertation* |
| Czech Republic | Indirectly, as national MTBF are prepared in collaboration with local government |
| Denmark | Indirectly, during national MTBF preparation |
| Finland | Involvement of Advisory Committee of Local Government Finances and Administration |
| France | Involvement of specific consultative bodies (*Conférence Nationale des Finances Publiques*) |
| Germany | Involvement of Stability Council |
| Italy | Draft SP is presented to the Standing Conference for Public Finance Coordination |
| Luxembourg | Informal involvement of '*Comité de Prévision*' |
| Spain | Involvement of the Fiscal and Financial Policy Council (CPFF) and (National Committee of Local Administration (CNAL) |

Source: Commission database on fiscal governance – Update 2011.

*3.3.3 Design considerations when running soft coordination mechanisms*

**Soft coordination arrangements can take various forms**: (i) intermittent meetings to exchange views without operational conclusions; (ii) temporary task force activity to accomplish a specific purpose;

(iii) regular coordination fora crowned by formal arrangements; and (iv) permanent structured coordination that entails a broad mission, strategically inter-dependant action with join monitoring of action taken, regular assessments and corrective mechanisms. The latter forms are obviously more ambitious.

**Intermediate entities may represent some or all subnational governments**. During coordination, a representative entity may take care of the interests of subnational governments (e.g. a national association of municipalities or a federation of regional entities). Having fewer counterparts around the table would be conducive to smoother decision-making. At the same time, the capability of such 'mediating bodies' to negotiate on behalf of their constituents should be carefully evaluated and conclusions drawn on what could be reasonably achieved given the support they can muster.

**They can also achieve various purposes.** Ranging from least to most ambitious, coordination arrangements can:

- *Inform subnational government on the fiscal stance and policies*. Central government provides information in relation to general considerations concerning recent reforms at the EU and domestic level. News on the latest fiscal objectives agreed for the central or general government are shared. Likewise, subnational governments report latest budgetary developments;

- *Explain the rationale for fiscal policy targets and actions*. Here central government explains its policy orientations for the incoming fiscal year(s). It seeks to secure general support from subnational authorities, without firm commitments however;

- *Share technical information pertaining to the preparation of budgets*. Here procedural footbridges are built between parallel budget preparations. Central and subnational government meet at technical level to discuss macroeconomic forecasts underpinning the preparation of annual budgets or multi-annual budgetary frameworks. During such technical meetings, central government provides general macroeconomic assumptions taking the form of key external assumptions. It also provides advance notice of estimates of forthcoming State budget measures that may affect revenue or expenditure of subnational government. Regarding budgetary forecasts, the existence of taxes shared among government levels usually provides an incentive for deeper coordination. Overall, ex ante sharing of technical information is expected to increase the overall consistency of budgets prepared across general government (see Box 3.2 in the case of Germany);

- *Allocate within government sub-sectors explicit objectives spelled out by fiscal rules for the central government* (or State government for local entities in federal States). Under this goal, burden-sharing arrangements can be negotiated among peers (see Box 3.4 on the case of Spain). The allocation between sub-national governments of individual fiscal targets may also be twinned with an agreement on shared budgetary forecasts (see Box 3.2).

- *Negotiate fiscal objectives for all sub-sectors*. In that case, coordination is tasked with more demanding objectives, namely the definition of fiscal targets under general constraints for the general government to be presented by the central government (see Box 3.3). This may require protracted negotiations with possible feedback on the setting of general government fiscal objectives. This extended form of coordination has taken the form of **Internal (or Domestic) Stability Pacts** in federal States or in unitary States with a high degree of decentralisation. Internal Stability Pacts usually combine several features: (i) formal coordination instances gathering representatives of government sub-sectors on a regular basis; (ii) operational tasks devoted to such instances with in particular the definition of individual fiscal targets for government sub-sectors; (iii) joint monitoring tasks based on agreed indicators; and (iv) corrective procedures. Internal Stability Pacts associate then some features of soft coordination with aspects more often seen in fiscal rules, in particular with the addition of regular monitoring and elements of enforcement.

*Box 3.2:* **Coordination arrangements pertaining to macroeconomic and budgetary forecasts in Germany.**

*The Working Party on Tax Revenue Forecasting (Arbeitskreis Steuerschätzungen) is an advisory council at the Federal Ministry of Finance since 1955. It includes the federal Ministry of Economics, economic research institutes, the Statistical Office, the Bundesbank, the German Council of Economic Experts, the finance ministries of the Länder and the Federation of German Local Authority Associations. There are two meetings a year. In preparation for the estimates of the Working Party, eight of its members, namely the economic research institutes, the Bundesbank, the Council of Economic Experts and the Federal Ministry of Finance produce, independently of each other, their own proposed estimates for each individual tax on a no-policy change basis. These proposed estimates are the subject of discussion in the Working Party. The Working Party discusses each tax until a consensus has been found. Revenue forecasts are made for the medium-term (the current year and the next five years) and form the basis for the draft budget of the following year and for the annual updating of the medium-term financial planning. Immediately after the meeting, the results are announced by way of a press release from the Federal Ministry of Finance. The tables of results are then put online so that interested members of the public can access them.*

*The Working Party on Tax Revenue Forecasting has a sub-committee made up of the Federal Ministry of Finance and the Länder to divide the tax revenues estimated by the Working Party among the individual Länder. The results of the breakdown of the tax revenue for the Länder often require modification before they are adopted as tax revenue estimates in the budget or the financial planning of a Land. Important reasons for this can be a significant amount of time between the budget date and the date of the tax estimate, foreseeable special developments in the taxes or the economic development of the respective Land, allowance made for planned changes in tax law as well as differences between the financial equalisation between the Länder calculated on the basis of the tax estimate, on the one hand, and the implementation of the financial equalisation three months later, on the other. Given the large number of local authorities (municipalities) in Germany, it is not possible to break down the results of the Working Group's forecast for individual municipalities. However, the Central Associations of Local Authorities, which attend the Working Party, supply the local authorities with information on revenue trends.*

### *Box 3.3:* **Examples of domestic Stability Pacts in Austria, Italy and Germany**

*In Austria, the second edition of the Austrian Stability Plan (ASP), released in 2012, has been enhanced as compared to the first layout and contains several fiscal rules. Deficit targets have been set for the years 2012-2016 (Article 3 of the ASP). From 2017 onwards, Article 4 provides that a budget balance rule in accordance with TSCG requirements will kick in. The lower limit for the structural deficit of general government will be set at 0.45% of GDP (0.35% for central government; 0.1% for Länder and municipalities). The new expenditure rule introduced in the SGP at EU level under the revised Regulation 1466/97 will apply to all sub-sectors of general government (Article 9 ASP). Similarly, a debt rule will apply to all general government sub-sectors following EU specifications. National (Article 4(4) ASP) and EU (Article 21 ASP) escape rules will apply. As regards monitoring, the National Statistical Institute and the Federal Court of Auditors are involved in the enforcement mechanism (Articles 17 and 18 ASP). If an inquiry by Statistics Austria concludes that a fiscal rule of the ASP has not been met, the Court of Auditors is to provide a public assessment. If the Court of Auditors concludes that a party is not in conformity with an ASP fiscal rule, a deadline of two months is given to the party to design consolidation measures to improve the budgetary position and to report them to a conciliation body (Schlichtungsgremium). The body is composed of representatives of all government sub-sectors (two from federal government, two from the provinces, and two from the cities and towns). If the consolidation measures are not delivered or deemed insufficient, the conciliation body can impose fines amounting up to 15 % of the deviation (the sub-sector responsible for the deviation is not allowed to vote on the decision). The fined party can appeal against the decision to a court of arbitration (Article 19 of the ASP). The court has to decide unanimously that an excessive deviation does not exist. In that case, the decision is reversed.*

*In Italy, a Domestic Stability Pact (DSP) was introduced in 1999. Following a major reform in 2009, it applies for a three-year period to regional and provincial administrations and to municipalities with more than 5000 residents. The DSP is jointly monitored by the Ministry of Finance, the Ministry of Home Affairs and the Council of State, Regions and Local authorities. Regions finance health expenditure and are subjected to a separate 'health pact'. Budgetary targets for the general government are set at the planning phase of the annual budgetary cycle (in Spring) and are broken down by sub-sector. Targets can be revised every year. In its 2011 fiche on fiscal frameworks, Commission services mentioned that the key weakness of the DSP has been the high frequency of changes made to its targets and coverage. As the Constitutional amendment of 2012 introduced the principle of a balanced budget for the entire general government sector and the principle of a sustainable public debt, subnational governments are required to contribute to public debt sustainability and a new debt rule should translate the principle in operational terms.*

*In Germany, under Article 109(1) of the Basic Law, the federal government and the Länder are autonomous and independent of each other in the management of their respective budgets. The federal government and the Länder each act separately on their own responsibility in making decisions on the compilation of budgets, the execution of budgets, control and auditing. Following the 2009 constitutional reform, Article 109(3) of the German Basic Law normally requires the federal government and the Länder to present balanced budgets without borrowing. The Länder regulate their budgets in such a way that the requirement of Article 109(3), first sentence, of the Basic Law is only met without revenue from borrowing. The 2009 reform grounded a Stability Council for enhanced monitoring of budgetary developments at the federal and Länder level. It consists of the Ministers of Finance of the Bund and Länder and the Federal Minister of Economics. It meets semi-annually and monitors budgetary developments based on annual reports submitted by the Bund and each Land. For that purpose, a number of indicators and associated thresholds have been determined. The Stability Council can issue early warnings by establishing the risk of budgetary crisis, and negotiate with the state concerned a consolidation programme based on a proposal from the State concerned. The Stability Council can require additional consolidation efforts if measures are deemed insufficient. However there are no sanctions at the disposal of the Stability Council to enforce consolidation programmes.*

Sources: European Economy Occasional Paper 91 –Feb 2012 – '*Fiscal Frameworks across Member States: Commission services country fiches from the 2011 EPC peer review*'; European Economy Occasional Paper

*(Continued on the next page)*

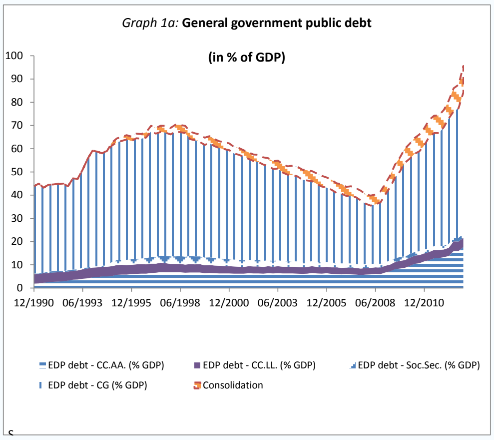
*Box (continued)*

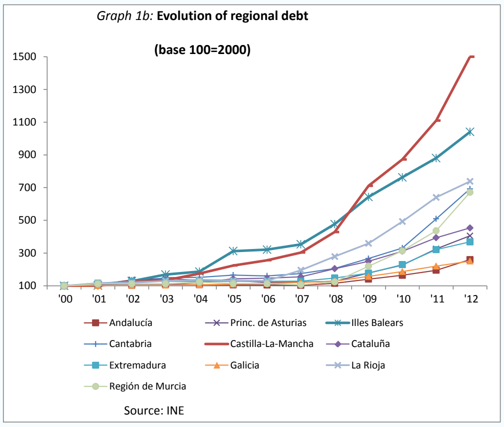
128 – Feb 2013 – '*Interim Progress Report on the implementation of Council Directive 2011/85/EU on requirements for budgetary frameworks of the Member States*'.

## *Box 3.4:* Fiscal relations between government tiers and coordination arrangements in Spain

*Spain is highly decentralised, with a significant share of spending powers devolved to the regions, known as Autonomous Communities (CCAA henceforth), mainly on health care, education and social services. The 1978 Constitution guarantees the right of the CCAA to self-government and ensures solidarity amongst them. The trend of expenditure decentralisation has been on-going since the setup of the CCAA and has accelerated in the last two decades. Excluding social security, around 35% of total consolidated general government expenditure is managed by the CCAA, whereas local governments are responsible for some 18%. In addition, effective spending powers on social services have been devolved to the CCAA. Regarding revenues, a sizeable share of tax receipts and fees are transferred to subnational governments, while at the same time they enjoy regulatory capacity over both shared and, above all, transferred taxes. Thus, shared and transferred taxes to the CCAA and local governments amount to some 29% and 15% of total consolidated government revenues, respectively; the remaining 56% remains under the control of the Central Government. The current ordinary regime of the financing system, reformed in 2009, foresees that 25% of the tax revenue is retained to the region where it is collected under the transfer arrangement, while 75% is pooled and redistributed according to the 'funding needs' of each region, determined according to the 'essential public services of the welfare state' that they have to provide. Fiscal agreements between the CCAA are ensured through a coordination forum, the Council on Fiscal and Financial Policy (CPFF), which brings together ministers of finance for the State and each CCAA. The CPFF in particular evaluates distribution/transfer formula from the central funds and fiscal targets for each of the CCAA.*

*In 2012, Spain adopted an organic Law on Budgetary Stability and Financial Sustainability with enhanced coordination features. The new debt rule foresees that the debt ceiling of 60% of GDP for general government is split in 44% for central government, 13% for all CCAA and 3% for local government. CCAA (or local governments) in breach of their targets set according to the fiscal rules have to submit an economic and financial plan to adjust their fiscal position. Their debt issuance has to be authorised by Central Government. Following falling revenues for subnational governments and unexpected slippages, fiscal discipline was also imposed through the creation of a suppliers' payment scheme to pay back CCAA's commercial arrears, and a Regional Liquidity fund to fund CCAA if needed against financial conditionalities.*



# 4. RECENT EVOLUTIONS IN THE EU AND SUGGESTIONS FOR FURTHER DEVELOPMENTS IN COORDINATION

### *4.1 Recent legal developments in the EU fiscal field: rewarding sound domestic coordination arrangements*

**Directive 2011/85/EU on budgetary frameworks stipulates the need for coordination arrangements**. It constitutes the first EU-wide policy initiative aimed at ensuring minimum requirements for national budgetary frameworks in a comprehensive manner. The provisions include the need for comprehensive fiscal data and rules governing domestic fiscal policy-making. It stipulates that national fiscal frameworks must comprehensively cover all general government tiers, if they are to aid compliance with the Stability and Growth Pact provisions. Specifically, this implies a need for '*appropriate mechanisms of coordination across sub-sectors of general government*' (Article 13). The Directive also calls for clarity when setting budgetary responsibilities of public authorities in the various sub-sectors of general government.

**The Fiscal Compact adopted as part of the TSCG also recognises the importance of proper involvement of all government sub-sectors**. As to the domestic implementation of the structural budget balance rule and its correction mechanism and among the common principles prepared by the Commission in accordance with Article 3(2) TSCG ([23]), common principle No5 suggests that '*the design of the correction mechanism shall consider provisions as regards, in the event of activation, the coordination of fiscal adjustments across some or all sub-sectors of general government*.'

**Following the adoption of the two-pack regulation on enhanced budgetary monitoring, the establishment of a common budgetary timeline provides an anchor for improved arrangements at the domestic level**. The setting up at the EU level of a common budgetary timeline for euro-area Member States should better synchronise the key steps in the preparation of national budgets, thus contributing to the effectiveness of the European semester for economic policy coordination. As a first step of this common budgetary timeline, Member States should make public their national medium-term fiscal plans at the same time as their respective Stability Programmes, preferably by 15 April and no later than 30 April. Another important milestone is the publication of draft budgetary plans by 15 October. Recital 6 stipulates: '*since compliance with the Stability and Growth Pact is to be ensured at the level of the general government and achievement of the budgetary objectives requires consistent budgeting across all sub-sectors of the general government, the publication of the draft central government budget should be accompanied by the publication of the main parameters of the budgets of all the other sub-sectors of the general government. Such parameters should include, in particular, the expected budgetary outcomes of the other sub-sectors, the main assumptions underlying those projections and the reasons for expected changes with respect to the stability programme assumptions*'.

**These initiatives provide impetus for a rethinking of coordination arrangements within general government**. While coordination arrangements have been addressed infrequently, recent steps have been taken in some Member States to improve domestic coordination arrangements. Sometimes reforms have been coupled with deeper decentralisation in unitary states, or comprehensive federalism reforms in federal Member States. The Interim Progress Report from the Commission on the implementation of the Directive on Budgetary Frameworks identified that work on effective coordination arrangements for sub-national governments was being carried out in many Member States, but elements reported by Member States were sometimes insufficiently specified (see Annex I for a detailed description of reforms as reported in the autumn of 2012).

([23]) 'Common principles on national fiscal correction mechanisms' COM(2012)342 of 20.06.2012.

*Box 4.1:* **Subnational governments' institutional reform in Portugal under the Economic Adjustment Programme**

*(i) The Local and Regional Finance Laws will be revised to adapt subnational budgetary frameworks to the principles and rules of the revised Budgetary Framework Law, namely (i) the inclusion of all relevant public entities in the perimeter of local and regional government; (ii) the multi-annual framework with expenditure, budget balance and indebtedness rules; and (iii) the interaction with the Fiscal Council.*

*(ii) Public financial management measures for fiscal reporting and monitoring and accounting in line with central administration will be implemented, and an effective commitment control system will be introduced. The number of public employees will be reduced by 2 per cent per year over the duration of the program.*

*(iii) The fiscal rules for subnational governments will be reviewed and early triggers for corrective action will be introduced. At municipality level, fiscal rules will not be defined in structural terms as at the national level, other solutions to correct for possible pro-cyclical bias will be determined. By contrast, at regional level, the fiscal rules at the national level may be replicated conditional on appropriate development of statistical methods for regional GDP figures. These have the advantage of being simple and easy to understand.*

*(iv) A procedure for an orderly debt resolution for regional and local governments will be designed and implemented.*

*(v) The revenue sharing mechanisms are to be revised and a fully-fledged medium-term fiscal framework in line with the central government will be introduced. The revisions also need to be designed in the light of the new EU fiscal framework.*

Source: Public Finance Report in EMU 2012 – European Commission – European Economy 4/2012

**The drive for reforms is especially pronounced in the economic adjustment programmes of several EU Member States**. Against the background of stringent consolidation needs, a genuine cooperation of all sub-sectors of government is critical. This is for instance the case in Portugal, where a broad-based overhaul of coordination arrangements is being phased in (see Box 4.1). In Greece, an Observatory has been set up and assesses ex ante budgets submitted by the local government. The Observatory monitors on a monthly basis budget execution against pre-established targets. Corrective action must be taken when a permanent and significant deviation is identified.

## 4.2 Elements for a sound integration of subnational government into domestic fiscal frameworks

### *4.2.1 Sound prerequisites for improved coordination arrangements*

Effective coordination does not only mean introducing rules or holding meetings. The elements below could be compatible with either hard or soft coordination arrangements.

*Box 4.2:* **Recent reforms concerning subnational governments in Denmark**

*In 2002 the Commission on Administrative Structure was mandated by the Danish government to conduct a study on the structure of the public sector and to propose recommendations to improve its functioning. In 2004 the Commission issued its final report in which it exposed its diagnosis on the structure of the public sector, highlighting notably that the small size and the important number of local administrative entities represent an obstacle to the conduct of efficient, consistent and coordinated public policies at a local level. Following this, the Commission recommended to undertake a profound reform of the public sector, including changes of boundaries and transfers of tasks between the state, counties and municipalities. In 2007, following a merging process, the number of municipalities was reduced from 271 to 98 to respect the principle that each new municipality should have the minimum size of 20 000 inhabitants. The 13 counties have been replaced by 5 regions. This reform was responding to the willingness of the authorities to enhance the financing autonomy of the municipalities without endangering their financial sustainability. Still, as of 2012, 59% of local governments' revenue comes from transfers and grants and 35% from local taxes. Newly-created regions take charge of some tasks originally assigned to counties. The control of local government expenditures relies firstly on a yearly signed budget agreement between the State, the national association of municipalities and the national association of regions. The negotiated amounts concern Municipalities and regions as a whole, so slippages may happen at the disaggregated level. Given this risk and taking into account the broader responsibilities of local government, two mechanisms have been introduced:*

*- A first direct safeguard reduces for year t+1 the municipalities' block grant of an amount equal to the difference between the level of expenditures recorded in year t for the whole group of municipalities and the level indicated in the agreement signed with the State;*

*- Following the introduction of the reform in 2008, local taxation increased markedly. This triggered the introduction the following year of a second safeguard that introduces individual and collective sanctions. In the first year following a tax increase observed in a given municipality, 75% of the additional revenue generated by the tax increase is offset by a corresponding decrease in the individual municipality's grant received from the central government. The remaining 25% of the increased revenue is neutralized by a cut in the block grant.*

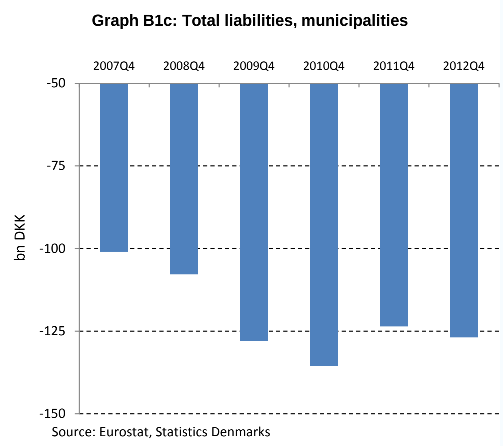
*- Finally, to further close the net, existing legal-based borrowing limitations for municipalities and regions complement the framework[1]. Together these measures have contributed to the stabilisation of local government debt.*

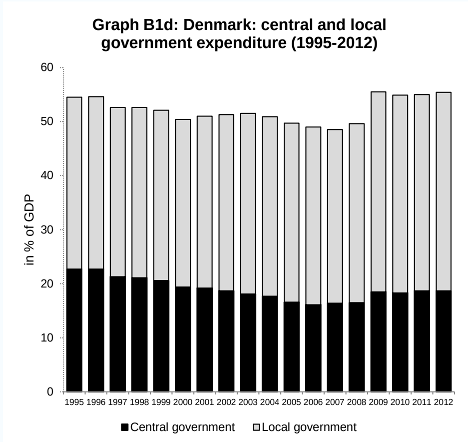
[1] The amount of loans contracted by a municipality cannot exceed the total amount of capital expenditures, existing loans repayments and costs of deferred property values taxes granted to pensioners.

*(Continued on the next page)*

*Box (continued)*

Graph 1:




***Source:***

**Accounting rules** across the whole general government should be uniform or at least with clear reconciliation tables to facilitate monitoring and comparability across sub-sectors. The Commission has recently released a report highlighting the benefits in terms of transparency of harmonised public sector accounting standards in Member States (EPSAS standards) ([24]). In particular, the broad implementation of accrual accounting would provide a comprehensive, comparable and accurate picture of the financial and economic position and performance of a government, by capturing in full the assets and liabilities as well as revenue and expenses of public entities ([25]).

An **effective and independent audit system** should be in place to guard against attempts to circumvent fiscal rules; dedicated decentralised audit entities may well work at the subnational level, provided the risk of capture at the subnational level is properly taken care of with appropriate safeguards of independence or functional autonomy; detailed nation-wide audit guidelines should be available and checks performed to ensure their consistent implementation.

**Timely, comprehensive and reliable fiscal statistics are critical for appropriate monitoring and enforcement**. A number of sizeable budgetary slippages at the subnational level have been identified only with a lag ([26]). Data access is critical to reduce information asymmetries, sound the alarm in case of deviation and allow all parties concerned to gather and agree on corrective action to meet fiscal commitments or rules. Resources for statistical reporting should be adequate and data requirements should be congruent with the indicators followed in national numerical fiscal rules. For instance, the existence of a municipal debt register in Bulgaria is considered to have facilitated the monitoring of the debt rule.

([24]) 'Towards implementing harmonised public sector accounting standards in Member States' COM(2013) 114 final of 06.03.2013.
([25]) Cash data might become misleading especially if subnational government accumulates payment arrears in times of expenditure retrenchment.
([26]) For example in September 2011, the Central Bank of Portugal announced that the Madeira autonomous region failed to report EUR1.1 billion in debt from 2008 to 2010 related to agreements between the government of Madeira and construction companies.

**Synergies between accounting and statistical reporting should be explored whenever feasible**. Usually fiscal rules are using cash-based or national budgeting rules for ease of use, although financial transactions linked to debt management are usually excluded to come closer to ESA-95 concepts. A Treasury Single Account (TSA) system, which is a unified structure of government bank accounts that gives a consolidated view of government cash resources, may improve the timeliness and quality of subnational fiscal accounts (Pattanayak and Fainboim, 2010) ([27]).

**The integration of existing budgetary schedules into a common national budgetary timeline would bring substantial benefits**. Even if such integration should not necessarily be grounded in law, the existence of a national budgetary calendar would integrate, for every general government sub-sector, milestones pertaining to the preparation of annual budgets and medium-term fiscal plans. Integration also provides an opportunity to check whether existing coordination arrangements ensure sufficient or timely participation of all government sub-sectors.

**Critically, a clear delineation of fiscal responsibilities between sub-sectors would foster accountability**. The assignment to specific levels of policies is heavily dependent on legacy, policy-specific considerations and domestic preferences. In Member States, the resolution of recurrent conflicts between sub-sectors has sometimes taken the form of successive, detailed compromises. These recurrent 'quick fixes' make the allocation grid of responsibilities excessively complex, generate overlaps, and effectively bar any public debate involving constituents. Discussions are limited to a small circle of specialists and decision-makers. Complexity also facilitates rent-seeking approaches at the expense of the common good. Overall, excessive granularity or complexity in cross-financing arrangements between sub-sectors should be avoided. Preferably, clearly-delineated blocks of public tasks/policies should be assigned to one specific public entity or level. Clarity in arrangements through simplification of existing arrangements would facilitate regular monitoring by Parliament and local assemblies and the conduct of evaluations of the quality of public expenditure.

### *4.2.2 Suggestions for subnational fiscal rules*

**The design of subnational fiscal rules should be simple enough** to meet rule specification constraints at subnational level due to fragmentation. Simple rules should foster accountability as much as possible given limited media visibility. In a context of fragmented supervised entities, rules designed without parsimony may also put too much of a burden on monitoring bodies at enforcement stage; rules with multiple objectives (including for instance stabilisation objectives) would be unwieldy to implement.

**Fiscal rules should be stable over time**. Recurrent revisions of the specifications of the rules, including their escape clauses, weaken the credibility of the rules and reduce reputational costs attached to their breach.

**Subnational fiscal rules should be backed up by effective monitoring and enforcement criteria.** These provisions are all the more important given lower media visibility at the subnational level and the diminished reputational costs that derive from it. Subnational fiscal rules should foresee effective enforcement actions.

**The use of existing public expertise in analysing subnational accounts and providing forensic assessments should be used to the full.** Given scarce available resources in some Member States, the active involvement of national courts of auditors or statistical institutes at monitoring and enforcement stages should be considered.

### *4.2.3 Suggestions for soft coordination arrangements*

([27]) 'Treasury Single Account: Concept, Design and Implementation Issues' (May 2010) IMF Working Paper WP/10/143.

**Coordination arrangements work best if properly integrated into the annual budget cycle, through required agenda items and expected outputs**. In particular, the preparation of key strategic documents, such as stability and convergence programmes and medium-term fiscal plans provide an opportunity for central government to reach out to subnational governments for better ownership of shared fiscal goals.

**Existing fiscal commitments applicable for general government should serve as the base for discussions**. The fiscal objectives laid down in documents such as Stability and Convergence programmes or medium-term fiscal plans and past commitments from earlier coordination rounds should form the base for discussions on updated fiscal objectives.

**Practical arrangements for soft coordination should be equipped with features conducive to better accountability**. To remove the risk that coordination instances are perceived as talking shops, a number of practical features should accompany coordination arrangements on the ground:

- An established timetable, structured agenda for meetings and clear decision-making procedures;
- Annual reviews of past budgetary outcomes with joint *ex post* analyses of possible deviations;
- Clear fiscal objectives expressed in numerical terms, broken down in sub-targets and conveyed promptly to relevant parties;
- A review of adherence to these fiscal objectives on a regular basis, in particular through the monitoring of budgetary execution on a medium-to-high-frequency basis;
- In a spirit of institutional loyalty, each party should commit to report events/facts that may cause deviation to its specific commitments, thus shaping some kind of alert mechanism;
- In the event of a deviation, timely procedures should be in place so that all parties to the coordination mechanism are convened to envisage ways to ensure that general government objectives are not put in jeopardy on account of localised deviations.

**The breakdown of general government budget balance or debt targets may be envisaged, but should take into account all existing arrangements across general government**. The Stability and Growth Pact and TSCG provisions refer to Medium-Term Objectives for each Member State. It does not necessarily imply that each sub-sector should be at the national MTO. If a fixed allocation formula or fixed targets is determined, full involvement of all government tiers to its preparation should be ensured, with careful estimates of present and future expenditure and revenue trends consistent with the envisaged breakdown, paying attention on a forward-looking basis to the future evolution of vertical and horizontal redistribution schemes. Periodic re-evaluation of the allocation formula may be foreseen. Similarly, announcing in advance that EU sanctions and fines would be allocated across sub-sectors in proportion to the responsibility of each sub-sector may foster better awareness of domestic fiscal goals, with the mitigating factor that sub-national government might not in full control of their revenue base, especially if they receive large transfers from other government tiers.

*4.2.4 Additional suggestions*

**Fiscal rules and enhanced coordination arrangements are complementary rather than exclusive of each other.** While numerical fiscal rules can discipline subnational outliers, coordination arrangements conducted at an aggregated sub-sector level take into account broader institutional constraints and the complex nature of domestic power-sharing arrangements, including vertical/horizontal redistribution arrangements between and/or within government levels. Following recent reforms in Denmark, a combination of fiscal rules and coordination arrangements seems to have given satisfactory results, at least in the first years following the reform, as it kept in check deficits and debts in the local government sector (see Box 4.1).

**Coordination arrangements should include robust monitoring and enforcement building blocks.** Experience of soft coordination arrangements shows that the absence of explicit consequences in case of non-compliance usually leads to weak enforcement.

**Sound fiscal rules do not preclude the need for timely information of subnational governments.** Predominant recourse to simple and effective fiscal rules may be considered, in particular in unitary States where subnational government does not control a large share of expenditure. Still, the need for proper involvement of subnational authorities remains important, given that enhanced awareness of shared fiscal goals may contribute, beyond improved fiscal outcomes, to more efficient public spending.

**Some role for fiscal councils can be envisaged in specific cases**. Usually the literature on fiscal councils makes little reference to the role fiscal councils may have in domestic coordination arrangements ([28]). Yet the remit of fiscal councils may include the assessment of subnational fiscal rules as part of their broader role to assess *ex post* compliance with domestic fiscal rules (like in Portugal according to the updated Budget Framework Law). Beyond that, there may be room for the occasional assessment of the performance of domestic coordination arrangements or assessment or of subnational entities, mostly in Member States with federal settings. The contribution of a third-party not involved in bargaining among government sub-sectors brings a non-partisan and independent view that may raise sensitive issues. For the sake of preserving its independence, the active participation of fiscal councils in operational coordination arrangements would not be absolutely necessary. As most fiscal councils have been recently grounded, it may be preferable that they first acquire unchallenged credibility through the successful fulfilment of their core tasks.

**Expenditure decentralisation cannot be the panacea**. Recent works have found that spending decentralisation generally improves fiscal outcomes. However the effect is not large and the positive effect of decentralisation is not robust to alternative specifications (Eyraud and Moreno Badia, 2013). Also, expenditure decentralisation accompanied by low subnational financial responsibility to cover their expenditure with own resources and by a large share of transfers from the central government is likely to be overall detrimental for the fiscal balance (Governatori and Yim, 2012) ([29]) The fact that evidence is not overwhelming may indicate that other considerations have a stronger bearing, and these considerations are closely linked to domestic institutional features. Further research would be necessary on these aspects.

**Benchmarking arrangements can foster bottom-up accountability and transparency**. While most domestic coordination arrangements presented here refer to top-down methods, another approach consists in peer-based comparison exercises with other domestic entities belonging to the same government level. This enables a subnational government to benchmark its own budget performance, either on the revenue or expenditure side, taking either an input-oriented approach or an output-oriented one. Such exercises are conducted by associations of local authorities (DK, FI, SE) ([30]) or a bank specialised in the funding of subnational government (BE) or even the central government (FR, IE). The provision of a public 'individual budgetary profile', positioning it with reference to other comparable local authorities can reinforce accountability at the disaggregated level, something less granular coordination mechanisms (fiscal rules and soft coordination) are ill-placed to achieve. Supervisory bodies such as Court of Auditors could and should provide support by providing elements of comparison methodology and performing themselves quality control checks. One difficult issue to handle however is the necessary trade-off between comparability and readability. Taking into account the complexity of local situations may make

([28]) '*What should fiscal councils do?*' L. Calmfors, S. Wren-Lewis – University of Oxford Discussion Paper Series No537 February 2011.
([29]) '*Fiscal Decentralisation and Fiscal Outcomes*' European Economy – Economic Papers 468 (Nov 2012).
([30]) For a description of the main features of the 'Open Comparisons' regular assessment exercise launched by the Swedish Association of Local Authorities and Regions (SALAR), see http://english.skl.se/activities/open_comparisons.

the indicators overly complex and therefore unfit for non-specialists. For instance, providing too many indicators would not be conducive to success. In the case grassroots' initiatives do not get enough traction, legal provisions that require subnational government to present benchmark comparisons under recognised methodology when releasing their annual budgets may be welcome in this context.

# 5. CONCLUDING REMARKS

**Overall, coordination arrangements have been strengthened in most Member States**. The trend towards stronger coordination has accelerated in the last few years in the wake of the economic and financial crisis, where EU policy initiatives have been instrumental in fostering better arrangements, whether in the form of fiscal rules or soft coordination mechanisms. Subnational government is being equipped with comprehensive fiscal rules in a growing number of Member States. Soft coordination mechanisms are becoming more structured and results-oriented, with in particular better monitoring procedures. The need for fiscal consolidation policies in difficult economic times has also spurred demands for increased coordination in Member States facing fiscal slippages in the subnational sector.

**Notwithstanding recent progress, the design and effectiveness of coordination mechanisms can benefit from further improvements**. Member States should capitalise on existing achievements to integrate further domestic budgetary timelines and ensure a genuine involvement of subnational government at an early stage within the annual budget cycle, taking advantage in particular of the preparation of multi-annual fiscal plans in the first semester of the year. Monitoring and enforcement attached to subnational fiscal rules should follow clear and effective procedures. In Member States with strong protective stipulations for the subnational sector, reinforcing soft coordination arrangements for federated entities should be the priority. Advances in fiscal transparency, which should be conducted on a broad front, would markedly facilitate the operation of coordination mechanisms. Tightened budgetary constraints would support the case for reform; without strong political impetus, little is feasible when it comes to reassessing more fundamentally fiscal relations within government sub-sectors, where these relations are not fully conducive to fiscal responsibility.

**The challenge towards more efficient public policies and spending is also valid for the subnational sector**. Despite institutional and practical hindrances, tackling expenditure inefficiencies at the subnational level may yield additional savings for the central –and general– government through lower transfer payments. This relates more generally to the efficiency of public expenditure, which can be addressed through a more ambitious agenda of programme budgeting and evaluation of public policies, including benchmarking. Over a longer time horizon, promoting local accountability through more active participation of constituents in local affairs may well yield substantial benefits.

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# ANNEX 1

## On-going reforms affecting subnational fiscal rules in EU Member States as depicted in the February 2013 Interim Progress Report on the implementation of Council Directive 2011/85/EU on requirements for budgetary frameworks of the Member States(31)

*Bulgaria*

The law on Public Finance intends to strengthen the interaction between the central and local governments in the conduct of a prudent fiscal policy. Article 164 of the draft law stipulates that the MoF shall approve the accounting standards and chart of accounts and give instructions to public-financed organizations in compliance with the EU requirements with regard to the reporting, statistics and budgeting of the public sector. Concerning Local Government, a medium-term budget target on a cash basis is introduced (article 30), together with further constraints on debt and debt payments (article 32) and a requirement for municipalities to set a spending cap for new commitments.

Regarding fiscal coordination with local government, it is expected that the Minister of Finance would discuss with the National Association of Municipalities 'the amount of the budget relationships of the central budget with the municipal budgets' within the medium-term budget forecast and would submit the minutes taken at these consultations together with the draft State Budget law to the Council of Ministers. Within the framework of a rolling three-year budget planning with a two-step annual budgetary procedure applicable to central government, Municipalities also have to prepare and adopt three-year budget forecasts (articles 82 to 84).

*Czech Republic*

With regard to the relatively significant fiscal decentralisation in the Czech Republic, the draft Constitutional Act approved by the government on October 2012 includes a rule for territorial self-government units (municipalities and regions). Its implementation should help ensure a comprehensive coverage of general government sub-sectors. According to this rule a territorial self-government unit (TSGU) should conduct economic activities so that its debt does not exceed 60% of its total average revenue for the last four years. If the TSGU's debt exceeds the limit, the municipality or region must reduce its indebtedness by at least 5% of the difference between the total value of the achieved debt and the 60% value calculated as above. If the TSGU does not reduce its indebtedness in this way the State will retain its tax revenue to the tune of 5% of the difference between the current total debt and the 60% value. According to the draft Constitutional Act, 'the retained tax revenue intended for territorial self-government units can only be released for payment of the territorial self-government unit's debt obligations concluded before the year in which the revenues was retained. The MoF also prepares legislation for insolvency proceedings for TSGUs.

*Denmark*

The Budget Law passed by Parliament in June 2012 introduces binding multi-annual expenditure ceilings for the three major public sub-sectors in Denmark, i.e. central government, municipalities and regions, respectively. The ceilings consist of nominal upper limits on actual spending and aim to ensure a close connection between the expenditure ceilings, actual budgets and the final accounts of each sector. The annual Budget Bill of the central government and the annual economic agreements between government and municipalities and regions must comply with the ceilings. Given the tradition of budget cooperation based on voluntary agreements between the central government and the local government bodies, the agreements imply mutual cooperation and coordination between the municipalities and regions

(31) Source: European Economy Occasional Paper 128, February 2013, Interim Progress Report on the implementation of Council Directive 2011/85/EU on requirements for budgetary frameworks of the Member States.

themselves concerning how to adjust collectively to the agreed limits. In addition, permanent legislative acts containing sanction mechanisms have been approved by the Parliament over the last few years. If the level of expenditures of a municipality or a region exceeds the agreed expenditure ceiling, cuts in general grants are to be phased in. The cuts would affect both the collective part of the grant (i.e. the whole group of regions or municipalities would be sanctioned), and the individual grant of the municipality or region concerned. The grant reduction can be up to DKK 3 bn. Cuts can also be triggered at municipality level if taxes rise above the agreed level.

*Estonia*

The Financial Management of Local Authorities Act of 2012 stipulates that local authorities must ensure that the operating result, i.e. the difference between operating revenue and operating expenditure is balanced or positive. Their net debt burden should stand below 60-100% of their operating revenue (the exact ratio depends on their individual financial capacity). Until the end of 2016, all local authorities are temporarily prohibited from increasing their net debt burden over 60%. According to plans amending the State Budget Act, fiscal planning would be harmonised so that all of the sub-sectors would process their multi-annual and annual plans in a synchronized way together with the State Budget Strategy and the Annual State Budget. The State Budget Strategy fiscal policy objectives would be binding to all general government sub-sectors and institutions.

*Italy*

The Constitutional amendment voted in April 2012 introduces the principle of a budget balance for the general government sector and the principle of a sustainable public debt (Article 1 amending Article 81). Breaking down these principles by sub-sector, sub-national governments –municipalities, metropolitan cities, regions, provinces and autonomous provinces– are required to contribute to public debt sustainability (Article 2(c) of Constitutional Law 1/2012) They are also subject to conditions for borrowing detailed in Article 4 of Constitutional Law 1/2012 amending Article 119: borrowings are only allowed (i) to fund capital expenditure; (ii) if amortization plans are adopted; (iii) provided that the overall budget in each region remains balanced. The same article further stipulates that no State guarantee is allowed on loans contracted by sub-national governments. Regarding fiscal planning, Article 8 of Law 196/2009 and its amendment in Law 39/2011 stipulate that local government have to determine fiscal objectives in compliance with the Italian Medium-Term Budgetary Framework (DEF), leading to the adoption of a 'Domestic Stability Pact' defining measures to achieve fiscal targets broken down for regions, provinces (including autonomous provinces), and municipalities. The DEF is submitted to a Permanent Conference for the coordination of public finance in order to ensure involvement at the sub-national government level.

*Lithuania*

A 'draft law amending the Law on the Budget Structure', under discussion at the time of the Interim Progress Report, would introduce additional provisions for local government. The budget of each municipality, whose budgetary expenditure according to cash flows exceeds 0.3 per cent of GDP at current prices of the previous year, should be implemented in a way that expenditure commitments (excluding investments) would not exceed revenue commitments. Moreover, excess municipal revenues (excluding excess revenue legally earmarked for covering the revenue shortfalls of other municipalities), shall be spent by the decision of the municipal council primarily for covering debt (if any).

*Portugal*

Article 87 of the recently-adopted Budget Framework Law (BFL) introduces the principle of annual indebtedness ceilings for the central government, the autonomous regions and the local government –the level of the ceilings are established in the annual Budget Law. Article 12(a) of BFL reasserts the obligation for autonomous regions and local government to constrain their borrowing according to their respective financing laws without prejudice to Article 87 of the BFL. In case of deviation, transfers received from the State Budget would be reduced. Article 12(i) of BFL entrusts the Portuguese Fiscal Council to issue opinions on the compliance with the budget balance rule defined in article 12(d) of BFL, the expenditure rule introduced in article 12(c) and the borrowing ceilings for autonomous regions and local governments.

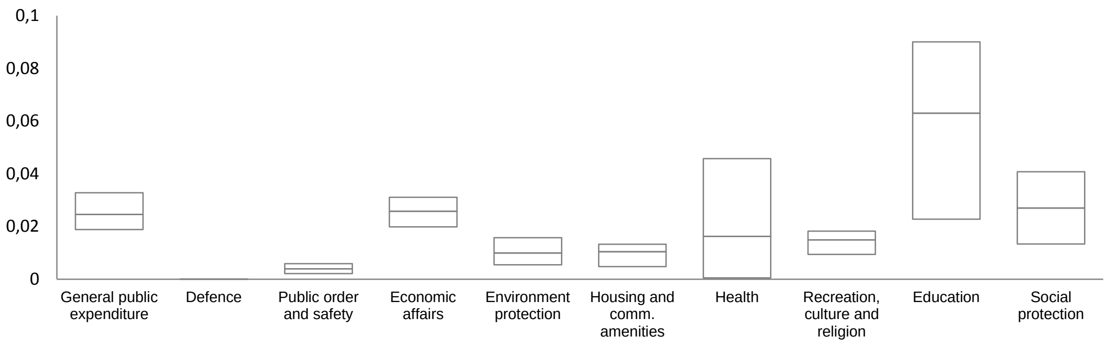
*Slovakia*

According to the new Fiscal Responsibility Law that entered into force in March 2012, local governments (municipalities and self-governing regions) are allowed to borrow (from outside the general government sector) only if a) the total sum of the debt of the municipality or self-governing region does not exceed 60 % of final current revenues of the preceding budget year and b) the sum of the annual instalments of the loans does not exceed 25% of final current revenues of the preceding budget year. Sanctions applicable from 2015 would amount to 5% of the difference between final current revenues of the preceding budget year and the amount equivalent to the 60% threshold. The borrowing rule is complemented by balanced budget rule for local governments. According to the rule, the current budget of local government has to be adopted either as balanced or in surplus. The Act on budgetary rules of local governments lists the possible cases where the current budget could be in deficit: when the budgeted expenditures contain earmarked funds from the State budget or from the budget of the European Union and unspent funds transferred from previous years. The capital budget can be in deficit (according to golden rule principles), provided that this deficit is financed by unspent funds of local governments transferred from previous years, loans or by surplus of the current budget in the respective fiscal year.

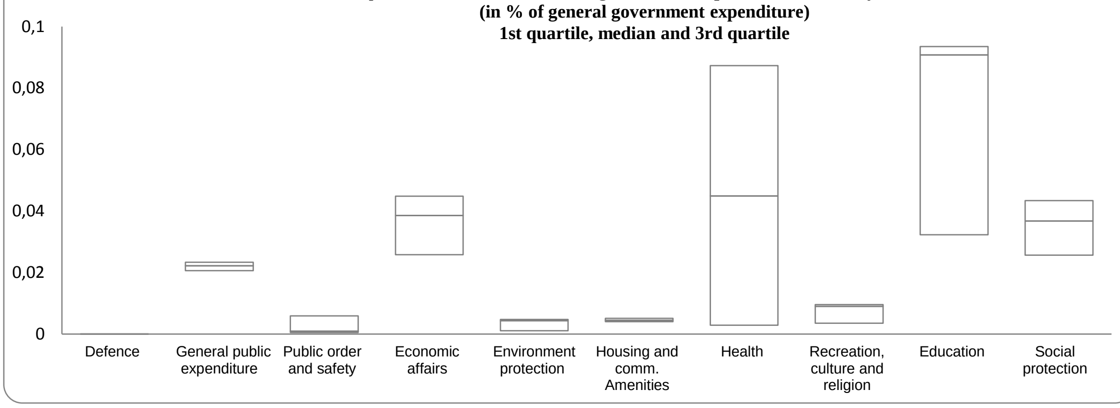
# ANNEX 2

## Level and variance of expenditure share of sub-national government in % of general government expenditure, 2011

*Graph A2.1:* **Breakdown of local government expenditure by COFOG in 2011**
**(in % of general government expenditure)**
**1st quartile, median and 3rd quartile**




*Graph A2.2:* **Breakdown of State government expenditure in 2011 by COFOG**
**(in % of general government expenditure)**
**1st quartile, median and 3rd quartile**



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