ISSN 1608-7143
OECD Journal on Budgeting
Volume 6 – No. 3

Fiscal Rules for Subnational Governments: Can They Promote Fiscal Discipline?

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Experience indicates that fiscal rules can be helpful as a disciplinary device at the central government level. This article explores whether fiscal rules could be usefully adopted in a decentralised framework, where the behaviour of subnational governments may undermine fiscal discipline.

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Fiscal rules are often seen as devices to ensure fiscal discipline.[1] They are typically enshrined in constitutional or legal provisions and are intended to influence policy design and anchor economic agents' expectations about a government's commitment to fiscal discipline over a relatively long horizon. At the same time, they also aim at enhancing accountability of policy makers, creating incentives for them to adhere to prudent policies.

Experience indicates that fiscal rules, while not a panacea, can be helpful as a disciplining device at the central government level. A related issue, perhaps less explored, is whether fiscal rules could also be used to limit policy makers' discretion at the local level.[2] In other words, could fiscal rules be usefully adopted in a decentralised framework, where the behaviour of subnational governments may undermine fiscal discipline? This article addresses this question.

The main conclusion is that fiscal rules are neither necessary nor sufficient to ensure fiscal discipline at the subnational level. In principle, both financial markets and co-operative arrangements across government levels could promote such discipline and provide the right incentives to local politicians to be fiscally responsible. Where, however, these arrangements are not feasible or fully reliable, fiscal rules could be useful. It should be recognised, nevertheless, that fiscal rules cannot secure fiscal discipline by themselves if the political will to adhere to them is lacking, or if the central government's commitment to a no bailout policy is not credible, thus leading to moral hazard.

The article is structured as follows. Section 1 reviews the main challenges to fiscal discipline posed by subnational governments. Section 2 explores under what conditions markets can exert effective discipline on public governments. Section 3 reviews co-operative arrangements between levels of government, which could alternatively be adopted to ensure the formulation and implementation of appropriate fiscal policies. The role of fiscal rules and the conditions for their effective implementation are covered in Section 4. Section 5 concludes.

1. Subnational governments' challenges to fiscal discipline

A number of factors create adverse incentives for subnational governments to overspend, undertax, and/or borrow excessively – all root causes of fiscal imbalances. These excesses can compound fiscal profligacy by the central government, or undermine the latter's efforts to ensure fiscal discipline, thereby jeopardising macroeconomic stability and, possibly, debt sustainability.

A first factor is the "common pool" problem. In an integrated national economic and financial space, the costs of fiscal indiscipline by one or more subnational governments (*e.g.* an increase in interest rates) are likely to spill over to the others. Moreover, each subnational government will have little incentive to save a windfall in shared revenues, as it may fear that it could lead to future reductions in its share, in favour of higher-spending jurisdictions.

A second factor is the moral hazard created by a history of bailouts of subnational governments by the centre. In such cases, the incentives for fiscal responsibility are weakened, as the costs of indiscipline are transferred to the national budget. Moreover, even an explicit central government's commitment to a no bailout policy may lack credibility, if local governments are responsible for the provision of essential public goods and services, and a disruption in such provision is likely to have strong political and social consequences.

A third factor that may adversely affect subnational fiscal discipline is a strong heterogeneity of subnational jurisdictions, not adequately addressed in the design of the system of intergovernmental transfers. If subnational governments differ substantially in their ability to meet centrally mandated standards in the provision of the public goods and services they are responsible for, and transfers from the centre are inadequate to bridge these gaps, pressures to run deficits may mount, especially if the subnational governments have access to bank or other forms of credit (*e.g.* supplier credit, or indirect borrowing through enterprises they own).

Finally, subnational governments enjoy (to varying degrees) constitutionally established autonomy. This may prevent the central government from setting and enforcing effective budget constraints (borrowing limits, or balanced budget rules) on them. The greater the legal or even the *de facto* autonomy of subnational governments, the lower the probability that top-down constraints may be feasible and effective.

In summary, all the above-mentioned factors may severely challenge the central government's ability to ensure fiscal discipline for the general government as a whole. In what follows, alternative approaches to meeting this challenge are discussed.

2. Alternatives to fiscal rules: reliance on market discipline

In principle, the market could exert disciplinary influence on subnational governments. The greater the discipline that markets can impose on subnational governments (for example, via financing and credit ratings), the lesser the need for budget constraints imposed from the centre.

However, broad experience suggests that there are a number of specific preconditions for effectiveness of market discipline on subnational governments:[3]

- **Availability of timely and reliable information on subnational finances.** Market participants need access to all the information required to evaluate the financial soundness of each government.
- **Governments' responsiveness to early market signals.** If subnational authorities do not react in a timely fashion to market signals (*e.g.* increases in borrowing costs), deficits and debt can mount to unsustainable levels, before the governments are shut off market financing.
- **No privileged access to financing.** If subnational governments can rely on privileged channels of financing (*e.g.* through portfolio requirements for banks), this weakens the role of the market in disciplining them.
- **No history or expectation of bailouts by central government.** Otherwise, the incentives for discipline faced by local authorities are weakened, as discussed in the previous section.
- Relatedly, **an adequate base of own revenues.** At the margin, subnational governments should be able to finance additional spending by raising own revenue, as this increases accountability to local constituencies.

The evidence on the (lack of) effectiveness of market discipline underscores that these preconditions are often not met. Non-transparent accounting, as well as the recourse to window-dressing and creative accounting, undermine the reliability of markets' assessment of subnational government finances. Local authorities may also be slow in responding to market signals. Finally, the possibility of recurring to financing from government-owned regional or local banks (or having such enterprises undertake quasi-fiscal operations for their shareholders) frequently undermines the effectiveness of market discipline. In all these cases, sole reliance on market discipline risks resulting in delayed and costly corrections, as shown by the recent evidence from empirical work on banking spreads on subnational bonds.[4]

Most importantly, a purely market-based approach is effective only if the central government can credibly commit not to bail out subnational governments in difficulty. The central government can only earn such credibility through a sustained history of no bailouts. The cases of Canada and the United States provide examples to this effect. In both cases, subnational governments (provinces and states) existed before the formation of a national/federal government. Even when some subnational governments in those countries experienced significant financial difficulties, the federal government resisted pressures to provide loans to them (Rodden, *et al.,* 2003; Ter-Minassian, 1997).

3. Alternatives to fiscal rules: co-operative arrangements

When some of the conditions for sole reliance on market discipline are lacking, co-operative solutions across levels of governments may be contemplated. These typically involve co-operative arrangements through an appropriate institutional set-up. In these cases, the incentive problem – namely, how to make local politicians accountable – is addressed through moral suasion and peer pressure. The main advantage of this approach is that it promotes dialogue across levels of governments, while enhancing local policy makers' awareness about the macroeconomic implications of their budgetary choices. At the same time, in cases where some constituencies can exert more political and economic influence on the centre than others, a co-operative approach may succumb to excessive bargaining power. Hence, a strong and even-handed leadership from the centre is likely to be necessary to make this approach viable.

Examples of co-operative approaches include the historical National Loan Council in Australia and the High Finance Council in Belgium. In Spain, decisions concerning intergovernmental relationships are taken by the Fiscal and Financial Policy Council (*Consejo de Política Fiscal y Financiera,* FFPC), established in 1980 and comprising the economic ministers of the central and the regional governments. In Denmark, bilateral discussions are held with subnational governments; rules are both set and enforced co-operatively by the association of regional governments. Enforcement of co-operative agreements may take place administratively, by penalties and sanctions applied by the central government (such as in Belgium and Spain) or by independent entities (as in Brazil, where the enforcement of certain provisions of the fiscal responsibility law is delegated to the judiciary system). Sole reliance on peer pressure for enforcement may not be sufficient, for example when unanimous consent of the members of the association is required, as in Austria, which may weaken incentives for co-operation.

4. Types of fiscal rules

In cases where the preconditions for the market and co-operative arrangements to exert effective fiscal discipline at the subnational level are lacking, fiscal rules can be adopted to ensure a transparent, more predictable and even-handed approach to promoting fiscal responsibility. Such rules can be of a procedural or of a numerical nature.

Procedural rules aim to enhance transparency, accountability, and fiscal management. They typically require the government to commit up front to a monitorable fiscal policy strategy, usually for a multi-year period, and to routinely report and publish fiscal outcomes and strategy changes. New Zealand pioneered this approach, and applied procedural rules within a Fiscal

Responsibility Law. Cross-country evidence suggests that, in countries with a weak record of policy implementation, procedural rules may work better than numerical rules. At the same time, the successful implementation of procedural rules requires modern budget systems and a high degree of fiscal transparency, and a substantial constituency for fiscal discipline and responsibility. Australia, Canada, New Zealand and the United Kingdom provide good examples of successful implementation of this type of rules.

Numerical fiscal rules refer to specific quantitative targets. They are intended to impose permanent constraints on fiscal policy, typically defined in terms of an indicator of overall fiscal performance (such as the budget balance and/or the public debt). Examples of numerical rules abound at the central/general government level. For instance, in the European Union, ceilings are specified for deficit and debt ratios. The United States implemented an expenditure cap mechanism (Budget Enforcement Act) from 1991 to 2002. Canada resorted to both legislated spending caps (Federal Spending Control Act, 1991-96) and unlegislated policy rule.

Numerical rules can help contain a deficit or expenditure bias, and address time inconsistency problems. However, they also introduce policy inflexibility and may create incentives to resort to low-quality measures to meet numerical targets. For example, in some countries the application of numerical rules has led to creative accounting practices aimed at circumventing the rules, including reclassification of expenditures, accumulation of arrears, and the use of public entities off-budget to perform government operations. The existence of an effective public financial management system is a necessary condition for proper implementation of numerical fiscal rules.

In addition, some desirable features of numerical fiscal rules include the following:

- **Appropriate coverage.** Fiscal rules need to be based on indicators that are as comprehensive as possible. Setting targets in terms of narrow indicators (for instance, the current budget balance) creates incentives to bypass them by using classification "tricks" and creative accounting. Even when coverage is comprehensive, there may be contingent liabilities and fiscal activities (such as those created by public-private partnerships, PPPs) that remain outside the coverage of the fiscal rule. In these instances, it is important to complement the rule with transparency requirements for such operations and estimates of their medium to long-term fiscal implications.
- **Complementarity of stock and flow indicators.** Medium-term debt limits should inform annual deficit limits, and *vice versa*. In other words, flow targets need to be consistent with stock ones. Specifically, rules on overall primary or operating balances need to be designed to ensure the maintenance of (or a sufficiently rapid convergence to) sustainable debt levels. Especially in

countries with relatively high levels of debt, this suggests the appropriateness of combining flow-based fiscal rules with stock-based ones.

- **Cyclical flexibility.** Fiscal rules need to allow for flexibility over the cycle. A possible solution would be to define numerical fiscal rules in cyclically adjusted terms, although it is computationally difficult to asses "local" cycles. In the United States, "rainy day" funds have been used to introduce flexibility in fiscal policy implementation, as part of the fiscal rules in almost all states (Box 1). In combination with rules calling for balanced budgets (exclusive of accumulation, or drawdown of the funds), rainy day funds have provided a transparent mechanism to save during good times, and have proved useful in smoothing the impact of cyclical revenue fluctuations on state expenditures.[5]
- **Avoiding inefficient expenditure cuts.** One possible risk of imposing numerical fiscal targets is that, when adjustment is required, productive but easy-to-cut spending, such as investment, may be sacrificed. In order to preserve the quality of adjustment, specific expenditure rules may be adopted by the subnational government, or through central government mandates.

Box 1. **Rainy day funds in the states of the United States**

Following the recession of the early 1980s, several US states introduced measures to address the adverse impact of recessions on local public finances. The number of states with rainy day funds (RDF) rose sharply from 12 in 1982 to 38 in 1989, and further to 45 in 1995. The main purpose of RDF is to smooth public spending during recessions and, possibly, increase public savings over the business cycle. In the absence of RDF, states, which are compelled by their constitutions or by statutory requirements to run balanced budgets, would have few instruments to avoid pro-cyclical fiscal policies. The need to smooth expenditure has increased over time, as the composition of state expenditure has shifted toward non-discretionary spending (in the early 1960s, about one quarter of state expenditure was on highways, *versus* about 45% on public welfare and education; in 2000, these shares had shifted to 8 and 65%, respectively).

Experience indicates that RDF cannot be relied upon for prolonged fiscal crises. RDF are often combined with other fiscal rules including expenditure or tax limits. Moreover, all states (with the exception of Vermont) have some form of balanced budget rule.

A number of conditions need to be met to ensure effective implementation of fiscal rules. These include: *i)* a robust legal basis; *ii)* a clear definition of institutional responsibilities; *iii)* transparent accounting, and timely and comprehensive reporting of subnational government operations; *iv)* firm and non-discriminatory enforcement of rules and sanctions; and *v)* perception by local taxpayers of benefits of their government's compliance with rules.

While fiscal rules for subnational governments may instill some fiscal discipline, they nonetheless cannot substitute for a properly designed system of intergovernmental relations. In particular, fiscal rules are unlikely to be effective in countries where expenditure assignments are not clear, subnational governments do not enjoy an adequate base of own revenue, intergovernmental transfers are not properly designed, and gap-filling transfers are actually used, creating moral hazard.

Designing appropriate sanctions to foster compliance of subnational governments with rules is challenging. For example, in Italy, when fiscal rules were first introduced for subnational governments through the Domestic Stability Pact in 1999, sanctions were initially monetary, based on cuts of transfers to non-compliant entities. However, it was soon realised that this further exacerbated the latter's financial difficulties at a time of distress. More generally, it is now recognised that financial sanctions give rise to a time-consistency problem, as fining a local government already experiencing difficulties could be politically difficult or even unconstitutional (Joumard and Kongsrud, 2003). For these reasons, in practice sanctions have generally moved away from monetary to administrative measures (Table 1).[6]

Administrative sanctions, however, are nonetheless difficult to design due to information asymmetries. Differences in local government sizes and historical and cultural aspects also complicate the design of sanctions that may fit all subnational governments (Joumard and Kongsrud, 2003). In some cases, penalties and sanctions may apply to public officials deemed responsible for non-compliance; in Brazil, sanctions include dismissals, fines, and even jail terms, as established under the Fiscal Crimes Law.

5. Conclusions

Fiscal rules cannot be a conduit to fiscal discipline if political commitment is lacking; nor can they remedy poorly designed systems of intergovernmental fiscal relations. Fiscal rules, also, are not the only solution to improving the incentive structure faced by local politicians. However, under certain circumstances, these rules can provide a useful policy framework.[7]

The most effective rules seem to be those based on a broad political and social support. This underscores the need for a substantial investment by economic policy makers in educating the political class and the public at large, both before launching a fiscal rules framework and after its implementation, to foster adequate ownership by the society at large. While some of the options identified above may not be feasible in all countries due to their specific institutional and legal framework, disciplining and enforcement mechanisms for subnational governments generally can be improved along several dimensions.

Table 1. **Types of sanctions and enforcement mechanisms in selected countries**

	Type of sanctions	Enforcement mechanism
Austria	Financial: Non-compliant local governments have to pay a fine proportional to the shortfall, up to a ceiling. If compliance is obtained within one year, the fine is returned; otherwise, the funds are allocated across compliant governments.	Co-operative: Application of sanctions depends on the unanimous decision of a commission involving the federal and local governments.
Belgium	Administrative: Limits on subnational borrowing.	Co-operative: The federal government is allowed to limit regional borrowing, following a recommendation of the Supervisory Council and in consultation with regional governments.
Canada	Administrative: In four provinces, ministries and members of the executive council are subject to significant cuts in wages for failure to achieve fiscal targets.	No formal co-ordination. A non-binding budget co-ordination exists via a dialogue among ministers.
Germany	No formal sanctions.	Co-operative: The Financial Planning Council (formed by the federal government, the states [*Länder*] and representatives of the communities) is charged with monitoring fiscal developments at all government levels and making recommendations in cases of non-compliance.
Ireland	Administrative: Defaulting authorities can be removed from office and replaced by a commissioner appointed by the central government.	Centralised: Subnational governments are monitored and controlled by the Department of the Environment and Local Government.
Italy	Administrative: Limits on the purchase of goods and services; prohibition to hire new staff and to contract debt to finance investment.	Co-operative: The State-Local Government Conferences are involved in the monitoring process.
Spain	Administrative: Non-compliant authorities have to submit a plan for correcting any fiscal deficit.	Centralised.

Source: Joumard and Kongsrud, 2003.

To avoid pro-cyclicality, balanced-budget rules should be supplemented by mechanisms to promote subnational savings during good times. From an economic point of view, it is more efficient to save during good times than cut expenditure during bad times. However, strong political pressures tend to discourage saving during upswings. Incentives could be enhanced through explicit transfers or a reward system.

Timely and comprehensive information on subnational fiscal outcomes should be published. Full disclosure of fiscal accounts is fundamental for the exercise of effective public pressure by citizens, subnational peers, and the market. This would allow early identification of fiscal indiscipline, so as to increase reputational costs of profligate policies and stimulate appropriate corrective action.

Local taxes should be promoted to finance discretionary expenditure at the margin. While transfers from the central governments may be the most appropriate form of funding spending mandates from the centre, discretionary subnational spending is best financed by resources mobilised locally. In this manner, local authorities face stronger incentives to evaluate the benefits of additional expenditure *versus* the costs of higher taxation, and local accountability is enhanced.

Notes

1. For a review of fiscal rules and the related literature, see IMF (2005a and 2005b).
2. In the remainder of this article, subnational governments represent levels of government below the "centre": these could be states in a federal system or lower levels of government (such as regions and provinces) in a unitary state. Similarly, central government refers to the first level of government (federal government in a federation and central government in a unitary state).
3. Some of these conditions were first discussed by Lane (1993).
4. See, for example, the analysis of interest spreads on German *Länder* in Rodden, *et al*. (2003). See also the discussion of the Canadian provinces' adjustment experience in Ter-Minassian (1997).
5. Their applicability to the European context is possibly limited due to the fact that, under the European system of national accounts (ESA95), rainy day funds are considered below-the-line items: drawing from these funds would be considered a financial transaction and not additional fiscal revenue (above the line). Therefore, resources drawn from rainy day funds could not be used to comply with the deficit limit set under the Stability and Growth Pact.
6. Countries with strong federalist systems, such as Australia, Canada, New Zealand and the United States, mostly rely on market discipline to foster compliance from lower levels of government.
7. In summarising the experience of the largest European countries with fiscal rules for subnational governments, Rattsø (2002) concludes that, overall, European countries have been able to avoid financially unsustainable situations at subnational level through the use of both fiscal rules and some discretion.

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