

# **Fiscal decentralization: How to achieve a hard budget constraint**

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# **Fiscal decentralization: How to achieve a hard budget constraint**

## **Plan of the talk:**

1. The problem
2. Theory
3. Empirical evidence
4. Decentralization in Europe
5. Internal stability pact (The Italian case)
6. Policy recommendations

# 1. The problem

Double devolution process in Europe:

\*Upwards towards the European Union

\*Downwards toward Local Governments

e.g.

Belgium (1992);

Spain (2003);

France (2003)

Italy (2001)

Germany

UK (2000)

## May threaten financial stability in Europe

\*Eroding central government's authority

\*Stimulating free-rider behaviour on local govts;

e.g. Stability and Growth Pact for Euro countries:

- Constraints on *General* Government's fiscal behaviour;
- But sanctions only on *Central* Government;

“Decentralization may soften Local Governments budget constraint and threaten overall national stability”

# Questions:

## 1. What theory suggests?

**\*What is a SBC problem?**

**\*When SBC problems are likely to raise?**

**\*Is decentralization bound to increase SBC problems?**

## 2. What is the available evidence on SBC, in general, in Europe?

**3. Which are the dangers, if any, of the current decentralization process in Europe?**

**4. What is the evidence on the Internal National Stability Pact?**

## 2. Theory

### **Three features of any SBC problem:**

1. Two hierarchical levels of governments, willing to play the SBC game:
  - Central government
  - Local government

## 2. Dynamic framework

### *Time inconsistency problem*

“Ex post, after some actions have been taken or threatened by local governments, central government is forced to take measures it did not want to take ex ante”



2.1 Why ex post and ex ante incentives of central government may differ?

2.2 Why central government cannot “commit“ ex ante?

3. Expectations are at the heart of the problem;

Local governments misbehave because they *expect* to affect central government behaviour by doing so;

# Commitment:

Private sector can commit...because there is a Public sector..

\*Governments find it much more difficult (because they are sovereign bodies)..

\*Constitutional rules need to be interpreted...

\*Sanctions are difficult to apply on democratically elected bodies...

# Ex ante / ex post incentives

- externalities

  - ..all other residents may be affected..

- direct blame on central gov.

  - ..no clear allocation of competence..responsibility shifting games..

.....both features point to not correctly defined allocation of functions and resources across governments...

...violations of correspondence principle..

...overlapping of competences..

**\*Decentralization *does not* imply softer budget constraints.....it may harden them..**

1. more autonomy at local level less likely extra money is spent on public goods which matter for global government.....

2. other local governments may object to a bail outs more than central government....

**\*But badly done decentralization *might*...**

**\*not clearly defined allocation of functions..**

**..blurring of responsibility**

**\*insufficient own resources at local level...**

**..lack of flexibility..**

**\* discretionary transfers ..not transparent data....**

**..lack of consensus..**

### 3. Empirical evidence

*Expectations* key of the problem,  
but expectations cannot be observed..

..Difficult to find *testable implications*..

\*Not all bailouts are examples of SBC  
problems..

..external causes..

..may not expected (fiscal coinsurance)..



\*SBC problems may be there even without formal bailouts..

..Excessive transfers and expenditure at local levels...

..Distortions in public expenditure at local level..

## **3.1 Inter-country and case studies:**

**Anecdotic evidence plenty but confuse..**

**..Large variety of instruments to control local finance...**

- 1. Market controls;**
- 2. Constitutional constraints;**
- 3. Hierarchical controls**

**Even larger variety of results...**

**Same instruments work in some countries,  
don't in others...**

**Financial relationships across levels of gov.  
embedded in the tradition (legal, political,  
cultural, etc.) of a country..**

**Difficult to find *general recipes* and *export solutions* to different institutional settings.**

## 3.2 Econometric studies

..Unsolved technical problems..

..Some evidence of SBC in European countries..

(Italy, Germany, Sweden, Spain)

..Difficult to find general lessons..

- \*Blurring of responsibility matters;
- \*Past bailouts matter;
- \*Vertical imbalance matter;
- \*Size matters but in the opposite direction (“too little too fail”)
- \*Political affinity matters;
- \*External constraints may shift expectations quickly;

# 4. Decentralization in Europe

Large differences in Europe..

1. Institutional (Federal, Regional, Unitary)
2. Level of decentralization
3. Pattern of local expenditure
4. Sources of financing
5. Degree of tax autonomy

But some common trends..

1. Increase in local functions
2. Substitution of transfers with tax resources
3. Substitution of ear-marked with block grants

# ***Dangers:***

1. Decentralization mainly takes place in (nationally) politically sensitive fields, Health, Education, Social Welfare.. (Spain, Italy, France..)

Overlapping, blurring of responsibility..



## 2. Local finance may not be up to the task..

Need large tax resources...

National taxes (Vat, Personal Income..)

Tax sharing rather than own taxes..

...Little budget flexibility, pro-cyclical budget,  
less accountability, perverse incentives...

## 5. National Stability Pact

But is there evidence of a loss of control in local finance?

- Two main strategies:

1. Consensual agreements and formalised cooperation..

Austria, Germany, Belgium, Denmark, *Spain*

## 2. Fiscal rules and administrative controls..

France, Italy, Sweden, (UK), Spain, Greece..

..All cases difficult to enforce sanctions..

Need unanimity, delayed in Germany

..But no evidence of loss of control..

low level of debt local level

# Italian case:

1. National Pact introduced 1999, (balanced budget) changed every year since..
2. Poor monitoring..
3. Harsh sanctions on paper  
...never applied..

Yet, it mostly worked..

..Basically all Regions and between 80-90% of Provinces and Municipalities respected the Pact...

..Moral suasion, intergovernmental agreements..

..in a nth best world, nth mechanisms may be the best one can do..

## 6. Conclusions and policy recommendations

### *Summing up*

- Empirical evidence on SBC weak, large variance of tools and results;
- No universal recipes, reasonable suggestions;

- Decentralization does not necessarily increase SBC, badly done decentralization might;
- Some worries for Europe (Italy, Spain, France ?, Germany) justified, but no empirical evidence (yet) of serious problems;

## *Policy recommendations*

- **Build correct financial relationships between levels of governments;**

**(taxes, functions, grants..), clear cut responsibility, budget flexibility**

- **Avoid too strict controls  
(e.g. ceilings on expenditure, hiring controls, ear-marked grants)**

**May be counter productive, less responsibility of local governments, more SBC problems..**



- **Exception some borrowing constraints  
(in place almost everywhere in Europe)**

**Large externalities, alternatives (market controls) poor..**

- **Search for consensual agreements..**

**Sanctions difficult to enforce, only viable alternative**