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FISCAL RULES FOR SUBNATIONAL GOVERNMENTS IN THE EMU CONTEXT

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Keywords: Fiscal decentralisation – economic and monetary union – stability and growth pact

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Fiscal Rules for Subnational Governments in the EMU Context[1]

di

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Summary

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

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Contents

1. Introduction 3

2. European Fiscal Rules and Fiscal Federalism 4

2.1. European fiscal rules 4

2.2. The role of subnational governments 5

3. What Solutions Are There? 8

4. The solutions adopted by five EMU countries 12

4.1. Austria 15

4.2. Belgium 17

4.3. Germany 20

4.4. Italy 22

4.5. Spain 24

5. Are the Solutions Adequate and Sustainable? 27

1. Introduction

The fiscal framework of the European Economic and Monetary Union (EMU) is historically a new development.[2] For the first time, sovereign countries have adopted common fiscal rules and a complex multilateral surveillance mechanism.[3] The new institutional setting has extensive implications for the European economies. It affects the conduct of fiscal policy and influences the allocation and distribution of government functions. This paper focuses on the impact of EMU fiscal rules on the relationship between central and subnational governments. Three critical areas can be identified.

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

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

Third, in order to reconcile fiscal soundness and budgetary flexibility in bad times, EMU fiscal rules rely on cyclically adjusted fiscal balances. At the subnational level, such measurement may be difficult to obtain; moreover, other devices designed to allow for budgetary flexibility may prove inconsistent with EMU fiscal framework.

This paper examines some solutions for making fiscal decentralization compatible with EMU fiscal rules and compares these possible solutions with the approaches of five European countries. The countries considered are extremely diversified in terms of institutional tradition, as well as size, population, and economic development. Three countries, Austria, Belgium and Germany, have a federal institutional structure – in Belgium a relatively recent development. Italy and Spain have substantially increased decentralization in recent years.

The structure of the paper is as follows. Section 2 examines European budgetary rules and their implications for the interactions among government tiers. Solutions for making decentralisation compatible with EMU rules are analysed in Section 3 from a theoretical point of view, and in Section 4 with reference to the experience of Austria, Belgium, Germany, Italy and Spain. Section 5 compares theory and practice and draws conclusions.

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[2] European fiscal rules apply to the fifteen European Union member states. Nevertheless, they are even more binding on the twelve countries which have so far joined the EMU.

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

2. European Fiscal Rules and Fiscal Federalism

2.1. European fiscal rules

EMU fiscal rules have been designed to ensure that national policies maintain a sound fiscal stance while allowing sufficient margins for budgetary flexibility in bad times.[4] On the one hand, fiscal sustainability is a central tenet of EMU: it is a precondition for financial and monetary stability. On the other hand, budgetary flexibility is needed for stabilization policy: it has become more important with the establishment of EMU, as member states can no longer rely either on a monetary policy tailored to national needs or on exchange rate adjustments.

The Treaty of Maastricht states that budget deficits cannot be larger than 3 percent of GDP unless (1) under exceptional circumstances, such as deep recessions; (2) they remain close to 3 percent; and (3) the excess deficit lasts only for a limited period of time.[5] If the deficit exceeds the 3 percent limit and the three conditions above are not met, the deficit is deemed "excessive" and it triggers a procedure intended to force adoption of corrective measures.

The Stability and Growth Pact (SGP) specifies what is meant by "exceptional" and "limited period". A recession is considered exceptional if real GDP diminishes by 2 percent. A milder recession (where the reduction in real GDP is at least 0.75 percent) may also be considered exceptional if, for example, it happens abruptly. The excess above 3 percent must be reabsorbed as soon as the "exceptional circumstances" have expired. The pact gives no quantitative specification of the concept "closeness to 3 percent".

The pact further specifies that each country should aim for a medium-term objective of a budgetary position "close to balance or in surplus." According to the European Council, compliance with the pact should be assessed by taking into account the cyclical position of the economy.[6] In practice, the SGP requires that each member state choose a budgetary target in cyclically adjusted terms and let automatic stabilizers or discretionary action operate symmetrically around it. The lower this budget balance with respect to the 3 percent threshold, the more leeway for countercyclical policy without the risk of an excessive deficit. Past experience suggests that in the majority of EMU countries a cyclically adjusted deficit between 0 and 1 percent of GDP should be adequate (Buti, Franco, and Ongena, 1997).[7] Compliance with the deficit threshold, as well as the 60 percent ceiling for the debt-to-GDP ratio, would prevent the public finances of EMU member states from taking unsustainable paths.[8]

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4 The economic policy framework of EMU is extensively examined in Buti and Sapir (1998), Buti, Franco, and Ongena (1997); and Brunila, Buti, and Franco (2001).

5 These three conditions make the 3 per cent threshold extremely binding. See Buti, Franco, and Ongena (1997).

6 See Council Resolution on the SGP, June 17, 1997; Council Regulation No. 1466, July 7, 1997; Council Declaration, May 1, 1998; and Opinion of the Monetary Committee, October 12, 1998, approved by the Council.

7 The issues related to the choice of the medium-term fiscal target are also examined in Artis and Buti (2000), Dalsgaard and de Serres (1999), and Barrel and Dury (2001).

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

Countries with debt ratios above 60 percent of GDP should also take into account the need to reduce them, at a satisfactory pace, towards the threshold. An increase in the debt ratio during recessions should be avoided.[9]

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

A country in excessive deficit is required to adopt corrective measures according to a fixed timetable. Failure to comply brings sanctions: the country must pay a non-interest-bearing deposit equal to 0.2 percent of GDP plus one tenth of the difference between the 3 percent ceiling and the actual deficit (up to 0.5 percent of GDP). For each successive year that the deficit is judged to be excessive only the variable component of the sanction must be paid. Should the excessive deficit persist, the deposit is converted into a fine after two years.

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

In the 1990s this framework proved effective in constraining deficit and debt levels; however, its effectiveness in shaping the fiscal policy of euro-area members has not yet been proved. In particular, EMU rules have not yet been tested by severe recessions or large-scale asymmetric shocks. The slowdown of 2002-2003 has so far been quite problematic for the countries (France, Germany, Italy and Portugal) which had not reached close-to-balance positions.[10] Moreover, it is not clear that the envisaged "automatic pilot" version of fiscal policy, in which automatic stabilizers work freely around a predefined cyclically adjusted target, would provide a sufficient degree of cyclical smoothing, in view of the larger requirements of fiscal stabilization in EMU (Brunila, Buti, and Franco, 2001). The funding of public investment may also prove difficult (Balassone and Franco, 2000b).

Another problem is whether budgetary procedures and institutions at the national level are consistent with the constraints imposed by the new EU framework.[11]

2.2. The role of subnational governments

The problem of monitoring the soundness of public finances of lower government tiers arises in all countries which are not highly centralized, regardless of EMU membership (Ter-Minassian, 1997). Within each country, the stability of monetary and financial conditions is a public good to which the central government and all subnational governments contribute by maintaining sustainable budget positions. There is an incentive for each subnational government to exploit the benefits accruing from the discipline of others without itself

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[9] Balassone and Monacelli (2000) analyse the implications of this provision for stabilisation policy.

[10] See Buti, Eijffinger, and Franco (2003).

[11] Budgetary rules in EU countries and their recent evolution are examined in Hallenberg, Strauch, and von Hagen (2001) and von Hagen, Hallet, and Strauch (2001).

complying with the rules (free riding). This may create a double cost for the other entities: the free rider's excessive indebtedness can put pressure on interest rates to rise and it can result in bankruptcies requiring bail-outs.

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

Excluding pervasive administrative controls, which by their very nature are incompatible with a federal structure, two solutions may be considered: the cooperative management of indebtedness and the introduction of rules and sanctions for noncompliance.[12]

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

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

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

[12] Rules may obviously be the outcome of a cooperative decision-making process, but once defined they avoid the need to search for a consensus about each budgetary policy issue. Ter-Minassian and Craig (1997) note that there is some scope for cooperation also in a rule-based approach.

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

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

First, EMU rules may exacerbate the free-rider problem, as they introduce an asymmetry in the structure of constraints and incentives faced by central and subnational governments. While compliance with budgetary rules applies to general government on all levels of government, EMU documents do not assign specific responsibilities to subnational governments. A representative of the central government of each member state sits on the European Council and commits the government of that member state to the common policies. The central government is held responsible and bears the costs of noncompliance, both in terms of the monetary sanctions and the loss of reputation.

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

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

The call for close-to-balance or in-surplus balances implies that most capital outlays have to be funded out of current revenues. Hence it is no longer possible to spread the cost of an investment project over all the generations of taxpayers who benefit from it. This discourages the undertaking of large projects producing deferred benefits and entailing a significant gap between current revenues and current expenditures. The disincentive is even stronger during the transition towards a balanced budget, when, in order to keep the flow of investment unaltered, the gap between current expenditure and revenue grows. This compression effect may be stronger for subnational governments, where investment spending can fluctuate considerably over time and the cost of projects may easily exceed available current revenues. “Building a school may be an extraordinary effort for a small town, an ordinary one for a big city” (Einaudi, 1948, p. 318; our translation).[14] The available evidence confirms the link between fiscal consolidation and cuts in capital spending. In 1992, the year of the Treaty of Maastricht, the deficit-to-GDP ratio exceeded 3 percent in nine EU countries. In 1997, for all

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[13] For example, this is the case in the USA. For a detailed analysis, see Knight and Levinson (1999) and McGranahan (1999).

[14] On deficit finance Pigou (1928, p. 717) argued as follows: “This process of anticipating revenue has greater justification in the case of a local than in that of the central government. The former deals with a smaller revenue, on which any extraordinary outlay will have greater effect, and it is restricted in its taxing powers, while the national government can more easily distribute its outlay from year to year, and possesses full control over its means of revenue. As a general rule, therefore, it is true that loans are convenient, indeed an indispensable, part of the financial machinery of the smaller bodies.”

these countries but Greece the ratio was at or below the threshold; all had reduced the investment-to-GDP ratio; all but Greece and the Netherlands had lowered the investment-to-primary-outlay ratio. Over the same period, investment ratios increased in three of the six countries that met the deficit criterion in 1992.[15]

Economic theory has long maintained that stabilization policy should be a responsibility of central government due to externalities and spillover effects (Musgrave and Musgrave, 1984). It has also maintained that subnational government tax bases should be chosen to minimize sensitivity to the economic cycle, thereby avoiding procyclical policies at the subnational level. This is often ignored in practice since rainy-day funds or the possibility of compensating for deficits in one year with surpluses in another provides flexibility for the effects of the cycle at the subnational level. These mechanisms are not consistent with EMU rules, which reconcile soundness and flexibility by aiming for a cyclically adjusted budget and targeting a ceiling for the nominal deficit. This practice is valid not only ex ante but also ex post. Moreover, EMU rules require estimates of cyclical developments and their effects on the budgets, which may be unavailable at the subnational level (or, if available, may be biased because of measurement problems due, e.g., to the mobility of factors).

3. What Solutions Are There?[16]

Adapting existing national regulations – As already pointed out, control systems in place in most countries set flexible ceilings for the deficit. The ceilings may exclude capital expenditure (golden rule) or may apply only on an ex ante basis (i.e., if the deficit overshoots the ceiling, the overrun can be compensated for in the following years). In some cases (e.g., some U.S. states) the deficit overshoot must be financed through recourse to specially constituted rainy-day funds, without going to the market.

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

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

Concerning capital outlays, the adoption of the golden rule for lower government tiers would have to be accompanied by an overall ceiling on investment expenditure by subnational

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[15] Balassone and Franco (2000b) also examine the possibility of introducing the golden rule in the framework of EMU fiscal rules. Support for the link between fiscal consolidation and investment cuts is also found by Roubini and Sachs (1989) and by Haan, Sturn, and Sikken (1996) for a sample of OECD countries with reference to different periods.

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

governments. The deficit thus allowed would have to be compensated for by a central government surplus with a generous enough margin to allow for counter-cyclical measures, so as to take into account the need for the overall cyclically adjusted general government budget to be close to balance or in surplus.

Allocating among decentralized bodies the overall deficit allowed for investment programs is difficult because subnational governments vary widely in population, infrastructure, overall receipts, etc.. Thus a cooperative approach could be contemplated. Decentralized governments cooperating to define overall budgetary targets would acquire greater responsibility by aiming consistently at the targets set and reaching agreement on the allocation of resources. Moreover, the peer-pressure incentive for compliance generated in a cooperative framework could be strengthened by allocating any sanction handed down by EMU to the bodies responsible for the overshoot.[17]

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

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

Rainy-day funds could lessen the incentive problem by increasing the visibility of imprudent budgetary behaviour. However, under the European System of National Accounts (ESA95), the rainy-day funds would have to be subject to limits, again raising the same difficulties concerning the definition of deficit ceilings.[18]

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

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

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[17] The overall ceiling and the sanctions should avoid the risk of a "pork-barrel" effect. See, for example, Chari and Cole (1993).

[18] In order to avoid this problem, the ESA95 would have to be modified. Resources drawn from rainy-day funds would have to be treated as government revenue rather than as proceedings of financial transactions. This would amount to a redefinition of EMU fiscal rules and of the relevant balance for budgetary policy.

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

Extending of European rules to only the larger decentralized (that is, regional) governments could be a solution, provided smaller governments have limited autonomy. Otherwise, the cost of adjustment would merely be shifted from the central government to the larger subnational governments.

A market for deficit permits – The thesis that the problems of externalities might be solved by creating appropriate ownership rights and allowing them to be freely traded was first put forward by Coase (1960). Casella (1999) suggests this approach to fiscal discipline within the EMU. Comparing the negative externality produced by governments running excessive deficits to that caused by environmental pollution, Casella suggests using the machinery developed in environmental economics to limit deficit levels.[19] The possibility of introducing a system of deficit permits for subnational governments was also raised in Italy (Commissione Tecnica per la Spesa Pubblica, 1998).

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

The scheme would apparently answer the three problems we have identified in reconciling fiscal decentralization at the national level and EMU fiscal rules. However, it is also subject to three main difficulties. First, while its effectiveness requires that the deficits of the various governments generate the same externality and are thus perfect substitutes, it must be recognized that the risk of triggering a financial crisis is not uniform across governments. If this risk were the function of a single variable, e.g., the level of debt, then one would merely have to make the value of the deficit permits of the governments inversely proportional to their stock of debt. However, the risk depends on a number of factors[20] and determining the value of the permits held by each government is complicated.

Second, the efficiency of the market for permits would depend on the level of competition. This makes the mechanism ill suited to situations in which the number of governments is small (within the EMU there would be just twelve players, all very different in size).[21]

Finally, there is no easy way to determine the initial allotment of permits. The possible criteria (GDP, population, etc.) would produce greatly differing allocations. If the demand for permits

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[19] An early suggestion of a market in pollution permits is Dales (1968). A vast body of literature has since developed. For a discussion of the benefits and limitations of the approach, see Baumol and Oates (1988).

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

[21] The problem could be attenuated by a continuous double auction market (a system used in many financial markets); see Friedman and Rust (1993).

exceeded the supply, then the countries with an allotment greater than their requirement would enjoy positional rents.

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

The third difficulty, the initial allotment of permits, would depend on political influence, at the national level as much as at the EMU level. It would be compounded, at least initially, by subnational governments' problems in adapting to the new procedure.

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

An overview – Each of the three solutions has drawbacks. In light of this, a combination of different approaches can have value.

- For larger subnational governments, a domestic replica of the SGP may be a feasible solution to both the asymmetric incentives problem and the need to buffer cyclical effects. For relatively large regions, the problem of lack of data is solvable and the small number of entities involved allows an effective peer-pressure system to supplement sanctions when dealing with the incentive problem. The need to spread investment costs over a number of years can be addressed by a "compensated" golden rule, that is, one with an overall deficit cap to be compensated for by a central government surplus. Cooperation may lead to an inefficient allocation of borrowing for investment projects. This would be the case if conventional criteria (e.g., size of population), which do not reflect the returns of the different projects, were used for the distribution of borrowing allowances. In this case, the introduction of a market for borrowing rights could induce more efficient outcomes.
- For smaller governments, a careful selection of tax bases can largely isolate their budgets from cyclical effects provided that they enjoy a limited degree of autonomy in terms of revenue. In this case, the requirement to keep the budget balanced in nominal terms - a less sophisticated rule than the one envisaged in the SGP - could be used to solve the incentive problem without any risk of inducing procyclical behaviour, thereby avoiding the data problem and reducing the monitoring difficulties arising in a "large number" context. Again, a "compensated" golden rule could be used in order to avoid an undue compression of capital outlays.

4. The solutions adopted by five EMU countries

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

Subnational financial autonomy is relatively high in federal states, such as Austria, Belgium, and Germany, and in the Nordic countries. Italy and Spain experienced a shift from a centralized to a decentralized structure over the last quarter of the 20th century.

In 1995, the ratio of subnational governments' expenditure to GDP ranged from 6.0 in Belgium to 32.3 in Denmark. However, a low/high ratio does not imply a low/high degree of financial autonomy. For example, in Italy, the Netherlands, the UK and Germany the ratio of subnational government expenditure to GDP was of the same order (ranging from 10 to 14 percent), but subnational governments' own revenues were limited in the first three countries (2.9 in Italy, 1.7 in the Netherlands, and 0.2 percent in the United Kingdom) while they covered almost all the outlays in Germany.[22]

On average, subnational governments in EU countries balance their budgets (Fischer, 2001). However, their budgets usually include sizeable transfers from central government.

Central governments usually set constraints on subnational governments' finances. In many cases, a golden rule is in place. In other cases, borrowing at the subnational level has to be authorised by the finance minister. In France, Ireland, and the United Kingdom, the central government can directly restrict borrowing by lower levels of government (Hallenberg, Strauch, and von Hagen, 2001). In Sweden a strong constraint on subnational government finances was introduced in 2001: subnational governments are required to balance their budgets every year and, when a deficit is recorded, the balance has to be restored within two years. In addition to limits for borrowing, EU countries frequently adopt explicit coordination agreements among different government tiers. Generally, these agreements are not legally binding. Only Finland does not have either coordination procedures or restrictions from central government.

Attention to the problems highlighted in the previous section was especially high in five EMU countries: Austria, Belgium, Germany, Italy and Spain. Of these, the first three have a federal structure (in Belgium this is a relatively recent development); the other two have substantially increased decentralization in recent years. During the 1990s, the share of subnational government taxes in general government revenue was relatively stable in Austria, Belgium and Germany while it grew substantially in Italy and Spain.

[22] Data concerning the composition of expenditure by level of government can also be misleading as a measure of the degree of decentralization when areas of concurrent responsibility between different tiers of government are relevant.

Table 1

Revenue, Expenditure and Net Borrowing in EU Countries in 1995

(as a percentage of GDP)

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

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

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

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

(3) For Germany, subnational government data refer only to regions.

Table 2

Composition of Tax Revenue and Social Security Contributions by Subsector of Government in EU Countries in 1998

(as a percentage of overall tax revenue)

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

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

(1) 1997 data.

Interestingly, none of the five countries has decided either to replicate the SGP at the national level or to introduce a market for deficit permits. Austria, Belgium, Italy and Spain have adapted their rules to the new European environment by introducing some explicit "domestic pact" although with different characteristics and scope. Germany has long discussed reforms, but in the end has left things unchanged, even though the agreement reached in March 2002 by the federal and regional governments about their joint responsibility for the commitments arising within the SGP represents a step towards a formal pact.

In all five countries rules are generally based on agreements between the centre and periphery (Fig. 1). The main exception is Italy, where largely the central government has so far imposed rules. This may be due to the relatively short Italian decentralization experience and to the lack of an institution representing regional governments at the national level (such as the Austrian and the German parliamentary chambers). Nevertheless, Italy also is moving towards a framework where negotiation, coordination, and consensus between centre and periphery are more important; for example, formal rules are being supplemented by informal procedures to reach agreements in the health sector.

Some margin of flexibility is allowed for investments (this is not the case in Austria, Belgium, and, only from 2002, Spain) while no explicit mechanism is in place for taking into account the effects of the economic cycle on public finances (Fig. 2).

Relevant differences exist in the degree of sensitivity of subnational governments' budgets to the economic cycle among the five countries and, within each country, among the different subnational tiers. First, the cyclical component of subnational governments' resources lies primarily within tax revenue; therefore, differences in the tax share of total revenue at the

Figure 1

Domestic 'Pacts'

	Imposed	Agreed
Explicit	Italy	Spain, Belgium, Austria
Implicit		Germany

Figure 2

Flexibility for investment

Explicit flexibility for the cycle	No	Yes
No	Austria, Spain, Belgium	Germany, Italy
Yes		

subnational level matter. Second, sensitivity may depend on which taxes are local. Third, sensitivity may depend on the way grants are designed.[23]

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

4.1. Austria

Austria has been a federal state since 1920. Government responsibilities are shared among three levels of territorial authority: the central government (*Bund*), nine federal regions or states (*Länder*), and about 2,350 municipalities (*Gemeinden*).[24]

The distribution of responsibilities between the central government and the regions is determined by the constitution.[25] Legislative responsibilities are conferred mostly on the central government. Administrative responsibilities are assigned mostly to the regions. The constitution makes the regions responsible for all matters that it does not explicitly reserve to other government levels. Despite the formal dominance of the central government, the regions exercise considerable discretion in their relations both with central government and the municipalities.

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

Austrian federalism is based on cooperation and coordination among the government tiers. This feature is apparent in the role of consensus for determining the degree of fiscal equalization. The structure of financial provisions is established by the Financial Constitution Law, which guides the assignment of shared and exclusive taxes. The general framework thus defined becomes operational through an ordinary law (Fiscal Equalisation Law) which establishes the details of the rules for tax sharing, intergovernmental transfer, and cost bearing among the three levels of government. Before being actually presented to the parliament, the Fiscal Equalisation Law is negotiated by the finance minister, the nine regional finance ministers, and the representatives of the municipalities. So far, without exception, unanimous

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[23] For example, in Germany current transfers from regions to municipalities mainly depend on the level of regions' tax revenues. Moreover, capital transfers from regions to municipalities often depend on the budgetary situation of the regions.

[24] The public sector includes also professional organizations, social security bodies, and public funds. Counties exist only as administrative subunits of the regions.

[25] On fiscal relationship among different government levels in Austria, see Thoni (1999), and Matzinger (2001a, and 2001b).

consensus has resulted for this law. The Fiscal Equalisation Law approved in 2001 covers the period from 2001 to 2004.[26]

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

In 1999 Austria introduced binding budgetary rules for subnational governments, which took the form of an explicit Domestic Stability Pact. The main target of the pact was the stabilization of general government deficit below the 3 percent threshold.

In Autumn 2000, a new Domestic Stability Pact was discussed in the context of the negotiations for the Fiscal Equalisation Law for the years 2001-04. In June 2001 the negotiations among central government, regions, and municipalities were brought to a positive conclusion.[27] The new pact sets budgetary obligations and consequences of noncompliance for all levels of government.

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

- Municipalities have to balance their budgets over the period 2001-04. This commitment concerns municipalities grouped according to the region they belong to.
- Regions as a group have to reach a surplus of 0.75 percent of GDP. The pact allocates the surplus required from each region mainly according to population. However, the regions in favorable financial condition have agreed to more ambitious targets than the other regions.
- The central government has to reduce its deficit in 2001 and 2002 and keep the level thus reached thereafter.[28]

The pact sets up several committees with advisory, coordination, supervision, planning, and implementation responsibilities.[29] The committees are the main information channel among governments. The pact requires all authorities involved to provide proper flows of information concerning their budgetary positions. Under prespecified circumstances, sanctions have to be paid for failure to deliver necessary information.

During the negotiations concerning the Domestic Stability Pact, a great deal of attention was focused on how to evaluate budgetary outcomes. In the end, an agreement was reached to use

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[26] Previous agreements applied to six year periods up to 1985 and to three-year periods thereafter.

[27] Like the Fiscal Equalisation Law, this Domestic Stability Pact covers the period from 2001 (retroactively) to 2004. See OECD (1999).

[28] Austria, Federal Ministry of Finance (2000).

[29] These are the national committee, which represents all levels of government, and eight regional committees.

ESA95 instead of the Austrian cash-based accounting method. This decision goes in the direction of setting common accounting standards for all levels of government and of harmonising accounting standards in a way which makes national rules compatible with those applied at the European level.

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

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

Sanctions amount to 8 percent of the contribution to the pact (i.e., the agreed change in the budget balance) plus 15 percent of the shortfall, but cannot exceed the shortfall itself. The fine is to be deposited at the Austrian central bank. If compliance is reobtained within one year, the fine is returned; otherwise, the money is allocated across the complying governments. Noncompliance does not lead to sanctions (1) if the general government overall budget is balanced; (2) if noncompliance is due to a change in the interpretation of ESA95 accounting rules; or (3) if there is a revenue shortfall concerning only one level of government due to a Supreme Court decision.

4.2. Belgium

Over the last 30 years, Belgium has been turned from a unitary and highly centralized country into a federal and very decentralized one (Greco, 2000; van Meerhaeghe, 1995; Todman, 1997; Bogaert and Père, 2001). The federalization of Belgium started in 1970 when regions and communities were introduced into the constitution.[30] In 1993 the federal nature of the country was established and the responsibilities of subnational governments were extended to their current scope.

The institutional structure of Belgium is particularly complex. It includes the federal government, three economic regions, three linguistic communities,[31] ten provinces, and about 600 municipalities. Regions and communities are not subordinate to each other. This structure is reflected in the complex allocation of functional responsibilities.[32] The regions are

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

[31] Todman (1997) notes that the two types of entities reflect the linguistic nature of the factors determining institutional changes as well as the different objectives of the French and Flemish communities. The Flemish put pressure for the creation of the linguistic communities; the French speakers insisted on the creation of the economic regions. The Flemish region and community are de facto merged.

[32] For instance, four levels of government are involved in the supply of educational services.

responsible for infrastructure, transport, agriculture, science policy, foreign trade, employment policy, and the environment. They also oversee provinces and municipalities. The communities are responsible for language use and the arts; they have a relevant role in education, social assistance, and public health.

Regions and linguistic communities have financial autonomy. The federal government remains responsible for raising most of the public revenues. An important part of these revenues is automatically transferred to regions and communities.[33] The revenues of the central government (VAT and personal income tax) attributed to regions and communities represent about 90 percent of their overall resources. The VAT share is allocated on the basis of the number of students. The personal income tax share of each region is determined on the basis of the income-tax revenues that can be attributed to each area. However, a solidarity fund provides some degree of redistribution across regions. Taxes collected by the regions and communities amount to 8 percent of total funds, while grants from the central government account for less than 3 percent of their total resources.

The completion of the federalization of Belgium in the 1990s took place in a context in which fiscal policy was very much affected by the development and the implementation of European fiscal rules. Accordingly, the development of rules and procedures applying to the budgetary decisions of subnational governments reflected both the pressures stemming from their increasing role and the need to comply with euro-level commitments. The approach taken by the Belgian authorities does not rely on uniform predefined rules (such as the balanced budget or the golden rule), but rather on the consensual definition of yearly targets. In this context, coordination mechanisms and the supervisory Conseil Superieur des Finances (CSF)[34] introduced in 1989 have a major role. This solution probably reflects the different initial budgetary positions of regions and communities, as well as their limited number. The tensions between the linguistic groups may also have had an influence.

There is no formal rule setting limits to expenditure, deficit, and debt. However, the CSF sets yearly guidelines for the expenditure growth and the deficit level of each institution (the federal government, regions, communities, and social security authorities).[35] Primary expenditure is recognized as the control variable for reaching the target set for the overall balance. Subnational governments are not expected to match expenditure overruns with increases in tax rates. The regions can levy supplements on national taxes, but they have to consult the federal government and the other regions. Regions and communities can issue bonds, but they must have the approval of central government.

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

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[33] The revenue structure of regions and communities is extensively examined in Todman (1997) and Spinnoy (1998).

[34] The CSF – Besoins de Financement des Pouvoirs Publics, which is in charge of drafting the reports concerning budgetary targets, includes representatives of federal government, regions, communities, and the central bank.

[35] See Bogaert and Père (2001) and Conseil Superieur des Finances (1998).

During the 1990s, the CSF indicated targets for each region and community. The CSF guidelines were reflected in the convergence programs of 1992 and 1996, and in the more recent stability programs prepared in the EMU context. Since 1992 the programs have referred to two groups of public authorities: Entity I, which consolidates the budgets of federal and social security institutions, and Entity II, which consolidates the budgets of regions, communities, and subnational authorities. Targets are set for the primary and the overall balance of the two entities.

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

The early stage of the decentralization process coincided with a period of sizeable imbalances in public accounts and a growing public debt. The final stage, in the 1990s, coincided with a phase of fiscal consolidation and declining debt-to-GDP ratios. Decentralization did not hamper the consolidation process. All regions and communities met the CSF deficit guidelines. However, the distribution of the consolidation effort was asymmetric (de Callataÿ and Savage, 1998; and Bogaert and Père, 2001). The federal and social security authorities largely contributed to fiscal consolidation in the 1990s. The rate of growth of primary expenditure was particularly low for Entity I, while Entity II was able to benefit from the strong revenue growth guaranteed by the transitional rules. De Callataÿ and Savage (1998) note that this asymmetry creates problems in terms of resource allocation (expenditure cuts can only be implemented on some budgetary items) and incentives (regions and communities may consider themselves immune from the effects of shocks).

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

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

The CSF suggests that each region or community produce an internal stability program covering the same period considered in the program submitted within the EMU framework. It

also advocates that the National Accounts Institute provide national accounts data for each region and community.

4.3. Germany

Germany has a federal structure made up of three main government levels: the central government (*Bund*), sixteen regions or states (*Länder*) and 15,000 municipalities (*Gemeinden*).[36] While the constitution confers powers primarily on the regions, these powers have been gradually eroded in favour of central government. This process is related to the importance of concurrent legislation and to the principle of federal law, overriding regional law.[37]

Each level of government has its own tasks and is responsible for financing the expenses related to those tasks. As far as budgetary decisions are concerned, in principle subnational authorities are autonomous. Nevertheless, there are important interrelations and interdependencies among the government levels. As far as the provision of public goods is concerned, the constitution establishes "uniformity of living conditions" (instead of minimum standards). Moreover, the constitution's "confederate principle" establishes that all governments guarantee for one another. Moreover, the budgets of municipalities are subject to direct financial monitoring by the regions and regions largely affect the financial position of municipalities by transferring important resources. In this sense, the structure of the German decentralization is hierarchical.

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

Given these basic features of German decentralization, it is important to stress that German federalism has been based on the cooperation among different tiers of government and among the authorities belonging to the same tier. This is also reflected in the framework of budgetary arrangements applying to subnational governments. There are explicit rules defined by the constitution. Moreover, there are implicit rules which are based on consensus rather than on the central government's power to impose them.

According to the budgetary autonomy of each level of government, each authority can finance its expenditure through borrowing. A golden rule budget constraint allows borrowing only for

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[36] On fiscal relationships among the different government levels in Germany see Deutsche Bundesbank (2001), Spahn and Föttinger (1997), Wendorff (2001), and Zimmermann (1999).

[37] Even in areas of primary regional responsibility, regions' tasks have been reduced by increasing joint decision making and sharing of responsibilities.

investment expenditure.[38] There is also an indirect limit to borrowing, which comes from the "confederate principle": each government has to take into account the effects of its choices on the other governments.

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

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

The cooperative nature of German federalism was confirmed after the approval of the Maastricht Treaty. Indeed, the Act on the Treaty on the European Union, which was approved by both the Bundestag and the Bundesrat at the end of 1992, established that "obligations arising for the Federal Republic of Germany from the legal instruments of the European Union … are to be fulfilled on the basis of an agreement between the federal government and the *Länder*."

In spite of this formal commitment, no provisions for a domestic stability pact were introduced in Germany. The federal government proposed to determine a legally binding allocation of the Maastricht deficit limit both vertically between central government and regions and horizontally across regions. This allocation would have been relevant only in the case of an excessive deficit for the general government, as defined in the Maastricht Treaty. The debate which followed this proposal concerned (1) the extent to which binding deficit allocations are actually required; (2) the method for allocating the deficit both vertically and horizontally; and (3) the rule according to which fines set at the European level should be paid by noncomplying governments. The debate was inconclusive, so that eventually no domestic stability pact was introduced.

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

With the publication of the most recent estimates on the general government deficit in 2001, the debate on the introduction of a domestic stability pact has gained new importance. Indeed, in 2001 regions seem to have played a role in determining a significantly higher-than-expected general government net borrowing. Moreover, in December 2001 the Bundestag and the Bundesrat agreed on an amendment to the budget principle act concerning the compliance with budgetary discipline in the EMU framework. This amendment is not a strictly binding rule. Nevertheless, it states that the federal government and subnational governments will aim

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

to reduce net borrowing and achieve a balanced budget and that, if budgetary discipline of the central, regional, and local authorities does not comply adequately with the requirements, the Financial Planning Council will discuss the reasons and make recommendations on adequate budgetary measures to be implemented. Finally, in Spring 2002, in the Financial Planning Council, the central and regional governments stated their joint responsibility for the commitment arising from the Stability and Growth Pact and reaffirmed the objective of balancing their budgets. They also agreed upon the introduction of ceilings to the outlays of the different government tiers.

4.4. Italy

After World War II, Italy retained a centralized structure for a long time. Although the 1948 Republican Constitution placed great emphasis on the role of the regions, five of which were granted a high degree of autonomy under special statutes, the 15 ordinary statute regions were actually established only during the 1970s. Up to the 1980s the responsibilities attributed to regions had been relatively limited. The decentralization process gained momentum in the 1990s and culminated in the constitutional reform of 2001, which has substantially extended regional powers.[39]

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

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

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

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

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[39] On fiscal relationships among different government levels in Italy, see Arachi and Zanardi (2000), Buglione (1999), Fausto and Pica (2000), and Messina (2001). On the constitutional reform, see Fazio (2001); Balassone, Degni, and Salvemini (2001), Fossati (2002), and Giarda (2002).

Between 1990 and 2000 the tax-levying power of subnational authorities increased significantly through the introduction of new local taxes, such as the regional tax on productive activities (IRAP), and surcharges on central government taxes, such as that on the personal income tax. The process also involved lower levels of subnational governments (municipalities and provinces), which are mainly responsible for local public transport, primary and secondary levels of education, and social and cultural services. These subnational governments were assigned the municipal tax on buildings (ICI) and a personal income tax surcharge. As a result, the ratio of subnational government revenue to GDP rose from 2.8 percent in 1990 to 7 percent in 2000. In 2000 a legislative decree was passed (No. 56/2000) replacing most of the previous state transfers with coparticipation in central government tax revenues, the most significant of which is a 38.55 share in VAT receipts.

The need for tighter budgetary discipline in subnational government finances was reinforced in the run-up to EMU. In 1996 and 1997 mandatory limits were introduced for transfers from the state to subnational authorities. In 1999 the so-called Domestic Stability Pact was enacted. This is actually a central government law, rather than a pact, and in spite of its name, it does not mimic the European pact. It is essentially a rule setting maximum ceilings to subnational governments' deficits growth. Its features hardly make it a binding rule. First, the deficit referred to in the Domestic Stability Pact is not a comprehensive measure, as it excludes health, capital, and interest outlays. Second, overruns with respect to the ceiling can be compensated for in subsequent years; moreover, amendments to the original law introducing the Domestic Pact have retroactively redefined the budgetary ceilings, allowing higher deficits than would have been possible otherwise.

These features make the Italian pact of little help in disciplining subnational governments with respect to EMU budget rules.[40] Also the budget deficit referred to for the Domestic Stability Pact is computed by cash accounting rather than by accrual accounting as the ESA95 requires. More generally, there are concerns about the quality, homogeneity, and timeliness of Italian subnational governments' accounting, which have so far made it especially difficult to monitor subnational developments and enforce budgetary discipline.

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

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

According to the new constitutional language, to fulfill their functions, subnational governments are no longer "assigned" revenues. They now "have independent resources. They

[40] For an analysis of the Italian Pact, see Balassone and Franco (2001a); Balassone, Franco, and Zotteri (2001); Balassone and Zotteri (2001); and, for a less pessimistic view, Giarda and Goretti (2001).

enact and collect taxes and enjoy own revenues; […] they share in the revenue from national taxes as generated in their territory."[41]

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

Italy does not have a good track record with respect to financial stability. Its experience with decentralization is relatively short, beginning only about twenty years before the Treaty of Maastricht was signed. The rules then enacted have been slowly tightened due to evident shortcomings and in connection with the speeding up of budgetary consolidation during the run-up to EMU. At present, Italy's arrangements can be characterised as explicit rules imposed by the centre. In principle, a golden rule is also in place for subnational governments. With the recent reform of the constitution, this rule has been given constitutional status. Flexibility for unexpected circumstances is allowed in that borrowing limits can be relaxed.

4.5. Spain

The territorial organization of Spain was changed by the 1978 Constitution, which introduced the regional governments. Since then, the regions have played an increasingly important role in the management and financing of public services.[42] This devolutionary process is not yet complete. The regions' own revenues still represent less than 30 percent of overall regional revenues. Some regions have not yet taken over the responsibility for major public services (such as health and education). The extent of autonomy varies across regions due to both constitutional reasons and the fact that the process of devolution has been based on a cooperative approach with the regions, which have been allowed to decide if and when to move to more advanced steps in the process.

Three groups of regions can be distinguished: (1) the Special Status Regions (SSRs), that is, the Basque Country and Navarra, which enjoyed some degree of administrative autonomy even prior to the 1978 Constitution and have had specific charter laws since the Middle Ages; (2) the so-called Constitutional Article 151 Regions (151Rs), that is, Andalucia, Catalonia, the Canary Islands, Galicia, and Valencia; and (3) the remaining ten regions, the so-called Constitutional Article 143 Regions (143Rs).

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

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[41] Constitution of the Italian Republic, article 119.

[42] On fiscal relationships between different government levels in Spain see OECD (1993); Monasterio, Sánchez, and Blanco (1999); and Gordo and da Cos (2001).

Decentralization in Spain conforms to three principles: (1) it should not undermine the unity of Spain, so internal barriers and hidden support are excluded; (2) least developed regions should be supported in the catching-up process; and (3) regional governments should have sufficient resources to finance the services in their domains.

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

During the transitional period, the financing needs of regions were negotiated on the basis of ad hoc calculations. The central government retained most of the taxing power, with regional finance based on transfers. Later arrangements gradually moved towards predetermined transfer mechanisms (based on formulas taking into account both cost variables, such as population and dispersion, and distributive variables, such as per capita income and fiscal effort) and larger autonomous financing sources. The last agreement assigned to the regions 15 percent of personal income tax receipts, with regulatory responsibilities for both the tax rate schedule and the amounts of deductions, allowing for a gradual growth of this share up to 30 percent.[43]

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

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

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

At the beginning of the 1990s it became evident that, given the growing weight of the regions, planned budgetary retrenchment, an essential tract of the strategy for the run-up to joining the

[43] However, the agreement was not signed by Andalusia, Castile-La Mancha and Extremadura.

EMU, could not be achieved without the involvement of regional governments. Improved coordination between central and subnational governments was one of the aims of the 1992-96 financing arrangement, whereby the regions also agreed to participate in the required fiscal adjustment to meet the targets set in the Convergence Programme. The central government made it clear that there was not going to be a bail-out of regions in financial distress.

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

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

In 2001, two new pieces of legislation were enacted: the agreement on Subnational Government Financing Law (Ley 7/2001 and Ley 21/2001) and the Budgetary Stability Law (Ley 18/2001 and the accompanying Ley 5/2001).[44]

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

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

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

[44] See OECD (1993); Monasterio, Sánchez, and Blanco (1999); and Gordo and da Cos (2001). Onrubia and Sanchez (2002) and Banco de España (2002) for a detailed analysis and evaluation of the reform.

Spain is a country with an good average record of financial stability. Its experience with decentralization is short. The process started little more than ten years before the Treaty of Maastricht was signed and there was no time to set up fiscal rules independently of the process of budgetary consolidation started by the run-up to EMU. Although Spain's rules were developed in the EMU context, there was no attempt either to replicate the Stability and Growth Pact at the national level nor to introduce innovative solutions like markets for deficit permits.

During the 1990s, Spain adopted a mixture of explicit and implicit rules largely based on consensus; in principle, a golden rule was in place for subnational governments, and flexibility for unexpected circumstances was allowed in that borrowing limits could be relaxed. Regional finance, largely based on predetermined transfers, seemed quite sheltered against revenue losses due to cyclical circumstances.

The recent reform will change the landscape of Spanish budgetary arrangements. Explicit rules for budgetary targets will replace negotiations. Flexibility will be reduced both with respect to investment (the target applies to the overall budget) and to the cycle (there will no longer be predetermined state transfers).

5. Are the Solutions Adequate and Sustainable?

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

Section 3 examined the possible solutions to these problems and made the following suggestions:

- For larger subnational governments, a domestic replica of the SGP, including explicit monetary sanctions, can be introduced to tackle both the asymmetric incentive problem and the need to buffer cyclical effects.
- For smaller governments, a careful selection of tax bases can largely isolate their budgets from cyclical effects. In this way the requirement to keep the budget balanced in nominal terms – a less sophisticated rule than that envisaged in the SGP – can be used to solve the incentive problem without any risk of inducing procyclical behaviour.
- To avoid compression of investment outlays, the introduction of a "compensated" golden rule (i.e., a golden rule with an overall deficit cap to be compensated for with a central government surplus) together with a cooperative mechanism to allocate borrowing according to the needs of the different governments, can be considered. If cooperation leads to an inefficient allocation of borrowing for investment projects, a market for borrowing rights can be considered as an alternative to induce more efficient outcomes.

The analysis in Section 4 highlighted the variety of approaches followed by European countries. Institutions, rules, and procedures strongly reflect national history, traditions, and political and cultural developments. However, the analysis has also shown the following:

- No European country has chosen to replicate the SGP at the national level. Indeed, in most countries there are no predefined sanctions for subnational governments contributing to a slippage with respect to the targets set for general government (the only exception is Austria). This may reflect technical problems related to the measurement of local GDP and the budgetary effects of the cycle.
- In fact, municipalities and other smaller subnational governments are usually assigned resources in such a way as to limit the sensitivity of their budgets to the cycle. Indeed, in some countries (e.g., Belgium) this also applies to larger regions. In general, the share of subnational governments' own taxes in revenues is still relatively low. This further contributes to insulating these governments from the cycle.
- All countries rely, albeit to different extents, on cooperative mechanisms to tackle the three identified critical areas. Parliamentary chambers representing regions and advisory councils including representatives of the different levels of government play a crucial role. The major exception is Italy, where effective decentralization is most recent and consensual procedures are gradually being introduced. The extent to which cooperation is supported by some element of control (often in terms of explicit supervision by the central government) seems to be in inverse relation with the length of the federalist tradition of a country. The elements of control are stronger in Italy (where the Domestic Pact is in fact a law enacted by the national government) and in Spain (where the involvement of regional governments in the consolidation of public finance was obtained thanks to a decision by the central government not to bail out subnational administrations) and lighter in Germany (where bailing out is actually foreseen in the constitution) and Austria, with an intermediate blend in Belgium (where borrowing by subnational governments is subject to central government approval).

The budgetary frameworks for subnational governments adopted by the five EMU member states examined have so far proved successful in terms of deficit control. In Belgium, Italy, and Spain the increase in fiscal decentralization has not hampered fiscal consolidation. Between 1993 and 2000, the deficit-to-GDP ratio has declined from 7.3 percent to balance in Belgium, from 10.3 to 1.5 percent in Italy, and from 6.8 to 0.4 percent in Spain.[45] In no country does the subnational government's finance seem to have put significant pressures on budgetary targets. Furthermore, the Belgian experience indicates that even in a country with significant tensions among the different regions a cooperative approach can be successful.

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

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

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

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[45] Excluding UMTS receipts.

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

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

The current budgetary frameworks are consistent with a limited degree of fiscal differentiation across regions. In most of the countries considered in Section 4, regional governments have limited autonomy in setting tax and expenditure levels. In this context, tax-sharing agreements are necessarily complemented with expenditure guidelines, since subnational governments do not have the possibility of compensating expenditure increases by higher revenue growth.[46]

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

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

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

In this respect the introduction of explicit domestic pacts, mimicking the SGP, has marked advantages over purely cooperative mechanisms. The introduction of predefined rules and sanctions may redress the incentive structure facing politicians and induce faster adjustments (Kopits and Symansky, 1998). It may also increase transparency and allow better control of policy implementation on the part of the electorate and the market.

While all countries are taking steps towards supplementing cooperation with some rules, in countries such as Italy and Spain, where decentralization is relatively young and where the

[46] The introduction of expenditure guidelines for EMU member states, to replace the SGP would be problematic in three respects: (1) institutionally, the question would arise of who is to set the reference growth rate of expenditure for each country (there would be an issue of sovereignty); (2) if the externalities of fiscal policy are determined by deficit and debt levels, rules should refer to these parameters and not to expenditure; and (3) operationally, as member countries can change their tax system the need would still arise to use rules for the budget balance.

number of governments involved is large, rules can be especially useful. Indeed, the reform recently enacted in Spain seems to reflect this. Explicit rules for budgetary targets have been introduced to replace bilateral negotiations. Flexibility will be reduced with respect to both investment and the economic cycle.

The feasibility of a rule-based approach depends on the adoption of a common accounting and statistical standard. At the European level this was achieved by reference to ESA95. This was also a key element of the cooperatively defined rules adopted in Austria. Unfortunately, this principle seems to meet difficulties in countries whose decentralization is young. In Italy, for example, it is sometimes claimed that the constitution gives regions autonomy also with respect to accounting practices. In Spain the recent reforms explicitly acknowledge the need to improve the degree of transparency of subnational government finances by requiring that a central statistical archive be set up to ensure that budgetary information of the same standard as that produced by central government is also made available by regions.

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