René Geissler
Gerhard Hammerschmid
Christian Raffer *Editors*

Local Public Finance

An International Comparative Regulatory Perspective

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Editors

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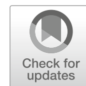
Introduction: The Relevance and Conceptualisation of Local Finance Regulatory Regimes



René Geissler, Gerhard Hammerschmid, and Christian Raffer

Abstract Although local governments are essential providers of public services and infrastructure across Europe, they ultimately depend on funding from higher levels of government. The clear relevance of local government finances necessitates effective regulation in order to ensure financial sustainability, but as of yet there has been hardly any comparative research regarding this particular topic. The 18 chapters contained in this volume bring together the work of 40 experts in the disciplines of political science, economics, and public administration research to approach the subject of local financial regulation in various scales and contexts across Europe. In this introductory chapter, we first outline key concepts such as fiscal decentralisation and regulation and briefly describe associated underlying theories and research. Secondly, we present comparative fiscal data to demonstrate the variance and trends of fiscal decentralisation across Europe. It also introduces the concept and components of regulatory regimes and develops the argument, that the effectiveness and outcome of fiscal regulation depends not only on the quality of individual components but also on the interactions of those components. We finally present the three guiding questions of this volume and provide a short overview of the chapters to follow.

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1 The Relevance of Local Government Finance

The city of Detroit, once a world capital of the automobile industry, made global headlines in July 2013 when it filed for bankruptcy after decades of decline, budget cuts, misgovernment, collapsing public services, poverty, and crime. With a debt of nearly $20 billion, it became the largest local government bankruptcy filing in US history. Though many factors nonetheless contributed to the crisis in Detroit, it can be largely understood as a failure of financial regulation. The state of Michigan, in charge of its financial regulation, failed in setting up a workable system and avoiding a budget crisis. There was a lack of clear fiscal rules, and the state treasury did not monitor the budget comprehensively nor did it have the effective instruments to intervene. The city of Detroit therefore demonstrates the long-term consequences of both insufficient regulation and state intervention.

The European approach to local government is different to the United States in many aspects. However, there is widespread consensus among practitioners and academics in both parts of the world that local governments matter. Whatever their particular constitutional status may be, local governments deliver a wide range of public services, assure important infrastructure, and are nevertheless key to citizens' trust in government. However, budgetary constraints and higher-level regulation affect and often substantially impair their functioning. In contrast to the importance placed upon local government within the EU's subsidiarity principle or the European Charta of local self-government,[1] there is only limited research regarding local government finance from a European comparative perspective and, in particular, its effective regulation.[2] This is surprising, given the importance of local public finance regulation to both centralised and federalised national governments. This research gap has become even more visible in the aftermath of the 2008 financial crisis, when effective regulation of national public finances became a cornerstone of EU legislation and policy. The consequences of this new regime and its resulting new coordination mechanisms (such as the European Semester) on local government finances have to date remained a dark spot in academic literature.

Based on the contributions of this volume, we see two main reasons for the importance of local public finance regulation: higher-level governments must provide local levels with their financial means, as the local governments in most countries are not financially self-sufficient. Furthermore, higher-level governments have a political responsibility to ensure adequate local government services for their citizens, with financial regulation as the main tool necessary to sustain those services. Higher legal funding and regulation therefore often comes with the caveat of decreased local autonomy.

[1] All Council of Europe members ratified this charter. It guarantees several elements of autonomy to local governments, including budgeting (The implementation of fiscal regulation: Insights from Germany).

[2] As an exception see Bouckaert et al. (2017) and Steccolini et al. (2017).

Over the last 20 years, we can observe a growing body of literature on government finance regulatory issues going along with increasing political relevance of the topic triggered by the financial crisis in 2008 (e.g. Hallerberg et al. 2007; Debrun et al. 2008; Dolls et al. 2012; Reinhart and Rogoff 2011; Heinemann et al. 2018). At the same time, there still remains a missing link between these discussions and similar debates on private sector financial regulation (e.g. finance, food, energy) as well as a lack of international comparative discussions on regulating local public finances.

Following the existing regulation literature approach (e.g. Lodge and Wegrich 2012), we understand 'local finance regulation' as the sustained and focused attempt of higher-level governments to alter the financial behaviour of local governments according to defined standards and purposes with the intention of producing financial sustainability. This may involve mechanisms such as gathering information, setting standards, and modifying practice.

This volume builds upon a joint project between the Bertelsmann Stiftung and the Hertie School which involves a network of more than 40 researchers across 20 European countries. It is based on both qualitative as well as quantitative methods and brings together the research from different disciplines such as public administration and public economics, which typically take very different perspectives on how to approach financial regulation.

From the past, we know that economic and fiscal hardship tend to go along with the rising relevance of fiscal regulation, be it on the national or local level in Europe and beyond. Given the current economic turmoil following the Covid-19 pandemic, we foresee a new wave of regulatory measures needed in the years to come to stabilise heavily affected local governments and to deal with growing debt levels. We hope that this volume may be of value for both academics and practitioners in this context. In 18 different chapters, we introduce the basic ideas and concepts of fiscal regulation, present new evidence from country cases and comparative analyses, and suggest policy guidance based on lessons learned of best practice.

Although the analytical perspectives, research disciplines, and methods of these various chapters differ, this volume is guided by the discussions of two key concepts: *financial decentralisation* and *financial regulation*. This introduction will outline the key aspects of these two concepts before providing a short summary of the various chapters of this volume.

2 Financial Decentralisation: Needs and Consequences

Financial decentralisation describes the process of reassigning expenditure functions and revenue sources to lower tiers of government (De Mello 2000) and is embedded in the theory of public finance developed by scholars like Musgrave (1959) and Samuelson (1954). The concept is linked to the theory of *fiscal federalism* (e.g. Oates 1972), which concerns the division of public-sector functions and finances among different levels of government (Bird 1999; King 1984). The merits

of a decentralised provision of public services have been put forwards by Wallace E. Oates' (1972) decentralisation theorem, which claims it as more efficient as well as better at providing welfare gains, since local governments are assumed to be more familiar with citizens' preferences than the central government.[3]

Two generations of fiscal federalism theories have developed over the last two decades. The *first-generation theory* suggests that, in addition to the decentralisation of expenditure functions, there exists a need for modest decentralisation of taxation based on the benefit principle (e.g. citizens should contribute to government in proportion to the benefits they obtained from that government) (Musgrave and Musgrave 1989; Dodge 2004; Oates 2005). In this view, the government's revenue-expenditure pattern is directly related to the provision of goods and services which are expected to meet citizens' preferences (Alchian 1950; Tiebout 1956). However, this first-generation theory makes the basic assumption that political decision-makers will always aim to maximise the welfare of their citizens, and it fails to recognise the fact that local government decision-makers may in fact be motivated by other, less honourable reasons to spend public money (Chandra 2012). With such a fundamental blind spot, this theory has effectively ignored very large—and rather interesting—parts of the story.

A more realistic understanding of public spending behaviour has emerged as a second-generation theory. It assumes that local decision-makers are subject to a 'deficit bias' (a tendency for governments to run excessive deficits), which constitutes an adverse incentive to overspend, undertax, and/or excessively borrow (Kotia and Lledó 2016). Informed by neighbouring fields like agency theory, information economics, or public choice theory, second-generation theories of fiscal federalism focus on the political economy of the intergovernmental structure and point to system-inherent incentives for encouraging the self-motivated careful behaviour of political decision-makers (Oates 2005). They incorporate institutional settings in order to address and contain these incentives. One key approach specifically constitutes local public finance regulation, the overarching topic of this edited volume.

What are the sources of this deficit bias? One important concept arising from these second-generation theories is the *soft budget constraint*, which may lead local jurisdictions into debt since decision-makers expect to receive transfers or even be bailed out by their upper-level governments (Kornai et al. 2003; Rodden 2002). Broadly speaking, the soft budget constraint problem is a consequence of coordination and sanction failure in a multilevel government system with decentralised

[3]This, however, does not apply to all kinds of public and private services. It leaves to consider which services should be provided by which government-level criteria, such as the degree of spillover internalisation, citizen mobility, or the ability to provide the service at a certain unit cost. Based on the *mobility of local citizens hypothesis* (Tiebout 1956), it is argued that most services with redistributive character should rather remain on the central level, as different redistributive schemes would lead to the concentration of low earners in those jurisdictions with the highest level of redistribution (Rossi and Daffon 2002). In general, fiscal federalism theory suggests making local governments responsible for 'place-specific' services and infrastructure such as childcare, streets, and water and sewerage works (Bird 1999).

functions (De Mello 2000) and can thus be attributed to agency theory and common pool problems. Conceptually linked to the soft budget constraint issue are further explanations for the deficit bias. Following Wyplosz (2013), two are of special relevance for the local government level: the tendency to push the burden of fiscal discipline upon future governments/generations and the political economy phenomenon of catering to interest groups at the cost of all taxpayers in order to increase the chances of re-election. All of them are similar in that they describe local political decision-makers, in the presence of the common-pool problem and negative spillovers, failing to internalise the consequences of overspending, an observation which gives good evidence to the importance of local public finance regulation.

In order to defend local politicians at this point—many of them who undoubtedly operate under the best of intentions—it is important to add that another flawed structure of intergovernmental finance itself can put local governments under pressure. One inherent risk of financial decentralisation is that revenue decentralisation does not match expenditure decentralisation and local governments thus suffer from insufficiently funded mandates. In combination with limited revenue autonomy, inadequate financial transfers provided by higher levels of government may also cause ongoing borrowing (OECD/KIPF 2016; Corbacho and Ter-Minassian 2013). Furthermore, negative external shocks to the local government budget such as economic crises can further jeopardise financial sustainability.

The following section provides European local government fiscal data in order to provide a first look at the development and current state of financial decentralisation. There is a clear need for regulation, as evidenced by the presented data.

3 Fiscal Decentralisation Trends in Europe

This section provides an overview of European local government finances in order to better understand the specifics of regulation which will be discussed throughout this volume. Our analysis is based on data made available by Eurostat's Government Finance Statistics and refers to all tiers of government which each country classifies as local.[4]

Figure 1 presents the 2018 data for local government revenue and expenditure as shares of general government revenue respective expenditure for all 28 European member countries plus Norway, Switzerland, and Iceland.[5] These two shares are the

[4]For example, counties (Germany, England), departments (France), regions (the Czech Republic, Denmark), or provinces (Italy, the Netherlands).

[5]In terms of local government expenditure, we use consolidated values and exclude transfer expenditure to other levels of government. We do this as we are interested in how much of general government expenditure to other sectors of the economy are made by local level governments. On the contrary, local government revenues are unconsolidated (i.e. they include transfer revenues from other levels of government), as we sought to know how much of general government revenue ends up at the local level. General government expenditure and revenues itself are internally

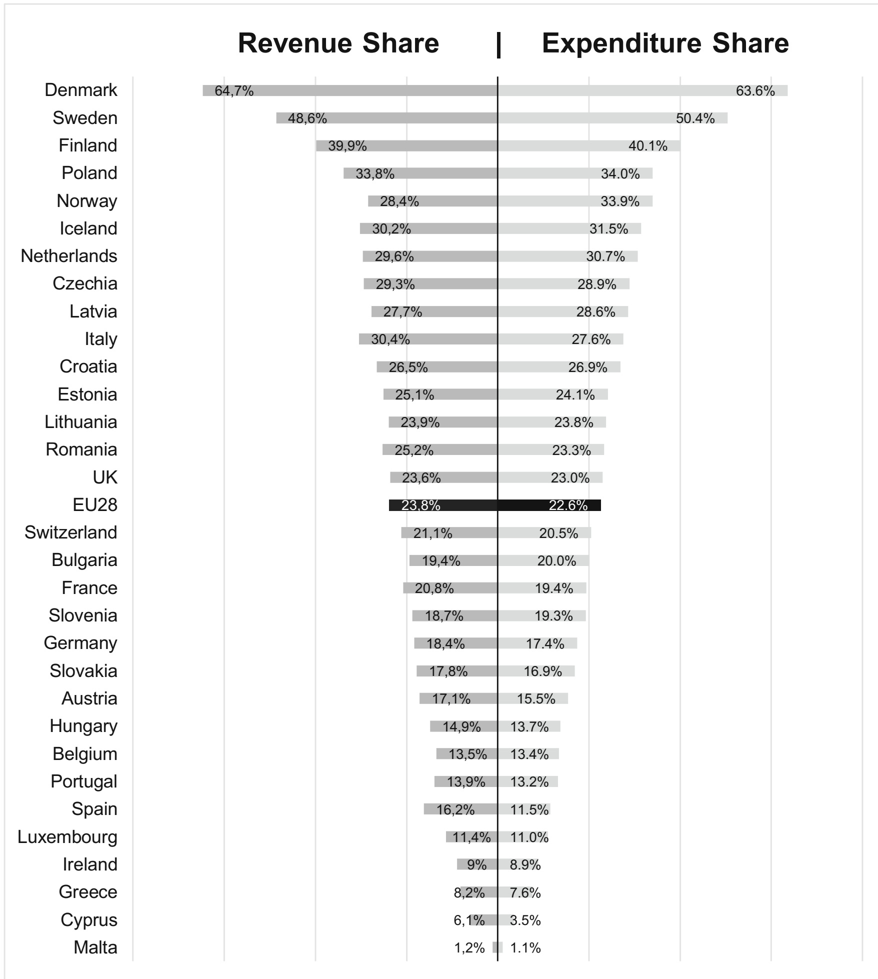

Fig. 1 Local government total revenue as share of consolidated general government revenue versus local government consolidated expenditure as share of general government consolidated expenditure. Own figure; Data: Eurostat Annual Government Finance Statistics

most common indicators of financial decentralisation (OECD/KIPF 2016). The Scandinavian countries (Denmark, Sweden, Finland, Norway, and Iceland) in addition to Poland show the highest levels of local government fiscal decentralisation for the year 2018. It is furthermore apparent that in general, in northern European countries, municipalities and cities account for considerable parts of general

consolidated, which means that intergovernmental transfers are neglected and revenue and expenditure streams within the general government (sum of local, regional, and central government and social security system) are only counted once.

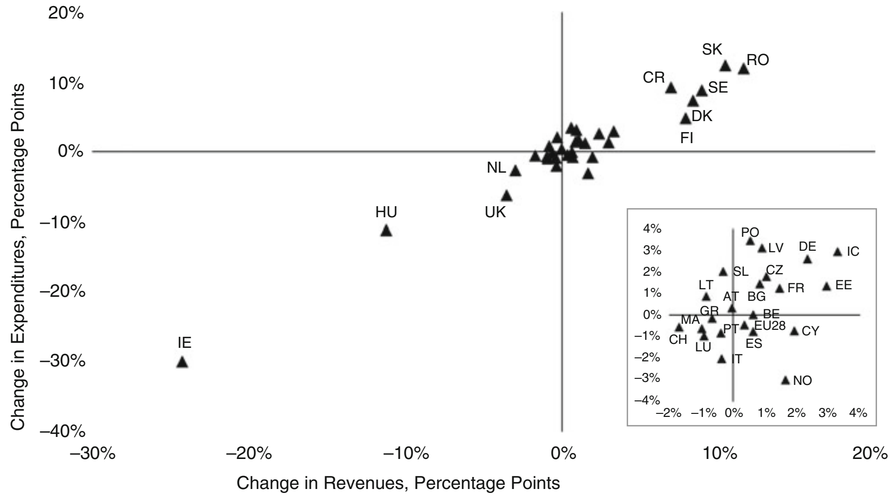

Fig. 2 2000–2018 changes of expenditure and revenue share. Own figure; Data: Eurostat Annual Government Finance Statistics

government revenue and expenditure. Representing the opposite end of the spectrum are Mediterranean countries such as Malta, Cyprus, Greece, Spain, and Portugal, as well as northern outliers Ireland and Belgium. This data is consistent with the findings discussed later in this volume of Ponce and Raffer, who have observed that local governments play a more important role in northern Europe than in the south. At the aggregate European level, local governments accounted for roughly one quarter of all government-related revenue and expenditure in 2018. However, Fig. 1 also indicates strong imbalances between revenue and expenditure decentralisation. Whereas in countries such as Austria, Cyprus, Italy, Romania, or Spain, the revenue share is higher than the expenditure share, we see the contrary for Norway.

Figure 2 plots the changes of expenditure and revenue shares for the period of 2000 till 2018. Local governments in countries in the upper-right corner have experienced rising shares of general government expenditure/revenue and, therefore, increasing financial decentralisation over the 8-year data sample. This change can be observed for Finland, Denmark, and Sweden, all of which traditionally aim for high levels of financial decentralisation, but it is also present in Croatia, Slovakia, and Romania, where it is somewhat a new trend. On the other hand, local governments in Ireland, Hungary,[6] and, to a lesser extent, the United Kingdom and the Netherlands have experienced the opposite. In the most extreme case, in Ireland the revenue share

[6]Ireland is an extreme case of fiscal recentralisation. Behind this remarkable development stands a traditionally weak local government level but also distinct reforms. In 2014, for example, the number of local governments reduced from 114 to 31. At the same time, water services, one of the few relevant functions, were assigned to a national agency (Geissler 2019). In Hungary, the Local Government Act, which went into effect in 2012, also brought about a wide recentralisation of public services (Raffer 2019).

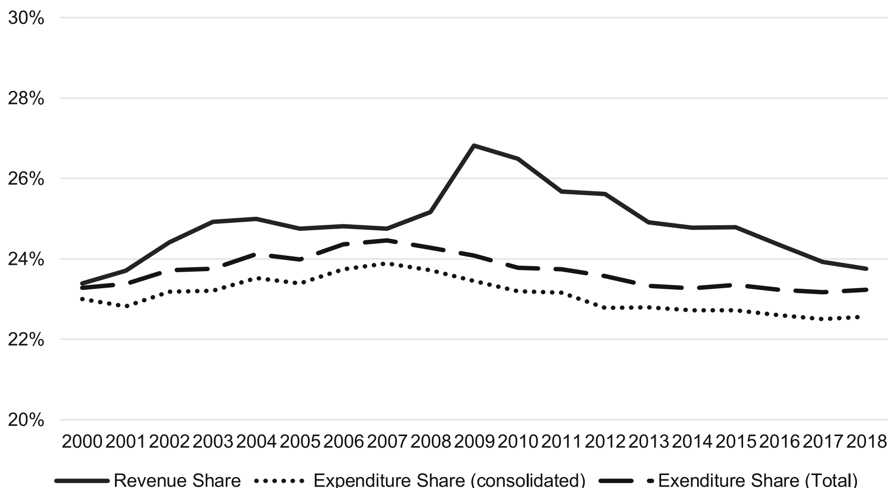

Fig. 3 EU28 Expenditure versus revenue shares (2000–2018). Own figure; Data: Eurostat Annual Government Finance Statistics

decreased by 24.2 percentage points and the expenditure share by 29.9 percentage points between 2000 and 2018. For the majority of countries, however, changes in the level of fiscal decentralisation remained rather marginal at a level of less than 4 percentage points. The weighted EU28 average (expenditure: −0.44%points/ revenue: +0.36%points) indicates that in 2018, the average level of fiscal decentralisation to local governments was more or less exactly where it has been in the year 2000.

Figure 3 shows the development over time of the weighted average local government revenue share (unconsolidated) and expenditure share (both unconsolidated and consolidated). The revenue share shows a somewhat nuanced cyclical pattern during and immediately following the 2008 economic crisis in which central government revenue was decidedly stronger (in absolute and percentage terms) than at the local level. During this time frame, local government expenditure share developed in a more stable manner with regard to both consolidated and unconsolidated expenditure. The figure also indicates a modestly decreasing average level of fiscal decentralisation in the EU28 following 2009.[7] The revenue share peak of 2009 was driven by a crisis-related drop of central government revenue. It also should be noted

[7]The level and development of fiscal decentralisation is commonly assessed by use of budget data. Such data however provides only a limited picture, as increasing shares of revenues, for example, do not necessarily tell much about changes in the local government autonomy to collect or spend these revenues. For this reason, the OECD has developed their own *tax autonomy indicato*r, which measures the taxation freedom of local governments. Following this indicator, tax autonomy increased in unitary OECD countries but changed only moderately in federal countries (see Trasberg et al. 2021, in this volume). For further autonomy indicators, see Raffer and Ponce (2021, in this volume).

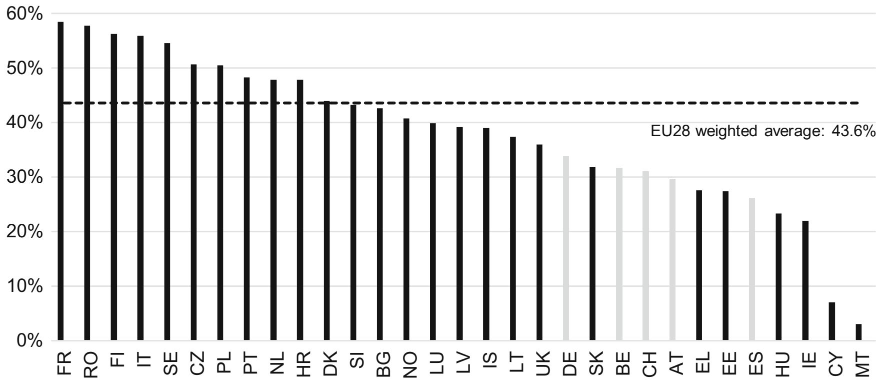

Fig. 4 Local government capital investment (Defined as gross capital formation and acquisition less disposals of non-financial non-produced assets) as share of general government capital investment. Own figure; Data: Eurostat Annual Government Finance Statistics

that Fig. 3 only reports shares and therefore does not allow for conclusions with regard to aggregate EU28 local government budget balances; local governments in Europe had in fact aggregate deficits until 2013.

As demonstrated in Fig. 4, local governments play a significant role when it comes to public investment. Within the European Union, they accounted for 43.6% of all public capital formation in 2018. Federal countries (marked in grey in Fig. 4) range at the lower end of the distribution, an observation which can be explained by that fact that the state level in these countries also accounts for considerable parts of subcentral public investment. It is also notable that the group of countries with above-average local government investment activity (France, Romania, Finland, Italy, Sweden, the Czech Republic, and Poland) is quite heterogeneous. The high share of local governments in terms of public investment therefore underscores the importance of sound and sustainable local government finances.

This brief empirical introduction has sought to demonstrate that there exists a considerable variance in levels of government federal decentralisation among European countries. However, one can certainly describe a modest recentralisation trend in Europe since the global economic crisis of 2008. Finally, it is important to note that although local governments do not account for large proportions of the general government public debt, they indeed play a key role in terms of public investment, a fact which underscores the relevance of sound local public finances and their effective regulation. More detailed insights in the theory and practice of local financial regulation will be discussed in several of the chapters in this volume, and thus the following section will summarise the basic understanding of regulation and some overall results of our research regarding it.

4 Key Components of Regulatory Regimes

There is a wide spectrum of definitions for the term *regulation*, ranging from 'all forms of social and economic influence' up to 'a specified set of legal commands' (Lodge and Wegrich 2012, p. 14ff). The former undervalues the importance of active decision-making by the state, and the latter narrowly limits regulation to only legal measures. To account for variation in meaning, we understand regulation as all forms of state authority intentionally applied to affect the behaviour of third parties (Black 2002). 'Third parties' in this regard are local governments. Areas subject to regulation are local government revenue and spending behaviour, which higher government levels are interested to control in the interest of stability and sustainability. This interference inevitably results in a decrease in local autonomy and therefore constitutes a thoroughly controversial political issue (Carrigan and Coglianese 2011).

Based on a magnitude of research, the literature regarding regulation in recent decades has shifted towards the concept of *regulatory regimes*, which centres around institutional structures and the assignment of responsibilities for carrying out regulatory actions (Hood et al. 2001). Within this approach, regimes are broken down into the following three components: (1) standards (in our case known as *fiscal rules*); (2) *monitoring procedures*; and (3) *enforcement instruments*. Based on our own research and the contributions of this volume, we add (4) *structure and capacity of regulators* as another distinct component crucial for the process and performance of regulation. Though these four components (see Fig. 5) can each be understood as separate factors, they function closely interlinked. An approach through the lens of regulatory regimes allows one to examine components separately while simultaneously acting under the guidance of an overall analytical framework (Hood et al. 2001). Furthermore, this approach allows one to better observe the linkages between its components and their impact on regulatory success.

Fiscal Rules Standards are often referred to as 'fiscal rules' in the field of local public finance, as it is more precise and better known to academics and practitioners (Hallerberg 2012). As the starting point of any regulation (Scott 2010), fiscal rules redistribute power (e.g. benefits and costs) in the form of limiting local governments' autonomy and, therefore, can be considered politically controversial. Fiscal rules impose long-lasting constraints on policy through numerical limits on budgetary

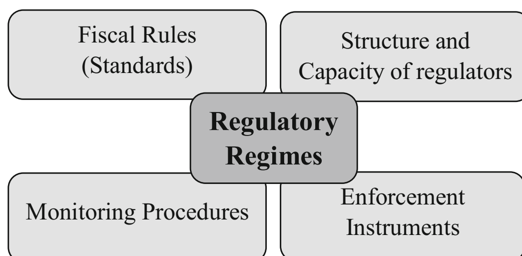

Fig. 5 Key components of regulatory regimes. Source: own

aggregates. They typically aim to ensure fiscal responsibility and debt sustainability by correcting distorted incentives and containing pressures to overspend (IMF 2017).

Monitoring Procedures Fiscal rules fall short if no one monitors and enforces compliance. Regulators need information on local governments' behaviours and financial situations. According to Lodge and Wegrich (2012, p. 72), monitoring is one of the most crucial tasks of regulators. Defined as the process of providing regulators with this necessary information, there exists a wide range of monitoring procedures at hand, such as reviewing budgets drafts, annual statements or the approval of loans. Each one bears specific advantages and disadvantages and costs for regulators as well as local governments. The design of monitoring procedures includes but is not limited to the following four different aspects: asymmetries of information, administrative capacities, the acceptable risks, and level of trust between the regulator and regulatees.

Enforcement Instruments Regulation serves to limit regulatees' range of action and, thus, often conflicts with their interests. As a consequence, the compliance of local governments cannot be taken for granted. Regulators have to enforce rules in case of determined violation (Gunningham 2010). In most countries, regulators have a range of instruments at disposal, ranging from simple informative rights up to the ability to dissolve the local council. Nonetheless, there are challenges involved with sanctioning such as political pressure by local government. Every regulator has to keep in mind their own capacities, the potential counter effects of their actions, and the risks of creating an escalating cycle.

Structure and Capacity of Regulators To set up financial regulation regimes for local governments, regulators can choose from a variety of potential structures to establish supervisory agencies. This decision is crucial, as administrative structures ultimately influence task fulfilment and regulation effectiveness (Egeberg 2007; Walker and Boyne 2009). The chosen structure of supervision must be tailored to the specific institutional setting, and it is thus important to consider factors such as political support, goal clarity, rationalities, the history of interactions with local governments, and the relative administrative capacity of the regulator and regulatees. Organisational structure and the capacity of regulators are therefore seen as a fourth key factor influencing the practice and outcome of regulation (Ebinger et al. 2017).

The effectiveness and outcome of regulation depends not only on the quality of each component individually but also on the components' adjustment (Lodge and Wegrich 2012). Despite the growing prominence of the regulatory regimes approach with regard to central governments, there still remains very limited academic attention to and discussion of fiscal regimes at the local government level. Specifically, how do the components of regulation vary between different countries, how have they evolved, and what impact do their implementations have on local public finance throughout the whole of Europe?

The research contained in this volume describes a huge variance regarding those four components and regimes within Europe (Geissler et al. 2019). Our comparison

also allows one to draw some policy-relevant conclusions regarding the interdependencies of regulatory components which affect the effectiveness of local public finance regulation (see Person and Geissler 2020).

As this brief overview shows, regulatory regimes require a high awareness for both their components' relevance and especially their interlinkages. Each single component is indispensable and must be effective in and of itself. There exist a variety of configurations within each component regulators from which can choose. However, each component's configuration can have consequences on the others. For example, a need for complex fiscal rules requires in turn higher demands in monitoring. The same effect holds true for the component of monitoring. An elaborate in-depth monitoring will detect a higher number of rule violations, requiring the regulatory regime to consider whether it is organisationally and politically prepared to act appropriately in enforcement. In general, the weakest part of the regulatory regime determines its overall impact. Even a very powerful supervisory body acting with clear-cut fiscal rules and equipped with efficient monitoring procedures is toothless if enforcement is weak. In addition, well-designed rules, appropriate sanctioning and monitoring procedures have only limited effects if there is an understaffed supervisory body. Ultimately, the most crucial aspect comes down to the capacity of supervision. This calls for a centralisation and concentration of regulator capacities and a larger distance and autonomy of regulatees to avoid regulatory capture.

Hence, it is advisable for higher-level government bodies to start with a thorough understanding of the specific local government system, especially regarding the administrative capacities of the regulator and regulatees. And they need to be aware of the various interdependencies of key components of regulatory regimes in order to establish effective local public finance regulation. Table 1 provides some first suggestions for regulators (Person and Geissler 2020).

5 Guiding Questions and Chapter Previews

Local public financial regulation is a complex field that demands a considerate balancing of the four components outlined above against one other as well as against the potential responses of local governments. Due to different institutional settings, historical developments, and local government structures, multilevel fiscal relations in European countries are extremely heterogenous. It would be therefore impossible to suggest a one-size-fits-all solution to local public finance regulation. Instead, each country needs to develop a specifically tailored regulatory structure in order to keep local governments on a sound fiscal footing. For this endeavour, comparative research from different government systems and different research traditions can provide helpful guidelines. This edited volume provides systematic comparisons and in-depth analyses of the regulatory components outlined and describes their impact on the functioning of local financial regulatory regimes. In general, this volume seeks to address the three following questions:

Table 1 Policy implications based on the interdependencies among regulatory components (own table)

Fiscal rules and organisation of supervisory agencies	If decentral regulators set fiscal rules, those have to be monitored and enforced decentral The more complex fiscal rules are, the more will economies of scales in central bodies be of relevance The vaguer fiscal rules are, the more decentral regulators should be
Fiscal rules and monitoring procedures	The more complex and numerous fiscal rules are, the more detailed and elaborate should the monitoring be designed As simpler fiscal rules are, as more media and public can engage in monitoring As higher fiscal rules' relevance is, as higher monitoring workload is acceptable As longer fiscal rules remain unchanged, as more efficient monitoring will become
Fiscal rules and enforcement instruments	As more vague fiscal rules are, as more discretion must be given in sanctions As clearer fiscal rules and sanctions are, as more credible the system must be
Structure and capacity of regulators and monitoring procedures	The simpler a monitoring procedure is the easier it is to concentrate regulators at the central level
Structure/capacity of regulators and enforcement instruments	As more centrally located regulators are, as less options of opposition exist Treasury as regulators can implement stricter enforcement As more regulators are involved in parallel, as more difficult enforcement will be As larger regulators' discretion in enforcement is, as more relevant organisational features are
Monitoring procedures and enforcement instruments	As more intensive monitoring is, as more rule violations will be detected and as more enforcement has to be implemented As more sketchy monitoring is, as more strict enforcement needs to be

1. How have local public finance regimes and its main components evolved in Europe?
2. Which policy and implementation challenges does local public financial regulation face in Europe?
3. Which measures have countries implemented in order to deal with budget crises at local government levels?

How Have Local Public Finance Regimes and its Components Evolved in Europe? Comparative research shows that local public finance regulation is a topic of increasing relevance. The sheer number and the implementation quality of fiscal rules in Europe are increasing (Kotia and Lledó 2016). This points to the important question of how regulatory regimes change and evolve over time. In their

contribution to this book, *Turley*, *Raffer*, and *McNena* focus on the role of fiscal rules imposed on the local government level in European countries. In doing so, they not only describe and evaluate the current rule set but also consider the impact of the 2008 economic and financial crisis on its development. In turn, *Wortmann* and *Geissler* examine the direct and indirect effects of the 2008 crisis on 21 European countries. In their article, they argue that the strengthening of local public finance regulation was a direct result of this crisis and related changes of EU legislation. *Trasberg*, *Raffer*, and *Moisio* add an empirical investigation of European local government tax structures and describe how the tax composition has changed as a result of the 2008 fiscal crisis. One of their main conclusions is that well-designed local tax structures act to prevent cyclical revenue fluctuations as source of budgetary hardship and, therefore, serve to decrease the necessity of local public finance regulation. In their classification study, *Raffer* and *Ponce* take a different perspective. The authors apply an empirical quantitative comparative analysis to cluster different regulatory components and find the patterns of regulatory regimes. Most importantly, they find a nuanced north-south/southeast pattern of regulatory strength in Europe, which to a certain extent mirrors well-established administrative traditions. The next three chapters enrich these cross-country analyses with in-depth country comparisons. *Bronić*, *Jerinić*, *Klun*, *Ott*, and *Rakar* focus on Slovenia, Croatia, and Serbia and show that the EU accession of the first two countries has acted as an important historical driver of the countries' regulatory regimes. *Nemec*, *Klimovský*, *Šagát*, *Plaček*, and *Sedmihradská* analyse the historical development and impact of financial rules in the Czech Republic and Slovakia. *De Widt*, *Thorogood*, and *Llewelyn* focus on the use of fiscal sustainability indicators in local government monitoring in the United Kingdom and the Netherlands. They provide an example of how different rules and governmental characteristics between the two countries have resulted in contrasting developments of indicators and monitoring. Overall, all seven chapters in this section show that—among other potential drivers—fiscal crises, EU legislation, administrative traditions, and path dependencies strongly affect the development of local public finance regulatory systems.

Which Policy and Implementation Does Local Public Financial Regulation Face in Europe? As fiscal regulation means to limit local governments' budget autonomy, it naturally is a controversial topic. Generally, one can differentiate two kinds of challenges: the setting up of regulatory regimes and their implementation. As outlined above, regulatory regimes consist of four basic components, each of which is privy to a manifold of specifications. Therefore, deciding on and defining every single component and considering its interactions present a challenge for higher-level governments. *Ebinger* and *Geissler* analyse the effect of the supervisory agency's structure on regulatory outcome. They refer to the prominent discussion on the impacts of bureaucratic structure on task performance. By means of five organisational dimensions, this chapter asks whether financial regulation is somewhat more difficult for some organisational structures of supervision than for others. Another article by *Heichlinger*, *Bosse*, and *Padovani* focuses on fiscal rules and the relevance of different accounting styles in measuring and defining those rules.

Accounting is a crucial element of fiscal regulation, as it influences the meaning and validity of fiscal indicators and, in turn, how regulators perceive the fiscal stability of local governments. The authors illustrate the pitfalls of defining fiscal rules as a consequence of different accounting styles across Europe. *Geissler* and *Wegrich* in their chapter deepen the regulatory component of rule enforcement. From a starting point, of a regulatory literature, they develop six key insights which regulators should consider when designing enforcement measures. In a second step, the authors categorise and discuss the enforcement styles of 21 European countries. They suggest that in order to increase compliance, regulators should make more efforts to understand rationales for compliance and secure political support. With this conclusion, the article leads up to a second kind of challenges in implementation beyond the institutional design of enforcement instruments. *Roesel* addresses the idea of political interference. In reality, fiscal supervisors often are not neutral and benevolent actors, and often partisans and party favouritism take precedence over official mandate. Using the samples of Germany and Austria, Roesel describes the impacts of such politicised regulation. *Person*, *Ebinger*, *and Zabler* utilise rich qualitative and quantitative data from Germany to explain the variety of political interferences. Effective regulation, political leadership, independence, and adequate resources are important prerequisites for effective regulation. These five chapters in general seek to illuminate the variety of challenges regarding the conception and implementation of fiscal regulation.

Which Measures Have Countries Implemented in Order to Deal with Budget Crises at Local Government Levels? As previously described, local public finance regulation is a common approach to prevent local governments from piling up large amounts of debt. Nevertheless, regulation may fail for various reasons, and local governments may find themselves at a financial dead-end, in which they are neither able to pay debtors nor to keep up public service provision. Such fundamental budget crises on the local government level leaves the central government in a delicate situation where it must decide if and how to help. In their contribution to this edited volume, *Allers* and *de Natris* take a closer look into the bailout practices which have been applied throughout Europe at the local government level. They find that countries with strict no-bailout clauses often, in fact, provide bailouts to local governments. The fiscally responsive behaviour of subnational governments seems to depend on a mix of measures, like the provision of sufficient funding and adequate fiscal supervision. A no-bailout rule, they conclude, is therefore neither necessary nor sufficient. *Person* focuses on local government insolvency regimes as another way to deal with budgetary crises. Although these allow for a well-defined process of debt restructuring, they are far from common in Europe. This chapter not only discusses insolvency regimes as alternatives to municipal bailouts, it also presents how they currently function in Hungary, Italy, Switzerland, and the United States. *Person* and *Geissler* add to this discussion by outlining the German history and institutional design of local government bailouts and in turn evaluate their impact on fiscal performance. They come up with a structure of bailouts referring institutional design, timing, and scope. In a different line of thought, *Kolliniati*, *Stolzenberg* and

Hlepas analyse the local government reactions in Greece and Germany to the economic and financial crisis of 2008. They find that though both countries have set up local government bailout programs, the intensity of monitoring, implementation of fiscal rules, and ‘top down’ acting of supervisory bodies was far more intense in the case of Greece. *Padovani* and *Du Boys* evaluate the consequences on local government budgeting as a result of certain adaptions after 2008 to the Italian fiscal regulatory framework. The results of their empirical chapter indicate that those changes in the legal and fiscal framework have indeed had an effect on different forms of expenditure. These five chapters overall demonstrate the necessity for central governments to employ different strategies in actively handling local fiscal stress, as Detroit and as other failures have demonstrated that a hands-off approach is far from the best strategy. *Saliterer*, *Korac*, *Barbera*, *and Steccolini* highlight the importance of local government’s financial resilience. Building on large-scale surveys and comparative case studies, they describe how institutional context influences local governments’ abilities to anticipate, absorb, and react to financial shocks. Fiscal regulation can force local governments to build anticipatory capacities; however, fiscal frameworks and central policies such as austerity may also drain local governments’ capacities to cope.

6 Conclusion and Outlook

The level of fiscal decentralisation in Europe has been rather stable over the last few years and seems to have reached an equilibrium. Within this equilibrium, local governments have acquired an established and important role in European multilevel systems. With this importance, in turn, comes responsibility, as running short of financial means leads to decreasing public service provision and bears the risk of constant underinvestment. Although there are various potential ways to reach and sustain sound local government finances (e.g. sufficient revenue provision, autonomy, etc.), evidence proves that financial problems are nevertheless ubiquitous at the local government level. It is therefore clear that the topic of local financial regulation is deserving of more scholarly attention.

A comparative look at local public finance regulatory regimes in Europe reveals just how wide a variety of systems exist. Each one has a unique history and has grown from within a particular national framework of institutions. Taking a deeper look into the country cases which build the ground for many of this volume’s articles, it becomes clear that, despite their best efforts, regulatory regimes operate at the mercy of accidental occurrences. Since regulatory systems are complex webs of rules, oversight procedures, and enforcement mechanisms, such developments have the potential to impair the entire regime.

The 2008 financial crisis, for example, triggered new waves of evolution and some amount of convergence. This observation refers to two arguments. First, the European Union started a common regulatory regime for state finances, which trickled down to local levels in one way or another. Second, large fiscal deficits

caused by the financial crisis and its following recession pressured states to strengthen local-level fiscal rules. This brings up one overarching conclusion of this volume: *periods of financial stress intensify regulatory regimes*. However, this conclusion must be taken with a grain of salt considering current circumstances. In the immediate period of corona pandemic and economic recession, one can indeed observe the opposite in some countries. For example, many German states have loosened local fiscal rules to essentially ease the stress on local governments during this troublesome period.

As there are different national and international drivers for change, there are manifold starting points for an intensification of regulation among the four components previously mentioned. Perhaps the most prominent is the strengthening of fiscal rules. Whereas enforcement measures typically carry a negative connotation and thus less political gains, changes in fiscal rules are typically easy to decide upon and offer politicians visible examples of their awareness and competency.

Therefore, one has to distinguish between rules and real implementation. Another feature gaining attention is local government bailouts. Once a somehow controversial and intransparent instrument, bailouts have evolved during the last decade into an accepted and widespread reaction to the ongoing financial difficulties of local governments in most countries. When considered as an indication of failed regulation, repeated municipal bailouts throughout Europe might give a hint to why and under what circumstances local government regulation might reach to its limits.

One of the main insights to be gained from this book is that the configuration of single components is less relevant than their proper alignment. Policy-makers pursuing effective regulation need to constantly review the manifold interdependencies among the regime components, the regime itself, and its broader institutional framework of local service functions, local funding, local democracy, multilevel politics, and other factors. With regard to these interlinkages, this volume is only a first step, but it also underlines the need for a deeper understanding of the mechanisms affecting regulatory effectiveness and how this is shaped by the institutional context of nationally different public finance systems.

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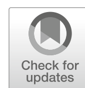
Part I
Concepts of Regulation

Budget Institutions for Subnational Fiscal Discipline: Local Fiscal Rules in Post-Crisis EU Countries



Gerard Turley, Christian Raffer, and Stephen McNena

Abstract Fiscal rules are institutional constraints on budget policymakers' decision-making discretion aimed at fostering prudent fiscal policy, promoting overall fiscal discipline, and ensuring long-term fiscal sustainability. Since the European sovereign debt crisis, fiscal rules have been at the centre of the debate on the EU's economic governance, the need to strengthen fiscal frameworks and improve policy co-ordination. This chapter outlines the origin, purpose, design, and coverage of local fiscal rules in EU countries over a decade after the 2008 financial crash. It presents a review of the empirical evidence on subnational fiscal rules and their impact and effectiveness on fiscal outcomes. The chapter ends with some concluding remarks and lessons drawn from the experience of fiscal rules across both time and space and outlines how policymakers can learn from this international experience.

1 Introduction

This chapter outlines the institutional arrangements commonly known as fiscal rules, as applied to local government. It begins with a definition of fiscal rules, the different types and the design features. We then outline the evolution of and rationale for fiscal rules and the arguments in favour and against such institutional constraints. A literature review on the impact and effectiveness of subnational fiscal rules on budgetary outcomes and fiscal performance follows. In the next section, local fiscal rules in EU countries are outlined, and the effects of the 2008 financial crash and the subsequent fiscal crisis on fiscal rules are analysed. In the concluding section, policy lessons are drawn from the international experience to date.

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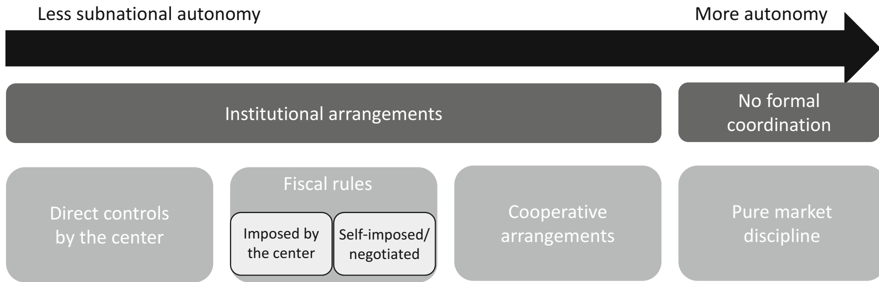

Fig. 1 Institutional framework for fiscal regulation. Source: Ter-Minassian and Craig (1997); Eyraud and Gomez Sirera (2015)

Using the conceptual framework of regulatory regimes, fiscal rules are an example of institutional arrangements for fiscal regulation.[1] Ter-Minassian and Craig (1997) outline a typology of these fiscal mechanisms or strategies (Fig. 1).

Of the four stylised classifications of control instruments (the other three being market discipline, cooperative arrangements and administrative controls), the rules-based fiscal framework is the focus of this chapter. As with these other models of institutional constraints, the objective of fiscal rules is to instil fiscal discipline, improve policy coordination and ensure public debt sustainability. We begin by defining fiscal rules and identifying the different types of rules and their design characteristics.

2 Definition, Types and Design

Often expressed in the form of predetermined numerical limits on budgetary aggregates or summary indicators, fiscal rules are long-lasting institutional constraints on budget policymakers' decision-making discretion, aimed at promoting overall fiscal discipline and ensuring sustainable public finances. Although the broad definition of a rules-based fiscal framework includes not only the numerical limits but also the budgetary procedures, transparency requirements and surveillance mechanisms, this chapter is primarily limited to the quantitative target element of fiscal rules.

The four main fiscal rules constrain deficits, borrowing and debt, expenditure and revenue, with Table 1 outlining how these rules are normally defined and usually

[1]Fiscal rules are a special case of policy rules, which, in turn, are part of the much wider rules versus discretion strand of literature in macroeconomics and, particularly, fiscal and monetary policy. For a discussion on *local* fiscal rules, the more relevant literature relates to local public finance, fiscal decentralisation, subnational borrowing and, in the case of this book, fiscal regulation.

Table 1 Typology of fiscal rules

Type of rule	Rule defined/expressed
Budget (fiscal) balance rule	A ceiling on the budget deficit, where the limit can be zero (a balanced budget), a maximum permissible deficit or a surplus. Expressed in nominal terms or as a percentage of GDP, in structural (cyclically adjusted) or primary balance or non-commodity terms. Encompass current only or current and capital or current and capital and off-budget items. Applies to submitted or adopted or realised budget. Deficit carry-over permitted or not permitted
Borrowing and debt rule	The borrowing and debt rule covers a range of constraints on government recourse to debt financing. It may impose limits to new borrowing (a ceiling on the issuance of new debt), on financing sources (e.g. Central Bank or external), gross or net debt levels (in nominal terms or as a percentage of GDP or revenue), debt service or to type of expenditure. The latter is a special case (and a variant of the budget balance rule), called the golden rule, where borrowing is limited to investment purposes
Expenditure rule	Limits to the growth in expenditure, expressed in nominal or real terms, or a ceiling on total expenditure or type of expenditure
Revenue rule	Regulations on revenue (e.g. tax burden as a percentage of GDP) or applied to certain tax revenues (e.g. property tax revenue increases or property tax rates) or specify the uses to which above forecasted or windfall revenues can be put, e.g. debt reduction purposes, or placed in a rainy day fund for future use

expressed.[2] Although apparently straightforward, in reality it is a little more nuanced, as there are overlaps between the different rules (and, indeed, between rules and administrative controls), and much depends on their interpretation and enforcement. This brings us neatly to the different characteristics of fiscal rules and the importance of design features (Table 2).[3]

As with other institutions, the design of fiscal rules is important for its effectiveness, as a poorly devised rule may not work and can even be counterproductive (Schick 2010). Notwithstanding the inevitable trade-offs between some design features, specific design attributes can increase the effectiveness of fiscal rules, e.g. comprehensive rule coverage; buy-in from local governments; sufficient flexibility and readily operational; harmonisation of accounting and statistical systems; quality of monitoring; and enforcement mechanisms (Kotia and Lledó 2016). The European Commission, in its index of the strength of fiscal rules, found that rules

[2]Another relevant policy rule is the no-bailout clause where an upper tier of government is precluded by law from bailing out a lower tier of government that is in financial trouble or distress. Although not unimportant, we omit this rule from our analysis.

[3]Although our focus is on local fiscal rules, these design features apply to all fiscal rules, i.e. regional, national or supranational rules. A breakdown of numerical fiscal rules by type of government is provided by the EC database on fiscal rules. In the context of design attributes, Kopits and Symansky (1998) have identified the following criteria of internationally accepted good practice – definition, transparency, adequacy, consistency, simplicity, flexibility, enforceability and efficiency. This is an alternative to the list outlined in Table 2.

Table 2 Design features of fiscal rules

Feature	Design characteristics
Fiscal framework	Free standing and independent of the budgetary process or integrated into a broader institutional framework, such as a medium-term budgetary framework (MTBF) and fiscal responsibility laws (FRLs)
Statutory basis	Constitutional or legal or coalition agreement or simply a policy guideline or political pronouncement
Imposition	Implemented from above by a higher tier of government or self-imposed or negotiated between different tiers of government (sometimes involving an intergovernmental council)
Number and complexity	One or a set of rules/simple or complex in terms of its operational scope and implementation
Scope of coverage	Current or current and capital or current and capital and extra-budgetary and quasi-fiscal activities
Time horizon	Annual or multi-annual or over the cycle or over the government's term of office/stock or flow or both
Flexibility	With respect to the economic cycle, timeframe, shocks, inflation (adjusted)
Escape clause	For exceptional events or unforeseen shocks
Sunset provision	Provision/no provision for periodic revision
Accounting system and auditing standards	Cash or accruals/treatment of contingent liabilities/depreciation rules/creative accounting[a]
Reporting requirements and statistical data	Accurate, standardised, reliable, timely and transparent information
Monitoring and surveillance agency	Government or independent body/early warning system (EWS)
Enforcement	Ex ante monitoring or ex post sanctions/imposed or negotiated
Sanctions for non-compliance	No predefined actions/correction mechanisms (triggered automatically or requires action), with financial, judicial or reputational sanctions

[a]Examples of budgetary gimmicks include reclassification of expenditures, moving items to a different fiscal year, off-budget items, arrears or borrowing from local public enterprises

(1) where objectives cannot be easily changed; (2) which are monitored and enforced by independent fiscal institutions; (3) which include automatic sanctions for non-compliance; and (4) which are subject to media visibility and scrutiny are deemed to be the strongest, which, in turn, is an important determinant of likely effectiveness (Hagemann 2012; European Commission 2018). Well-crafted fiscal rules reflect the careful balancing and trade-offs confronted by technocrats and policymakers in their pursuit of fiscal policy objectives.

Before reviewing the literature on the effectiveness of (the type and design of) subnational fiscal rules on fiscal outcomes and performance, we briefly outline the rationale and evolution of fiscal rules, as well as the arguments in favour and against such institutional restrictions.

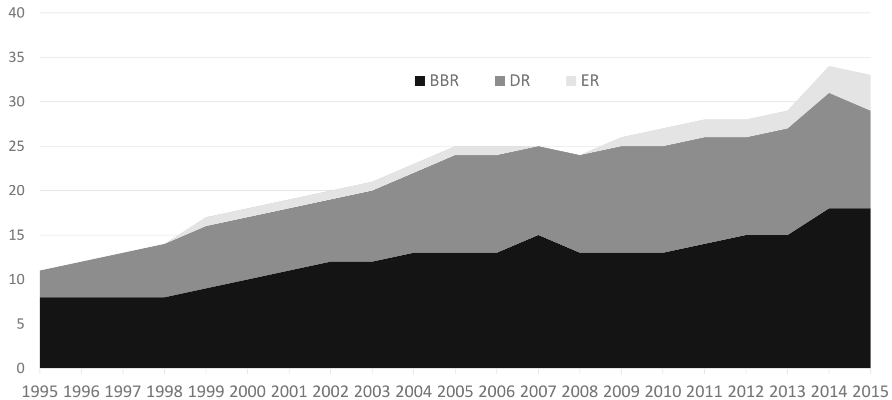

Fig. 2 Development of fiscal rules over time (1995–2015) for the EU-28 member countries, in absolute numbers (own graph, data source: European Commission Fiscal Rules Strength Index)

3 Evolution, Rationale and Costs

3.1 History and Evolution

Fiscal rules are not a recent invention. Several countries have a balanced budget rule in their constitution, and some of those date back to the end of the nineteenth century (Asatryan et al. 2018). In the USA, for example, the states adopted balanced budget rules of varying strength before the year 1900 (Henning and Kessler 2012). However, by 1990 the IMF fiscal rules database still showed less than ten countries worldwide having implemented fiscal rules on either a national or subnational level. By 2009, the number of countries had increased to 80 (Kumar et al. 2009).

The picture is similar from a European perspective. Based on the European Commission's fiscal rules database, Fig. 2 shows that the number of numerical fiscal rules imposed on local governments in the EU-28 increased significantly since 1995 (Raffer et al. 2018). While the number of balanced budget rules more than doubled, the number of debt rules increased more than fourfold (albeit starting from a lower level).

This gain in prominence of numerical fiscal rules within the member states of the EU can be explained by successive reforms in the fiscal governance framework, which emphasised both an increased coverage of supranational fiscal rules and their embedding in national legislation. As a consequence, the number of rules for lower levels of government has soared in the past couple of decades (Kotia and Lledó 2016). A closer analysis reveals that, in terms of the balanced budget rule and debt rule, not only has the number increased but so also has the quality of implementation, monitoring, and enforcement (Raffer et al. 2018).

3.2 Rationale

The theoretical background to fiscal rules is based on the idea that politicians and governments suffer from a deficit bias, which leads to an adverse incentive to overspend, undertax or borrow excessively (Kotia and Lledó 2016). In the absence of this bias, public budgets would fluctuate depending on economic or political conditions, mainly driven by the business cycle and counter-cyclical fiscal policy (Wyplosz 2013). In reality, however, the deficit bias is a threat to fiscal discipline and manifests itself in different levels and trends of local government debt (Foremny 2014). Combating the deficit bias is acknowledged as being '…one of the most formidable challenges facing multi-tiered systems of government…' (Rodden 2002: p. 670).

A large literature identifies reasons that explain this bias. At the local level, three seem to dominate: (1) the tendency to push the burden of fiscal discipline to future governments and generations; (2) the political-economy problem of catering to interest groups at the cost of taxpayers in order to increase the probability of re-election; and (3) the expectation to receive transfers from upper tiers of government (Wyplosz 2013). Whereas only the third driver is exclusive to local government, what all three have in common is that local politicians, in the presence of the common-pool problem and negative spillovers, fail to internalise the consequences of overspending.

Likewise, a local government may be lured into moral hazard in the face of a potential bailout by the central government once it is unable to meet its financial commitments (Rodden 2002; Pisauro 2003). This idea is formalised in the concept of the soft budget constraint, a widely described syndrome that arises when an economic agent is not held to a fixed budget but finds its budget constraint softened by the prospect of external support because of its financial difficulty (Kornai et al. 2003). Plenty of research shows that fiscal decentralisation with weak local government fiscal autonomy and high levels of top-down transfers increases this tendency and consequently deteriorates fiscal discipline; see, e.g., Kotia and Lledó (2016), Eyraud and Lusinyan (2013) or Plekhanov and Singh (2007) for a discussion of vertical fiscal imbalances (VFI) and fiscal discipline.

The deficit bias contributes to the ubiquitous phenomenon of governments running deficits far too frequently and piling up unsustainable amounts of public debt. Moreover, it is commonly cited as an argument for intervention in the political process that drives the preparation, adoption and execution of the budget (Wyplosz 2013).

3.3 Arguments for and against Fiscal Rules

In theory, well-designed and implemented fiscal rules have the power to eliminate the deficit bias (Wyplosz 2013). Following case-study literature, they are a good

compromise among available institutional arrangements to foster fiscal discipline since they may be more palatable to local governments than administrative controls, they may also offer more stability than (potentially negotiable) fiscal targets set by intergovernmental fiscal bodies and they may be the best alternative in countries where the preconditions for effective market discipline are absent (Kotia and Lledó 2016). Also, in terms of transparency, fiscal rules are considered preferable to administrative controls and statutory limits defined in the context of the annual budget process, which is subject to short-term political bargaining (Ter-Minassian and Craig 1997). Kopits (2001) describes their depoliticised nature as a further advantage. By anchoring economic agents' expectations and restricting the fiscal behaviour of governments, binding fiscal rules can act as a disciplinary and commitment device aimed at providing credible fiscal policy. More broadly than just aimed at fostering prudent budgetary policy, fiscal rules can also be used to constrain the size of the public sector, support intergenerational equity and contribute to economic growth and stability (Sutherland et al. 2006; Ter-Minassian 2007).

In regulatory practice, rules are often seen more critically. One debate centres on the old rules versus discretion dichotomy. Because rules can never be fully contingent, situations may arise that would make any rule rather costly to respect. Therefore, rules must be flexible enough to accommodate unforeseeable contingencies (Wyplosz 2013). Related to this argument are the risks that fiscal rules may induce pro-cyclical fiscal policy and also distort the allocation and composition of public spending. Moreover, policymakers are likely to evade fiscal rules, to look for loopholes or to change or simply ignore them. As soon as the political costs of abiding by the rule outweigh the benefits, policymakers will abandon them. Hence, rules are useful if they raise the political costs of fiscal indiscipline. This implies that proper embedding in institutional arrangements of monitoring and enforcement is crucial (Wyplosz 2013). Another risk lies in over-complexity. Opacity makes adherence harder to monitor and can lead to circumvention.

Considering all this, numerical fiscal rules have the power to contribute to fiscal discipline if there is a benevolent and powerful external enforcer with the power to sanction noncompliance. But, as Braun and Tommasi (2002) put it, this is rarely the case.

4 Literature Review

In this section, we review a sample of empirical studies, as well as three survey articles, published between 2001 and 2018, that investigates the effectiveness of fiscal rules at achieving fiscal discipline, in developed and developing countries. The survey articles and the majority of the empirical studies suggest that fiscal rules are useful and effective in promoting fiscal responsibility. Only Escolano et al. (2012) find no link between fiscal rules and better fiscal outcomes at the subnational level; also Debrun et al. (2008) suggest that central government fiscal rules are superior.

Proving a causal relationship between fiscal rules and fiscal outcomes is challenging, due to the potential endogeneity problem. Budget rules are not exogenous (Braun and Tommasi 2002). Countries with more sensible and prudent fiscal policies may be more likely to introduce fiscal rules, making it difficult to assess the relative significance of the fiscal rule versus their underlying fiscal preferences. Foremny (2014) and Kotia and Lledó (2016) use instrumental variables, while Grembi et al. (2016) use a quasi-experimental approach to overcome the endogeneity problem. Together, they provide results indicating that numerical fiscal rules matter for local government fiscal discipline. Heinemann et al. (2018) apply a meta-regression analysis to 30 studies published during 2004–2014, of which five analyse municipal fiscal rules. Their analysis concludes that fiscal rules have a constraining effect on fiscal aggregates at the national level, especially for deficits. However, they also show that as studies use more sophisticated identification strategies to deal with the endogeneity problem, the impact of fiscal rules decreases.

A survey article by Kennedy and Robbins (2001) reviews seven empirical studies, mostly at the provincial/state level in Canada and the USA. Six support the use of fiscal rules, suggesting that their existence reduces the cost of borrowing. Overall, Kennedy and Robbins (2001) conclude that fiscal rules are a useful tool, but they are not necessary in all cases. Similarly, Crivelli and Shah (2009) review subnational fiscal rules adopted in 66 industrial, developing and transition countries and find that fiscal rules are especially useful in countries with a poor reputation for fiscal prudence. Fiscal rules are not necessary if there is some other form of control. In Canada and the USA, although the federal governments do not impose any fiscal rules on the sub-federal governments, most provinces and states have self-imposed rules. In these cases, pure market discipline, via the interest rate on sub-federal debt, is another form of control. Crivelli and Shah (2009) note that fiscal rules are often manipulated or circumvented, for example, local government deficits in Italy being partly financed by arrears to suppliers, Chinese subnational governments borrowing from local banks and enterprises (even though borrowing for current spending on their own account is forbidden) and Australian local governments using financial leases to circumvent borrowing limits. Heinemann et al. (2018) conclude that the constraining effects of fiscal rules are strongest for studies using municipal data.

Rodden (2002) describes fiscal rules as a political response to the intergovernmental commitment problem. His cross-national study of 43 local and state governments between 1986 and 1996 finds that restrictions on borrowing and a high level of tax autonomy tend to be associated with smaller deficits. His evidence suggests that in unitary countries with local governments that have a high transfer dependency, restrictions on borrowing are effective in maintaining balanced budgets over the long term. In these cases, central governments impose borrowing restrictions, as the local governments lack the tax-raising powers to deal with fiscal problems. Whereas in federations, the subnational governments have more tax autonomy, so they can increase their own taxes to balance the budget.

Following earlier work by von Hagen and Eichengreen (1996), several studies focus on the significance of VFI when trying to assess the impact of fiscal rules (Rodden 2002; Plekhanov and Singh 2007; Escolano et al. 2012; Eyraud and

Lusinyan 2013; Foremny 2014; Kotia and Lledó 2016). Large VFI mean that subnational expenditure assignments are much greater than revenue assignments. These large imbalances tend to weaken fiscal discipline. In these situations, central governments impose fiscal rules to protect themselves from the danger of a subnational fiscal crisis or default.

Plekhanov and Singh (2007) suggest that no particular control is always effective in promoting fiscal discipline although, like Rodden (2002), they suggest that fiscal rules should be imposed as VFI widen. Their study of 43 countries (federal and unitary, industrial and emerging) during the period from 1982 to 2000 finds that in the case of low VFI, self-imposed fiscal rules lead to better fiscal outcomes. If VFI are large, direct administrative controls over subnational borrowing are superior to fiscal rules in the short run. The significance of tax autonomy and VFI is also highlighted by Foremny (2014), who finds that fiscal rules work better in unitary countries. Rules are not effective in federations, where instead more tax autonomy helps to avoid fiscal deficits. This finding also applies to unitary countries with large local governments that have extensive tax-raising powers, e.g. Denmark and Sweden.

In contrast, Debrun et al. (2008) find that fiscal rules at the central and general government level are statistically superior to subnational fiscal rules in terms of impact on overall fiscal performance. This study covers EU countries in the years between 1990 and 2005. Similarly, Escolano et al. (2012), in a study of fiscal decentralisation across the EU for the years 1990 to 2008, find that although an index of overall (general, central, subnational) fiscal rules is correlated with the general government balance, subnational fiscal rules on their own are not associated with improved general government fiscal performance.

Grembi et al. (2016) investigate the effects of the relaxation of a fiscal rule in some 1050 Italian local governments, using a differences-in-discontinuities technique. They find that fiscal rules enforced by the central government can be effective, even in a country with weak political institutions, as in Italy. Relaxing the fiscal rule leads to lower taxes and increased deficits.

Both Ter-Minassian (2007) and Kotia and Lledó (2016) suggest that fiscal rules are helpful and effective but should not be seen as a panacea for fiscal problems. Separate reforms are also required, such as reducing excessive VFI. Following Debrun et al. (2008) and Escolano et al. (2012), Kotia and Lledó (2016) use a fiscal reaction function to test whether the strength of the fiscal rule is related to subnational fiscal discipline. Their study covers 26 European countries between 1995 and 2012, and they find that stricter fiscal rules improve subnational budget balances. They also find that at high levels of VFI, the effects of the fiscal rule weaken. In these cases, reforms to reduce VFI would complement the fiscal rules.

In general, past empirical literature provides ample evidence for the effectiveness of fiscal rules on the subnational/local level. It is a stylised fact that the existence of VFI plays a significant role in the way they work. However, many studies also highlight the need for better identification strategies to deal with the endogeneity problem.

5 European Fiscal Crisis and Local Fiscal Rules in EU Member States

In the past decade or so, the EU has witnessed some extraordinary events, beginning with the 2008 financial crash and followed by the Great Recession of 2008/2009, the eurozone sovereign debt crisis and the 'bailout' of several EU countries but also the years of austerity (in some but not all EU member states) and subsequent economic recovery. These economic events resulted in changes to the fiscal rules at local level, not only in relation to the actual number but also coverage, legal basis and enforcement (OECD 2013; Eyraud and Gomez Sirera 2015; Raffer et al. 2018).

In some cases, local fiscal rules were relaxed or even suspended to help boost economic activity and prevent pro-cyclical fiscal policy at the subnational level. In other countries, subnational fiscal rules were tightened and particularly so at regional government level. In other cases, new rules were introduced, or existing rules modified, e.g. the budget balance rule became more prevalent, as did, albeit to a lesser extent, the cyclically adjusted balance (despite the well-known problem of its measurement and even more so at local government level because of data availability). These changes were in part a response to the economic crisis and the revised EU fiscal governance framework but, admittedly, also due to greater decentralisation in some countries and the emergence of the so-called 'next- or second-generation' fiscal rules, arising out of lessons learnt worldwide from the experience of earlier first-generation rules (Schaechter et al. 2012; OECD/KIPF 2016; Geissler et al. 2019).[4]

In Table 3 we outline the numerical local fiscal rules in EU countries as they existed in 2017/2018, one decade after the start of the financial crisis. As for the types of rules at local government level, a budget balance rule exists in almost all EU countries, but in practice, its definition, coverage and application vary across member states. The same applies to the borrowing and debt rule, as its form varies across EU countries, with the debt stock and golden rule version being more popular than the new borrowing or debt service variety. At local level, expenditure rules are not common with only a handful of EU member states adopting them. In terms of the number and mix of rules, in all cases local governments across the EU have two or more local fiscal rules in place, with, as alluded to above, a preference for (some type of) budget balance rule combined with a borrowing and debt rule. The detailed country notes in the Appendix highlight the differences in how local fiscal rules (on deficits, debt, and expenditure) across EU countries are actually defined, not to mention cross-country variations in the monitoring and enforcement of such rules.[5]

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[4]Although there is no established definition of second-generation fiscal rules, they appeared after the global financial crisis and are in general more enforceable, flexible and operational than their predecessors (Eyraud et al. 2018).

[5]Due to a word count limit (an editorial rule!), we are prevented from providing more details on country-specific examples of fiscal rules. Country examples of changes to local fiscal rules post

Table 3 Local fiscal rules in EU member states

	Budget balance rule (BBR)	Borrowing and debt rule			Expenditure rule
		Debt stock	Debt service	Golden rule	
Austria	x	x		x	
Belgium	x	x		x	
Bulgaria	x	x	x		x
Croatia	x		x	x	x
Cyprus	x			x	
Czech Republic	x	x			
Denmark	x	x		x	x
Estonia	x	x		x	
Finland	x				x
France	x			x	
Germany	x			x	
Greece	x	x	x		
Hungary	x		x		
Ireland	x			x	
Italy	x			x	x
Latvia		x		x	
Lithuania	x			x	
Luxembourg	x			x	
Netherlands	x	x			
Poland	x	x	x	x	
Portugal	x	x			
Romania	x		x	x	
Slovakia	x	x	x		
Slovenia		x		x	
Spain	x	x		x	x
Sweden	x			x	
UK	x			x	

Source: OECD/UCLG (2016); European Commission (2018); Geissler et al. (2019)
Note: We exclude the revenue rule because of its virtual absence at local government level across EU member states. We also exclude Malta because of its size

6 Conclusions and Lessons

To recap, fiscal rules are constraints designed to restrict fiscal policy and, in doing so, ensure fiscal discipline. Applying and enforcing fiscal rules is as much a political economy issue as it is an administrative and technical matter. Indeed, if strictly

crisis can be found in sources cited in this chapter, most especially in OECD/KIPF (2016) and Geissler et al. (2019).

enforced in a mechanical way, as with any blunt instrument of governance, fiscal rules can have unintended consequences. Hence, flexibility is necessary, with policymakers needing to consider cyclically adjusted rules combined with temporary escape clauses in times of economic crises.

Continuing on this cautionary line, fiscal rules can be amended, manipulated, evaded, suspended, or abandoned. Moreover, as Braun and Tommasi (2002: p. 3) note when writing about subnational fiscal rules in Latin America:

> . . . it is not immediately clear why enacting or signing a law, pact, constitutional amendment or international treaty that states that a certain fiscal variable must respect a certain numeric target will affect the behavior of economic and political actors in such a way that the rule will be respected.

We are reminded here of Goodhart's law where any observed statistical regularity will tend to collapse once pressure is placed upon it for control purposes, i.e. when a measure becomes a target it ceases to be a good measure (Goodhart 1975). Aside from the difficulty in testing for the effectiveness of fiscal rules, the empirical evidence that does exist for the impact of fiscal rules on budgetary outcomes is not entirely conclusive, but, on a more positive note, if properly designed and appropriately implemented, the overall conclusion is that fiscal rules matter (Poterba 1997; Debrun et al. 2008; Grembi et al. 2016).

In support of fiscal rules, as they cannot include all possible contingencies, there will be a need for some judgement or, more generally, as Kopits (2001, 2014: p. 139) puts it when presenting the case for fiscal rules in the context of conventional fiscal policy, the need for '. . .constrained discretion. . .', i.e. maintaining a sound fiscal stance while allowing sufficient margin for budgetary flexibility to counteract the economic cycle and cushion against unexpected shocks. While fiscal rules may be more than simply veils and can help to instil or foster fiscal discipline by constraining the behaviour of political actors, they have limitations (including suffering from time inconsistency) and are not meant to be a universal panacea (Wyplosz 2013; Turley and McNena 2018). They are not a substitute for sound fiscal policy or for a well-designed system of intergovernmental fiscal relations. Likewise, they are not a necessary condition for fiscal adjustment or consolidation. Political commitment and will is important, as is broad electoral support, which, in turn, depends on the need for public dialogue. Likewise, adequate public financial management systems are also required.

As with other elements of intergovernmental fiscal relations, fiscal rules are country-specific when it comes to their design and application. Indeed, there is great diversity in country approaches and experiences, as outlined in this chapter. These cross-country differences need to be carefully considered when tailoring suitable local fiscal rules as we know from elsewhere that one size does not fit all. With no ideal or best rule, the choice of rule or set of rules will depend on country circumstances, economic structure and initial conditions, the wider intergovernmental fiscal framework and the priority given to different policy objectives.

Over a decade after the 2008 financial crisis, we see that local fiscal rules are common in all EU member states, with the budget balance rule and the borrowing

and debt constraint most prevalent. There exist large cross-country differences in the way they are expressed, monitored and enforced. Despite the changes to the rules that we have witnessed since the financial crash, and with more refinements inevitably to follow, local fiscal rules are here to stay, as an established part of the intergovernmental fiscal framework for countries where spending, taxing and borrowing powers are decentralised and where fiscal discipline remains a priority.

Appendix

Austria	Austrian municipalities are obliged to adhere to the BBR. Nonetheless, not every respective state law contains this rule explicitly. Debts are generally restricted to fund capital spending and are subject to state approvals
Belgium	BBR in place in all three regions. Municipalities can take out loans, which are used for capital expenditure. This 'golden rule' restricts borrowing to investment purposes. Moreover, there are region-specific regulations. In Wallonia, there is a nominal per capita debt limit. Exceptions in certain fields (like security) are possible. In Flanders, there are no direct limits to outstanding debts of a municipality
Bulgaria	BBR in place. The annual amount of municipal debt payments for each municipality may not exceed 15 per cent of the annual average amount of own revenue and the block equalising grants for the past 3 years. As for the expenditure rule, the average growth rate of expenditure for the forecasted medium-term period is limited to the average growth rate of the reported expenditure for local activities for the last 4 years
Croatia	A general constraint for all local government units is that total local loans cannot exceed 2.3% of the revenue generated by all local government units in the previous year, while the total debt service of an individual subnational government unit cannot exceed 20% of budget revenues from the previous year. There are limits on the salaries of local officials
Cyprus	According to the Municipal Act, municipalities can borrow to fund capital expenditure and debt refinancing. Municipal loans have to be approved by the Council of Ministers
Czech Republic	BBR in place. Debt limit at 60% of 4-year average of revenues
Denmark	BBR in place. Loans restricted to capital spending. Expenditure limits in place, on the aggregate
Estonia	BBR at general government level but with a breakdown by level of government. Municipalities can borrow but only to fund investment projects. Total debt is limited to 60% of operational revenues in the respective budget year. Depending on self-financing capacity, this ceiling may rise to 100%
Finland	BBR in a 4-year planning period. No formal debt limits. Indirect local government spending limit
France	BBR in place. There is no limit to the amount borrowed for all local governments, as long as it is for investment purposes. No formal debt limit
Germany	BBR in place. Debt is restricted to fund capital spending. No formal debt limits

(continued)

Greece	Total local debt is restricted to a maximum of 60% of annual revenues. Debt service to a maximum of 20% of annual revenues
Hungary	Debt service in any year has to be under 50% of the own-source municipal revenues
Ireland	BBR in place. Debt is restricted to fund capital spending
Italy	BBR in place. Golden rule allows debt to finance investment
Latvia	Borrowing is permitted to finance investment projects. Overall debt of each local government cannot exceed 20% of last year's revenues
Lithuania	The annual budget law limits municipal borrowing to 60% of forecasted revenue, and all borrowing limits are approved by the MoF during the budgeting process. Municipalities can borrow within these limits but are expected to balance their budgets in 3 years' time. As part of the broader legal framework on fiscal rules, each municipality is required to produce a nominal balanced budget on cash basis
Luxembourg	BBR in place. Borrowing permitted to finance investment
Netherlands	BBR in medium-term perspective. There is short- and a long-term debt ceiling. They apply more to the term structure of government debt then to total debts. The short-term ceiling demands that the average net short-term debt (due within 1 year) is limited to 8.5% of budgeted spending for each quarter of a fiscal year. The long-term ceiling limits the amount of long-term debt (maturity more than 1 year) for which the interest rate is subject to change in a given year to 20% of budgeted spending. These ceilings can indirectly limit the amount municipalities can borrow in practice
Poland	BBR in place. The amended individual debt limits (total debt and debt service) are based on gross savings calculated over a 3-year period
Portugal	BBR in place. Debt limit of 150% of average net current revenues in the three preceding years
Romania	Local government budgets, excluding loans to finance investment and debt refinancing, have to be balanced. Local governments cannot contract or guarantee loans, if their annual public debt service (principal payment, interest, commissions) including the loan they want to contract is higher than 30% of their own revenue
Slovakia	Local governments' current budget has to be adopted either as balanced or in surplus. Total debt cannot exceed 60% of current revenue in the previous budget year in nominal terms; annual instalments to reimburse debt cannot exceed 25% of revenue in the previous budget year in nominal terms
Slovenia	No normative budget balance rule for Slovenian municipalities. There are debt rules pertaining to municipal debt (expressed as a percent of budget)
Spain	A 2012 law passed a structural budget balanced rule and debt ceilings for all levels of government, as well as expenditure rules for SNGs. The debt ratio of the general government must not exceed 60% of GDP. This general debt ratio distributes as follows: Central government 44%, CAs 13% and 3% for all local governments. The provisions within the SGP are considered within the Spanish public administrations' expenditure rule. Article 12 establishes that the growth rate of the adjusted primary expenditures of all levels of government cannot exceed the Spanish medium-term GDP growth rate. Local governments must take this growth rate as reference for their local budgets
Sweden	According to the local government act, local governments are obliged to balance their budgets. No countrywide local debt limits
UK	BBR in place. Borrowing restricted to capital spending

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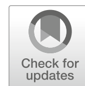
Fiscal Rules at the Local Level: The Challenge of Enforcement



René Geissler and Kai Wegrich

Abstract Despite the growing significance of fiscal rules, there is little research about tools and practices of enforcement at the local level. Addressing this knowledge gap, this chapter makes three contributions: first, we review the literature on regulatory enforcement in the 'public-to-private' context and discuss six key insights. Second, we provide an empirical overview of enforcement instruments across 21 European countries and discuss them in light of those key insights. Third, we present findings from an in-depth over-time analysis of enforcement practices in Germany's largest state, North Rhine-Westphalia. We find that European supervisory bodies have a range of instruments that broadly follow the logic of the 'enforcement pyramid' at their disposal, but there is substantial cross-national variation in the instruments used. The case study reveals a 'back and forth' enforcement style alternating between strengthening and loosening rules and enforcement measures. We find political logics, regulators' capacities and economic contexts as key drivers. Finally, we conclude that the idea of enforcement as a rational application of legal norms is unrealistic. In order to increase compliance, regulators should make more of an effort to understand the underlying rationale for compliance and violations; they need to secure political support and a credible strategy for escalating sanctions in case of non-compliance.

1 Introduction

All regulatory systems seek to influence or change the behaviour of those that are at the receiving end of standards, norms and rules. No matter if standards seek to influence the behaviour of car drivers, investment bankers or local governments, the

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question of how to make sure that those ‘regulatees’ (as they are often called in the parlance of the regulation literature) comply with standards is similarly critical. In the field of regulating budgets of subnational governments, for example, one cannot expect local governments to comply with fiscal rules without any form of monitoring and sanctioning in place. In the absence of enforcement, rules aiming at balanced budgets or limiting debt (see the Chapter “Budget Institutions for Subnational Fiscal Discipline: Local Fiscal Rules in Post-Crisis EU Countries” on fiscal rules in this volume) will likely remain ineffective.

The design of rules and their enforcement link directly. For example, rules can be more or less binding, allowing regulators more or less discretion in enforcing them. At the same time, ways and means of enforcement are critical (cf. Lodge and Wegrich 2012, Chapter 4). Those include monitoring of compliance and, in particular, detection of non-compliance and the application of measures of ‘behaviour modification’. Yet, the focus of debates about fiscal rules—in general and in the context of local government in particular—is mostly on the standard setting dimension at the expense of enforcement. Particular research on the enforcement of fiscal rules for local governments is missing.

Against this background, this chapter seeks to shift attention to the enforcement of fiscal rules by making three contributions. First, the following section reviews and summarises the literature on enforcement in the field of regulation, i.e. regulating businesses and citizens. While regulating private entities is very different from regulation inside government (Lodge and Hood 2010), the aim is to extract key insights—and potentially lessons—from this literature regarding successful enforcement strategies as a starting point. Second, we provide an overview of the variety of enforcement styles across 21 European countries, using the strategies discussed in the second section as an analytical lens, drawing on previous research in which one of the authors was involved (Geissler et al. 2019). Third, we zoom in on the German case of North Rhine-Westphalia. The case study allows us to study the interaction between the economic situation, political considerations and enforcement over time. The concluding section highlights lessons learnt, in particular concerning the opportunities and limits of learning from ‘outside’ government regulations for ‘regulation inside government’.

2 Six Insights from Regulatory Enforcement

Despite the vast scope of research on regulation and enforcement, spanning all kinds of policy fields, world regions and including non-state and transnational regulation, the literature has developed key insights for the development of effective enforcement strategies (cf. Gunningham 2010; Lodge and Wegrich 2012, Chapter 4). As we noted above, context is critical for effective enforcement strategies, and the six key insights from the enforcement literature are not to be confused with off-the-shelf best practices. Rather, they highlight key aspects of the context that those seeking to improve enforcement should take into account. The first three insights relate to the

understanding of the 'regulatees'—those to whom regulatory standards apply and we have in mind when thinking about compliance or non-compliance. In the literature on (social) regulation, the regulatee is usually a private, profit-seeking company—a mining company, a restaurant, a car manufacturer or a bank. Insights four to six are more about the regulator, about procedures that could be useful, capacities and the political context.

Understanding the Regulatees: Motivation and Capacity

The task of agencies charged with enforcement might seem simple at first sight: detect non-compliance and exercise sanctions according to what the rulebook stipulates. Failures of detection and sanctioning would be the main source of a lack of compliance with regulatory standards. However, the literature on enforcement has shown that not only the fact of non-compliance matters but also the underlying causes; good enforcement strategies take these causes for non-compliance into account. One can distinguish two dimensions for understanding the reasons for violation of standards: motivation (or behavioural predisposition) and capacity (ability to comply). Moreover, these will not be evenly distributed but will vary substantially across any population of regulatees (Lodge and Wegrich 2012, p. 76–80).

In other words, the motivation dimension refers to the willingness to comply, which can simply be scored as either high or low. Some people using public transport might not want to pay for a ticket because they are keen to save the money, they think the service is poor or they already pay too much in taxes. Other people have a high willingness to comply, maybe because they think public transport is important and they can contribute to its financing or because to them it is wrong to violate the law. Also, capacity might vary between people. The ability to pay for the service, knowledge and skill of how to buy the right ticket is linked to capacity. For example, tourists in a city going to buy a metro ticket, who are not aware it needs to be validated before they enter, are technically dodging the fare. They are willing to comply and actually spend money to buy tickets but lack the knowledge to 'administer' the full process. Lodge and Wegrich (2012) called those 'organisationally incompetent'—they violate standards involuntarily.

Such a person is very different from someone who knows very well how the system works but wants to save the money. Maybe he/she actually knows how the inspection system works and actively tries to evade controls. People with high capacity and low willingness to comply are 'amoral calculators' (Kagan and Scholz 1984). Then there are those who are unwilling to comply but also lack the knowledge or capacity; Lodge and Wegrich (2012) call them 'principles objectors', because these people do not calculate their gains and risks but take a principled stance. Finally, there are the 'honest triers'—those with high willingness to comply and knowledge/capacity to do so.

It should be clear that the preferred situation for the regulator (and from a compliance perspective) is to have as many honest triers as possible and only few amoral calculators and principled objectors. Such a situation would reduce the need to control, sanction and punish all resource- and conflict-intensive activities that also

might make the organisation unpopular in the public and political eye. So, the key takeaway is that having many amoral calculators actively seeking to evade compliance is problematic. Nevertheless, the problem is also that the regulator might not know what the motivation actually is, ex ante.

Pure Deterrence and Persuasion Enforcement Strategies Do Not Work
These insights concerning the drivers of compliance behaviour allow assessing enforcement strategies, i.e. developing conjectures about the chances whether a particular strategy will be effective. The starting point of debates on enforcement strategies is the distinction between two pure types, deterrence (or punishment) and persuasion (cf. Gunningham 2010). As the name says, the 'deterrence' or 'punishment' strategy stresses the consistent and 'hard' application of sanctions in light of norm violations. The 'persuasion' approach, in contrast, relies on sanctions only as a last resort and is generally more open to excuses from regulatees; the persuasion approach emphasises 'restorative' action, i.e. correcting behaviour.

The two pure approaches have very different behavioural assumptions. The deterrence approach rests on the assumption that compliance behaviour is the result of a rational calculation of the costs and benefits of compliance with norms (cf. Becker 1968; Stigler 1971; Ritchey and Nicholson-Crotty 2011). If the benefits of non-compliance are higher than the costs, a rational actor will display non-compliance. The cost-side of this equation includes the severity of punishment (e.g. fees for fare-dodging in public transport) but also the likelihood of detection (getting caught). One implication of this approach is to increase the severity of sanctions when monitoring cannot be intense, i.e. the likelihood of getting caught is low.

The deterrence approach obviously is designed for 'amoral calculators', and empirical research has indeed shown that it can work. Thornton et al. (2005) show that the threat of very high penalties can be effective for large corporations. Visibility of sanctioning is an important precondition, i.e. to be deterred one needs to see others getting caught (cf. Ritchey and Nicholson-Crotty 2011 on road safety). But the approach has the major downside of alienating 'organisational incompetent' norm violators, potentially creating a 'culture of resistance' (Bardach and Kagan 1982); the tax payer who gets a hefty fine because he/she made an 'honest mistake', in their own favour, in trying to comply with the complex tax law will hire a tax advisor to get their money back in next year's declaration, Braithwaite (2007) argues. An overtly hard-nosed sanctioning approach comes with the risk of creating more amoral calculators, who will learn to find loopholes. Such an approach, research in the field of workplace health and safety suggests (cf. Kelman 1981), is also not conducive in facilitating trust, open conversation and learning between regulators and regulated companies. Kagan (2019) argues that strong, punitive sanctioning is one of the factors leading to the costly system of 'adversarial legalism' in the USA.

This is exactly the strong suit of the persuasion approach: in interaction with honest triers and the organisational incompetent, a persuasion-based approach can help to increase voluntary compliance with regulatory standards. Advice, support and warning are the key tools to achieve this. However, the downside of a pure

persuasion-based approach goes beyond the obvious. This enforcement strategy lacks a way to deal with the amoral calculator, who might actually feel vindicated in his inclination to violate norms. Also, the honest trier might reconsider their position on realising that others get away with non-compliance (this effect has been observed in tax enforcement Bergman 2009). Ironically, this approach might also increase the number of amoral calculators.

In short, both pure strategies come with major limitations and create unintended effects that make the lives of regulators more difficult. Hence, mixed strategies are seen as the way forward.

Mixed Strategies: Responsive Regulation and the Enforcement Pyramid
In debating how to combine the useful aspects of both pure enforcement strategies, and to avoid their downsides, Ayres and Braithwaite (1992) develop the image of the enforcement pyramid in a concept of 'responsive regulation'. This became the dominant model for a mixed enforcement strategy, informing a range of efforts to improve enforcement practices globally (cf. Lodge 2015; Parker 2013; Baldwin and Black 2008; Braithwaite 2007; Waller 2007). The key point—and the message that the pyramid seeks to get across—is that the basis and most frequent enforcement behaviour is at the soft (persuasion) end—educating, advising and warning. Soft (or cooperative) ways of engaging with regulatees is important as a starting point, because the inspectors do not know how the regulatee will respond—by cooperatively adjusting their behaviour towards compliance or by trying to evade. Regulators don't want to alienate regulatees ('create' more amoral calculators), so they start cooperatively. Yet they are prepared to escalate the sanctioning when the cooperation is not mutual.

This is the core idea: being responsive to the regulatee's behaviour in the application of warning and sanctions. Even when a company has responded in a non-cooperative way, and the escalation of sanctions was necessary, the regulator is prepared to reward cooperative behaviour with de-escalation. The enforcement pyramid avoids overreaction against organisational incompetent regulatees making honest mistakes, but regulators using the strategy will follow through on amoral calculators in an escalating way—if they don't respond to warnings and mild forms of sanctioning with cooperative behaviour (showing willingness to comply).

Two aspects of the enforcement pyramid are critical, and some limitations need to be mentioned. For the effectiveness of responsive regulation, willingness to use severe sanctions—like taking a company out of business—must be a real option that is (legally, politically, organisationally) feasible and which the regulator is willing to apply at the end of a process of consistent escalation in response to non-cooperative behaviour. This 'big gun' is 'benign', because escalation is stepwise and de-escalation is always an option. Second, the 'middle ground' of sanctions is essential for the responsive nature of enforcement to happen. These are sanctions that are substantial but proportionate to the degree of non-compliance. If these 'middle-ground' sanctions are not available to regulators, they can only choose between warnings or strong sanctions (big guns). Such big guns might be contested,

for example, in court, or not applied in the first place—given the lack of proportionality.

The enforcement pyramid is a principle for effective enforcement that builds on experiences with contrasting pure strategies and their limitations; it has informed the formulation of many enforcement strategies across the globe, but of course, there are limits and limitations. First, responsive regulation requires the possibility and capability for repeat interaction between regulator and regulatee. Second, the contact point within a regulated organisation (e.g. the compliance officer) must be able to coordinate within the organisation the response that is agreed with the regulator—difficult in large corporations. Third, stepwise escalation might not be acceptable in high-impact areas—such as environmental safety, financial markets or food safety. Fourth, responsive regulation demands high capacity from regulators.

Risk-Based Regulation

Another element of improving enforcement is to think in terms or risks. Risk-based regulation (Hutter 2005; Black 2005; Black and Baldwin 2010) follows up on the ideas of responsive regulation but puts emphasis on the challenge of limited resources of agencies and potentially unlimited demand for monitoring, sanctioning, negotiating, etc. Consider the number of restaurants, food production and processing companies that a food safety regulator has to monitor. Frequent site visits to all companies are often impossible, so methods of risk assessments are used to decide about which company is inspected more or less frequently. Two criteria are driving this decision: first the generic risk that some activity poses to the regulatory goals (e.g. meat processing versus water-filling companies) and second the compliance history of a particular company (which is the 'responsive' element in risk-based regulation). Elements of self- and co-regulation are an important element in risk-regulation approaches. Establishing standards and procedures of how a particular company goes about meeting regulatory standards helps regulators assess the likelihood of future compliance. In other words, risk-based regulation has a forward-looking or preventive element and is not only about detecting and sanctioning norm violations.

Risk-based regulation poses high demands on regulators, who will become more data-driven and systematised when trying to use these ideas (Lodge and Wegrich 2012, p. 86–89). The approach comes with its own risk, namely, that the generic risk analysis is actually accurate (think of the ignorance of systemic risks in the financial sector prior to the 2008 financial crisis). Another risk is that risk-based regulation extensively relies on documentation and indirect control of self-regulation schemes of companies rather than direct inspections within companies. In the near future, big data and artificial intelligence will be used more extensively in detecting and analysing risk patterns. While this development bears substantial potential, it also comes with increasing demands on regulators' analytical capacity.

Rules Versus Principles

Enforcement strategies don't function independently from the design of regulatory standards. One core debate is about the respective advantages and disadvantages of rules and principles. Rules are simply defined as narrow and specific prescriptions,

while principles are broad and vague standards. A speed limit (max 30 km/h) is a rule; the demand to 'drive carefully and considerate of others' is a principle. From this example, one might take that rules are more effective, they directly prescribe what is allowed and what not, and a definition of violations will be very clear. And, this is certainly true for simple situations. However, under more complex conditions, a rule-based approach can turn out to be problematic. In complex contexts, working with rules means that the regulator needs many different rules to cover the domain. By implication, the likelihood increases that rules contradict each other and open up loopholes for amoral calculators—think of the tax code as an example. Moreover, as Braithwaite et al. (Braithwaite and Braithwaite 1995; Braithwaite 2002) have shown in a study of nursing homes in the USA and Australia, a rule-based approach with many narrow prescriptions leads to partial and inconsistent monitoring—the rulebook for inspections of nursing homes in the US case was simply too complex to thoroughly check through all of its points.

Under conditions of complexity, principles might work better, mainly because they don't incentivise regulatees to engage in formal and creative compliance and facilitate a professional conversation among regulators and regulatees—this was Braithwaite et al.'s observation in Australian nursing homes. However, there are also important examples of failed principle-based regulation, such as financial regulation in the UK before the 2008 financial crisis. The UK financial regulator at that time, the Financial Service Authority, presented itself as an evidence-based, risk-based and principle-based regulator. In essence, principle-based regulation was seen as an element of 'light touch' and market-oriented regulation that did not detect the risks building up on the financial market (Black 2010, p. 12–14). One important requirement for principle-based regulation to work is that regulators have analytical skills to understand and assess the behaviour of companies (missing in the case of complex banking activities involving risk models that only a small group within the bank could follow). For principles to work, trust between regulators and regulatees is needed, but reliance on (too many) rules can inhibit the development of trust. In any case, designers of enforcement strategies have to be mindful of potentially unintended effects of relying on rules.

Administrative Capacities and Political Support

Smart enforcement strategies require high levels of administrative capacities (Lodge and Wegrich 2014). As well as the sufficient human resources needed to carry out inspections, analytical capacity is required to develop a good understanding of regulatees' motivation and capacities and use of risk analysis in a considerate rather than formal and bureaucratic way. The stipulation of advanced enforcement strategies without the presence of sufficient administrative capacity might undermine their effectiveness. Of course, political support is an important factor of effective enforcement as well. Enforcement does not happen in a politics-free world. At the same time, developed administrative capacities and a high reputation of an agency are important factors in defending the autonomy and impartiality of regulatory agencies.

These political factors might weigh stronger in the context of 'regulation inside government' and potentially limit the application of enforcement strategies applied

in the context of regulating private entities. As Lodge and Hood (2010) in their review of debates about regulation inside government argue, it might exactly be the 'inside' character of agency-to-agency regulation which could limit the application of some elements from the toolbox of enforcement strategies. For example, 'taking local government' out of business might be a theoretical option (via 'state commissioners' taking over the management or bankruptcy procedures), but political ties that bind levels of government could make the application of this 'big gun' highly unlikely. Another question is what the equivalent of 'middle-ground' strategies such as fines in the context of local government supervision should be. We will further explore these and related issues based on our two-step empirical analysis.

3 Enforcement Styles Across Europe

The following comparison of enforcement styles across 21 European countries draws on material and data from an empirical study, in which one of the chapter's authors was participating (Geissler et al. 2019). This study used document analysis and expert interviews to explore a number of dimensions of local government financial supervision, and the mapping of instruments used to enforce fiscal rules was one of those dimensions. Table 2 provides an overview of instruments and procedures. Two caveats need to be made in relation to the table: first, we only included instruments present in more than one country—in order to draw attention to wider trends and not to individual outliers.[1] Second, the type of analysis presented in Table 1 only covers the formal instrumentation, as stipulated in national legislation. How these tools are applied in practice and which other informal enforcement tools potentially are available to supervisory bodies is not covered in this analysis (but see Sect. 3 for a case study). However, the overview of the formal instrumentation offers substantial insights. It not only shows the range of instruments available but also the cross-national variation in instrumentation mix. The analysis also points at interesting outliers, in particular Sweden where no formal instrumentation for the enforcement of fiscal rules exists.

Table 2 sorts instruments broadly according to the logic of the enforcement pyramid, introduced in the previous section. The nine instruments of supervision escalate in terms of the intrusiveness and severity of sanctioning. Public warnings constitute the softest instrument, although it is likely that such measures are preceded by internal and informal warnings. The "naming and shaming" character of the instrument could be considered as an already rather intense measure since it puts political actors into the spotlight and seeks to change behaviour through the incentive of maintaining a favourable public reputation. Approval rights are another

[1]Among the enforcement instruments skipped is the personal liability of the local treasurer in England, forced mergers in Finland and the insolvency procedure in Italy (the only country were insolvencies occur regularly).

Table 1 Four types of regulatees

		Willingness to comply	
		Low	High
Knowledge and capacity to comply	High	Amoral calculator	Honest trier
	Low	Principled objector	Organisationally incompetent

Source: adapted from Lodge and Wegrich (2012), p. 80

instrument at the softer side of the enforcement pyramid. While the approval procedure as such serves purposes of detection, declining approval has a clear sanctioning effect and limits local autonomy. This instrument type allows for calibrating the severity of enforcement measures, ranging from declining loans or some section of the budget to the disapproval of the full budget.

Moving towards more severe and intrusive measures, objection against decisions of the local government not only covers the budget but any decision with financial implications. This tool allows the supervisory body to nullify decisions taken by local governments. Seven countries can draw on this tool. The next step up the enforcement pyramid is the substitution of local decisions by those of the supervisory body. Four countries use this tool, which constitutes a severe intrusion into local autonomy. Supervisory bodies in five countries also have the power to apply financial sanctions, such as cuts in grants for violations of balanced budget rules. While one might argue that such measures might do more harm to local governments that experience financial stress, from an enforcement perspective an underlying logic could be that those local actors are considered as amoral calculators responsive to financial incentives.

The most frequently used instruments are consolidation measures imposed on local governments in response to violations of fiscal rules. While regulators using this tool put responsibility for budget consolidation squarely into local governments' domain, they often come in a combination of sticks and carrots. Typically, imposed consolidation measures are combined with bailouts, i.e. transfers from higher levels of government (see Chapter "Preventing Local Government Defaults: No-Bailout Policy and its Alternatives" in this volume). Those bailouts are conditional on compliance with intense reporting requirements and the implementation of consolidation measures—all measures that limit local autonomy. If local governments reject these measures or they remain ineffective in achieving progress towards budget consolidation, central governments can 'take over' the day-to-day management of local governments. Resorting to measures like this implies a complete loss of local autonomy. Under such rule, the central (or state) government acts instead of local officials, usually in person of a 'state commissioner' but keeps the respective local government in place. The dismissal of elected local officials is the ultimate sanctioning device in this enforcement pyramid—but this 'big gun' is only available to supervisory bodies in Austria and Germany.

While this analysis of the supervisory instrumentation in 21 European countries remains an overview and does not capture enforcement practices, it does still allow

Table 2 Enforcement of fiscal rules in 21 European Countries (as of 2018)

Land	Public warning	Approval of loans	Approval of budget	Objection of local decisions	Substitution of local decisions	Financial fines	Cutback measures	State administration	Dismissal of city council/mayor
Austria		X		X					X
Belgium			X	X			X		
Bulgaria							X		
Czech Republic						X			
Denmark						X	X		
England								X	
Estonia	X	X		X	X		X		
Finland							X		
France								X	
Germany		X		X	X		X	X	X
Greece				X			X		
Hungary		X				X	X	X	X
Ireland		X					X	X	
Italy						X	X		
Netherlands			X				X	X	
Poland				X	X			X	
Portugal			X			X	X	X	
Slovenia		X					X		
Spain	X	X					X		
Sweden									
Switzerland		X		X	X		X	X	
Sum	2	8	3	7	4	5	15	9	3

Source: Geissler et al. (2019)

for conclusions regarding the 'responsiveness' of enforcement strategies. The first insight resulting from the enforcement literature briefly introduced above was that regulators need a good understanding of why non-compliance occurs and how to adjust enforcement measures accordingly, taking into account motivation and capacity for violating (and observing) fiscal rules. The toolbox summarised in Table 2 provides regulators with the necessary degree of discretion and options to accommodate enforcement measures according to the respective local context. In most countries, soft enforcement instruments proceed strict ones, such as imposed consolidation or the 'take over' by a state commissioner. Usually, legal norms formalise the enforcement pyramid allowing both local governments and regulators to anticipate next steps and adjust their behaviour.

Insights 2 and 3 point at the risks of relying on both pure enforcement strategies, 'deterrence' and 'persuasion' and suggest a mixed strategy following the logic of responsive regulation. Regulators should be flexible and have a range of different instruments at their disposal as well as be able to apply them in a consistent way. That means rewarding cooperative behaviour of regulatees and respond with stepwise escalation of sanctions in the face of non-compliance.

However, persuasion can include informal measures that do not cross the border of formal interventions of supervisory bodies and are hence not captured in this analysis. In-depth case studies are needed to explore the role of informal means of persuasion. However, the available tool set allows to escalate interventions stepwise, also to provide incentives and rewards to local governments and to avoid threatening with the 'big gun' when this is not credible. However, making good use of mixed strategies requires time, administrative capacity and iterative interaction to build trust.

Elements of risk-based regulation (insight 4) can be identified in the practice of credit approvals in eight countries. In countries using this tool, only local government lending practice is subject to monitoring and control, not the full budget as such. As debt limits are a cornerstone of fiscal rules, approval procedures allow for early detection of potential violations and can often prevent their occurrence. For most local governments, loans are a relevant source for funding of capital spending; hence, limiting access to credits is a rather severe sanction since investment in local infrastructure would be postponed or reduced. Such investments are also an important source of political credit claiming by local politicians. Outside this logic of risk-based regulation, credit approval procedures can serve another function. For example, in Austria and Germany, monitoring includes the full budget, but regulators withhold credit approvals as a sanction in response to rule violation.

The cross-national comparison shows that the majority of countries tends towards a rule-based approach. While some general underlying principles, such as the principle of fiscal sustainability, are relevant in all countries covered, fiscal rules and respective enforcement regimes are overall rather specific and detailed. However, two countries display stronger elements of a principle-based approach—Sweden and England.

In England, regulation of local finances rests on several codes of practice, prepared by the Chartered Institute of Public Finance and Accountancy (CIPFA), a

professional body for executives in local finance. Those codes build a framework ensuring that capital investments, treasury management and budgeting in general are sustainable. Therefore, any local government sets its own debt limits within those general principles. Private external auditors review the appropriateness of local rules and its implementation. Whereas the Swedish law, for example, requires local governments to set their own fiscal targets aiming at sound financial management. Annual financial statements must contain an assessment and are subject to an audit by the respective in-house audit office. In both countries, the state does not monitor those audits formally, but they have to be published.

This overview of the instrumentation of supervisory bodies enforcing fiscal rules vis-à-vis local governments in 21 European countries shows first and foremost the diversity of tools available. The similarities to enforcement tools and strategies known from 'state-to-private' regulation are evident. As in the world of regulatory enforcement, administrative capacities are essential for making effective use of tools and strategies. The various instruments displayed in Table 2 put different demands on supervisory bodies. For instance, cutback measures have to be assessed and monitored, the 'take over' of local governments' business by a 'state commissioner' shifts the workload (and political conflicts) to regulators. Different ways of organising local government supervision might come with advantages and disadvantages in handling these challenges, as Ebinger and Geissler show in this volume. Finally, enforcement needs credibility to be effective. An obvious lack of capacity or of political support damages this credibility and weakens local compliance. The following section explores the challenges of using enforcement tools and powers in one case.

4 Back and Forth: The History of Enforcement in North Rhine-Westphalia

Moving from an overview of enforcement tools in a range of European countries towards a 'tools-in-use' perspective, we present findings from a case study on the implementation of fiscal rules in Germany's largest state (Land) North Rhine-Westphalia (NRW). NRW provides ample evidence for the handling of enforcement tools under stress, given the prolonged budget crisis at the local level in this region. We show how enforcement tools were used differently at different points in time, discussing the role of administrative capacities and the design of fiscal rules. A particular focus is on the interaction between political considerations of the use of enforcement tools and the (changing) fiscal context. Thus, the functioning of financial supervision is not only shaped by the design of the legal framework but also by its implementation. The following section describes the evolution of financial supervision following those two dimensions (see Table 3).[2]

[2]This section builds on empirical material presented in Person and Geissler (2020).

Table 3 Evolution of fiscal regulation and implementation in North Rhine-Westphalia

Year	Legal amendments in fiscal rules and enforcement	Implementation
1987	BCC as precondition for bailouts	Voluntary participation, BCC not binding
1991	BCC obligatory in case of unbalanced budgets	Supervision limited to moderator role, lacking sanctions
1994	BCC as binding part of annual budgets	Political considerations and excessive demands of supervision
2006	Advisory austerity commissioners as substitute for state commissioners	Limited to consulting
2011	Bailout program 'strengthening pact'	New fiscal rules, monitoring and enforcement as a precondition of bailouts, strong political backing by state government
2020	Suspending of fiscal rules	Regulators lose their function

Source: Person and Geissler (2020)

The statutory mandate of financial supervision in NRW is clear: ensure sound fiscal management of municipalities, assess compliance with budgetary law and sanction violations of fiscal rules. To fulfil their tasks, supervisory bodies have a range of instruments at their disposal (see Table 2, in particular row on Germany). Public warning and monetary fines, as used in other countries, are missing in the toolbox of supervisory agencies. When applying these instruments, regulators must observe the principle of 'community-friendly' behaviour and interfere as little as possible with local self-government.[3] The supervision of local government finance is set up as a three-tier system: the Ministry of the Interior is responsible for the legal framework and coordinates the supervisory agencies. These agencies are 'district governments' (which are devolved administrative units of the state government) in charge for counties and cities, whereas counties supervise (smaller) municipalities.

The case of NRW shows the difficulties in developing a consistent approach to enforcement over time. Instead, the narrative is one of 'back and forth' between a more stringent and a more lenient practice, starting in 1987. At that time, some larger local governments accumulated substantial amounts of deficits and required so-called 'cash credits' (Kassenkredite) to finance the running budget—a violation of existing fiscal rules. After several years of basically ignoring the issue, the Land government enacted a new bailout programme combined with demanding 'budget consolidation concepts' (BCC) from participating local governments. While one could argue that this new approach indicates a more stringent approach to the enforcement of fiscal rules, participation remained voluntary, and supervisory bodies depended on local governments' goodwill.

This voluntary approach was made mandatory in 1991. However, in practice, supervisory bodies were still limited to the role as moderator, as they could not prescribe any consolidation measures or enforce their implementation. In light of

[3]This principle of local public finance regulation builds on the constitutional guarantee of local self-government in Germany.

rising debt levels during times of the economic downturn in the 1990s, BCC finally became a binding part of local budgets for cities violating the rules, which supervisory bodies had to approve. In case of a denial of approval, local governments had to work under the status of 'provisional budgeting' that limited local autonomy and capacity substantially. As the budget crisis spread across NRW, an increasing number of local governments had to adopt BCC and thereby adding to the workload of supervisory bodies. While the narrative so far suggests a step-wise tightening of enforcement tools and procedures, in practice the rules and tools were handled less stringently within an informal bargaining system (Holtkamp 2016). In light of legal limitations and the constitutional principle of local self-government, supervisory bodies issued only vague formal directives. At the same time, informal negotiations were used to formulate specific conditions for budget approvals.

These practices of regulation did not prevent further aggravation of local budget distress. With BCC becoming the 'new normal' but remaining ineffective in overcoming budgetary crisis, reputation and power of supervisory bodies declined. With more severe sanctions lacking, local governments developed 'strategies of resistance' (Holtkamp 2016), among others, using political ties to undermine the enforcement of budget cuts.

In 2006, NRW's Ministry of the Interior introduced a new institutional role that should strengthen the development and implementation of BCC in cooperation with local governments: the 'advisory austerity commissioner' (Sparkommissar). However, such a commissioner was dispatched only three times, and the budget crisis worsened, nonetheless (Zabler 2016). In the wake of the global financial crisis, NRW's local budgets deteriorated in an exceptional manner, and deficits and cash-credits skyrocketed. The Ministry reacted with loosening sanctions aiming to reduce the number of municipalities in budget crisis. In particular, the period for budget consolidation, which had to be presented in BCC, was extended to 10 years.

The so-called 'Pact for Strengthening Municipal Finances' brought a fundamental change in fiscal regulation in 2011. Through this program, the state provided bailouts to financially distressed municipalities in exchange for encompassing consolidation measures and strict supervision. The discretion of supervisory bodies was reduced, and sanctions for breaking fiscal rules became a more realistic scenario—a change that was supported by supervisory officials as well as local treasurers (Ebinger et al. 2017, p. 20ff). This program mobilised enormous unprecedented local measures, e.g. increases of local taxes, which—in conjunction with the rapid recovery of the economy after the financial crisis—substantially improved the budgetary situation of local governments. At the end of this decade, budget deficits and cash credits diminished, and local governments complied with fiscal rules. As an irony of fate, the corona-pandemic in 2020 caused an economic downturn of unseen extent and heavily strained local budgets (Freier and Geissler 2020). The Ministry decided to suspend fiscal rules such as the balanced budget requirement, suspended enforcement instruments like BCC or provisional budgeting.

As became evident, the regulatory regime of local fiscal rules changed substantially over time in the case of NRW. At times, these changes reflect the attempt to make enforcement of fiscal rules, and in particular, consolidation measures, stricter

and more binding. At other times, the response to the 'impossible job' of enforcing fiscal rules was to loosen or suspend them. The case reinforces key insights from Sect. 2 of this chapter, namely, that understanding the underlying rationale for norm compliance is critical and that mixed strategies are essential for effective enforcement. In NRW, the stricter tools from the enforcement pyramid were either missing or their application was not a realistic option. Administrative capacities of supervisory bodies were stretched thin during times of widespread budget crises, too. But it is important to note that the lack of stricter enforcement tools is mainly due to the political logic of the process—local governments could use their 'direct line' to the Ministry to prevent too strict enforcements and call for relaxing fiscal rules in times of need and crisis. In those times, breaking fiscal rules was less a matter of motivation and more of limited local capacities given declining revenues and growing welfare expenditures.

While one can describe the enforcement style in NRW as using a mixed strategy, its main characteristic are inconsistent changes over time. The Land government changed its approach from lenient, providing bailout measures, towards stricter control and sanctioning and back to loosening fiscal rules and providing bailouts in times of fiscal stress. The extent of the local budget crisis and the widespread use of BCC evidently overstretched the supervisory agencies' capacities. Regulators became subject to local gaming and negotiations were in-transparent and showing unforeseeable results for local executives. Most importantly, the enforcement pyramid was not credible, as the ultima ratio of sending a state commissioner was used rarely.

The case of NRW is quite appropriate to demonstrate the impact of political support on the enforcement of fiscal rules. For an extensive part of the period covered here, the fiscal supervisory regime was characterised by 'drifting principals' (Schillemans and Busuioc 2015). In trying to avoid conflicts with local governments with potential political reverberations, the various state governments did not demand a strict enforcement of fiscal rules. This observation confirms earlier research findings suggesting that politicians ignore fiscal rules, as long as the benefit of larger fiscal scope outweighs the political costs of rising debt (Wypolz 2012, p. 522). Therefore, fiscal rules have to shift political costs of rule violation.

It was the external pressure of the global financial crisis—and the bargaining chip of additional funds from the bailout programme—that shifted political attitudes towards stricter regulation. Nonetheless, the state had to pay a price for this change in strategy. Strict enforcement was only possible against the background of state bailouts. At the same time, state government committed itself to back regulators.

5 Conclusion

This chapter has made use of a surprising knowledge gap: while there is substantial interest in fiscal rules, including those applied to the local level, there is little research about tools and practices of enforcement. However, there is a rich literature

from the field of ('public-to-private') regulation on enforcement that the paper used to extract six key insights for designing enforcement strategies. The empirical overview of the toolbox available to supervisory bodies in 21 European countries charged with enforcing fiscal rules vis-à-vis local governments showed that those agencies do have the formal tools to apply lessons from 'private-to-private' regulation, such as using ideas of responsive regulation and applying the enforcement pyramid. The comparative overview also showed that the toolbox of enforcement powers is relatively thin at both ends of the enforcement pyramid: advisory and persuasion-based tools are at least not visible in the formal toolbox of regulators and might be confined to the domain of information interaction. The 'big gun' of very intrusive interventions is often missing or not a realistic option.

The case study of the German Land of North Rhine-Westphalia uncovered major challenges for the design and consistent use of enforcement strategies in local government finance supervision. On the one hand, political ties binding actors across levels of government make the threat of 'big guns' fairly unrealistic. Repeatedly, local political actors could bank on the Land level to bail them out when the going gets rough or for it to refrain from too hard enforcement measures. On the other hand, the Land politicians are not free from responsibility for local affairs—strict enforcement of fiscal rules might hurt them politically (via electoral punishment) and might also have negative economic effects. The influence and leeway of the higher levels increases when they have (additional) financial resources to distribute and can connect those to compliance with fiscal rules. As a general conclusion, the idea that enforcement of fiscal rules is a question of a rational application of legal norms is unrealistic. It is more a political game shaped by the economic context, electoral incentives and the incentives that the respective players have in complying with fiscal rules. As Lodge and Hood (2010) have discussed with regard to the challenges of 'regulation inside government', it is the closeness of actors that make a 'tougher' regulatory approach problematic. The way this political game is played will not leave the motivation of local governments to comply with fiscal rules untouched. In other words, backtracking from the consistent enforcement of fiscal rules might change the motivation towards lower willingness to comply and trigger the development of 'strategies of resistance' (Holtkamp 2016).

Still, making enforcement strategies smarter remains important, and the main lesson from the enforcement literature is to improve the lower- and mid-level elements in the toolbox, for example, making use of public commenting and analysis and also providing comparative analysis of local budget practices. Experiences with more principle-based approaches in Sweden and England should be studied further. Nevertheless, any variation of smarter enforcement strategies, as the regulatory scholarship emphasises, requires investment in administrative capacities.

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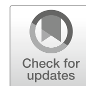
Financial Supervision of Local Governments: An Organisational Hurdle



Falk Ebinger and René Geissler

Abstract There is a general consensus on the effects of bureaucratic structures on task implementation and performance. Nonetheless, there has been very little research in the field of local public finance regulation. This article analyses the question of organisational structure in the field of local public finance regulation by surveying 18 European countries. We present five organisational dimensions, which potentially relate to regulatory outputs, and analyse their relation to four fiscal indicators. Those organisational dimensions are (1) the department owning the task of fiscal oversight, (2) centralised or decentralised implementation, (3) implementation in the form of one concentrated or several deconcentrated (regionalised) administrative units, (4) involvement of audit court(s) and (5) task execution by higher local government tiers. This analysis carefully demonstrates whether fiscal performance is somewhat more difficult for some organisational structures than for others. The number of countries per dimension shows that in the field of local public finance regulation, some options are more likely than other ones. Moreover, our results indicate that those organisational categories, such as "task ownership" and the involvement of "audit courts" link to higher financial performance. These results can help practitioners at the respective government levels to reconsider given bureaucratic structures.

1 Introduction

While there is a limited body of literature on the fiscal regulation of local governments, very little research has focused on a potentially crucial aspect: the design of the organisational structure of regulatory bodies and its immediate and indirect

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consequences. The absence of any reflection on this topic is not as surprising as it first seems. This gap in scientific knowledge links directly to a fundamental question in public organisation research: How does bureaucratic structure influence administrative behaviour and "street-level" policymaking[1] within public organisations? Despite its fundamental character, this question still lacks adequate and systematic treatment. With reference to distinguished scholars in the field, Morten Egeberg reported in 1999 "the somewhat surprising observation that literature reviews and comprehensive research reports on comparative administration revealed the discipline had little to contribute concerning the implications of various structural configurations". Despite his attempt to frame a modern research agenda at the time, Egeberg's appraisal could possibly be almost identical today. Lægreid and Verhoest (2010, p. 15) state in the foreword of a popular anthology: "Generally there is a lack of reliable knowledge about the effects of different organisational forms on performance". However, to not generate a misleading impression, there is consensus that structure and organisation have significant effects on the fulfilment of tasks in the public and private sector (e.g. Egeberg 2007; Walker and Boyne 2009; Ebinger 2013; Ebinger and Richter 2016).

Governments have a wide range of potential organisational structures at their disposal to establish fiscal regulation of local governments. Which ministry is responsible for the implementation of regulation, which administrative bodies implement this function in practice, and in which cooperative structure? Generally, each government must consider "structure", as it pertains to the importance of the task, which includes feasibility as well as the capacity to build expertise and achieve effective implementation.

This contribution takes a first step to fill this research gap. In the field of financial oversight, there are very few internationally comparative studies upon which to draw. Cross-national comparison is one of the most rewarding strategies for discovering and explaining national pathways and outcomes in public policy implementation. Therefore, this contribution will follow this strategy and, drawing upon a comprehensive survey of fiscal supervisory structures in Europe (Geissler et al. 2019), will provide a first exploratory comparison of these structures in 18 European states.[2] To do so, we will outline the relation between distinct organisational choices and local governments' fiscal indicators. Thus, we can carefully demonstrate whether fiscal performance is somewhat more difficult for some

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[1] We use the term "policy-making" in accordance with Egeberg's "substantive policymaking", i.e. "the kind of policymaking most bureaucrats are supposed to engage in most of the time" (1999, p. 156). This "kind of policymaking" refers to Lipsky's observation that street-level bureaucrats have "substantial discretion in the execution of their work" (1980, p. 3); see Ringeling's concept of "policy discretion" (Bresser and Ringeling 1995, p. 129).

[2] In contrast to further chapters of this volume, which cover 21 countries, we excluded Switzerland, Sweden and England. The Swiss case is difficult to analyse due to its extreme federalism among 26 cantons, overstretching an institutional comparison. Sweden lacks any formal supervision and, therefore, cannot be part of an organisational analysis. EUROSTAT does not provide fiscal data for England.

organisational structures than for others. We summarise by discussing the observed outcomes against the background of financial supervision design in European countries.

2 Theoretical Framework and Research Design

2.1 Theoretical Argument

There are numerous theoretical models on the causal links relating bureaucratic structures and outputs. Building on a neo-institutionalist framework, one assumes that institutional factors influence "the choices of actors, the sequence of moves, as well as the information they control [. . .]" (Tsebelis 1999, p. 4). Consequently, the specific administrative configurations within the investigated administrative models should make some employee and stakeholder actions more rewarding or adequate than other ones (Scharpf 2006). The specific institutional setting surrounding the actors relates to, among others, the way in which politicians and higher administrative levels criticise or support an administrative body. Further, it relates to goal clarity or ambiguity perceived by the stakeholders and management decisions and administrative behaviour considered appropriate within this administration. Bureaucratic structures and different organisational arrangements are presumably a key factor, which influence or even determine the output and outcome of an agency (cf. March and Sutton 1997; Egeberg 1999). However, this influence should not be interpreted as structural determinism as postulated, for example, in classical institutional theory approaches (e.g. from government theory) (cf. Kuhlmann et al. 2011). As such, the starting point of this chapter is the acknowledged neo-institutionalist basic assumption: institutions matter without determining an actor's actions and performance, but they constitute an enabling framework and corridor for action (see Peters 2005).

Recent research strands have dealt with questions of state organisation and reform, implicitly or explicitly. For example, intensive theoretical debates have developed concerning the "rescaling" of state institutions through privatisation, marketisation, autonomisation, decentralisation and territorial amalgamation. These issues were discussed in governance research, economic research, fiscal federalism, regulation, competition models and social capital research (cf. Batterbury et al. 2006; Treisman 2007; Lægreid et al. 2008; Ebinger et al. 2018; Ebinger et al. 2019). The trend of independent administrative units, which developed during the course of the NPM, produced a very fruitful line of research within the public administration community (Verhoest et al. 2010). Public management research has developed a strong approach to explain the performance of public administrations based on the role of leadership and management (cf. May and Winter 2007). However, those strands of research have somehow lost sight of the impact of organisational structures on task implementation.

When looking for a method to evaluate the effects of organisational structures, classic public administration literature comes to mind. Early on, basic configurations of administrative organisation (e.g. direct or indirect political control; degrees of vertical and horizontal differentiation; decentralisation or privatisation) were associated with a certain performance profile (see Wagener (1981) for instructive accounts). One can assume, for example, that larger administrative units generate economies of scale and more routine task execution. Monofunctional state agencies are associated with pronounced expertise, while multifunctional "territorial administration" by state agencies is expected to achieve economies of scope across policy fields, an elevated degree of policy coordination and options for consistent political control for national or subnational governments (Ebinger 2013). Finally, smaller local authorities led by an elected official are associated with a high degree of legitimacy, superior local knowledge and subsequently a more efficient allocation of resources (Swianiewicz 2010). Those main arguments have undergone various differentiations in theoretical reasoning over time. Nonetheless, they remain lodestars of organisational design.

Based on this reasoning and the given empirics, we identify five organisational dimensions present in fiscal supervision regimes in Europe, which are linked with outcomes of regulation. These are (1) which department owns the task of fiscal oversight, (2) the question of centralised or decentralised implementation, (3) implementation in a concentrated or in several deconcentrated (regionalised) administrative units, (4) the involvement of audit court(s) and (5) the execution of the task primarily by higher local government levels or associations.

1. Task ownership: We define the ultimate responsibility for a specific task as task ownership. This responsibility usually lies with a ministerial department but can also be shared between departments or attributed to third parties, e.g. audit courts as independent bodies. The designation of the ministry in charge is a relevant aspect when scrutinising the design of the oversight structures in supervision. Referring to advanced principal-agent theory (Knott and Miller 2008, p. 391) and theory of regulatory capture (Potter et al. 2014), we argue that ministries have divergent goals in fiscal supervision. Other programs and the objectives of a ministerial department are major factors, which could potentially influence the definition of goals and how resolutely they are pursued. When conflicts of objectives occur, tough decisions must be taken. (De-)prioritising or compromising program goals are the only option. This might have severe consequences in the political (and subsequently administrative) support for certain programs. Political support is considered an important environmental factor in public management, e.g. being essential for effective leadership, and is connected to the superior performance of an agency (Moynihan and Pandey 2005; Stazyk and Goerdel 2011).

One generally assumes that principals really care about delegated tasks, that they want to hold their agents accountable, want their agents to act according to the principal's preferences, and will intervene if they discover unwarranted actions by the agents. The reality, however, draws a much more nuanced picture (Schillemans

and Busuioc 2015, p. 200). Principals often are not unambitious or even ambivalent towards set goals. The two ministerial departments involved in most of our cases are the Ministry of Finance and the Ministry of the Interior. We do not want to delve into or overemphasise hypotheses on the potential differences between the rationales of Ministries of Finance and the Ministries of the Interior. However, one can assume the former usually has a rather narrow set of goals directed towards a sustainable public budget, whereas the latter usually carry responsibility for a broad range of policies and programs directed towards local governments.

A second set of categories refers to the administrative structure of regulatory bodies. We distinguish two dyads of real-type organisational choices:

2. Centralised or decentralised allocation: This category refers to the intensive discussion on decentralisation versus centralisation in its various forms, which has become one of the most prominent issues in public sector reform worldwide (Treisman 2007). The core question is *who*, e.g. which level of government should be responsible for certain tasks – central government, state government or local government? In many instances, decentralisation proved to be ill-suited for tasks with specific exigencies, such as financial supervision (Kuhlmann et al. 2011).
3. Concentrated or deconcentrated (regionalised) administrative responsibility: This category refers to the core question of *how* the execution of tasks should be organised; in deconcentrated, smaller, often regionalised units close to the addressees of the service or in a single, large-scale unit? Concentrated task execution might generate efficiency gains by bundling resources and capacities, as well as facilitating communication and coordination (Briault 2000, p. 217 f.). In recent years, the ideology of economies of scale has dominated administrative reform debates at the state level. Deconcentrated or regional administrations were merged, which resulted in possibly more professional but also more geographically and mentally distant administrative bodies.

Public administration literature addresses another category of organisation, which may warrant meaningful discussion. Administrative bodies may differentiate by the scope of functions they provide. Monofunctional bodies have a narrow set of functions within one policy, while multifunctional authorities bundle a diverse set of functions for a given territory. Both models come with a long list of pros and cons (Kuhlmann et al. 2011, p. 24 ff.; Ebinger 2013): Monofunctional bodies specialise in one certain function, with a highly specialised staff and clear goals. In contrast, multifunctional authorities bundle capacities, generate economies of scale, and implement a broad range of often conflicting public services in a territory (Egeberg 2007, p. 117). Although there is an indication of higher performance by monofunctional authorities (Egeberg 1999, p. 162 ff.), both models can be counter-effective, as well. Monofunctional authorities might overstress their own policies, escalate conflict and carry higher risks of “capturing” by interest groups. Multifunctional authorities might end up lacking capacities and heterogeneous implementation across different territories. Finally, this organisational dyad refers to the question of whether functional or territorial specialisation is more relevant.

Reviewing the 18 country cases at hand, we found not one performing monofunctional supervisory authority. Therefore, due to methodological reasons, we were unable to analyse this category.

A third type of indicator considers choices in the integration or the entrustment of special stakeholders in the administration of local budget supervision:

4. Audit courts: Independent auditing bodies are often associated with a professional and very assertive task execution, which focuses primarily on fiscal accountability issues.
5. Higher local government tiers: A dominate role by local governments in supervision duties might be associated with a higher customer orientation and local knowledge but might also incur bias towards and agency capture by the local governments supervised. Of course, local government tiers are decentralised organisation, as mentioned in (2). Nonetheless, their local-level character makes this organisational structure special.

Our analysis will show whether and in which ways interrelations exist. We cannot test for effects of these configurations. While not making claims for causality, results might inspire a conceptual discussion of regime elements in organisational design. Therefore, this mapping can be a source of information for practitioners. From an academic point of view, results might serve as a starting point for deepening research into the causes and impacts of organisational choice.

2.2 Methodological Approach

The unit of analysis is the institutional settings in 18 European countries. For each of the structural characteristics introduced in the previous paragraph, we outline where the respective country stands on four established fiscal indicators for local budgets. Each of those five categories shows two values. We dichotomise the sample of 18 country cases and visually crosstab the binominal output (country groups) for each category and for each of the four fiscal indicators in separates graphs. To balance the misleading impact of temporary variation, we use the average value of the 8 years, 2011 to 2018. We do not claim for direct statistical effects, so we do not stress on statistical values, such as means and variance, but look for obvious country group differences.

The budget-related indicators are the following[3]:

- Local Government Aggregate Expenditures as Share of General Government Expenditures

[3]The data source for the displayed indicators is the Eurostat Annual Summary Government Finance Statistics. The authors give special thanks to Christian Raffer for providing those data and to Moritz Schmid for supporting the graphic representation.

This indicator demonstrates the general importance of the local level and hence political relevance of local spending and budget health.

- Local Government Aggregate Transfers as Share of Total Local Government Revenue.

  This indicator shows the sources of local government revenues. Are they transferred predominantly by the state, or can local governments draw on a significant share of own taxes?

- Local Government Aggregate Debt as Share of General Government Debt

  This indicator shows the overall weight of local government debt within state budget and debt.

- Local Government Budget Balance in Aggregate Terms as Share of National GDP

  This indicator shows the difference between the local government's revenues and its expenditures, expressed as a ratio of gross domestic product (GDP) to show the aggregate ability of local governments to meet their financial needs. A positive balance indicates a surplus, a negative a deficit.

We must note, however, that one cannot take these budget indicators as straightforward performance measures of the oversight system. This also holds true for the budget balance indicator or local debt share, which usually are at the heart of fiscal regulation (see the Chapter "Budget Institutions for Subnational Fiscal Discipline: Local Fiscal Rules in Post-Crisis EU Countries" in this volume). Nevertheless, strong differences between the country groups per category can indicate whether some organisational structures meet the challenge of supervision in a more appropriate way than other ones. Local government expenditure and local government transfer are no indicators for fiscal performance, but both reflect the fiscal relevance of local governments within a given state and local levels' fiscal autonomy. These are relevant framework conditions for fiscal regulation, which might reflect its organisational structure.

3 Analysis

As the number of cases is low ($n = 18$) and the coding of regime characteristics is necessarily rather crude, we do not propose elaborate quantitative analyses but present visualisations to provide a first, exploratory mapping of the regime/budget relations.

3.1 Task Ownership

We argued above that task ownership of local government fiscal regulation at the ministerial level might relate to selected budget indicators. We argued that

ownership should express itself in a departmental specificity in prioritising, organising and executing fulfilment. In our case, ownership is mostly either allocated to the ministry of finance or the ministry of the interior. The finance department is almost exclusively concerned with budgetary affairs and the fiscal health of public budgets, and the Ministry of the Interior is often responsible for local government affairs and numerous policy programs of more specialised branches of government, too. Our analysis will reveal if maintaining budgetary discipline is on average more difficult for administrations subordinated to a Ministry of the Interior.

In 7 out of 15 countries, regulatory responsibility is located in the sphere of the Ministry of Finance (BG, CZ, ES, HU, IT, PT, SI), and in 8 countries, the Ministry of the Interior is responsible (AT, DE, DK, EE, EL, FI, IE, NL). Belgium, France and Poland are excluded from this analysis because their systems could not be assigned clearly to one of the two ownership models due to federal diversity, double affiliation or ownership by a third, non-affiliated entity (see Geissler et al. 2019).

Figure 1 shows the empirics of this category for each of the four fiscal indicators. Data points in the upper row represent countries with Ministries of the Interior in charge of fiscal regulation; the lower row of points shows countries with Ministries of Finance. This analysis on political ownership reveals noteworthy results. First,

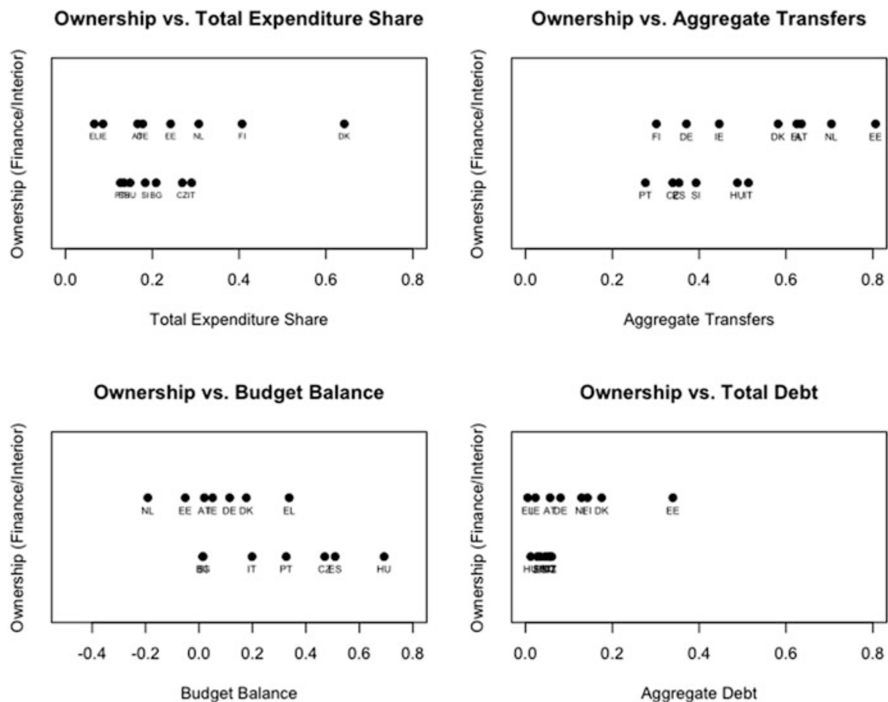

Fig. 1 Ownership of policy related to key budget figures. Key: Lower line, Ministry of Finance; upper line, Ministry of the Interior. Source: own. Regime data and fiscal indicators taken from Geissler et al. (2019)

there is an overlap between the two groups in our sample: most cases are in the same range of each fiscal indicator for both groups. However, there are distinct cumulative patterns, depending on the political ownership of the groups. Across all local-budget indicators, variation is significantly higher within the group of countries in which the Ministry of the Interior is responsible for local government fiscal supervision. This increased variation is a consistent pattern and does not attribute to individual outliers.

There is higher variation in local governments' share of total expenditures in the set of countries in which Ministries of the Interior organise local fiscal regulation. They receive on average a much higher share of transfers than their peers under the supervision of Ministries of Finance do. Their average distance to a balanced budget is lower. However, in considerably more states with regulatory systems controlled by Ministries of the Interior, local governments carry a relatively higher share of public debt. In a nutshell, Ministry of the Interior-driven systems are more heterogeneous in their overall importance within the state (measured by expenditure share), are more likely to depend on high levels of state transfers, are less likely to generate high surpluses and carry on average a much higher share of public debt.

3.2 Administrative Structures: (De-)Centralisation and (De-) Concentration

As argued above, we expect – in accordance with public administration literature – bureaucratic structures to influence task implementation and performance. The two most basic variations in administrative setups are the degree of decentralisation and deconcentration.

(De-)centralisation describes on which level the operative core of fiscal oversight rests. We only differentiate between the national level (centralised) and a subnational level (decentralised) (cf. Mayntz 1997, p. 90ff.). The latter also covers states in federal countries, as well as higher local administrations entrusted with supervision. Centralised units are closest to their superordinate ministry and the most separated from stakeholders or customers (in our case local governments). Strong binds with the ministerial apparatus could ensure a good standing and high political support but also lead to high functional politicisation and regular interference. Due to economies of scale, one can expect strong expertise and professionalism.[4]

Ten out of 18 cases are defined as centralised systems located at the national level of government (BG, DK, EE, ES, FI, EL, IE, PL, PT, SI), and eight locate on the subnational level (AT, BE, CZ, DE, FR, HU, IT, NL). Figure 2 shows that both centralised and decentralised supervisory bodies exist among the "standard" local

[4]We cannot make such strong assumptions for the decentralised units in our sample, as this subsample is heavily diverse. It also includes systems in federal states, which might characterize as highly centralised.

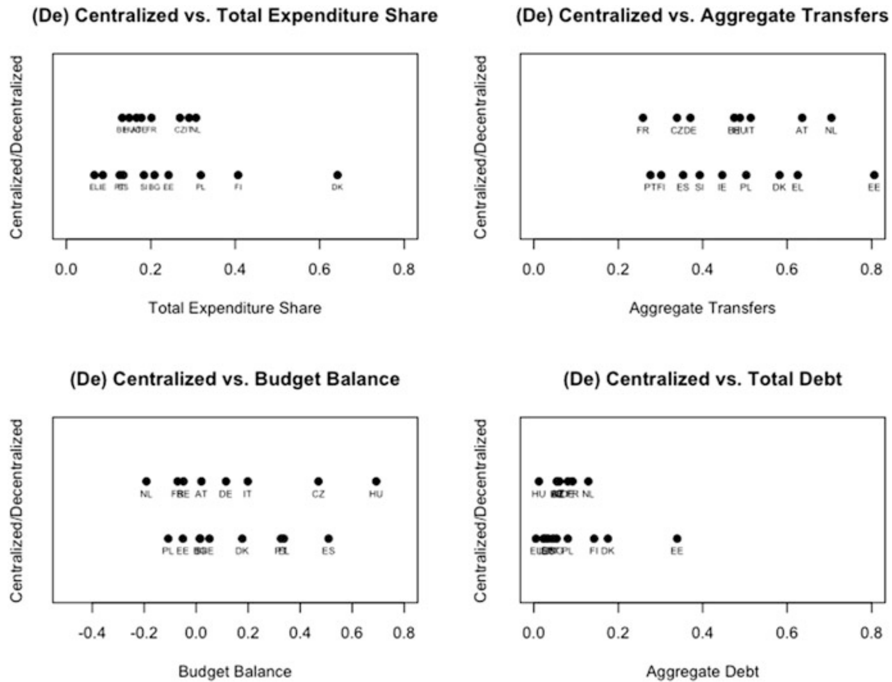

Fig. 2 (De-)centralisation related to key budget figures. Key: Upper line, decentralised task allocation; lower line, centralised task allocation. Source: Own. Regime data and fiscal indicators taken from Geissler et al. (2019)

government systems, which administer between 10 and 30% of total public spending. Outliers below (EL, IE) or above (DK, FI) this range are among the countries with centralised supervisory systems. One can observe no visually obvious relation between the share of transfers in local government budgets and the budget balance of local governments. Only centralised systems show outliers in relation to total local government debt. In all, there is no obvious link of this organisational category to fiscal data.

(De-)concentration describes how supervision structures at the responsible level of government. This usually includes whether regionalised branches of central government execute supervision or a concentrated administrative unit. Concentrated units might be more efficient and achieve higher goals based on easier communication, coordination and control. Regionalised services are commonly associated with a higher proximity to clients and an elevated knowledge of the local situation. However, as with decentralisation, one must admit that deconcentration can take many forms and be implemented to various degrees, depending on the country's size, population and urban structure. Ten out of 18 cases are defined as concentrated systems (BE, BG, CZ, DK, EE, FI, IE, NL, PT, SI, lower row, Fig. 3), and eight are labelled as deconcentrated (AT, DE, EL, ES, FR, HU, IT, PL, upper row, Fig. 3).

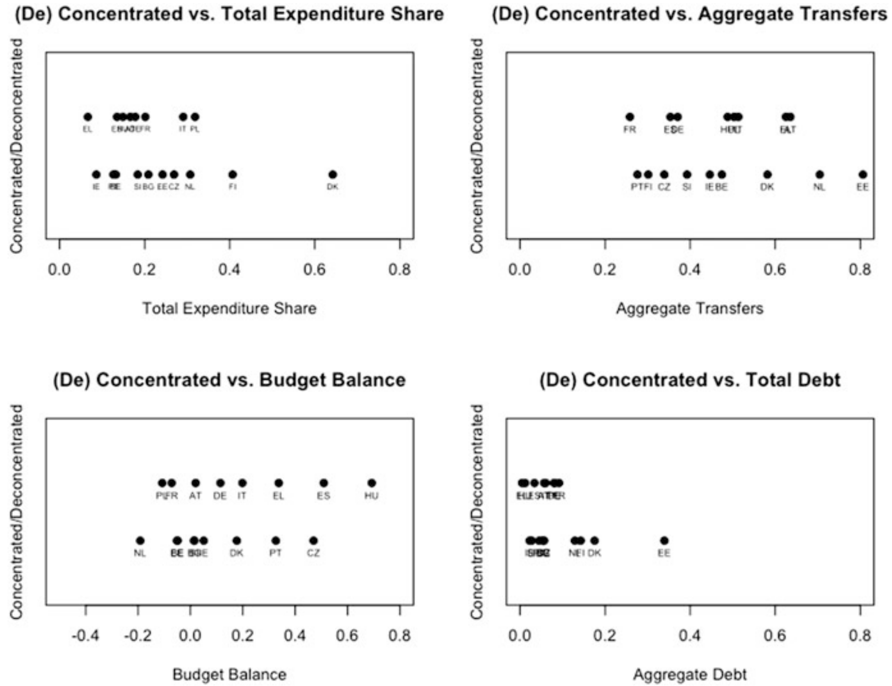

Fig. 3 (De-)concentration related to key budget figures. Key: Upper line, deconcentrated task allocation; lower line, concentrated task allocation. Source: own. Regime data and fiscal indicators taken from Geissler et al. (2019)

Figure 3 indicates that systems with concentrated and deconcentrated supervision do not differ substantially concerning the local share in public expenditures (apart from the outliers FI and DK) and the share of transfers in their local budgets (with NL and EE on the upper extreme). While we do not detect any meaningful difference from the graph on budget balance, the local share in total debt is considerably higher in systems with concentrated fiscal supervision structures. The visual result from each fiscal indicator is quite similar to the one above (central/decentral). Nevertheless, an in-depth look at the structure of country groups shows significant differences, highlighting that both categories are not identical in meaning.[5]

[5]While analytically clear-cut, the concepts of *decentralisation* and *deconcentration* might be functionally overlapping. For example, in the Dutch case, supervision is administered decentrally by the 17 provinces but executed on that level by 1 concentrated office per province. Nevertheless, the “who” and “how” dimensions should not be intermingled analytically.

3.3 Special Stakeholders in Fiscal Supervision

As outlined above, the entrustment of special stakeholders in the administration of local budget supervision might have effects on knowledge, on interaction and on the diligence of the supervisory process.

Audit courts or similar independent organisations at the national or regional level are a common way to increase independence and expertise in local government fiscal supervision. While we are explicitly not interested in external auditing, in some cases, audit courts are (also) responsible for the entire supervision; in other systems, they are complementary organisations for special cases only. Our data show that audit courts play a significant role in 6 out of 18 countries studied (AT, EE, FR, IT, PL, PT, upper row, Fig. 4). Figure 4 shows that among local governments in systems without audit court participation, the share of public spending is somewhat more diffuse. The opposite is true for the share of transfers from the state level. At the same time, local systems supervised by audit courts show on average more balanced budgets (less outliers both in negative as well as positive terms) and show much less

Fig. 4 Audit court participation related to key budget figures. Key: Upper line, audit court participation; lower line, no audit court participation. Source: own. Regime data and fiscal indicators taken from Geissler et al. (2019)

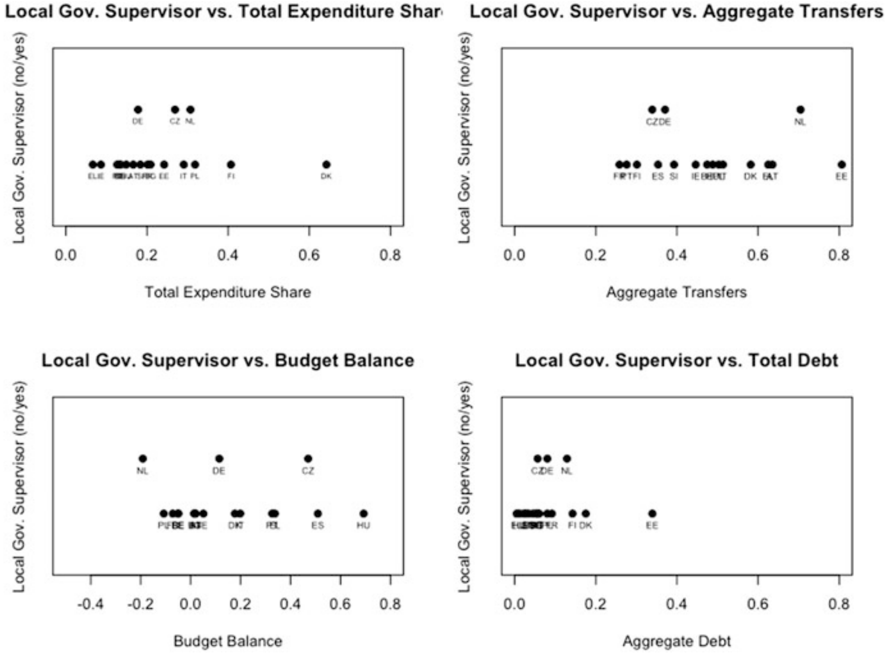

Fig. 5 Local government involvement in supervision related to key budget figures. Key: Lower line, no local level involvement; upper line, local level involvement. Source: own. Regime data and fiscal indicators taken from Geissler et al. (2019)

variation in the share of total public debt. However, public debt is not per se lower in systems with audit court participation. In all, the picture is rather incoherent.

In several states, higher local government levels or local government associations are entrusted with a supervisory role. As outlined above, this could result in an increased distance between the responsible ministerial department and the supervisory unit and influence the knowledge, modes of interaction and the diligence of the supervisory process, too. Local governments commissioned during fiscal supervision by way of administrative decentralisation are led by (boards of) elected politicians. Consequently, one can expect them to develop an explicitly responsive attitude and high functional politicisation and therefore suffer more often from political interference and possess less executive autonomy than units in different administrative structures. Furthermore, supervisors in these units possess low managerial autonomy and low professionalism due to their subordinate position in the apparatus.[6] In our sample, only three states include higher local government levels or associations in the supervisory system (CZ, DE, NL, top row in Fig. 5).

[6]An in-depth analysis of the German case supports the thesis of politicisation as shortcomings in steering by the respective ministry (Ebinger et al. 2017).

Figure 5 depicts the countries with corresponding local government systems within a small range in terms of share in total public expenditures. This does not clearly show the share of transfers and budget balance, since the three cases with local government participation cover an extremely wide range. Concerning total debt, local government participation does not seem to have a strong effect, either. However, given the smallness of this country group, we should not overstress this observation.

4 Discussion and Conclusion

Despite its proven impact, the organisational structure of public service provision remains a side story in public administration research (Egeberg 2007). While there is a small but enlightening body of research, which studies the effects of bureaucratic structures on organisational performance and substantial evidence drawn from studies on agencification and regulatory bodies, there is still a considerable lack of understanding on explanatory factors and the underlying mechanisms. The financial supervision of local governments is a prime example of this research gap. While this regulatory branch traditionally exists in most countries and has a high impact on local governments and states alike, hardly any robust comparative research on its structuring is available so far. This article takes a first step by identifying five organisational dimensions in which the 18 surveyed European countries vary significantly: task ownership, decentralisation and deconcentration of task execution, audit court participation and, finally, a supervisory role of higher local government levels or associations.

The mapping of the organisational dimensions shows first the condition of heterogeneous supervisory structures in these countries, against all theoretical expectations (DiMaggio and Powell 1983). It discloses organisational options and its distribution among countries. Obviously, in the field of local public finance regulation, some options are more likely than others. History has perhaps proven some options as less suited or shown that additional factors (e.g. constitutional status, allocation of functions, types of local level system) promote and constrain specific options.

Second, as we matched these five organisational dimensions with four eminent fiscal indicators in a cross-national comparative design, the data gave some visual indications that fiscal performance might correlate with distinct forms of organising fiscal supervision. In addition, it might hint – with much precaution – at the fact that in some organisational structures, balanced budgets are more difficult to achieve or maintain than in others.

We found instructive clusters of countries for "task ownership", the "involvement of audit courts" and "higher local levels". Regulatory systems under Ministries of the Interior show higher variations in all fiscal indicators and are more heterogeneous in fiscal importance and performance (measured by share in total spending and budget balance). Special actor involvement goes along with smaller ranges of fiscal

indicators and lower values. In comparison, we do not see clear dimensions of central/decentral and concentrated/deconcentrated structures. Drawing on this study, we can see first indications of regime clusters. One can claim that fiscal supervision of local governments benefits by task ownership by the Ministry of Finance and the involvement of audit courts.

Summing up, this very first and explorative approach provides insightful results on the systematic effects of bureaucratic structures, despite the methodological limitations. Of course, there are many more factors to be considered in explaining bureaucratic task implementation. As samples are small, consolidated findings on the impact of varying structures scarce and the underlying mechanisms unknown, the presented approach can only uncover systematic internal properties of certain organisational types in an explorative way. These results can help practitioners at the respective government levels to reconsider or evaluate given bureaucratic structures and become aware of the typical pros and cons. On the academic side, we contribute to the valuable discussion on the effects of structural configurations and regime elements and provide starting points for more analytically oriented studies on the effective implementation of fiscal regulation and the interplay of structures, processes and institutions at large.

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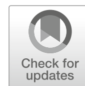
European Patterns of Local Government Fiscal Regulation



Christian Raffer and Andrés Ponce

Abstract European countries employ heterogeneous and complex systems to regulate local government budgets. Although the topic has become increasingly relevant in the face of past and future economic and budgetary crises, there is a lack of cross-country studies in this field, due in part to the institutional complexity of financial regulatory systems. With the help of extensive case study data processed with quantitative comparative analysis, we conduct a classification study which suggests a new way to analyse the commonalities in fiscal supervision structures, supervision routines and numerical fiscal rules in 21 European countries. In addition, we derive an aggregate index of regulatory strength. This allows us to identify a European north-southeast divide with looser regulatory regimes in the north. Such a pattern fits with existing theories of state traditions and might serve as useful heuristic for future debates about local government fiscal regulation.

1 Introduction

Fiscal federalism is a major trend in European multilevel governance (Eyraud and Badia 2013). Seminal works by Charles Tiebout (1956) and Wallace E. Oates (1972) have acknowledged that local service provision better matches residents' preferences. However, one inherent risk of decentralisation and the related fiscal federalism is that revenue decentralisation does not match expenditure decentralisation. Inadequate financial means then may cause permanent borrowing and jeopardise fiscal sustainability (OECD/KIPF 2016; Corbacho and Ter-Minassian 2013). This is aggravated by the deficit bias, which describes a government's adverse incentive to overspend, undertax or excessively borrow and at the local level is commonly

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associated with the presence of soft budget constraints (Kotia and Lledó 2016; Wyplosz 2013; Kornay et al. 2003).

As general insight, fiscal federalism has made local governments a critical factor for general government fiscal stability (Council Directive 2011/85/EU). At the same time, it reduces central governments' direct control over public finances, since in most countries local government accounts are not part of the central government budget system (Bartlini et al. 2018; Boex and Kelly 2013). That is why the so-called second-generation theories of fiscal federalism put forth approaches to restore this control (Oates 2005). Here, regulatory regimes come into play. In general, they consist of four central dimensions: the responsible regulatory body (1) that implements fiscal rules (2), monitors local budgets (3) and enforces rule adherence (4) if necessary (see Geissler and Wegrich (2021) in this book).

Extensive case study work shows that EU countries usually employ quite elaborate heterogeneous systems of local government fiscal regulation (Geissler et al. 2019; Dafflon 2002). This complexity may be one reason for the scarcity of comparative studies in this field (Stocker 2010). In this chapter, we propose a new perspective on the topic by grouping European countries according to commonalities in their local fiscal regulatory regimes.[1] This inductive approach to classification narrows down the described complexity (Lidström 1998), provides a potential narrative for future research and is meant as heuristic device for describing key characteristics of these political-administrative institutions (Hendricks et al. 2011). Our work builds upon existing classification literature in comparative local governance research (e.g. Swianiewicz 2014; Hesse and Sharpe 1991; Page and Goldsmith 1987) and follows Wolman's (2008) criteria for good classification schemes (see Annex). We contribute to this literature by focusing on fiscal regulatory regimes in Europe.

Based on the case studies published in 2019 by Geissler, Hammerschmid and Raffer, we collected information on three of the four main dimensions of fiscal regulatory regimes in 21 European countries.[2] Country groups are identified through qualitative comparative analysis (QCA). Whenever possible, we evaluate regulatory strength in each dimension and additionally propose an aggregate index depicting the combined strength for the two dimensions 'fiscal rules' and 'supervision'. Our core finding is a European north-southeast divide in regulatory strength. Whereas the European north is characterised by a low number of fiscal rules and relatively weak supervision, we observe a higher number of fiscal rules and stricter monitoring in the south and southeast of Europe.

This chapter is structured as follows: Part 2 provides an overview of the literature on local government classification and the existing cross-country research on local government fiscal regulation. In Part 3, we explain the dataset and our method before we present our results in Part 4. In Part 5, we discuss the findings and draw some conclusions.

[1] Since data for this classification study (see Geissler et al. (2019)) consists of information about the European municipalities, we refer primarily to municipalities when we speak of local government.

[2] Due to their high variety, we do not consider enforcement measures.

2 Literature

Literature with country classifications based on local government characteristics has a long-standing tradition. An early contribution was made by Shaw in 1895, and ever since the field has grown extensively. Many classification schemes consider central-local relationships and local government autonomy as key dimensions (Batley and Stoker 1991).

A seminal classification study was published by Page and Goldsmith (1987). They analysed commonalities among Western European countries with regard to central-local relationships alongside the three dimensions: functional decentralisation, local discretion in service execution/resource allocation (covering legal rules and control of local revenue) and local politicians' access to the central state. Whereas Northern European countries were characterised by high discretion and a large set of local services, Southern European countries showed opposite characteristics. Page (1991) and John (2001) identified a similar north-south divide. Among other dimensions, Norton (1994) considered the constitutional position of local government, formal powers and different forms of control and distinguished three European systems of local government: the South European (France, Italy), the North European (Sweden, Denmark) and a British group. Hesse and Sharpe (1991) similarly differentiate three groups of countries regarding vertical power relations between municipalities and upper-level governments: a Franco group (France, Italy, Belgium, Spain, Portugal, Greece), an Anglo group (the UK, Ireland) and a North/Middle European group (Nordic countries, the Netherlands and Germany; following Heinelt and Hlepas (2006), Austria and Switzerland can also be added). With a broader lens on local democracy in Europe, Loughlin et al. (2011) expand the list and propose four European traditions: Germanic, French, Anglo-Saxon, and Scandinavian.

Swianiewicz (2014) builds a classification system that incorporates tax autonomy, shape of the grant system and local government debt over GDP into a local government typology with an exclusive focus on Eastern European countries. He identifies five types of countries, some of which are relevant to our sample. These include Type I (Hungary, Poland, Slovakia), Type II (Czechia, Estonia, Latvia) and Type III (Bulgaria, etc.). Although those types are not easily attachable to the above-mentioned north-south division, in terms of political culture, they tend to be more similar to the European south than to the north.

These country classifications provide the following first insights: (1) the dimension of local government discretion plays a substantive role in many classification systems and is often operationalised in terms of financial autonomy, (2) the groups of countries vary depending on the chosen set of dimensions, and (3) there seems to be a point to differentiating Southern European and Northern European/Anglo-Saxon local government systems in a broad sense. At the same time, a similar distinction is not as easy for new democracies in Eastern Europe. This already points to a first working hypothesis: when grouping countries following their systems of local government fiscal regulation, a north-south distinction among European countries

Fig. 1 The maps depict local government financial autonomy based on respective sub-indices calculated by Ladner et al. (2016), Sellers and Lidström (2007) and Heinelt and Hlepas (2006). The darker a country, the less financial autonomy local governments have (own figure)

with weaker regulation in the north can be expected. Moreover, Eastern European countries tend to resemble the south more than the north of Europe. Existing research from neighbouring fields provides initial support for this hypothesis (see Fig. 1). In their classification study on the strength of municipal mayors, Heinelt and Hlepas (2006) analysed data for 17 European countries. Their sub-index on the municipal position in vertical power relations aggregates information on the degree of locally provided services, financial autonomy and relevance in terms of the amount of local expenditure. With reference to this sub-index, they conclude that the three country groups proposed by Hesse and Sharpe (1991)—North- and Middle European, Anglo, Franco—have ample explanatory power. The right map in Fig. 1 provides the sub-index results for all 17 countries: the darker a country, the weaker the position of local governments in relation to higher-level governments.

Sellers and Lidström (2007) propose a similar sub-index on fiscal supervision in their classification study on decentralisation. They analyse secondary data from 21 countries for the years around the turn of the millennium. This sub-index combines information on intergovernmental grants as a proportion of local government revenues, the OECD local tax autonomy indicator and requirements of hierarchical approval or other conditions local governments must follow in order to borrow. The middle map in Fig. 1 depicts their analysis of 15 EU countries in their sample plus Switzerland. Darker shading denotes stricter fiscal supervision in that country.

The work of Ladner et al. (2016) on a local autonomy index (LAI) is the basis for the left map in Fig. 1. It depicts a rank of 28 European countries and Switzerland and is based on the sum of the three LAI sub-indicators fiscal autonomy (freedom to decide over taxation), borrowing autonomy (freedom to decide over taking out loans) and administrative supervision based on data for the year 2014.

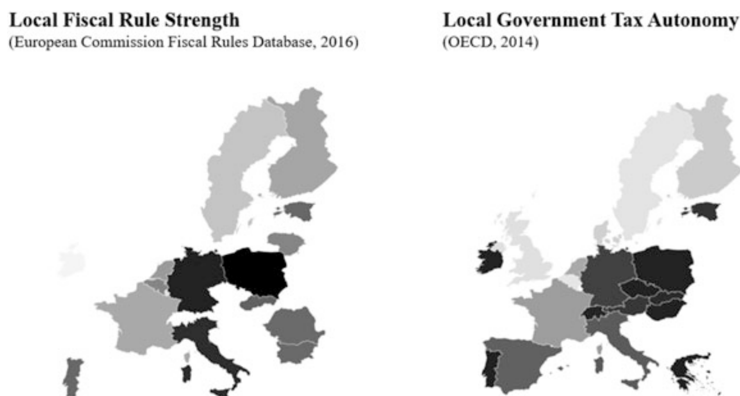

Fig. 2 The left image depicts Local Fiscal Rule Strength for 2016 based on the European Commission's Fiscal Rules Database. The map includes the average rule strength for all countries for which the database contains a fiscal rule in 2016 that applies to local governments. The darker a country, the stronger the fiscal rules were on average. The right image depicts local government tax autonomy for 2014 based on the OECD tax autonomy database. The map includes all European countries in the database and shows the share of tax revenues for which local governments can set tax rates without any restriction (sum of the index dimensions a1 and b1). Darker shaded countries denote a smaller share of tax revenues for which local governments can set the tax rate (own figure)

In sum, Fig. 1 provides evidence for a north-south pattern of local government discretion, albeit with some clear deviations such as Ireland. The highest levels of discretion exist in Finland, Sweden, Germany, Austria and Switzerland. Compared to that, countries of the Napoleonic state tradition (Portugal, Spain, France, Italy, Greece, Belgium) experience less financial autonomy at the local level. This seems also true for Anglo countries with particularly strong financial restrictions in Ireland. Taking the new EU member states into account, Eastern European countries also experience higher degrees of financial restrictions similar to Southern Europe. None of the three studies, however, focuses exclusively on fiscal regulatory regimes.

Also the European Commission's Fiscal Rules Database and the OECD Tax Autonomy Indicator can be used for country classification (Fig. 2). Both may be seen as approximations of local government financial autonomy. The Fiscal Rules Database (European Commission 2020) provides information about the quality of fiscal rule implementation at all levels of government. Information is aggregated to one fiscal rules strength index, which—in its components—is close to our notion of regulatory regimes. The left map in Fig. 2 shows all countries for which the database contains a fiscal rule in the year 2016 that explicitly applies to the local government level. The darker a country, the stricter the average implementation of all fiscal rules imposed on local governments was in 2016. The OECD Tax Autonomy Indicator (OECD 2020) comprises information about the freedom sub-central governments (regional/state and local) have in their decisions upon taxation.[3] The right map

[3]For detailed information, see Annex 1 of Trasberg et al. (2021) in this book.

shows all European countries for which the OECD provides a distinct local government tax autonomy index for the year 2014. Darker shading indicates a smaller share of total local tax revenues over which local governments had full discretion in setting tax rates. Both maps in Fig. 2, again, support the notion of a north-south or north-southeast divide, with Ireland again being an outlier in terms of tax autonomy.

A related stream of research relies on collections of country reports outlining local government fiscal regulation. Dafflon (2002), for example, edited a collection of reports about local budget and borrowing restrictions in Austria, Belgium, Denmark, France, Germany, Italy, Norway, Switzerland, Spain and England. The book, however, does not provide a structured comparison and justifies this with the high complexity of respective systems (Rattsbø 2002). In a similar way, Liu (2013) analyses subnational debt and insolvency, Von Hagen et al. (2000) subnational bailouts and Moreno (2012) legal characteristics of 27 European local governments which contain regulatory elements.

Moreover, there is a growing body of empirical studies about the effectiveness of local fiscal rules from an international perspective which provides interesting insights into the interplay of fiscal/institutional conditions and rule effectiveness (see Turley et al. (2021) in this book). One important result is the relevance of implementation strength (which basically is the quality of the existing regulatory regime) for fiscal outcomes like budget deficits (Kotia and Lledó 2016).

In the following parts of this chapter, we add our approach to European country classification with a focus exclusively on local government fiscal regulation. We start by describing our method and data.

3 Method and Data

We apply qualitative comparative analysis (QCA) to analyse local government fiscal regulation. This method allows for modelling key characteristics of regulatory systems in terms of set relations (Schneider and Wagemann 2012: 1–8). We aim to exploit the inherent characteristics of QCA, that is, to generate variables based on theoretically grounded arguments and conduct logical operations in order to unravel plausible patterns across countries.

The set relations approach assigns set membership scores which yield condition variables. In assigning set membership to a country (calibration), we use both theoretical knowledge and empirical information. The most well-known forms of QCA are crisp sets (csQCA) and fuzzy sets (fsQCA) (Schneider and Wagemann 2012). In our analysis we use crisp sets, which stands for a dichotomous operation where units (in our case countries) are either members (1) or non-members (0) with respect to a specific condition, such as the existence of a given numerical fiscal rule implemented at the local government level. The advantage is a clear difference between cases.

The dataset for this chapter provides information about local level fiscal regulation in 21 European countries (see Annex). We compiled it by using the extensive case study work on local government finances in Europe conducted by the German

Bertelsmann Foundation and the Hertie School in Berlin (published as Geissler et al. 2019). This source provides a systematic overview of local fiscal regulation, fiscal rules, procedures of monitoring and enforcement mechanisms for each country in the sample. By highlighting country scrutiny as the basis of this work, we ensure the consistency of the calibration strategy.

In a first step, we compiled conditions which describe the form of each country's regulatory system. We focus on baseline conditions covering the following three regulatory elements: fiscal rules (balanced budget rule, debt rule, expenditure rule),[4] supervisory body (government level responsible for supervision: central or non-central) and supervision mechanism (budget and debt monitoring: ex ante or ex post). Patterns arising from these baseline conditions are analysed in the results of Part 4. We do not consider means of enforcement due to its high variety.

In a second step, we transformed the conditions on fiscal rules and supervision mechanism to compile a strength variable for each. For fiscal rules strength, we simply counted the number of fiscal rules in each country (1 to 3) and assumed that regulatory strength is higher in countries with more fiscal rules (for the details, see Annex). With regard to supervision mechanism, we assumed that no supervision is the weakest form, ex ante supervision of the local budget is stricter than ex post supervision, and both are weaker than a combination of ex ante and ex post supervision. Since in all countries with ex post supervision there is also ex ante supervision, we again assign values from 1 to 3. Finally, the two strength indices are aggregated in order to generate an overarching 'regulatory strength index'. The higher the resulting regulatory strength index value is, the stricter we assume the regulatory system to be (we differentiate low, moderate and high strength). For example, a country which imposes one fiscal rule (e.g. an expenditure rule) on local governments and does not check rule adherence at all (neither ex ante nor ex post) would end up with an index value of 1 and is assumed to have a low strength regulatory system. In contrast, a country that imposes three fiscal rules on local governments and checks adherence before and after the budget is implemented would receive an index value of 6. In this case, we would assume high regulatory strength. Finally, we use the index values to analyse spatial patterns. We do not include the level of supervision into the overarching strength index because it is country specific whether local or central-level supervision is stricter.

4 Results

In this section, we present the results of our analysis of local government fiscal regulation for the 21 European countries in our data sample. Each subsection includes a description of the data and a map visualizing the data. We start by

[4]There exist no revenue rules in the sample of countries. Debt rules primarily cover rules which limit the amount of debts.

analysing the number of fiscal rules which exist in each country. Second, we look at supervision, describing whether the local level is essentially supervised by central or decentral authorities. Thirdly, we evaluate the configuration of local supervision and discuss common features. Lastly, we analyse the overall strength of the regulatory system.

Fiscal Rules Six countries coloured in light grey share the existence of only one numerical fiscal rule imposed on local governments (Fig. 3, Table 1). Most of them have a balanced budget rule. In addition, 12 countries coloured in dark grey share the existence of two fiscal rules for the local level, whereby most of them have a combination of a balanced budget and a debt rule in place. In this group Italy stands out by having both a balanced budget and an expenditure rule. The three countries coloured in black—Bulgaria, Denmark and Spain—share the existence of all three rules in place for the local level. Although the picture is mixed, there is in general more than one fiscal rule in place in the region of Eastern Europe. Two out of the three countries with three fiscal rules in place are in the south.

Supervisory Body Assessing the institutional location of the supervisory body reveals a group of nine countries in black (Fig. 4, Table 2) clustered mostly in Central Europe, which share a decentralised system of local government fiscal supervision. For federal countries this means that supervision is fully or partially

Fig. 3 Number of fiscal rules in place for the local level in 21 European countries (For detailed information about the types of fiscal rules in each country, see Annex)

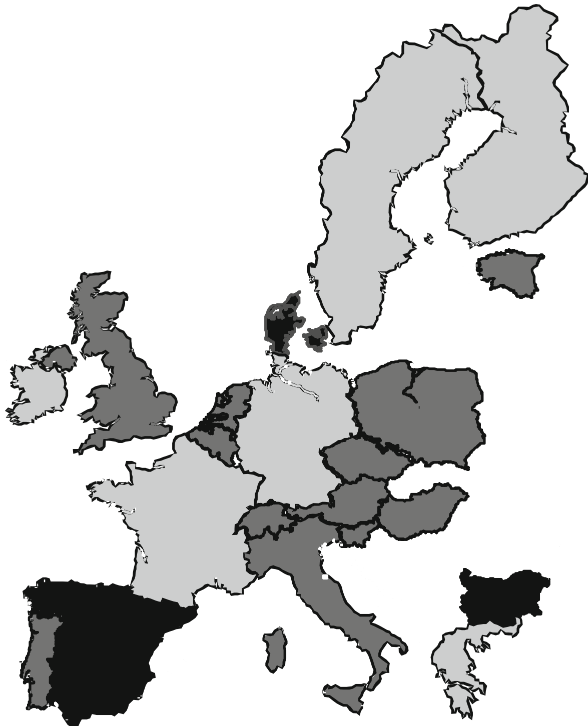

Table 1 Number of fiscal rules in place for 21 European countries

Code	Cases	Number of fiscal rules	Countries
1 (map: light grey)	6	1	DE, EL, FI, FR, IE, SE
2 (map: dark grey)	12	2	AT, BE, CH, CZ, EE, IT, PL, PT, UK, HU, NL, SL
3 (map: black)	3	3	BG, DK, ES

Note*:* The number of fiscal rules corresponds to the existence of either a balanced budget, debt and or expenditure rule

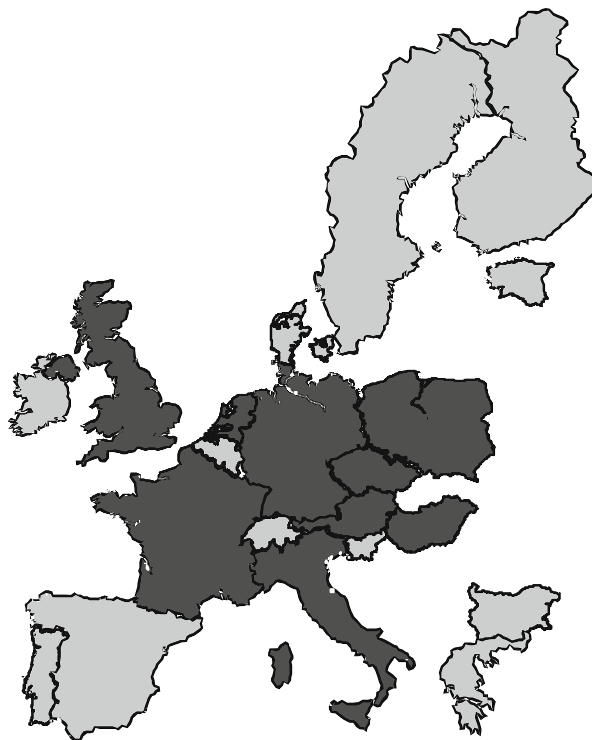

Fig. 4 Central vs. decentral fiscal supervision in the 21 European countries

Table 2 Type of supervisory body, central or decentralised

Code	Cases	Supervisory body	Countries
1 (map: light grey)	12	Central	BE, BG, DK, EE, EL, FI, IE, PT, SE, SL, ES, CH
2 (map: dark grey)	9	Decentral	AT, CZ, DE, FR, HU, IT, NL, PL, UK

Note: If supervision in federal countries is concentrated on the national or state level, a country is considered centrally supervised; if supervision is conducted below the state level (e.g. district), it is assumed as decentrally supervised. In Austria, for example, districts as the lower level of state administration and supervision approve loans (Geissler et al. 2019). In Germany, the lowest possible supervisory body is located at county level

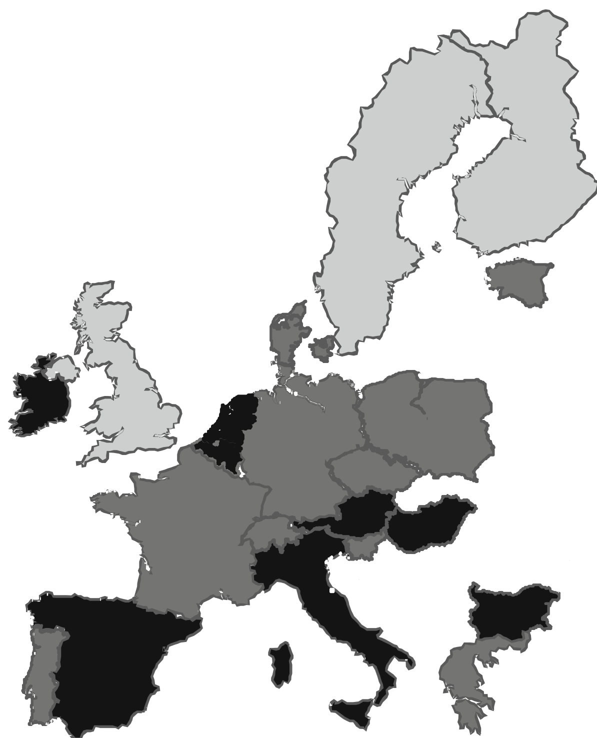

Fig. 5 Timing of supervision (ex ante, ex post) for the 21 European countries

Table 3 Timing of Supervision: none; ex-ante; ex-post; both

Code	Cases	Supervision mechanism	Countries
1 (map: light grey)	3	None	FI, SE, UK
2 (map: dark grey)	10	Ex-ante	CZ, DE, DK, EE, EL, FR, PL, PT, SL, CH
3 (map: black)	8	Ex-post	AT, BE, BG, HU, IE, IT, NL, ES

located even below the regional level. In contrast, in a group of 12 countries scattered across Europe coloured in light grey, supervision is concentrated at the central level or for federal countries at the regional level.

Supervision Mechanism Our analysis of the timing of supervision shows a clear pattern (light grey) of countries located in the northern regions of Europe in which local government budgets are supervised neither ex ante nor ex post (Fig. 5, Table 3).[5] In addition, Estonia, Portugal, Greece and most countries in Central Europe, coloured in dark grey, share the existence of only ex ante supervision. While the group of countries coloured in black, mostly gathering in the south or

[5]As ex ante supervision, we assume the supervision of the budget plan or some form of credit permission. Ex post supervision is the supervision of the budget report or the budget execution.

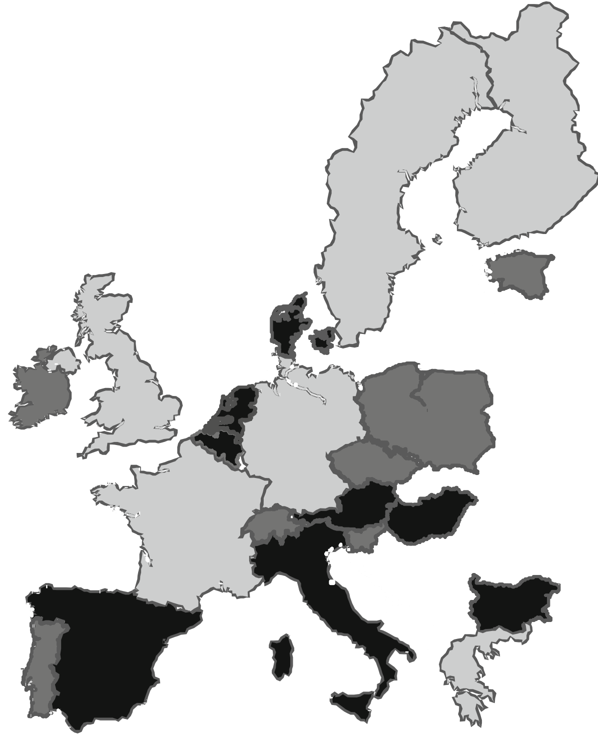

Fig. 6 Regulatory strength in 21 European countries

Table 4 Regulatory strength

Code	Cases	Regulatory strength	Countries
1 (map: light grey)	6	Low	FI, SE, DE, EL, FR, UK
2 (map: dark grey)	7	Moderate	CZ, EE, IE, PL, PT, SL, CH
3 (map: black)	8	High	BE, AT, DK, IT, BG, HU, ES, NL

southeast, has implemented both ex ante and ex post supervision. Obvious exemptions are Ireland, Belgium and the Netherlands.

Overall Regulatory Strength The analysis of regulatory strength reveals that countries in the European north and centre impose rather weak forms of regulatory systems on local governments (Fig. 6, Table 4). These countries have, in general, only one fiscal rule in place and have either only ex ante or no supervision. Countries in dark grey show a moderate level of fiscal regulation. This group has two fiscal rules in place and ex ante supervision. An exemption is Ireland with only one fiscal rule and both ex ante and ex post supervision. Countries in black have relatively strong fiscal regulatory systems in place with two or three fiscal rules, mostly balanced budget and debt rules, and either ex ante or ex ante and ex post supervision.

Countries with regulatory systems of moderate and high strictness are predominantly located in the European south and east, with the exemption of Ireland, the

Netherlands, Belgium and Denmark. This supports the hypothesis of a European north-southeast pattern in terms of local government financial autonomy. Not included in this analysis is the existence of local government insolvency regimes, which formally exist in Italy, Hungary, Switzerland and, to a certain extent, Austria (see Person (2021) in this book). If we interpret these as ultima ratio to cope with persistent local government fiscal misdemeanour, integrating insolvency regimes into the regulatory strength index would corroborate the identified pattern.

5 Discussion and Conclusion

Country classifications can never completely describe a country. As Hendricks et al. (2011) point out, even within one identified group of countries, there are considerable variations. This remark applies as well to a classification system that covers the complexity of local government fiscal regulation. Therefore, we refrain from providing a conclusive interpretation of our empirical results. Instead of proposing three distinct groups of countries with low, moderate and high regulatory fiscal strength–as Fig. 6 would suggest—we find it more convincing to speak of a general north-southeast pattern with in tendency stricter regulatory systems in the south and southeast. This perspective allows for exemptions like Ireland, Denmark, the Netherlands, Belgium or Greece without depriving the concept of its explanatory power.

From the perspective of local government fiscal stability, this pattern points to an interesting paradox: countries with strong fiscal stability (e.g. those in Scandinavia) tend to employ regulatory systems of low strength, whereas countries with a history of local government financial instability (e.g. Hungary, Italy) have stricter regulatory systems in place. This might indicate that fiscal regulation has only limited effects, that its implementation only follows budget crises rather than prevents them or both. The question of effectiveness has been extensively discussed in the literature about the impact of fiscal rules on budget outcomes (e.g. Heinmann et al. 2018), and the aforementioned paradox stresses the endogenous nature of fiscal institutions (e.g. Poterba 1996).

Nevertheless, the relative regulatory strength of some countries identified in this study fits quite well with existing historical experiences and underlying state traditions. An obvious explanation for the low index scores of most Scandinavian countries comes from the traditionally strong financial position of local governments in the European north. In the late 1980s, Sweden and later Denmark, Norway and Finland experimented with reforms by which local governments freed themselves from central control (Hendricks et al. 2011). High financial autonomy and low regulatory strength in Sweden and Finland can be interpreted in this tradition. Denmark, however, seems to have taken a different path, as shown by high financial autonomy in the early 2000s (see Fig. 1, right and middle map) and decreasing freedom in recent years (see Fig. 1, left map, and Fig. 6).

For the Rhinelandic states of Belgium, the Netherlands, Luxembourg, Germany, Austria and Switzerland—all of which, except Belgium, are part of the north and

middle European group in the Hesse and Sharpe (1991) classification—the picture is less clear. In general, they are influenced by the Germanic state tradition of decentralization and legally protected subnational governments but also by the Napoleonic tradition with weaker local governments (Hendricks et al. 2011). Compared to its neighbours, Germany has a particularly less strict regulatory system (Fig. 6). The rest of countries in this group, however, have implemented relatively strict regulatory systems.

The Anglo-Saxon group of countries have been described by Hendricks et al. (2011) as 'hypercentralised' with a high concentration of power at the central level. Hence, local governments in Ireland and the UK are traditionally weak. This may serve as an explanation for the relatively strict fiscal regulation of Irish local governments, though it does not explain the situation in the UK, where the previously bureaucratic and insufficient system of strict control was reformed in 2003 to a system of local fiscal self-regulation (Geissler 2019).

All the larger Southern European states developed in the Napoleonic state tradition and therefore share a history of strong centralization and a concentration of political and administrative power (Hendricks et al. 2011). This led to local governments with low legal discretion (Heinelt and Hlepas 2006). In broad terms, this historical pattern may serve as an explanation of stricter regulatory systems on average in the European south (Fig. 6). For the Eastern European countries in the sample, there is no easy connection to state traditions, due to the common Soviet history and different development paths after the fall of the Iron Curtain (Hendricks et al. 2011). However, as Swianiewicz (2014) points out, the political culture of Hungary, Slovakia and Bulgaria, as well as Czechia, Poland and even Estonia, resembles traditions in the European south more than the north and therefore is likely to produce local governments with low financial autonomy. This is mirrored by our results (Fig. 6) and corroborated by Ladner et al. (Ladner et al. 2016; see Fig. 1). In addition, the identified general north-southeast pattern of regulatory strength is also quite in line with the spatial distribution of further existing financial autonomy measures/classifications (European Commission 2020; OECD 2016; Sellers and Lidström 2007; Heinelt and Hlepas 2006).

With this study, we contribute in several ways to existing literature. First, we cut down the complexity of cross-country local fiscal regulation and make it accessible to a narrow focus international comparison. This comes at the cost of information loss, which we recognise as a limitation of our approach. However, the results may provide a useful heuristic for future comparative research. Second, we add to the field of local government classification literature by taking the new perspective of local government fiscal regulation. Third, we show that there is a north-southeast pattern of regulatory strength, with less strict regulation in the North. This result, which is built upon extensive data collection, not only finds external validation from previous studies in related fields, it also fits at least partially with historical developments and derived state traditions. Future research should not only draw a more detailed picture of the rough pattern we propose, but it should also analyse reasons for deviating countries and the role of the European Union in harmonizing regulatory policy.

Annex: Additional Methodological Information

Table A1 Criteria for good classification, following Wolman (2008), p. 90–91

No.	Criteria for good classification	Application in this study
1	Object of classification	Local government fiscal regulatory regimes
2	Unit of classification	Local governments
3	Population being classified	21 European countries
4	Dimensions of classification and classes within these dimensions	***Fiscal Rules**:* Existence of balanced budget rule (BBR), debt rule (DR), expenditure rule (ER) ***Supervisory Body:*** Central or sub-central government level ***Supervision mechanism:*** Ex ante, ex post
5	Criteria for classification	***Fiscal Rules:*** Existence of respective rule (1 = yes/0 = no) ***Supervisory Body:*** Central government (1 = yes/0 = no) ***Supervision Mechanism:*** Ex ante/ex post/ex ante and ex post (1 = yes/0 = no) ***Strength Indices:*** See below
6	Are dimensions/classes relevant to its purpose?	Yes. Dimensions and classes (conditions) cover the typical characteristics of regulatory regimes (rules, supervisory body, supervision mechanism). Due to high variety, we do not cover enforcement mechanisms
7	Is assignment to classes mutually exclusive and exhaustive?	Yes. Due to the research design, a country can only be assigned to one group of countries in each condition
8	Is the classification scheme parsimonious?	Yes. The approach of assessing regulatory strength by aggregating the baseline conditions allows for reducing the different conditions to one final model that classifies according to regulatory strength
9	Ordinal categories whenever possible	Classification of fiscal rules: bivariate Classification of supervisory body: bivariate Classification of supervision mechanism: bivariate Classification of strength: ordinal

Note: Own table

Baseline Conditions

Fiscal Rules Conditions

Condition *BBR*: countries with a balanced budget rule for the local level.
Condition *DB*: countries with a debt rule for the local level.
Condition *ER*: countries with an expenditure rule for the local level.

Supervisory Body

Condition *Central*: countries in which the central government conducts supervision of the local level.

Supervision Mechanism

Condition *Ex Ante*: countries in which local governments are monitored ex ante.
Condition *Ex Post*[6]: countries in which local governments are monitored ex post.
Condition Ex Ante and Ex Post: countries in which local governments are monitored ex ante and ex post.

Use of Baseline Conditions to Develop Strength Indices

Fiscal Rules Strength Index

We used the fiscal rules conditions (BBR, DR and ER) to compile the strength of fiscal rules for each country. As a result of accumulating those conditions, we obtained a variable in which (1) stands for countries with only one fiscal rule in place, (2) stands for countries with two rules in place and (3) stands for countries with three fiscal rules.

Supervision Strength Index

We used ***ex ante***, ***ex post*** and ***ex ante and ex post*** conditions to compile a supervision strength variable. By comparing those conditions, we obtained a variable in which (1) stands for countries with no supervision; (2) stands for countries with only ex ante supervision; and (3) stands for countries in which both ex ante and ex post supervision are present.

Overall Regulatory Strength Index

We used the **fiscal rule strength index** and **supervision strength index** to compile an **overall regulatory strength index**. The values arising from this exercise range from 2 to 6 (no country has a value of 0 or 1), denoting the quantity of fiscal rules in place and the depth of supervision in any given country. We coded countries with scores of 2 and 3, as “low regulatory strength” (**1**). Those with a score of 4 are coded

[6]In the country sample, ex post supervision only occurs when any given country also has ex ante supervision in place for the local level.

as moderate regulatory strength (**2**). Finally, those with scores of 5 and 6 are coded as high regulatory strength (**3**).

Additional Information about the Data

Table A2 Calibration of fiscal rule conditions (columns 2–4) and supervision conditions (columns 6–8), aggregation to related in-group strength indicators (columns 5 and 9) and aggregation to an overall fiscal regulatory strength index (column 10). Column 11: calibration of supervisory body

	Fiscal rules				Supervision mechanism					Supervisory body
Country code	Balanced budget rule	Expenditure rule	Debt rule	Fiscal rule strength	Ex post	Ex ante	Ex ante and ex post	Super-vision Strength	Overall Regulatory Strength Index	Central
AT	1	0	1	2	1	1	1	3	5	0
BE	1	0	1	2	1	1	1	3	5	1
BG	1	1	1	3	1	1	1	3	6	1
CH	1	0	1	2	0	1	0	2	4	1
CZ	1	0	1	2	0	1	0	2	4	0
DE	1	0	0	1	0	1	0	2	3	0
DK	1	1	1	3	0	1	0	2	5	1
EE	1	0	1	2	0	1	0	2	4	1
EL	0	0	1	1	0	1	0	2	3	1
EN	1	0	1	2	0	0	0	1	3	0
ES	1	1	1	3	1	1	1	3	6	1
FI	1	0	0	1	0	0	0	1	2	1
FR	1	0	0	1	0	1	0	2	3	0
HU	1	0	1	2	1	1	1	3	5	0
IE	1	0	0	1	1	1	1	3	4	1
IT	1	1	0	2	1	1	1	3	5	0
NL	1	0	1	2	1	1	1	3	5	0
PL	1	0	1	2	0	1	0	2	4	0
PT	1	0	1	2	0	1	0	2	4	1
SE	1	0	0	1	0	0	0	1	2	1
SL	1	0	1	2	0	1	0	2	4	1

Note: Own table

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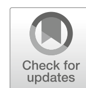
Local Public Finance Regulation in Southeast Europe: A Comparison of Slovenia, Croatia and Serbia



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Abstract Local public finance regulation differs among countries. The intention of this chapter is to compare current regulatory systems, uncover similarities and differences and provide some cautious explanations on developments. As example, three Southeast European countries—Slovenia, Croatia and Serbia—will be analysed. These countries share a similar history. However, their local public finance regulation developed in different directions, with different reform efforts and different budget constraints. This chapter investigates the regulatory regimes of local public finance, tries to explain the paths these three countries followed and examines the ensuing results. It starts with a description of local government structure and local government finance, followed by a comparison of fiscal rules and supervision. These three countries are still more similar than some of them would like to admit. This holds true especially when it comes to the availability of reliable statistical data, hesitation in substantially reforming their local government systems, simplifying financing and raising local government autonomy. Referring to local government public finance itself, Croatia and Slovenia have stricter regulations than Serbia, as EU accession served as a driver for the quality of fiscal governance.

1 Introduction

As many different types of local public finance regulation exist in every modern country, there is a lack of understanding on how they develop and which factors influence this development. This chapter will shed some light on this issue by comparing fiscal regulation in three Southeast European countries—Slovenia,

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Croatia and Serbia—all of them once part of Yugoslavia. These three countries share a common history, culture and legal, political and economic system; as such, they are quite similar in their origins. However, local governments faced different challenges, and policy development took different paths, which ended up in various regulatory systems, which the local governments had to follow. This chapter describes those current systems, exposes similarities and discrepancies and offers cautious explanations for the status quo. Section 2 provides some brief insights on relevant background information concerning the structure and functions of local governments. Section 3 explains the fiscal position of local governments and the basic features of their funding. Section 4 contains the heart of this chapter, which describes regulatory regimes in Croatia, Serbia and Slovenia according to the components of regulatory regimes, i.e. fiscal rules, supervision, monitoring and implementation procedures.

2 Local Governments' Structure and Functions

Prior to 1990, Slovenia, Croatia and Serbia were states within the same federal country—Yugoslavia. Slovenia was divided into 62, Croatia into 102 and Serbia into 190 municipalities. There were no counties or regions. Cooperation between municipalities was established through municipal associations. With the dissolution of Yugoslavia, administrative structures in the three newly established states took various paths, but a constitution guarantees local self-government in each one. However, fiscal relevance at the local level is minimal compared to the EU average. As an example, the local share of total public revenue ranges between 12 and 15%, while the EU average is 27%.[1]

Croatia started the first territorial reorganization in 1993, establishing 418 municipalities, 68 cities, 2 districts, 20 counties and 1 city-county. Since then, the number of local governments has changed several times, and Croatia now has 428 municipalities, 127 cities, 20 counties and 1 city-county (Zagreb). Croatia is the only one of these three countries with a two-tier local government and, similar to Slovenia, a large number of municipalities with small populations.[2]

The Slovenian Constitution determines municipalities and regions as constitutional categories, but so far only municipalities exist. Slovenia gradually increased the number of municipalities from 62 to 212, with more than half of them counting less than 5000 inhabitants. This was a reaction to the pre-independence, socialist era of centralization, combined with post-independence political bargaining in parliament until 2006. The reason for not establishing regions was the constitutionally

[1]Local share of public revenue is 12% in Croatia, 14% in Serbia and 15% in Slovenia (NALAS 2018, 22).

[2]The average Croatian municipality has 2700 inhabitants (ranging from 137 to over 16,000), average city 23,000 inhabitants (from 1500 to over 800,000), and average county 165,000 inhabitants (from 45,000 to around 450,000).

provided bottom-up concept, combined with an absence of political will (Rakar and Klun 2019, p. 182). However, following a change to the Constitution in 2006, which introduced the top-down concept of establishing regions, political parties were still unable to reach an agreement. In 2009, the financial crisis began and removed regions from the political agenda until spring 2019.[3]

There has been no significant change to Serbia's administrative structure since the 1960s. Since then, several municipalities have received city status (currently 29), but the country maintained a single-tier and, with the exception of the capital Belgrade, an almost completely monotype local government (Milosavljević 2015). As in Slovenia, the debate on regionalization began albeit a bit later, but without a clear vision or the political will for implementation, although several cabinets have announced this policy since 2000 (Jerinić 2016). Serbia still lacks a comprehensive decentralization strategy, which would answer open questions concerning the establishment of an additional level of local government or a full-fledged regionalization (Milosavljević and Jerinić 2016). Differences among local governments regarding size and population are significant (Milosavljević and Jerinić 2017). Compared to Slovenia and Croatia, Serbian cities and municipalities have a much higher average population (close to 50,000) (Table 1).

Numerous experts on local government have argued that there are too many local governments in Croatia and that, consequently, many of them do not have sufficient financial and material resources (see, e.g. Ott and Bajo (2001), Atanasijević et al. (2016) and Koprić (2010)). However, it seems that there is not enough political will to change the situation. One can say the same for Slovenia, where the local level is disadvantaged by its one-tier structure (see, e.g. Vlaj (2011) and Virant and Rakar (2017)). All three countries have the ability to overcome insufficient structuring and a lack of resources by cooperating with inter-local governments.

The Slovenian Constitution defines *original tasks* as "local affairs which may be autonomously regulated by the municipality affecting only residents of this municipality" (Art. 140, Par. 1). The *delegated tasks* are defined as "performance of specific duties within the state competence, legally transferred to the municipalities" (Art. 140, Par. 2). The general Local Self-Government Act (LSGA) lists original tasks (e.g. spatial development, preschool education, waste and water management, some tasks in the field of social protection) and is further specified in sector-specific legislation.[4] The functions of urban municipalities have a bit wider scope, as they also include urban development (Constitution, Art. 141). Additionally, municipalities may determine other original tasks by their statutes (LSGA, Art. 21 and Constitution, Art. 140). In practice, however, delegated tasks are almost inexistent, mainly due to unstable territorial structure (see *supra*) and related capacity issues

[3] In spring 2019, based on the initiative of the President of the Republic of Slovenia, president of the National Council and presidents of municipal associations, an expert group was formed which delivered drafts of regional legislation (www.pokrajine.si).

[4] For a complete list of municipal competences, see the Catalogue of Municipal Competences, available at http://www.lex-localis.info/TabView/VsebinaTabs.aspx?SectionID=c6c26383-9df0-4f89-8f05-67d774f72bab

Table 1 Local-level structure (authors based on legislation and countries' statistical data; own calculations)

	Croatia	Slovenia	Serbia
Number of municipalities/cities	428 municipalities 127 cities 1 city county	212 municipalities[a]	145 municipalities 29 cities[b]
Average population of municipalities/cities	7,384	9,855	48,156
Number of counties/regions	20	–	–
Average population of counties/region	165,000	–	–

[a]Eleven of them are urban municipalities
[b]These numbers include 29 local governments in the territory of Kosovo i Metohija, which, pursuant to Serbian Constitution, are listed in the Act on Territorial Organization of the Republic of Serbia (Serbian only—Zakon o teritorijalnoj organizaciji Republike Srbije), OG 129/07, 18/16, 47/18, Belgrade: Official Gazette

(cf. Haček and Bačlija 2014), which consequently places Slovenia in a de facto separationist model of local government (Kuhlmann and Wollmann 2019).

In Serbia, the Constitution broadly defines own tasks as tasks of "local interest" (article 177).[5] The Local Self-Government Act (LSGA) enumerates those own competences in more detail, while its 2018 amendments also envisage a Register of Competences which is intended to provide a complete list of both original and delegated local government tasks.[6] Unlike Slovenia, Serbian local governments cannot establish additional own competences by their statutes but can regulate in more detail those established by the Constitution and the LSGA. Original competences include tasks in the fields of spatial and urban planning, communal services, environmental protection and disaster management, road maintenance, child protection, primary education, social welfare, culture and sports, etc. (Milosavljević and Jerinić 2012). The capital city of Belgrade performs some additional functions listed in a specific law.[7] Delegated tasks are numerous and established by sectoral legislation and for the most part are identical for all local governments. It is not always easy to differentiate own and delegated competences, due to unclear legislation and splitting competences between the central and the local level. Serbia is the only one among these three countries, which has not ratified Article 4 para. 3 of the European Charter of Local Self-Government on the subsidiarity principle (Council of Europe 2017).

[5]Constitution of the Republic of Serbia, OG 98/06, Belgrade: Official Gazette. Available in English at: http://www.ustavni.sud.rs/page/view/en-GB/235-100028/constitution

[6]Local Self-Government Act (Serbian only – Zakon o lokalnoj samoupravi), OG 129/07, 83/14, 101/16, 47/18.

[7]Act on the Capital (Serbian only - Zakon o glavnom gradu), OG 129/07, 83/14, 101/16, 27/19. Belgrade: Official Gazette.

In Croatia, according to the Act on Local and Regional Self-Government (ALRSG),[8] counties, cities and municipalities can perform their own and delegated tasks. Croatian *cities* and *municipalities* perform activities of local importance directly addressing citizens' needs but are not—constitutionally or legally—assigned to central government bodies. These include, amongst others, housing and community amenities, spatial and urban planning, childcare, welfare, primary healthcare, preschool and elementary education, consumer protection, environmental protection, fire brigades, road, etc. *Counties* carry out similar activities, which are of regional importance. *Large cities*, which are centres of a wider area, can perform certain additional tasks usually performed by counties, e.g. maintenance of public roads, the issuance of building and location permits, implementation of spatial planning documents, etc. As in Slovenia and Serbia, local governments' tasks are usually specified in sector-specific acts, as the ALRSG lists only general types of tasks (e.g. housing and community amenities, spatial and urban planning, communal activities). According to ALRSG (Art. 23), state administration tasks (delegated tasks) performed by the local government are determined by law. However, in practice it is almost impossible to determine which tasks could be considered as delegated and which as their own. According to Škarica (2013), there is no reliable legislative criteria that distinguishes local governments' own tasks from delegated tasks. Furthermore, there is no explicit provision in any sector-specific acts as to whether local government tasks belong to a self-governing (own) or delegated part of the local government. The majority of local government functions are financed from their own budgets, while the so-called decentralized functions (primary and secondary education, social welfare, healthcare, and fire protection) are partially financed from the national budget.[9]

In Slovenia, most funding is spent on education (kindergartens, primary schools) and economic affairs (roads) (Ministry of Finance of the Republic of Slovenia 2019). In Serbia, official functional expenditure statistics do not exist. According to NALAS (2018), major shares of budgets are spent on public services and education. The biggest weakness is the lack of public investment. In Croatia, general services take the lion share of budgets, too. Beyond this, economic affairs (such as local transportation, construction/maintenance of local roads), housing and education are of relevance.

[8] Act on Local and Regional Self-Government (Croatian only), (OG 33/01, 60/01, 129/05, 109/07, 125/08, 36/09, 36/09, 150/11, 144/12, 19/13, 137/15, 123/17). Zagreb: Official Gazette.

[9] In the early 2000s, these so-called decentralized functions were transferred to local governments, with 6% of personal income tax revenues earmarked for their implementation. Expenditures that cannot be covered by this 6% are funded from the national budget as earmarked grants and legislated annually in the bylaws of national line ministries. Thus, the amount of these earmarked grants depends on function-specific minimal standards determined by national bylaws (e.g. for primary education – number of pupils, classrooms and school buildings) (NALAS 2018).

3 Local Governments' Finance

The legal framework of local public finance builds upon different legislation, such as the Constitution, the European Charter of Local Self-Government, the Local Government and Local Government Financing Acts and special legislation on debt, taxes, regulation, etc. In all countries, local governments are funded by taxes, grants and non-tax revenues.

The structure of local governments' taxes differs significantly, but in all three countries, the main tax revenue is the personal income tax (PIT). In Slovenia and Serbia, central and local levels share the PIT, while in Croatia the PIT flows to municipalities, cities and counties. Slovenia and Croatia also use the PIT for fiscal equalization. When it comes to other taxes shared and collected at local levels, the situation among countries differs.

In contrast to Croatia and Serbia, the Slovenian tax structure has remained almost the same since the 1990s. Croatia implemented numerous relevant tax changes. Until 2017, the PIT was shared among counties, cities, municipalities and central government. However, since 2017 it is shared only among counties, cities and municipalities. Since 2018, the real estate transfer tax, once a shared tax, is allocated solely to cities/municipalities. In contrast, the government abolished several further local taxes.

In the early 1990s, the main idea in Serbia was to finance local expenditure from local governments' own resources and delegated tasks from shared revenues, allocated based on criteria. There was no real local tax (Kristić 2006). The system, thus, became highly centralized and complex (Levitas 2004). Since 2006, own revenues include property tax, administrative and communal fees and other income, such as fines, rent, sales of services, interest, donations and voluntary taxes. Local governments determine the rates. Shared revenues include a share in the PIT, inheritance tax and the property transfer tax, as well as shared fees, determined by legislation.

In all three countries, the local governments' taxation autonomy is rather low, meaning that local taxes provide only limited room for manoeuvre in the case of eventual fiscal crisis and austerity needs. In Croatia, cities and municipalities can decide only about the tax rate on the use of public land, while for all other taxes, rates must be within limits defined by national law. In Slovenia, municipalities can decide to introduce a property tax, but if they do, central government determines the base and rates. In Serbia, local governments can determine the property tax[10] rate, however within the limit set by the national law (Arsić et al. 2012).

All countries allocate general grants and specific purpose grants, both in manifold variation. The main difference between countries lies in the criteria for grants allocation and their funding (from national budget or from PIT). Fiscal equalization plays an important role. Slovenia has met this challenge by a formula of PIT sharing

[10]Excluding the transfer tax (in the case of sale of property), gift and inheritance tax, which are both shared revenues of the local government.

since 2009. Since 2018, Croatia has taken a similar approach, equalizing revenues by a share of PIT. In Serbia, equalization implements by special grants.

Non-tax revenues are an important part of financing and are usually the most important source of own revenues for local governments. In Slovenia, there are no limitations in the local governments' determination of charges and fees, in Serbia there are some limitations in rates determined by the law, while in Croatia local governments have little control over base and rate of fees and charges (except for land usage and land development fees). Slovenian municipalities can determine rate and base for so-called compensation for the use of building land.

In all three countries, local authorities are free to decide how they spend their revenues, with the exception of earmarked grants (to be used for their determined targets) and earmarked non-tax revenues (to be used for the purposes defined by law).

Summing up, one can conclude that these three countries have small local public sectors, minimal taxation autonomy, and some extent similar tasks, while there are substantial differences in local financing. While Slovenia made substantial changes in its tax structure at the beginning of its independence, Serbia retained a system very similar to the Yugoslavian system, and Croatia made constant changes to its tax structure by keeping previous regulations and adding others. During the financial crisis, public debt in all the local governments of each country increased substantially. Austerity measures in Slovenia and Serbia resulted in cutting government transfers (for Serbia see Levitas 2010), but there was no change in regulation on debt issuing or other measures connected to local revenue raising in any of the observed countries. In Slovenia, most municipalities had no debt before the crisis; therefore, there was enough room for borrowing during the crisis period. In Serbia, borrowing regulation is very generous.

4 Components of Regulatory Regimes

In this section, we describe the regulation of local public finance in the three countries examined according to basic components of fiscal rules, monitoring procedures, organization of supervision and enforcement. Each country has a credit ceiling for the local governments, as well as various borrowing control and oversight mechanisms. Slovenia and Croatia, as EU members, additionally must follow the Stability and Growth Pact (SGP), which includes local public finances. Thus, the SGP's criteria for total public debt and annual budget deficits (less than 60% and 3% of GDP, respectively) are the basic guidelines to limit overall public borrowing in these two countries. Although formally not a member of the EU, Serbia also tries to satisfy the SGP's two criteria (NALAS 2018). As argued by NALAS (2018), local government borrowing was relatively low in all three countries in 2017, compared to the national government borrowing. This is mainly due to the very conservative, rigid and centralized local borrowing regulation and the fact that total public debt levels to GDP levels were above the 60% limit. Thus, it is unlikely that national

governments will stimulate or even allow more local borrowing until the total public debts in these countries falls under 60% of the GDP. In fact, NALAS (2018) shows how total outstanding local government debt, in per capita terms, decreased in all three countries in 2017, compared to 2015.

Legal and Institutional Embeddedness of Supervision

In Croatia, several acts define fiscal rules and control of local governments. The Budget Act stipulates a balanced budget rule (Article 7).[11] The Act on Fiscal Responsibility determines rules, which limit general government spending, general government deficit and public debt; responsibility for lawful and purposeful use of budgetary funds; and the system of control and supervision.[12] Amongst others, the Act on the System of Internal Control in Public Sector sets and regulates responsibilities, relations and competencies in the development of the internal control and internal audit as part of the internal control system in the public sector. Its goal is to establish good financial management practice for an ethical, efficient and accountable public sector.

In Slovenia, the Public Finance Act defines regulation. Slovenian public finance should follow the rules and trends determined by the EU stability framework integrating local public finance (Rakar 2019). Fiscal rules were integrated into the Constitution and explained in detail in the 2015 Fiscal Rule Act, which determines the framework and methods for fiscal stability in the medium term.

In Serbia, the Budget System Act contains basic regulations.[13] There is a Commission for Local Self-Government Financing, which consists of a president and five members appointed by the government and five by the national local government

[11] According to the balanced budget rule, a local government's budget must be balanced: total revenues and receipts must cover total expenditures and outlays. If, during the budget year, expenditures and outlays increase or revenues and receipts decrease, the budget must be balanced by identifying new revenues and receipts and/or reducing the budgeted expenditures and outlays. Thus, local governments normally plan balanced budgets, but at the end of the fiscal year, there is often a deficit or surplus. If they have ended the fiscal year with a deficit, local governments are obliged to include it in the next year's budget proposal and projections for the following 2 years and also present how they plan to cover that deficit. Budget Act (Croatian only), OG 87/08, 136/12 and 15/15. Zagreb: Official Gazette.

[12] It is applied to state budgets, local governments, extra-budgetary users of state and local budgets; legal persons that are in accordance with ESA 2010 classified within the general government budget sector; companies owned by the state or local governments; and other legal entities established by the state or local governments. The newest version of the Act, effective since 2019, is fully adjusted to the SGP and the so-called Six Pack acquis. It also prescribes that the Statement on Fiscal Responsibility must be submitted to the Ministry of Finance by March 31 of the current year for the previous year. By submitting the Statement, the heads of institutions confirm that they are responsible for the legal, earmarked and purposeful spending of resources and for the efficient and effective functioning of the internal control system within the framework defined by their budget (Act on Fiscal Responsibility (Croatian only), OG 111/18. Zagreb: Official Gazette).

[13] Budget System Act (Serbian only – Zakon o budžetskom sistemu), OG 54/09, 73/10, 101/10, 101/11, 93/12, 62/13, 63/13, 108/13, 142/14, 68/15, 103/15, 99/16, 113/17, 95/18, 31/19, 72/19. Belgrade: Official Gazette. Although without publishing concrete data, the Serbian Government claims that, in sum, all local governments have balanced budgets and that in the past several years

association. The Commission is authorized to analyse the criteria for and the allocation of transfers; monitor the vertical and horizontal equality of the system, the level of local debt and the results of changes in the system; and prepare annual reports and proposals for amendments and improvements (LSGFA, Art. 50-53).[14] However, the Commission does not have any supervisory prerogatives, and its real influence is questionable. As an example, during the preparation of crucial amendments to the LSGFA in 2011–2012, the Commission did not even meet (Kmezić et al. 2016). Despite recent improvement in the composition of the Commission—thanks to the efforts of the local government association—it is still far from fulfilling its tasks (CPES 2013).

Fiscal Rules

Slovenia and Croatia provide a balanced budget rule for local governments. In Serbia, the law allows an annual deficit of up to 10% of current revenues.

The fiscal rules for regulating short- and long-term borrowing are similar, but there are significant differences in the possible ways to borrow. Slovenia only allows domestic credits, while in Croatia and Serbia local governments can issue bonds and securities. In Serbia, local governments can borrow on foreign capital markets and in foreign currency, too. However, Serbian local governments cannot provide guarantees for legal entities under their ownership, while Croatian and Slovenian can.

In Croatia, the Budget Act regulates borrowing. Local governments may incur *short-term debt* to fund their regular activities in cases of uneven revenue collection over the year (without any consent) and *long-term debt* for capital investments (the purchase of non-financial assets) with the consent of the relevant local representative body and national government's approval. The total annual debt service for each local government caused by borrowing may not exceed 20% of its revenues realized in the preceding year.[15] Local governments' borrowing is regulated in detail by additional rules and other legislation.[16] Thus, the annual national budget execution act sets the overall annual limit for borrowing by all local governments (e.g. for 2020 the overall annual limit for all local governments together amounts to 3% of their total operating revenues in 2019).[17] The national government has changed the local government borrowing limits a few times since 1996, but these were relatively small

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they have been in surplus (Ministry of Finance 2019, Fiscal Strategy for 2020 with projections for 2021 and 2011, pp. 27-28 - in Serbian only).

[14]Local Self-Government Financing Act (Serbian only – Zakon o finansiranju lokalne samouprave), OG 62/06, 47/11, 93/12, 83/16, 104/16, 95/18. Belgrade: Official Gazette.

[15]The amount of total annual debt service includes the average annual credit and loan service commitments and liabilities arising from issued securities and certain guarantees and approvals granted, as well as arrears from preceding years. For more, see Ott and Bronić (2016).

[16]For more details, see, e.g. annual acts on the national budget execution and rules on the procedure for borrowing and issuing guarantees and granting approvals by units of local and regional self-government (Croatian only), OG 55/09 and 139/10. Zagreb: Official Gazette.

[17]The 3% limit does not apply to (1) local governments which obtained approval from the national government by December 31, 2019, for borrowing not realized in that year; (2) local governments from specially supported areas; (3) for projects co-financed by EU funds; and (4) for energy

changes usually made without systematic analysis (Bajo and Primorac 2010). Some local governments issue bonds, but these are negligible in quantity compared to the amount of borrowing. Bajo and Stavljenić (2017) analysed local governments' borrowing during the financial crisis in Croatia (2010–2015) and argued that some were borrowing without the consent of the national government and exceeding the above-mentioned limits. They argue that the state should regulate borrowing by the city of Zagreb, which has a dual status as city and county, separate and different from all other local governments, since it is the single biggest borrower and has often broken the national government's borrowing rules. Furthermore, the same authors argue that the local governments' utility companies are a source of potential financial instability and risk, since borrowing by these companies to finance capital projects have become a means of circumventing the national government's borrowing restrictions.

In Slovenia, the current limit on borrowing restricts debt service payments to 8% of the previous year revenues (without donations and investment transfers).[18] Municipalities are free to borrow up to 5% of the adopted budget for liquidity purposes. There is no previous approval by the Ministry of Finance if repayment takes place within the budget year. Since municipalities can borrow only from the Slovenian credit market, all banks are aware of the regulation and therefore provide only short-term loans. If repayment is not met, the municipality's bank account can be blocked. Public companies and public institutions founded by municipalities can incur debts only with the consent of the municipal council and if repayment is assured without budget resources. The amount of borrowing should be included in the municipal annual budget act. Municipalities can go beyond the mentioned debt limit to co-finance infrastructure projects from EU funds. In 2017 and 2018, municipalities were able—apart from the Ministry of Finance—to get approval from the Ministry of Economic Development and Technology for investments in local public infrastructure and goods of special interest to citizens. The main reason was to use EU resources more efficiently and to stimulate municipalities after the crisis, during which investment spending almost stopped. As previously mentioned, municipalities can borrow only from banks and similar institutions approved by the Bank of Slovenia. Municipalities, which are included in a treasury single account system, can only borrow from the Ministry of Finance.[19] Municipalities may incur long-term debts only for investments included in the adopted budget following prior consent by the Minister of Finance.

Serbia differentiates local government borrowing to finance current liquidity, which arises from imbalanced revenues and expenditures, and long-term borrowing

efficiency projects (Act on the Execution of the 2020 National Budget of the Republic of Croatia (Croatian only), OG 117/19).

[18]The draft amendment of FMA-1 envisages an increase to 9%.

[19]Slovenia introduced the Treasury Single Account System in 2002. Its main objectives are to provide an effective overview on cash resources, reduce borrowing costs and ensure central state information.

Table 2 Fiscal rules (authors based on legislation)

	Croatia	Slovenia	Serbia
Balanced budget rule	Yes	Yes	Deficit up to 10% of current revenue
Debt rules	Total annual debt service below 20% of previous year's revenues	Service on long-term debt restricted to 8% of previous year's revenues	Total debt limited to 50% of previous year's revenues Interests below 15% of previous year's revenues

to finance capital investments. During the budget year, liquidity loans may not exceed 5% of total revenues of the previous year's budget and needs to be repaid before the budget year's end. There are ceilings for long-term borrowing, as well. The amount of unsettled long-term debt for capital investment may not exceed 50% of the total current revenues in the previous year, except for loans that last longer than 5 years. The amount of redemption and interest due in each year on all outstanding long-term borrowings for capital investments may not exceed 15% of the total realized previous year's current revenues. Local governments can also issue municipal bonds, but like Croatia, the municipal bonds market is still in *statu nascendi*. The first bonds were issued in 2012 by Novi Sad, the second largest city in Serbia (Miladinović 2012). The Budget System Act (Art. 27ž) also sets fiscal rules for local governments. Inter alia, local fiscal deficit cannot exceed 10% of the local government's revenue in the current year. In the case of public investment, local authorities can submit a request for approval of a higher deficit to the Ministry of Finance. If the deficit exceeds the threshold without prior approval, the Minister of Finance suspends the transfers and shared revenues to local governments for the next budget year in that same amount. The unavailability of data on actual utilization of this option by local governments precludes the analysis of its short- and long-term consequences (Table 2).

Monitoring and Enforcement

As in any country, implementing fiscal rules, and therefore various kinds of monitoring and enforcement procedures, is a challenge. In Slovenia and Croatia, single approvals for borrowing work as a monitor and driver for fiscal discipline. Slovenian municipalities must also present their budget drafts to the Ministry of Finance, but do not have to receive approval (Rakar and Klun 2016).

In Croatia, there are several instruments to control borrowing by local governments: (1) the Ministry of Finance approves all local governments' long-term credits, all guarantees given by the local governments as well as most of the

approvals they give (ex ante control). (2) The Budget Act stipulates a balanced budget rule (ex ante control, the representative body cannot vote if it is not balanced, and ex post control, a threat of penalty for disregarding the balanced budget rule). (3) Local governments must report to the Ministry of Finance on a quarterly basis in regard to their borrowing/guarantees/approvals (ex post control). (4) Some local governments have internal controls units or staff[20] (ex post control). (5) Each year, the State Audit Office performs audits of a number of local governments (ex post control). Finally, (6) the Ministry of Finance carries out budgetary supervision at the request of citizens, the Minister of Finance, national government administration bodies, local governments and other legal entities.

According to the Public Finance Act, each public authority in Slovenia is obliged to maintain internal control systems whose aim is the efficient, effective, and functional use of public resources. This internal audit is independent, organizationally separated from the managing executive structures, and aims to perform an objective review and evaluation of operations and the internal control system. The municipality can also use external financial controls. Each year, the internal unit must report on budget proposals and enacted budgets, including the opinion on consolidated public finance (including local finance). The report must be presented to the local major. The Ministry of Finance gains insights by approving any local debt, meaning that rules on local borrowing are very strict. However, there are no rules on ex post controls. Each municipality's council is obliged to elect an external, independent control board, which should control local public finance performance (i.e. efficiency of expenditures, management of local property, etc.). However, controllers are only allowed to report on mistakes, point out malpractice, etc.; prosecution is a matter for the police and other authorities. The Court of Auditors of the Republic of Slovenia conducts revisions in determined number of municipalities.

In Serbia, the Public Debt Administration within the Ministry of Finance monitors local borrowing. In addition, there is a mandate of the State Audit Institution.[21] Since 2010, local governments, like all public funds' beneficiaries, are obliged to establish an internal audit. Beyond this, they are also subject to review by the Supreme Audit Institution. However, the Fiscal Council (independent state body accountable to parliament) determined that there is no systematic record of the condition of local public finances. There is almost no horizontal coordination among central-level authorities who are supposed to monitor and oversee local government finances (ministers of finance, of economy and of state administration and local governments), resulting in a piecemeal monitoring which is unable to systematically react to important problems. Although several pieces of legislation

[20]The Ministry of Finance must publish annual reports on the internal controls of the users of the national and local governments' budgets. It also requires local governments to appoint persons to deal with suspicions of irregularities and fraud.

[21]State Audit Institution Act (Serbian only – Zakon o Državnoj revizorskoj instituciji), OG 101/05, 54/07, 36/10, 44/18), Belgrade: Official Gazette.

Table 3 Monitoring of fiscal rules (authors based on legislation)

	Croatia	Slovenia	Serbia
Organization in charge	Ministry of Finance State audit office	Ministry of Finance External control boards The court of auditors	Ministry of Finance State audit institution
Monitoring procedure	Approval of borrowing Quarterly reports	Approval of borrowing Presentation of budget drafts	No systematic procedure

envisage obligatory supervision, control and reporting of local government operations (and beneficiaries of their assets), they are not adequately applied in practice (Fiscal Council 2017). Local governments and their associations have regularly raised this issue, but it remains addressed inadequately by central government.

The following procedures apply to enforcement. In Slovenia and Croatia, a single approval to borrow serves as a driver for adhering to fiscal rules. In Croatia, the Budget Law provides sanctions for legal entities and responsible persons in the case of non-compliance with legal frameworks (e.g. violation of borrowing limits, borrowing for current expenditures). Although some local governments have violated borrowing limits, these sanctions have not been applied (Bajo and Primorac 2010). The Serbian Ministry of Finance may cut transfers, should rules be violated. The Public Debt Act makes borrowing outside the provisions of the law a misdemeanour.[22] However, it does not regulate consequences for the public entity itself (Table 3).

Dealing with Budgetary Crisis

Regulation in the case of fiscal stress is vague in all three countries. In Croatia, no legal regulations concerning local governments' bankruptcy or bailout exist, and there have been no such cases as yet (Dobrić et al. 2016). However, local governments have experienced very critical financial situations several times (e.g. the cities Zlatar and Slavonski brod). In such cases, they have usually solved their financial problems themselves, although in the case of Zlatar the Government partially helped by making a relatively small grant available—which could be considered as a sort of bailout (Pavlina 2010).

When it comes to financial distress, Slovenian municipalities normally must prepare a stability, recovery and debt-managing plan, but there is no legally fixed procedure. The Ministry of Finance can approve additional borrowing to solve the financial problems determined by this debt-managing plan. The municipal council must confirm this plan and adopt it as a special local act. When municipalities do not fulfil their financial obligation to private companies, they are usually sued in the court. Consequently, the municipality's bank account may be blocked and revenues, which are not needed for determined tasks, will be used for the repayment of debt. The bank account can be blocked, too, if the municipality's debt exceeds the

[22]Public Debt Act (Serbian only – Zakon o javnom dugu), OG 61/05, 107/09, 78/11, 68/15, 95/18. Belgrade: Official Gazette.

established limit. In such cases, municipalities usually sell some of their property. As in Serbia, the Bankruptcy Act explicitly excludes state bodies, including local governments.

As mentioned previously, the Bankruptcy Act in Serbia explicitly excludes its application to state bodies, including local governments and legal entities founded or funded by local governments (Article 14).[23] However, since the main problem of local governments concerning borrowing are past due payments, the solution is not to be sought in bankruptcy rules, but rather in greater transparency in planning and executing the local budgets (Pločić 2013). If deficits exceed without prior approval by the Finance Ministry, the Minister suspends transfers and shared revenues for the next budget year. The same law defines the suspension of transfers and shared revenues in more cases: local authorities must follow central government guidelines for planning the total volume of revenue, the salary funds, the number of employees and subsidies (Article 36a). They must implement the decisions based on the budget inspection (A. 89) and must remain within the limits of indebtedness prescribed by the Public Debt Law (A. 89).

5 Conclusion

This chapter describes the fiscal regulation of local governments in three countries, which share a common history—Croatia, Slovenia and Serbia. The intention is to compare current regulatory systems, expose similarities and differences and offer cautious explanations on developments.

This chapter looks at the structure, functions and finance of local governments through reference to general framework conditions. Local levels have curbed fiscal relevance, deliver a limited range of services and show huge variations in the number of inhabitants. Among these three countries, only Croatia has a two-tier local government (counties). In Slovenia and Serbia, creating two-tiered local governments and regionalization itself is still an open issue. Although taxation rights and history differ, taxation autonomy is low and fiscal centralization is high in all three countries, with the personal income tax as the main tax source.

All three countries need to strengthen local governments by decreasing the number of local units. Political discussions exist, as well as numerous research and analyses by local and international experts. However, political will is lacking. This holds true even against the background of the financial crisis, which affected local governments, and the numerous institutional changes, which accompanied EU membership for Slovenia and Croatia and the preparations for Serbia's accession. The given political systems with weak and often coalition governments, particularly at local levels, prevent substantial changes of local public regulation in these

[23]Bankruptcy Act (Serbian only – Zakon o stečaju), OG 104/09, 99/11, 71/12, 83/14, 113/17, 44/18, 95/18, Belgrade: Official Gazette.

countries. The Serbian Government in 2019 initiated work on a new policy document on decentralization.

Fiscal regulation exists in all countries, with different legislation to define fiscal rules, supervisory bodies in charge of monitoring and enforcement, credit ceilings for local governments and various control and oversight mechanisms. Slovenia and Croatia, as EU members, must follow the SGP with its strict ex ante controls on borrowing and required approvals from finance ministries and, in some cases, of governments and must have functioning state audit institutions. Serbia has a special Commission for Local Self-Government Financing but still lacks systematic state records of local public finances. The European Commission regularly raises issues of local government finance in Serbia's EU accession progress reports. In addition, there is a general criticism of the current local government system, with its significant differences in the size and capacities of municipalities, as well as lack of vertical coordination.

There are remarkable differences in fiscal rules among these countries. While Slovenia and Croatia face a balanced budget rule and limit local debt, there is no balanced budget rule in Serbia, and debt limits are broader. Obviously, joining the EU was a catalyst to make fiscal control stricter in Slovenia and Croatia, which shows a direct impact on the fiscal regulation of local governments. Beyond this, one can assume, EU accession improves the quality of public administration in general, being another precondition of sound fiscal regulation.

Finally, these three countries still share similarities when it comes to the lack of reliable statistical data, poor local government autonomy and the hesitation to regulate local government financing in a more transparent way.

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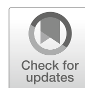
The Impact of Fiscal Rules on the Financial Management of Municipalities: A Comparative Analysis of the Czech Republic and Slovakia



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Abstract This chapter explores the impact of fiscal rules on the indebtedness of municipalities in the Czech Republic and Slovakia from a comparative perspective. Our analysis focuses on the content of municipal fiscal rules, their impact on aggregate levels of local government debt in both countries and the financial situations of individual local governments with excessive debt. The findings indicate that municipal fiscal rules in Slovakia are slightly more comprehensive than those in the Czech Republic; however, the way they regulate aggregate level of municipal debt is very similar. Despite very similar starting points, the number of municipalities with excessive debt levels is significantly higher in the Czech Republic than in Slovakia. Though both countries face the problem that excessive borrowing is legally prohibited, the practice does still take place in a number of local governments. Excessive borrowing is exclusively found in small municipalities with a very limited chance to escape from the debt trap, as the regulatory regime of both countries does not lend itself to bailout or bankruptcy.

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1 Introduction[1]

Fiscal rules have gained increasing attention amongst scholars as well as policymakers and practitioners. Broader definitions (e.g. Dietrichson and Ellegard 2015) understand fiscal rules as the formal rules and informal norms related to the drafting, approval and implementation of budgets. According to Schakel et al. (2017), fiscal rules impose long-term constraints on fiscal policy through numerical limits on budgetary aggregates and stricter procedures for the budgetary process. Schakel et al. (2017) furthermore define two ways in which fiscal rules are expected to affect the budgetary process. From a procedural point of view, fiscal rules impose lower discretion for relevant decision-makers at the municipal level, and from a content perspective, they impose sharper multi-year expenditure ceilings. Overall, they structure political decision-making with the goal to strengthen fiscal transparency and predictability. To realise this, they prescribe requirements for reporting budget outcomes and define ways in which to achieve budgetary targets. Fiscal rules therefore serve both as a safeguard to ensure the efficient financial management of public funds and as an emergency brake to limit deficit. From the perspective of economic theory (see, e.g. Badinger and Reuter (2017)), there are several reasons for implementing fiscal rules. For instance, in periods of economic growth, they are employed as measures to correct distorted incentives and generate pressure against overspending. More precisely, they help to ensure both fiscal responsibility and government financial sustainability.

Both the Czech Republic and Slovakia were established as independent republics in 1993, having formerly been part of a federation. Both countries joined the EU in 2004, and Slovakia adopted the Euro in 2009. As a member of the Euro Area, Slovakia must fulfil the Stability and Growth Pact and the "two pack" (agreed upon in 2013), which requires members to submit budget drafts for scrutiny in autumn before they are adopted as part of a budgetary surveillance cycle. The Czech Republic is free from this obligation. In both countries, municipalities act as the lowest level of territorial self-government, with the second level being self-governing regions. Both the Czech Republic and Slovakia initially adopted very loose fiscal rules to regulate municipal financial management. However, in order to achieve macroeconomic fiscal discipline, they have since decided to introduce step-by-step stricter local fiscal rules to ensure budgetary discipline. This chapter aims to compare the impact of these recently introduced fiscal rules on the indebtedness of municipalities in the Czech Republic and Slovakia.

Many current studies (e.g. Caselli and Reynaud 2019; Grembi et al. 2016) use econometric quantitative approaches to analyse the effects of fiscal rules on different outcome variables such as public deficits. This chapter takes a somewhat different perspective and deals with the impact of fiscal rules on the financial management of municipalities in the Czech Republic and in Slovakia from a more

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qualitative-descriptive approach. This approach is, from our perspective, more suitable than econometric quantitative approaches, not only because it serves to better address the specifics of post-communist countries but also due to a lack of sufficient financial data for the local government level. This chapter aims to contribute to scholarly literature and research in several ways. First, it provides an analysis that can be generalised for Eastern and Central European countries still burdened with the heritage of Communism. Second, it expands the available empirical evidence regarding the effects of fiscal rules on municipal-level financial management. Third, the chapter provides comparative information about developments in the Czech Republic and Slovakia, which started from the same point but have followed their own paths since 1993.

The chapter is organised as follows. We first introduce the current municipal systems and fiscal rules in both countries, then we present our findings on the impact of fiscal rules on the financial conditions of municipalities in both countries. The final section summarises and discusses the broader implications of our analysis, including a comparative perspective.

2 The Emergence of Municipalities and Fiscal Rules in the Czech Republic and Slovakia

The history of modern local self-government in the Czech Republic and Slovakia (then known as Czechoslovakia) started after the Velvet Revolution in November 1989. According to Niznansky and Hamalova (2013), a new system of public administration which reflected the ongoing economic and political changes in society was built after 1990. This included the switch from a socialist system of national committees (Bercik and Nemec 1999) to the standard dual system under which local self-government was restored and strengthened and the establishment of a new governance system of a deconcentrated state administration. These changes were intended to overcome and eliminate the shortcomings of the former centralised control of state administration under communism (Kosorin 2003).

The system of national committees, which delivered both state administration as well as local government functions at the same level, was abolished in 1990 by the *Act No. 369/1990 Coll. on Municipal Administration*. Afterwards, a new system of self-governed municipalities was established based on municipalities as territorial and administrative units. Another critical legislative piece from this period was the *Act No. 518/1990 Coll. on the transition of the funding function from national committees towards municipalities, central bodies of state administration and local state administration bodies*. By this law, the rights and obligations of the former local national committees in designated areas were transferred to municipalities, and the basic functions of municipalities were defined. Municipalities became full-fledged decision-makers at the local level, with their own budgets and bodies. They were equipped with the exclusive right to make decisions independently and

act independently in all matters pertinent to the administration and development of the municipality and its property, as long as such acts were not otherwise assigned to the central state or to another legal body or natural person. The core responsibilities allocated to Czechoslovakian municipalities in this period were the management of movable property and real estate in the ownership of the municipality, securing public order in the municipality and local infrastructure and utilities and services such as public transport, roads, cemeteries, water, culture, sports, tourism and childcare (Nemec et al. 2000). With the highest voter turnout in Czechoslovak history (63.75%), the first municipal elections of November 1990 marked the beginning of a new era of local democratic governance.

2.1 Municipal System and Fiscal Rules in the Czech Republic

The Municipal System and its Revenue and Expenditure Structure

The Czech Republic is a unitary state. The 1993 Constitution establishes two levels of subnational government: regions and municipalities. There are currently about 6250 municipalities in the country, making the Czech Republic one of EU member states with the highest territorial fragmentation (Thijs et al. 2017). Statistics show that roughly 56% of Czech municipalities have less than 500 inhabitants and that about 78% of the Czech municipalities have less than 1000 inhabitants (Kadecka 2012).

The Constitution of the Czech Republic is the highest legislative source which regulates municipalities. Part 7 of the Constitution, paragraphs 99–105, defines the main principles of municipal and regional self-government. The role of municipalities is defined in the *Law on Municipalities 128/2000* and the *Law on the Capital Prague 131/2000*. In addition, municipalities are subject to numerous other legal acts, which either regulate their management (e.g. *Law on Budgetary Rules for Territorial Entities 250/2000*; *Law on Tax Assignment 243/2000*, *Law on Accounting 563/1991* and *Law on Municipal Audit 240/2004*) or specify their responsibilities in specific policy areas (e.g. *Law on Education 561/2004*; *Law on Roads 13/1997*).

Municipal councils are elected in democratic elections which take place every 4 years. Councils are responsible for approving a yearly budget and voting about its amendments. The mayor is elected by the council from amongst its members, and the municipal manager is appointed by the mayor.

Czech municipalities are 'equal' from the point of having their own responsibilities, but not so much in the area of delegated responsibilities, which are financed by transfers from the central state. According to current legislation, the state has to cover all the costs of delegated responsibilities to be executed by municipalities. Municipalities, however, often claim that this is not the case and that this system contributes extra pressures to their municipal budgets. Due to the very fragmented municipal structure, not all municipalities have the same amount of delegated powers. Currently, Czech municipalities can be divided into the following three categories, each with their own scale of delegated responsibility (see Kadecka 2012):

205 municipalities with extended powers, 388 municipalities with a commissioned municipal office and over 5600 common municipalities. Municipalities with a larger scale of delegated responsibilities, especially municipalities with extended powers, spend a significant amount of their own resources to co-finance delegated responsibilities sometimes to the detriment of their financial health (Sedmihradska and Pago 2018).

The municipal financing system has undergone several changes during the last two decades (Nemec et al. 2016). In 1993, a tax sharing system based on income taxation was introduced. This system has been fundamentally changed twice and modified another two times since. The first fundamental change in 2001 was realised within the framework of the public administration reform and extended the list of shared taxes by a value added tax using a model of sharing three centrally collected taxes—personal income tax, corporate income tax and valued added tax—with the aim to stabilise municipal revenues. The second major change came into effect in 2008, when substantial differences in per capita revenues between small and large municipalities were reduced by significantly changing tax share calculation coefficients. Minor modifications have been connected with adjustments of allocation mechanisms.

For the last 10 years, municipalities have received a relative constant share of 20 to 23.6% of three centrally collected taxes (personal income tax, corporate income tax and value added tax). The percentage of sharing is defined by the *Law on Tax Assignment 243/2000*, and the revenues are distributed amongst individual municipalities based on criteria defined by the law. Key allocation criteria are population, area size and number of students. An additional size category assures that larger municipalities—assigned with a higher coefficient—have slightly higher per capita revenues.

This structure of revenues and expenditures has been very stable for the last years. The most important revenue is the shared tax revenue (slightly above 50% of total municipal revenues), and transfers represent approximately 15% of total municipal revenue. The main self-generated revenue is real estate tax. However, the *Law on Real Estate Tax 338/1992* affords only minimal decision-making power to municipalities on the tax rate, i.e. municipalities can approve three different coefficients by which the tax rates are multiplied (Sedmihradska and Pago 2018). *The Law on Local Fees 565/1990* authorises municipalities to impose local fees, with currently eight different fees currently in effect. Municipalities have discretion over the fee base and fee rate within an upper limit specified by the law. Apart from local fees, municipalities collect fees for administration (especially related to delegate responsibilities execution) and particular types of environmental pollution or damage.

Municipalities spend the highest proportion of their budgets on the delivery of local communal services, such as waste management (classified as part of environmental expenditures according to COFOG[2]) and water and transport (classified as economic functions). The most relevant part of administrative expenditures is

[2]COFOG = Government expenditure by function.

salaries, with municipalities employing approximately 85,000 staff members and salary expenditures making up 15–16% of total municipal expenditures. 25–30% of total municipal expenditures are capital investments.

With regard to expenditures, Czech municipalities spend approximately 10–12% of their GDP, a statistic which has not changed for the last 20 years. A local autonomy index calculated for the Czech Republic (Placek 2018) reached the value 40.75 in 1990, slightly over the value 60 in 2000, and has not changed since. Most of public spending (approx. 30% of GDP) is realised on the central government level. The share of regional self-government is marginal, consisting of only 2% of GDP. This data considered, it is clear the Czech Republic remains a rather centralised country from the perspective of local government spending, despite it having undergone an intense decentralisation process.

Fiscal Rules

Three core legislative documents set the system of fiscal rules for municipalities in the Czech Republic: the *Law on Budgetary Rules for Territorial Entities 250/2000*, *Government Decree 346/2004* and the *Law on Rules of the Fiscal Responsibility 23/2017* (including its *implementation Law 24/2017*).

The core source of budgetary rules for municipalities is the *Law on Budgetary Rules for Territorial Entities* Parts 2–4. Part 2 of this law defines the budget, the structure of municipal revenues and expenditures and rules for transfer and grants from other levels. Part 3 defines the rules for the budgetary process, such as budget drafting, approval and management and approval of changes and the final municipal account. Part 4 sets the rules for establishing municipal legal bodies (i.e. municipal companies, budgetary organisations). This law, however, only imposes very few real restrictions on municipalities to manage their own finances. The most important exception is in Paragraph 4, which states that municipal budgets must be balanced or in surplus. This is legal obligation and controlled by the prosecutor. A budget deficit is allowed only if the deficit can be covered from a municipality's own reserves (i.e. reserve fund) or by external funding (i.e. borrowing for capital expenditures).

This brief overview of the *Law on Budgetary Rules for Territorial Entities* shows that the Czech Republic, for a long period, had outlined only very loose fiscal rules for the financial management of municipalities. The situation changed slightly in 2004, when the *Government Decree 346/2004* (valid only till 2008) established a 'debt service indicator'. This indicator was calculated by the Ministry of Finance by relating the debt expenditure level to the base, as follows:

a/ debt expenditure = paid interest rate, principal debt payments, bond repayments and leasing payments,
b/ base = achieved tax and non-tax revenues and transfers and grants.

The Ministry was required to contact relevant municipalities if this indicator became higher than 30%, in which case the municipalities would be requested to explain their reasons and to propose and realise counter measures. In critical cases, the Ministry was granted the right to terminate grant transfers to the municipality.

In 2008, the system of monitoring municipal debts was changed by the *Government Decree 1395/2008*. Since this change, both liquidity and debt ratio are calculated. If the municipal liquidity is in the interval < 0; 1 > and, at the same time, the debt ratio (borrowing to actives) is over 25%, the process described above is to be initiated by the Ministry of Finance.

As a reaction to fiscal problems connected with the 2008 financial crisis, the Czech Parliament passed in 2017 the *Law on Rules of the Fiscal Responsibility 23/2017 Sb*. The necessity of this law was connected especially with the need to transpose *EU Directive 2011/85/EU of November 8, 2011, on requirements for budgetary frameworks of the Member States* into Czech national legislation. However, due to internal political conflicts, the Czech Republic approved its national law with massive delay, compared to most other EU members. This law was followed by the *Law 24/2017 Sb*., amending other laws in relation to passing the *Law on Rules of Fiscal Responsibility*. This new legislation (Parts 14 and 15 of the *Law 24/2017*) tightened fiscal rules on the regional as well as municipal levels. It directly regulates the level of external debt of municipalities by setting the maximum debt level at 60% of the average total revenues of the municipality over the last 4 years. This new legislation, however, did not include any rules for bailouts and bankruptcy, an issue which still remains unregulated in the Czech Republic.

2.2 Municipal System and Fiscal Rules in Slovakia

Municipal System and its Revenue and Expenditure Structure

Much like the Czech Republic, Slovakia is a unitary state, and its constitution, approved in 1992 and effective from January 1, 1993, establishes two levels of subnational self-government: regions and municipalities. The territory of Slovakia has always been highly fragmented, with 3473 municipalities in 1921 and 3237 in 1947. Today, there are almost 2900 municipalities in Slovakia, not including city subdistricts. According to Thijs et al. (2017), at 1871 average number of inhabitants per municipality, Slovakia ranks second lowest amongst EU member states (compared to 1690 in the Czech Republic and 1885 in France). Only 2 cities, Bratislava and Košice, have a population size over 100,000 inhabitants, and only 7 other towns or cities have a population of over 50,000 inhabitants. Almost 70% of all Slovak municipalities have fewer than 1000 inhabitants (Klimovsky 2014).

Similar to the Czech Republic, the highest legislative source regulating municipalities is the Constitution of the Slovak Republic. Part 4 of the Constitution—Paragraphs 64–71– defines the main principles of municipal and regional self-government. The position and activities of municipalities are regulated by a set of other laws passed by the Slovak Parliament, for example, the *Law 138/1991 on municipal property*, the *Law 583/2004 on budgetary rules for territorial self-government*, the *Law 416/2001 on decentralisation*, the *Law 50/1976 on territorial planning and building control*, the *Law 346/1990 on election to municipal bodies*, the *Law 502/2001 on financial control and audit*, the *Law 303/2001 on the election*

of territorial authorities and the *Law 446/2001 on the property of territorial authorities*.

Unlike the Czech Republic, Slovakia did not pass a new law on municipalities after the split of Czechoslovakia in 1993, and the already mentioned *Law 369/1990* (as amended) on municipal administration still acts as the main specific legislative source for municipal-level government. Municipal councils are elected in democratic elections which take place every 4 years. Councils are responsible for approval of the yearly budget and vote about its amendments. The mayor is elected directly by popular voting, not by the municipal assembly as is the case in the Czech Republic. The municipal manager is appointed by the mayor.

Unlike the Czech Republic, all Slovak municipalities are considered ‘equal’, both with regard to their own and their delegated responsibilities. This means that even the smallest municipality has to deliver all its delegated responsibilities (i.e. the registry or building office) in the same capacity assigned to a large city. Although this situation has been the subject of frequent criticism from academia and practice, it has been met by only few implemented solutions, such as the establishment of municipal cooperations (e.g. Klimovsky 2014).

As part of a comprehensive decentralisation reform between 2000 and 2004, the *Law 369/1990* was substantially amended in 2001, whereby the autonomous status of municipalities was significantly strengthened and the scale of their responsibilities enlarged. Despite this, Slovak municipalities spend much less compared to their Czech counterparts, spending approximately 7% of GDP compared to 30% of GDP for central government. Similar to the Czech Republic, spending on the regional self-government level is only marginal. This means that despite the strong decentralisation process taking place since 2000, Slovakia remains a centralised country from the perspective of municipal spending (OECD 2016). The fact that Slovak municipalities spend in relative terms less compared to their Czech counterparts could be explained particularly by the higher level of transfers for delegated responsibilities.

Municipal funding between 1990 and 2005 was based mainly on shared taxes (i.e. personal income tax, legal entities’ income tax, road tax) and transfers. This situation partly changed after 2005 when fiscal decentralisation was implemented. Some fees became local taxes, whereas in terms of shared taxes, only personal income tax (PIT) remained in this category (Klimovsky 2014) (unlike the Czech Republic, where the combination of three taxes is shared). The percentage of sharing PIT is annually decided by the Parliament when voting the law on the state budget (most recently, municipalities receive 70% from PIT revenues). The calculation of the share from personal income tax to a concrete municipality is based on a very complicated formula, where the core parameters are the number of inhabitants, the number of students and the number of people over the age of 62. This formula slightly differs from the Czech Republic redistribution formula, in that it does not include the area size and does not foresee a size coefficient.

With regard to the structure of revenues and expenditures, the situation has been very stable since 2006. The two most important types of revenue are shared tax (approx. 40% of total municipal revenues) and transfers to cover the costs of delegated responsibilities (approx. 25% of total municipal revenues). Own tax

revenues still represent only a limited share of municipal financial revenues (approx. 15%) and have grown only slowly over the last 10 years. Municipalities in Slovakia are able to levy seven different taxes, including a property tax and six specific local taxes on goods and services. In contrast to the Czech Republic, Slovak municipalities are free to decide whether or not to levy each tax, to set the rates of all local taxes and to exercise a large autonomy on tax bases (exemptions, rate reduction).

For expenditures, the situation is very similar to the Czech Republic, with one major exception. The most important expenditure item is education, including the salaries of teachers (mixed own and delegated responsibility; financed mainly by the earmarked transfer mentioned above but partly also from own revenues), which amounts to approx. 40% of all municipal expenditures. The second most important expenditure area according to COFOG are administrative expenditures, especially staff salaries (approx. 25% of total municipal expenditures). According to the Ministry of Finance (2019), Slovak municipalities employ approx. 200,000 employees; however, this figure is not comparable with other countries, as it only includes all teachers in primary and similar schools. The expenditures for local communal services are ranked third, with housing as the fourth largest expenditure area of Slovak municipalities. Capital expenditures for investment purposes have varied over the years from 15 to 20% of total municipal expenditures, depending on the amount of EU co-financed local investments.

Fiscal Rules

Fiscal rules for municipalities in Slovakia are determined in a very general way by the main *Law on Municipal Administration* (Paragraphs 7–10) and, similarly to the Czech Republic, defined in a more detailed way by the *Law 583/2004 on Budgetary Rules for Territorial Self-Government*, which applies to both municipalities and self-governing regions. As a member of the Euro Area, Slovakia adopted the *Law on Fiscal Responsibility* in 2011 as a compulsory reaction to the fiscal crisis. This law specifies measures in case of debt over the defined limit of 60% and will be described later in more detail.

The *Law on Budgetary Rules for Territorial Self-Government* Part 2 defines the municipal budget and its revenues and expenditures. Slovak municipalities with more than 2000 inhabitants are obliged to compile their program budgets. Part 3 of the *Law 583/2004* defines the rules for the budgetary process. It states that local budget must be balanced or in surplus (§10), a legal obligation controlled by the prosecutor. The capital part of the budget may be in deficit, so long as such a deficit is covered by reserves, external sources or a surplus of the current part of the budget. Part 4 provides detailed regulations for external financing. Loans, repayable financial assistance and bills and bond transactions are allowed (Sagat et al. 2019), but only for the capital part of the budget. An exception allows municipalities to use borrowing in the current part of the budget, but only to bridge the time gap between revenues and expenditures within one budgetary year. The total amount of the municipal debt may not, according to paragraph 17, exceed 60% of the total current revenues of the previous year, and the sum of debt repayments shall not exceed 25% of the total current revenues of the previous year. Paragraph 17 also states that

municipalities are obliged to monitor the debt development and repayments and, in the event of overruns, take effective measures.

The primary persons responsible for monitoring municipal finances are the mayor and the municipal controller. If the debt exceeds 50%, but is below 58%, the mayor has to inform the municipal council about the situation within 15 days. If the debt is between 58% and 60%, immediate measures to balance the budget must be taken. In the case that the total amount of debt exceeds 60%, the situation is regulated by two legal sources: the previously described *Law 583/2004 on Budgetary Rules for Territorial Self-Government* and the *Constitutional Act No. 439 /2011 on Budgetary Responsibility*. *The Law on Budgetary Responsibility* was introduced as reaction to fiscal problems connected with the 2008–2010 crisis, and its Article 6 regulates the municipal level. If the debt exceeds 60% of total current revenues, the municipal controller must report this situation to the Ministry of Finance, and the mayor must inform the municipal council of the situation and the reasons behind it. The Ministry of Finance is then to apply the respective sanctions, as defined by the *Law on Budgetary Responsibility*.

Paragraph 19 of the *Law on Budgetary Rules for Territorial Self-Government* defines the measures to be taken for specific cases of indebtedness. The municipality must introduce a 'recovery regime' if the number of overdue payables exceeds 15% of current revenues or if any accepted payable is not paid out within 60 days of the due date. The maximum length of this regime is 90 days, but it can be extended by the Ministry of Finance for a period of up to another 90 days. If the financial situation of the municipality does not improve during this recovery period, the 'forced administration regime' is introduced by the Ministry of Finance. It is also introduced in cases when the 'recovery regime' was necessary but not introduced by the municipality.

This analysis indicates that Slovak fiscal rules for municipalities are slightly more detailed than those in the Czech Republic, especially when defining the specific 'regimes' for municipalities with excessive debts. However, much like the Czech Republic, the existing Slovak legislation does not deal with bailouts and municipal bankruptcy. Such measures are not sufficiently regulated and are currently dealt with on a case by case basis.

3 Impact of Fiscal Rules on the Financial Conditions of Czech and Slovak Municipalities

This section will analyse the impact of fiscal rules on the financial conditions of municipalities will by assessing key local public finance indicators such as municipal debt levels in a comparative perspective.

Municipal Debt Level

Fiscal rules are expected to help keep municipal debt within a sustainable level. Tables 1 and 2 provide a basic overview of the aggregated municipal finance

Table 1 Municipal revenues and expenditures for the Czech Republic from 2011 until 2018 in mil. CZK (authors' own, based on Monitor data (https://monitor.statnipokladna.cz/)

	2011	2012	2013	2014	2015	2016	2017	2018
Tax revenues	141,901	145,534	161,725	170,087	175,393	190,750	206,315	226,220
Other revenues	118,198	86,795	87,110	96,716	98,697	80,400	81,623	97,217
Capital revenues	8508	8742	7340	6109	5358	7800	6305	7426
Revenues total	**268,607**	**241,071**	**256,175**	**272,912**	**279,448**	**278,950**	**294,243**	**330,860**
Current expenditures	194,009	167,661	173,002	178,502	179,734	187,839	205,537	228,239
Capital expenditures	75,785	67,413	65,663	85,439	77,884	51,410	67,272	94,347
Expenditures total	**269,794**	**235,075**	**238,666**	**263,942**	**257,619**	**239,250**	**272,809**	**322,586**
Surplus/deficit	**−1187**	**5996**	**17,509**	**8970**	**21,829**	**39,700**	**21,434**	**8274**

26 CZK ≈ 1 EUR

Table 2 Municipal revenues and expenditures for Slovakia from 2011 until 2018 in thousands EUR (authors' own, processed from (https://www.mfsr.sk/sk/financie/verejne-financie/uzemna-samosprava/)

	2011	2012	2013	2014	2015	2016	2017	2018
Current revenues	2,824,741	2,880,252	3,185,922	3,288,466	3,546,529	3,747,306	3,916,634	4,236,868
Capital revenues	659,333	518,949	415,964	342,176	568,125	324,691	264,027	448,235
Fiscal operations	514,504	298,554	261,364	398,467	465,361	316,950	413,787	566,313
Revenues total	**3,998,578**	**3,697,754**	**3,863,250**	**4,029,109**	**4,580,015**	**4,388,947**	**4,594,448**	**5,251,416**
Current expenditures	2,603,315	2,654,787	2,926,117	3,042,061	3,187,240	3,297,431	3,491,758	3,767,830
Capital expenditures	861,541	665,802	576,946	587,406	893,570	465,379	636,539	916,980
Fiscal operations	383,677	222,352	176,772	225,652	253,976	265,881	163,667	191,796
Expenditures total	**3,848,533**	**3,542,941**	**3,679,834**	**3,855,119**	**4,334,786**	**4,028,691**	**4,291,964**	**4,876,606**
Surplus/deficit	**150,045**	**154,813**	**183,416**	**173,990**	**245,229**	**360,256**	**302,484**	**374,810**

situation for both countries over the period between 2011 and 2018. Unfortunately, data for both countries before 2010 is not available due to a change of calculation methodology. The data for both countries shows that municipal finances from an aggregate view are stable and healthy, with budget surpluses since 2012 allowing for a continuous decrease of debt burden.

Table 3 and Figs. 1 and 2 present data for the development of the municipal debt in the Czech Republic and in Slovakia. Unfortunately, datasets before 2010 are not available for the Czech Republic. The data documents for both countries show the limited impact of the financial crisis on the municipal debt level. In the Czech Republic, municipalities reacted to decreased revenues primarily by savings from efficiency increases and some cuts (Sedmihradska and Bakos 2016). For Slovakia during the crisis period, the Slovak Association of Municipalities reported that only in the year 2012 did municipal revenues slightly decrease from the previous year. This was mostly due to the central government providing special grants to municipalities to compensate for the decreasing share of tax revenues. This, in combination with savings, helped to keep the total level of municipal debt below a critical level.

Figure 1 shows in more depth that the relative level of Czech municipal debt has been decreasing since its peak in 2012, which was caused by the decreased level of resources in 2012. In Fig. 2, the Slovak Republic shows a similar pattern, but the decrease is slower.

The percentage of total municipal debt of all municipalities to total municipal revenues was almost identical in 2011 in both countries (slightly above 30%). Such a level of debt did not impact the overall fiscal stability of both countries, especially taking into account that municipal budgets represent only a rather small percentage of the GDP. However, as previously described, the fiscal rules for municipalities have since been tightened in Slovakia in a more comprehensive way.

The major difference between both countries is the fact that, from 2013 onwards, the relative size of municipal debt in the Czech Republic decreases much faster compared to Slovakia—in fact, the absolute level of municipal debt is growing in Slovakia. This is surprising, considering the fact that municipal fiscal rules in Slovakia are more comprehensive than those in the Czech Republic. Any systemic research or evaluation providing explanations of this paradox is lacking. We assume that because the national and local fiscal situation in both countries has been fully satisfactory and improving after 2012/2013 (up until the COVID-19 crisis), international organisations and academia have not chosen to focus on this issue. Our initial interpretation of this situation is that the higher levels of municipal debt in Slovakia were caused by the general political situation in the country, in which social-democratic governments lead by the political party SMER held power from 2012 to 2020.

Municipal Debt: Sources and 'Victims'

According to data from the Ministry of Finance, the largest source of debt in the Czech Republic are bank credits (72%) and to a lesser degree municipal bonds (14.7%). In 2018 the number of municipalities with debt was 3198, which is about 50% of all Czech municipalities (this relative figure has not changed in recent years).

Table 3 Total municipal debt in the Czech Republic in mil. CZK and in Slovakia in bill. EUR (authors' own, based on Monitor data for the Czech Republic [https://monitor.statnipokladna.cz/] and on the Ministry of Finance data for Slovakia)

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
CZE	x	x	x	83.3	82.4	90.0	92.2	88.9	86.9	71.9	69.0	68.6
SVK	0.83	0.9	1.14	1.37	1.29	1.26	1234	1237	1375	1335	1363	1455

26 CZK $\approx$ 1 EUR

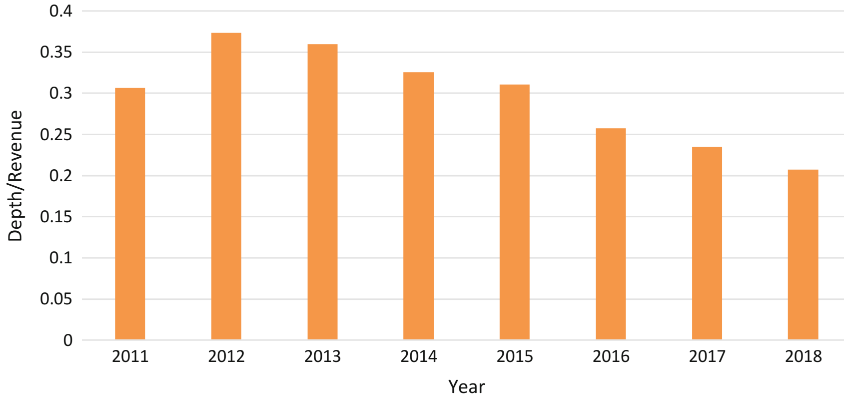

Fig. 1 Relative size of the Czech municipal debt (authors' own, based on Monitor data [https://monitor.statnipokladna.cz/])

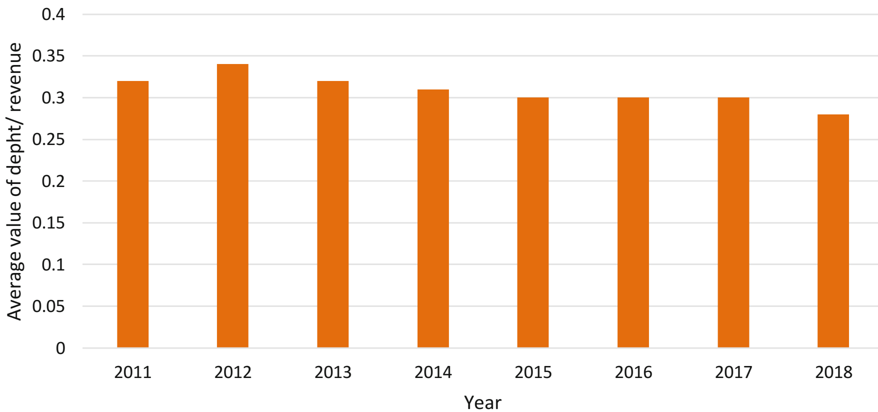

Fig. 2 Relative size of the Slovak municipal debt (authors' own, based on the Ministry of Finance: [https://www.mfsr.sk/sk/financie/verejne-financie/uzemna-samosprava/])

Almost 50% of overall municipal debt is related to the four largest cities (Prague, Brno, Ostrava, Plzeň). The municipal debt of Prague, including the debts of its city districts was 21.1 bill. CZK in 2018.

The situation in the Slovak Republic is slightly different. Similar to the Czech Republic, the main source of debt are bank credits (78%). The second most important borrowing option for Slovak municipalities is loans from the State Fund for Development of Housing (15%). Also similar to the Czech Republic is that the highest proportion of absolute debt is related to the two largest cities (Bratislava and

Kosice; almost 30%). In contrast to the Czech Republic, during the last 4 years, Slovak municipalities have not issued municipal bonds.

The fiscal situation of Czech municipalities is monitored by a Monitor.[3] For 2018, the Monitor provides the following data:

- 517 municipalities reached debt ratios of over 60%.
- The total liquidity of 125 municipalities was in the interval < 0; 1 > .
- The ratio of external resources to total actives of 98 municipalities was higher than 25%.
- Ten municipalities revealed a critical fiscal situation, with all three indicators beyond the accepted range.

For Slovakia, the number of problematic municipalities is 58 (according to the criteria set in the fiscal rules), which is slightly over 2% of the total number of municipalities. Table 4 shows the situation of the most critical municipalities with a debt rate of more than 200%.

The data shows an interesting contradiction to the findings from the total aggregate debt levels presented above: The aggregate municipal debt in the Czech Republic is decreasing, but the number of municipalities with fiscal problems is much higher in the Czech Republic (almost 10%) compared to Slovakia (2%). This situation suggests that the fiscal rules in Slovakia have been less effective from the point of minimising the total level of the municipal debt, although they have been more effective from the point of limiting the number of critically indebted municipalities.

Excessive Municipal Debt: A Problem Mostly Faced by Small Municipalities
One core finding from our research is that all problematic municipalities (according to the national fiscal rules) in the Czech Republic and in Slovakia are small municipalities and that their excessive level of debt is the result of specific local situations.

For the Czech Republic, we can provide three examples of this, based on a research published by Hornek and Juptner (2020). In one case, the municipality of Nebanice decided to build 20 new family houses and received in 2001 a subsidy of eight million CZK from the Ministry for Regional Development. The municipality used this subsidy and other credits to start construction; however, potential buyers of the houses dropped out. As a result, the municipality was left with over 12.5 million CZK in debt linked to this failed construction project. In the municipality of Bublava, financial problems can be connected with the construction of an aquapark. The municipality received a state subsidy of 20 million CZK for the construction, but the state later decided to stop the co-financing. The construction of the unfinished aquapark had to be stopped and was never finished. This created excessive obligations for the municipality to return the more than 30 million CZK to the central state and to pay 20 million CZK to the construction company for the work that was

[3] https://monitor.statnipokladna.cz/2019/

Table 4 Slovak municipalities with a debt level over 200%: financial sums in EUR (authors' own, based on internal materials of the Association of Municipalities of the Slovak Republic, with permission)

Name	Revenues	Current expenditures	Capital expenditures	Bills	Bank credits	Debt level %	Inhabitants
Brezovec	64,091,706	3,037,342	61,045,509	0.00	116,457,060	537,192	38.00
Tasula	106,165,247	6,320,428	98,264,079	0.00	98,481,846	180,352	19,000
Orechova	18,652,892	9,091,839	8,421,053	0.00	67,077,604	88,418	25,600
Habura	141,383,747	17,937,420	119,871,449	0.00	125,482,112	63,420	49,500
Spisský Stiavnik	242,535,095	206,254,743	23,944,358	0.00	35,897,149	43,247	290,300
Bratislava - Devin	78,610,521	77,553,546	0.00	28,3925,380	0.00	39,378	163,600
Dvorianky	52,206,554	26,271,984	22,995,979	0.00	77,481,472	31,733	64,900
Secianky	65,581,057	15,531,509	48,051,089	0.00	46,301,629	29,062	36,100
Durdove	102,765,784	6,246,208	29,580,355	0.00	24,451,546	23,671	14,700
Vrchtepla	39,806,524	7,018,787	22,001,207	0.00	16,029,217	22,607	26,900
Rohoznik	5,834,061	2,343,970	3,487,120	0.00	3,487,120	22,575	353,400
Cestice	61,762,802	33,159,368	25,394,843	0.00	73,367,931	21,886	85,400
Pecenice	12,548,650	4,229,262	8,298,274	0.00	7,716,598	20,356	12,600

partially completed. In the municipality of Prameny, debt was incurred when it was decided to build a mineral water bottling plant. After obtaining the building permit in 1998, the municipality acquired investors and spent 17 million CZK. Construction was however never finished, as it was blocked by environmental protesters. By 2008 the debt connected with this unsuccessful construction reached an astronomical amount of 50 million CZK for a municipality with an annual budget of three million CZK.

In Slovakia, except for the city district of Bratislava-Devin, all cases of critical municipal debt were small municipalities which had borrowed for capital projects. Though it appears surprising that banks decided to provide such long-term credits, we did not investigate this for more details. The most interesting case, from our point of view, is rather the city district of Bratislava-Devin. Our research revealed that the problems of Bratislava-Devin started at the end of the 1990s in connection with a political decision to build new houses and to sell them to residents. No bank agreed to finance the project, and the municipality decided to cover the costs by bills. Between 1997 and 2000, a total of 23 bills have been issued (some of them to pay the costs of previous bills), and, in the end, the debt caused by this unsuccessful construction project reached nearly 10 mil. EUR (1 EUR = 30 Sk). From April 2005 until today, the municipality has been operated under a 'forced administration regime'. The municipality is able to repay existing debt on a level of up to 10,000 EUR per year with no chance to escape from the debt trap. As a result of the 'forced administration regime' situation, the municipality is not allowed to realise capital investments and also cannot apply for EU funds (for more, see Tunega (2014)).

4 Conclusion

This chapter has analysed the impact of existing fiscal rules on the indebtedness of municipalities in the Czech Republic and in Slovakia from a comparative perspective. The system of fiscal rules regulating financial management of municipalities is very similar for both countries and a clear indicator for strong path dependency, as both countries started from the basis of the same Czechoslovak municipal *Law 369/1990*. The core mechanisms applied to regulate borrowing are the same: the rule that borrowing is possible only for capital expenditures and that the maximum allowed level of debt is 60% of the defined base. However, the two countries introduced this law at very different times: Slovakia in 2004 as a requirement of the Eurozone and the Czech Republic in 2017.

Our analysis also showed some minor differences. In the Czech Republic, the responsibility for debt oversight lies not only within the municipalities but also with the Ministry of Finance, which systematically monitors the situation and is responsible to act in the case of problems. In contrast, in Slovakia the municipal controller is responsible to inform the Ministry of Finance about excessive debt burden and the Ministry does not take a proactive role. Though the Czech Republic had started to tighten fiscal rules before the crisis in 2004, it adopted the legislation connected with

EU rules for fiscal responsibility which did have an impact on municipal fiscal rules only in 2017. The Slovak Republic tightened fiscal rules after the crisis in 2011, especially via the amendment of the Paragraph 19 of the *Law on Budgetary Rules for Territorial Self-Government*, which provided for implementation of recovery regime, forced administrative regime and fines in cases of excessive municipal debts. Our analysis also suggests that the fiscal rules determining financial discipline of municipalities in Slovakia are slightly more comprehensive compared to the Czech Republic, especially because of the very detailed Paragraph 19 of the *Law on Budgetary Rules for Territorial Self-Government*.

Concerning the capacity of fiscal rules to regulate the aggregate absolute and relative level of debt, the data provided in our analysis clearly documents that municipal fiscal discipline is not a critical issue in either the Czech Republic or Slovakia. The absolute and relative levels of municipal debts (from the national level) are acceptable and do not show any long-term risks, taking into account that the COVID-19 impact is too difficult to estimate at this time. Domestic watchdogs like the National Bank and National Audit Office in both countries do not report municipal indebtedness as a problem, and no established international organisation has criticised the indebtedness of Czech or Slovak municipalities. Neither the EU Semester, the OECD Government on Glance nor the COE monitoring reports include any warnings or criticism related to this topic; however, they do all criticise the countries' high level of territorial fragmentation.

Over the last decade, only the Czech municipal system in 2011 has showed a small deficit in aggregate financial accounts. For all other years, municipal budgets in both countries are in surplus. However, the situation differs between the two countries. Whereas the overall Czech municipal debt has been decreasing since 2013 by a rather significant amount, the opposite is true for Slovakia, which reported the highest cumulative debt in 2018. The fact that Slovak municipalities have a positive fiscal balance for all years in the period of 2011–2018 but also several years with an increase in the cumulative debt deserves interpretation. Our explanation is rather simple: cumulative borrowing is increasing; however, it is decreasing in relative figures (Fig. 2), as the total municipal revenues/expenditures grow faster than debt.

The level of fiscal discipline in both countries is relatively similar with the relative size of the municipal debt, with 21% in the Czech Republic and 28% in Slovakia. This confirms that fiscal rules, in combination with all other state institutions and regulatory elements, have been in both countries sufficiently effective to keep the absolute and relative levels of municipal debt under control on the country level. The authors' opinion is that the percentage of relative debt in both countries is fully acceptable. The representative of the Slovak Association of Municipalities (ZMOS) responded to this issue in an online interview as follows:

> According to the opinion of ZMOS, the level of municipal debt is not problem in Slovakia. The debts are caused by necessary investments to cope with the modernisation deficit on the municipal level and partly also by the need to co-finance EU projects and housing projects supported from the State Housing Fund. All these investments are realized with the aim to increase the quality of life of our citizens.

The analysis of the capacity of fiscal rules to regulate individual (excessive) debts shows that the absolute and relative number of municipalities with more than 60% debt ratio in the Czech Republic (517 municipalities/approx. 10%) is significantly higher compared to Slovakia (58 municipalities/approx. 2%). In both countries, mostly small and very small municipalities have specific financial problems which can be connected with wrong investment decisions. The less positive situation of the Czech Republic on first glance appears a bit illogical, because it might suggest that the more bottom-up oversight in Slovakia (by municipal controllers) is more effective compared to top-down oversight in the Czech Republic executed by the Ministry of Finance. The authors are not in favour of this explanation. To find other explanations, the authors evaluated other possible factors with the potential to cause this situation—territorial fragmentation, the contents of fiscal rules and the timing of adoption of fiscal rules.

Territorial fragmentation and especially the number of very small municipalities in the Czech Republic are slightly higher compared to Slovakia. This fact, connected with our finding that excessive debts are an issue only for small municipalities (in both countries), may play a role, but in our opinion cannot be the core explanatory factor. The municipal fiscal rules in Slovakia are slightly more comprehensive compared to the Czech Republic, but the differences in the ways of how the absolute level of the municipal debt is regulated are very marginal. The authors again do not feel that the contents of fiscal rules can serve as explanatory factor. The possibility that the only recent (2017) rule of a maximum 60% debt ratio in the Czech Republic would contribute to the relatively high figure of critically indebted municipalities also cannot be confirmed. The number of municipalities with a debt ratio over 60% increased from 456 in 2017 to 517 in 2018, and the number of municipalities with critical levels of all three monitored fiscal indicators (per the text above) increased from 6 to 10 in the same period.

The fact is that the difference between the number of critically indebted municipalities in the Czech Republic and Slovakia is very difficult to explain and calls for additional research which was unfortunately outside the scope of this chapter.

Thus, our analysis of the capacity of fiscal rules to regulate individual (excessive) debts paints a not very positive picture and highlights three core problems:

1. The first core problem in both countries is the fact that excessive borrowing is legally prohibited but nevertheless exists in some cases.
2. The second core problem currently regards only the Czech Republic, where the number of excessive indebted municipalities did not decrease after the acceptance of tightened fiscal rules in 2017.
3. The third issue for both countries is the fact that small municipalities in critical situations are at present left with no solutions or chance to escape from their debt trap. In both countries, the instruments of bailout and bankruptcy are not part of any valid legislation and cannot be used as a solution. The possible support from the state to overcome financial problems (e.g. bailout) is based on subjective decisions and may, but must not always, be provided. This leads to situations

such as the Bratislava-Devin example in which the municipality falls in a debt trap for 20 years with no systemic solution to act as a lifeline.

The final interesting overall finding is that the fiscal rules determining financial discipline of municipalities in Slovakia are slightly more comprehensive compared to the Czech Republic. This being noted, the level of municipal fiscal discipline in both countries is very similar, and the higher number of critically indebted municipalities in the Czech Republic seems not to be a result of a lower effectiveness of fiscal rules. Moreover, tightening the rules in the Czech Republic in 2017 did not appear to have any positive impact on the number of critically indebted municipalities in this short-term perspective. With this considered, the authors are left to ponder the question if, in fact, 'less is more' when it comes to developing effective local public financial regulation.

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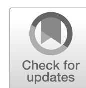
Monitoring Local Government Financial Sustainability: A Dutch-English Comparison



Dennis De Widt, Tim Thorogood, and Iolo Llewelyn

Abstract Monitoring of local public finance is an essential part of fiscal regulation, although national approaches interact with political and economic environments. England and the Netherlands provide telling similarities and differences in their local government contexts and approaches to such indicators. After a brief discussion of theoretical issues, this chapter compares the use of financial sustainability indicators (FSIs) in Dutch and English local government. It reviews the history, current use, bodies involved, the indicators themselves, and approaches to monitoring. In England, a long history of central oversight of local government, focused upon performance, came to an end in 2010. Ever since, there has been no systematic FSI monitoring, as central government has not implemented its own model, the NAO has not been legitimated, and the local government sector itself has only recently started focusing on financial resilience. The Netherlands has traditionally placed its focus with respect to FSI monitoring on fiscal rules, which are monitored at the regional level of the provinces. More than in England, the Dutch local government association has supported the development of FSIs whilst local government reporting on FSIs is mandatory. Finally, we show how different fiscal rules and governmental characteristics have resulted in contrasting developments of indicators and monitoring.

1 Introduction

Monitoring of local government (LG) finances is an essential part of regulation, as without monitoring, compliance with fiscal rules cannot be verified and regulation will fail. The idea of monitoring has been attempted with considerable variation and effectiveness since the 1990s but a widely agreed and applicable approach remains

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elusive. Scholars suggest that effective approaches need to interact with political and fiscal environments, which vary widely between jurisdictions (Jacob and Hendrick 2012). Therefore, this chapter assesses how two European countries, England and the Netherlands, monitor LG finances via financial sustainability indicators (FSIs). Both countries traditionally emphasise the avoidance of budget deficits as the most critical aspect of LG financial sustainability but have taken different monitoring approaches in practice. After reviewing and comparing each country's approach, we assess the extent to which those different approaches reflect country-specific conditions including perceptions of risk.

Most developed states practice monitoring of LG financial sustainability (García-Sánchez et al. 2012). Systems have been in development since at least the 1990s, led by scholars and practitioners in the USA, stimulated by high profile LG financial crises in the 1970s, such as New York's fiscal crisis in 1975 (Listokin and Burchell 1981). The primary purpose is to detect leading indicators of fiscal stress, thereby enabling remedial action in order to avert a crisis. However, debate on critical issues, including what constitutes fiscal stress and which measures are most effective to identify it, in particular, early enough to enable corrective steps, has been ongoing throughout. Most approaches focus on indicators of solvency (variously defined). Methods have been developed encompassing both short-term (e.g., liquidity measures such as the quick ratio and operating measures such as fund balances and deficits) and long-term indicators (e.g. long-term liability ratios including liabilities per capita). Many US states implement those indicators, for example, in the popular Financial Condition Index (Wang et al. 2007). The latter sometimes includes assessing long-term changes in population to reflect changes in the local tax base (Kloha et al. 2005; García-Sánchez et al. 2012; Jacob and Hendrick 2012) and reliance upon external grants and so exposure to changes in higher-level government policy (Cohen et al. 2017; Rivenbark and Roenigk 2011; Trussel and Patrick 2009).

In addition to which particular indicators to use, debate has focused on whether they may be combined into one single overall indicator (Clarke 2015) and whether reference points should be absolute (an acceptable specific level of solvency) or relative (to either a reference group and/or over time) (García-Sánchez et al. 2012). Many empirical approaches, both in the USA and Europe, apply regression analysis to identify whether a suggested combination of indicators is effective in practice. However, more recently some scholars identified that some well-established monitoring regimes demonstrated no correlation with identifying fiscally distressed LGs (Spreen and Cheek 2016) and assessed such approaches as not meeting suitable tests of reliability and validity (Clarke 2015). Underpinning many of these debates is the issue of whether solvency, however, defined, is in and of itself an adequate concept to define financial sustainability. Obviously, there is a tension between solvency and service levels with research suggesting a positive correlation between high solvency and low service levels and vice versa (Zafra-Gómez et al. 2009).

Recently experts argued that use of indicators alone is misplaced, as financial sustainability, viewed from an open systems perspective, results from a dynamic process, where internal decisions by LGs interact with the external environment. Decisions being taken in the present time can affect future sustainability, requiring

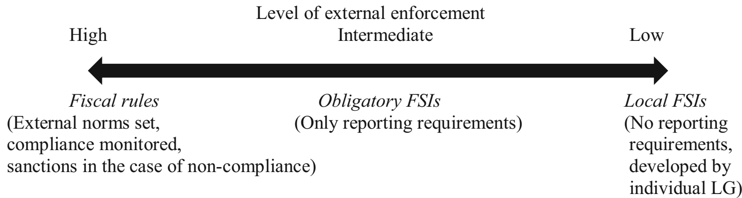

Fig. 1 Financial sustainability indicators (FSIs) and extent of external enforcement

an additional focus on decision-making processes (Jacob and Hendrick 2012). From this perspective, there is no single best strategy for assessing LG financial sustainability, but approaches need to be analysed against the background of the political and fiscal environment of any jurisdiction (Jacob and Hendrick 2012). In addition to this complexity, countries differ significantly in constitutional, legal and fiscal structures, which all affect LG accountability, LG funding and LG service demands. There is a great variety of LGs and circumstances. However, comparing approaches taken in different states, understanding how they reflect country-specific risks and assessing their efficacy enables both scholars and practitioners to better judge which approaches best suit their circumstances and those of each LG being monitored.

The purpose of this chapter is to review the current use of financial sustainability indicators (FSIs) for LGs in two contrasting countries—England and the Netherlands—and assess how far they reflect country-specific risks. In both countries, local government is responsible for roughly one-quarter of public spending and offers telling institutional contrasts to enable a comparison: England is a majoritarian system having no formal constitutional protection for local government, whereas the Netherlands is a decentralised unitary state where local government is embedded in a consensual-corporatist system (De Widt and Laffin 2018). Some of the FSIs we analyse are in use as fiscal rules—with authorities' performance against these rules expected to indicate critical information on their financial sustainability. However, not all FSIs applied to analyse LG finances are fiscal rules that are enforced by regulators. LGs may be legally obliged to report their performance on certain FSIs, without any norms set externally, whilst LGs themselves may also develop FSIs (e.g., to incorporate risk factors that are important but unique to the local authority). Hence, as illustrated in Fig. 1, FSIs can be analysed on a continuum, showing the extent to which external bodies monitor or enforce their use, and whether FSIs are linked to externally set norms.

The remainder of this chapter details the use of FSIs in England and the Netherlands. The chapter looks at the organisations involved in the monitoring of LG finances and the FSIs in use, including in some specific cases of municipal financial distress. Subsequently, we compare and contrast these approaches. We consider how far differences reflect the political and fiscal environments of each country and country-specific perceptions of risk. Finally, we summarise our conclusions and identify areas for further research.

2 England

2.1 Constitutional Arrangements

In England, LGs have limited scope to raise their own revenues and highly depend upon transfers from central government. These transfers have reduced considerably since 2010 leading to severe financial pressures on English LGs and raising concerns about their financial sustainability (NAO 2018). English LGs are institutionally heterogeneous including 'single-tier' LGs in some areas, 'two-tier' counties and district councils in others. Some regions also have directly elected mayors. Whilst LGs are able to incur budget deficits, they are unable to borrow to fund current expenditure. For any individual LG, the budgeted expenditure for any one year cannot exceed the total amount it intends to raise from taxation, central government transfers, other revenue and the revenue reserves it has at the beginning of the year. The chief financial officer in each LG must identify the required corrective actions by councillors if an unbalanced budget situation occurs. Following the scaling back and subsequent abolition of the Audit Commission, after 2010, systematic central publicly available monitoring of LG finances ceased. In the absence of a systematic and transparent national approach, the UK's public finance accountancy organisation (the Chartered Institute of Public Finance & Accountancy, or CIPFA) recently developed schemes to provide such an approach using publicly available information provided by LGs.

2.2 History on Use of FSIs

From 2002 onwards, the Audit Commission developed a system of Comprehensive Performance Assessment (CPA). It reported on how well a council was performing against a broad set of indicators including service, corporate as well as financial performance. Councils were placed in criteria-based categories both for current and expected future performance. 'League tables' were published annually to compare LGs' performances.

The financial standing of an LG formed a major part of this approach and consisted of several elements based upon an auditor's opinion and drawing upon their annual audit work. These elements included setting a balanced budget, setting a capital programme, financial monitoring and reporting, meeting financial targets and financial reserves. After 2008, a system of Comprehensive Area Assessments replaced the CPA, designed to include other public sector providers in an assessment of an LG area continuing to include financial assessments. However, a new government announced the abolition of the Audit Commission in 2010, and immediately the assessment approach was abandoned. This ended any comprehensive central and public monitoring of the finances of LGs.

2.3 Current State of the Use of FSIs

LGs annually submit a range of (unaudited) financial data to the Ministry of Housing, Communities and Local Government (MHCLG), which is publicly available. It does not provide FSIs, as this requires the processing of data to provide ratios, comparisons and trends. Such processing is undertaken by MHCLG and CIPFA on an ongoing basis, by the National Audit Office (NAO) as part of occasional reports on LG finances and, occasionally, by an LG's auditor.

MHCLG

The Ministry uses information from a range of sources including budget outturn data from each LG submitted annually (publicly available) to monitor LG financial health. However, there is no published scheme of FSIs and neither does the Ministry publish information on LG financial health. The NAO criticised this approach and described it in 2014 as 'limited' concluding the Ministry 'does not know enough about whether local authorities are close to failing financially' (NAO 2014, pp. 33–34). A further review by the NAO in 2018 stated:

> The Department… has developed a local authority sustainability tool, which models the share of 'inflexible spend' (on social care and debt servicing) by each authority against the scale of its reserves. Authorities with higher shares of inflexible spend and lower levels of reserves are less financially resilient. It then investigates authorities in more detail. (NAO 2018)

However, neither the detailed methodology nor the resulting information is publicly available.

Some criticism of the approach has continued. In 2019, a parliamentary LG committee concluded that the government needs a more regularised and consistent approach to monitor LG financial sustainability. However, in its response, the Ministry argued that the resilience index recently provided by CIPFA (below) was sufficient.

National Audit Office (NAO)

With the exception of work undertaken as part of compiling periodic audit reports on the LG sector as a whole, the UK's NAO has no function in compiling or monitoring local government FSIs. However, in its 2018 periodic report on the financial sustainability of local authorities, it highlighted two financial measures: overspending (i.e. in-year variances between planned services, budgets and outturns, requiring correction via financing from reserves, savings in non-service budgets or extra income) and trends in and size of total reserves. The report also showed how LGs with social care responsibilities (which are increasing long term due to demographic changes) had increased proportionate spending in their hard-to-reduce social care budgets resulting in reducing future flexibility (arguably itself an FSI). The NAO concluded, 'These trends are not financially sustainable over the medium term' (NAO 2018, p. 8).

In addition to those measures, the NAO reviewed 'service sustainability' showing how continuous reductions in spending on services actually reduced service levels

(albeit finding that the impact on service users was uncertain); thus, effectively using a fourth FSI as suggested by the more broadly based models of financial sustainability (NAO 2018).

Auditors

In accordance with the UK's Code of Audit Practice 2015, auditors must satisfy that the audited body '. . .has made proper arrangements for securing economy, efficiency and effectiveness in its use of resources'. NAO guidance identifies 'sustainable resource deployment' as an area that the auditor may wish to consider as part of their audit coverage and 'financial sustainability pressures' as a key risk. There is no requirement for auditors to use any specific FSIs as part of their work. However, in 2019 the government commissioned an independent review of English local authority financial reporting and external auditing (the Redmond Review). It is widely expected to include consideration of how auditors can be more effective in highlighting risks of financial sustainability. This report followed increasing concern about English LGs' financial sustainability and the limited role of auditors in identifying sustainability concerns.

CIPFA's Measurement of Resilience

From 2019, responding to concerns about financial resilience in the local government sector, CIPFA published a Financial Resilience Index. It consists of a set of nine primary (and seven secondary) 'indicators of financial stress', in addition to the external auditor's Value for Money assessment and a Children's Social Care Judgement (provided by the social care inspectorate) for each LG using publicly available information (the annual returns each LG submits to the MHCLG).[1] There is no single, overall, indicator, but each indicator is placed on a risk chart showing the level of risk that this indicator suggests. Each LG is compared to similar LGs in a comparator group analysis. The details on how the risk assessments are determined are not publicly available. Table 1 lists the primary indicators.

In launching the indicators in December 2019, CIPFA found that the majority of councils were not showing signs of stress but about 10% showed 'some signs of potential risk to their financial stability' (Public Finance 2019). However, the index received a mixed reception from LGs. They were concerned it could be misinterpreted, that it was too crude and looking back might overrate an LGs financial health as it does not take into account future financial plans (LGC 2019). These views reinforced concerns expressed by the English Local Government Association (LGA) that a handful of indicators could not adequately summarise and forecast the financial health of large and complex organisations such as local authorities (LGA 2018). Table 2 summarises the current use of explicit FSIs by bodies at a national level.

[1]The Financial Resilience Index is freely accessible on CIPFA's website: https://www.cipfa.org/services/financial-resilience-index/financial-resilience.

Table 1 Indicators from CIPFA financial resilience index

CIPFA primary indicator	Definition
Reserves sustainability measure	Ratio between the current level of reserves and the average change in reserves in each of the past 3 years
Level of reserves	Ratio of the current level of reserves (total useable) to net revenue expenditure
Change in reserves	Average percentage change in reserves over the past 3 years
Interest payable/net revenue expenditure	Ratio of interest payable and net revenue expenditure
Gross external debt	Gross external debt amount
Social care	Ratio of total spending on adult and children's social care to net revenue expenditure
Fees and charges to service expenditure ratio	Proportion of fees and charges to net revenue expenditure
Council tax requirement to net revenue expenditure	Ratio of council tax as proportion of net expenditure
Growth above baseline	Difference between the baseline funding level and retained rates income, over the baseline funding level

Source: CIPFA (2019)

Table 2 Local government FSIs in use at the national level, England

Body	FSIs used	Notes
MHCLG	• Inflexible spend (debt servicing + social care)/reserves	This is the only indicator officially acknowledged by central government; there are likely to be others
NAO	Overspending (i.e. in-year variances between planned service budgets and outturns) + trends in and size of total reserves + increasing inflexible spend (social care) + service level	Used in periodic reviews of sector finances
CIPFA	• Reserve ratios (level; changes; sustainability calculation) • Interest ratio + gross debt • Social care ratio • Income ratios	Published since 2019 each year on a comparative basis

Source: Own composition

2.4 *Case Study: Northamptonshire County Council*

English law requires the chief financial officer of a local authority to issue a Section 114 Notice if he/she anticipates an unbalanced budget. Since 2000, there has only been one Section 114 Notice issued in an English LG: Northamptonshire County Council (NCC) in February 2018. In January 2018, MHCLG had already decided to intervene in the financial affairs of NCC through the appointment of a team to inspect the council. Legislation enabled Ministers to enforce such an inspection if they felt that the council was failing in its duty to provide 'best

value' in its services. Subsequently in 2019, MHCLG appointed commissioners to run the council, a situation still in effect in 2020.

At the beginning of 2018, the Council reached a point where it was unable to set a credible balanced budget for the following year. This followed 3 years of financial mismanagement in which NCC, continually failing to reduce expenditure to match revenues, only managed to balance its budget by the use of one-off funds including the use of capital receipts thereby flouting the fiscal rules. Amongst the reasons for this situation were poor financial planning and control resulting from a complex, devolved, organisational structure and a culture lacking in accountability (Caller 2018).

Table 3 shows the CIPFA financial resilience index data for NCC in the 2 years preceding the crisis (2015/16 and 2016/17). This data was only published subsequently in 2019. Two measures were not applicable as they relied on 3-year averages, whereas the index only reverted to 2015/2016. The table suggests that CIPFA produces its risk-level assessment for each LG on a comparative basis, using county councils as a comparator group for NCC. Two indicators, 'level of reserves' and 'interest payable/net revenue expenditure', clearly indicate a high risk (in fact, indicating the lowest reserves and highest interest payable compared to all county councils in both years). Reserves had fallen significantly from 7.09% of net revenue expenditure to 4.68% between 2015/2016 and 2016/2017, suggesting that the 'change in reserves' indicator, if assessed, would also indicate high risk. The 'social care' ratio (indicating inflexible spend) also deteriorated, suggesting a higher-risk assessment. 'Gross external debt' continued to increase over 2 years, contrary to the trend amongst all county councils. However, other indicators do not appear to suggest high or increasing risk.

CIPFA's index does not include overspending (outturn compared to budget), which is used by the NAO in its occasional reports and widely used in the international literature. However, NCC managed to disguise its overspending on services by virements from one-off funds including the use of capital receipts. This happened even though social care spending consistently exceeded planned budgets and would otherwise have led to an overspend overall (Caller 2018).

The Council received adverse audit value for money judgements for 2015/2016 and 2016/2017, which is unusual in English LGs and should have sounded alarm bells, whilst a 'peer review' carried out by the LGA of NCC's finances in September 2017 was highly critical of the situation. Again, no action was taken (LGA 2017).

3 The Netherlands

3.1 Constitutional Arrangements

Local government in the Netherlands exists within a 'small consensual–corporatist state, where decision-making is about "eternal" deliberation, consultation and compromising' (Kickert 2012, p. 300). Policymaking in the Dutch

Table 3 CIPFA financial resilience index applied to Northamptonshire County Council

CIPFA primary indicator	NCC risk level 2016/2017	NCC score 2016/2017	Minimum comparator group county councils 2016/2017	Maximum comparator group county councils 2016/2017	NCC risk level NCC score 2015/2016	NCC score 2015/2016	Minimum comparator group county councils 2015/2016	Maximum comparator group county councils 2015/2016
Reserves sustainability measure	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Level of reserves	High	4.68%	4.68%	53.89%	High	7.09%	7.09%	53.41%
Change in reserves	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Interest payable/ net revenue expenditure	High	10.93%	1.03%	10.93%	High	8.04%	1.6%	8.04%
Gross external debt	Medium-High	£714,013k	£158,023k	£1,210,502k	Medium-high	£647,725k	£222,761k	£1,227,580k
Social care	Medium-high	69.3%	57.27%	70.86%	Medium	64.71%	54.27%	69.23%
Fees and charges to service expenditure ratio	Medium-low	7.75%	5.12%	15.38%	Medium-low	7.71%	4.82%	10.9%
Council tax requirement to net revenue expenditure	Medium	58.88%	53.25%	75.82%	Medium-high	53.56%	51.28%	71.7%
Growth above baseline	Medium	3.00%	-1%	5%	Medium-High	2.00%	-2.00%	3.00%

Source: Own composition, based on the CIPFA financial resilience index database (https://www.cipfa.org/services/financial-resilience-index/financial-resilience)

intergovernmental system emphasises equality in public service provision (Goedhart 1989), which is reflected in a sophisticated local government funding system that is characterised by a high degree of redistribution. The local institutional landscape is highly homogenous in the Netherlands, with all 355 Dutch LGs having the similar legal position of municipality (*gemeente*) and demonstrating a high degree of homogeneity in their duties and tasks. In the Dutch system, the provincial level carries the main responsibility for monitoring LG finances. The 12 Dutch provinces conduct local financial supervision on behalf of the Ministry of the Interior and Kingdom Relations (hereafter referred to as the 'Interior Ministry') but do enjoy a high level of autonomy in conducting their supervision.

In recent years, municipal finances have received growing attention. The 2008 financial crisis significantly impacted Dutch local finances, especially by putting real-estate investments at risk in which many Dutch municipalities had become extraordinary active since the 1990s (Ten Have 2010). In addition, three major social welfare tasks were decentralised to the municipal level in 2015. As a post-2008 austerity measure, central government reduced the original budget related to these tasks of EUR 15.6 billion by EUR 6 billion. There has been increasing reporting that these new tasks increased financial pressures at the local level (AEF 2017). This context has stimulated the development and increased application of FSIs in the Netherlands in recent years.

3.2 History on Use of FSIs

Traditionally, the main regulation in the Dutch system to prevent municipal financial risk has been the balanced budget rule. Dutch LGs are required to set a materially balanced budget, which indicates that structural income covers structural costs, whereby the term 'structural' refers to a period of 3 years. Therefore, an LG is allowed to show a budget deficit in the current or next budgetary year but should be able to present a balanced budget in its 3-year estimates. At least, in theory, this implies a municipality is able to set a continuously unbalanced budget without getting into trouble with the provincial regulator, as long as it can present a balanced budget in its 3-year forecasts (De Widt 2017).

Provincial regulators formally review two additional indicators when deciding upon a municipality's supervision status. These additional indicators were introduced in 2000 as part of a new law on the financing of subnational governments, called *Wet Fido*. The new law tightened the relatively liberal Dutch subnational treasury framework, which had shown shortcomings following the secret commercial banking activities by the province of South Holland in the 1990s leading to a loss of more than EUR 20 million. To mitigate risks arising from holding short-term liquidity, Fido introduced a cash limit (*kasgeldlimiet*), which determines that short-term debt may not exceed 8.5% of the total municipal exploitation costs. Fido also introduced an interest risk norm (*renterisiconorm*), which prohibits LGs from refinancing debt exceeding 20% of their total annual budget. The interest risk

norm aims at reducing risks that may emerge by having to refinance large sums of long-term debt in any particular year. By doing so, Dutch LGs pay attention to a proper spread of the maturity of their debt portfolio in time (Zanten-Lagendaal and Wijnands 2001).

The monitoring focus of the provinces and especially the strong focus by the provinces on the materially balanced budget when deciding on the supervision status of a municipality have drawn significant criticism (e.g. Rfv 2017). It has also incentivised the development of additional FSIs in recent years.

3.3 Current State of Use of FSIs

Role of the Interior Ministry and Provincial Supervisors

As the supervision of municipalities is a responsibility of the provinces, the main role of the Interior Ministry, with regard to local finances, is to ensure that the legal framework in which municipalities operate contributes to the financial sustainability of the intergovernmental financial system as a whole. There is debate as to which specific tasks the Ministry requires in order to fulfil its 'system responsibility'. Nonetheless, the department currently exercises the following roles in relation to municipal finances.

The Ministry interacts directly with municipalities following its responsibility for the Section 12 support system, which is a temporary additional annual funding allocation municipalities can apply for if they face financial distress. In order to decide whether a municipality is entitled to a Section 12 bailout, inspectors from the Interior Ministry will scrutinise a municipality's income and expenditure levels against a set of comparator municipalities. In addition, it will investigate whether the municipality is disadvantaged in terms of having a lower than average income or higher than average expenditure on non-discretionary budget posts. Only if the municipal deficit exceeds two per cent of what the municipality receives from the Dutch Municipal Fund can it be considered for Section 12 emergency support. An income threshold is also in place demanding that the local property tax is set at a rate at least 20% above the national average and fees for sewage systems and refuse collection are cost-covering (BZK 2017).

Together with the provincial supervisors, inspectors from the Interior Ministry will offer municipalities the opportunity of a budget scan. By providing an in-depth analysis of a municipality's finances by comparing it to a set of comparator LGs, the scan largely uses the same methodology as applied by Section 12 inspectors. The report containing the scan's results is then sent to the municipality, and, unless the municipality objects, it will be published. The report often provides recommendations for the municipality as to how it could strengthen its financial position. Although a municipality cannot be obliged to implement the report's recommendations, the municipal council is required to provide a written response on the budget scan's results. The Interior Ministry is able to subsequently monitor the extent to which the municipality implements its recommendations. However, it is only once a

municipality receives Section 12 support that it must comply with directives from intergovernmental regulators.

In recent years, the Interior Ministry also tried to bring more uniformity in the supervisory approach. Whilst there has been some improvement in this regard (e.g. BZK 2008; Joint Provinces 2020), provincial monitoring continues to be characterised by differences. The report on the results of provincial supervision, which the Interior Minister sends to the Dutch Lower House annually, reflects this finding. The report builds on provincial reports and shows significant differences in the level of detail of provincial financial supervision (e.g. BZK 2016). The quality of provincial financial supervision has faced criticism for lacking critical mass (in terms of both staff numbers and staff expertise), whilst an independent review showed that provinces often demonstrate shortcomings in preventing municipalities from having to apply for Section 12 support (Rfv 2017). The provincial approach may relate to the fact that provinces do not bear any financial consequences if municipal finances derail, as it is the collective of municipalities paying for Section 12 bailouts, through the Dutch Municipal Fund. Hence, several proposals for alternative supervisory models have been made, including setting up a single national body to regulate municipal finances (Van der Lei 2019).

In cooperation with the Finance Ministry, the Interior Ministry is also responsible for maintaining the institutional mechanisms and distribution criteria used for the allocation of general grants, which constitute the main revenue source for most Dutch LGs. As part of this responsibility, the Interior Ministry carries out regular reviews of grant features that may cause municipal financial stress. In addition, the Interior Ministry uses observations made with Section 12 municipalities to refine the distribution system. This partly explains the substantial reduction in Section 12 LGs over the past decades. For instance, in the 1950s, the majority of Dutch LGs received Section 12 support, but since 2000, the number has varied between two and five LGs annually (Financial Relations Council 1996).[2]

The Interior Ministry also commissioned reviews in relation to the decentralisation of welfare duties and tasks mentioned previously. This included a study on the causes of municipal deficits in youth care spending, which resulted in significant additional funding (e.g. EUR 420 million for 2019 alone).[3] Since the reporting year 2016, the Interior Ministry has also annually employed a consultancy organisation to analyse financial trends emerging from municipal accounts. This analysis concentrates on social expenditure, including how these expenditures impact on the timeliness of the submission of municipal financial statements. Finally, the Interior Ministry commissions reviews in collaboration with other organisations—for example, with the Association of Dutch Municipalities (VNG), and the Ministry of Infrastructure and Environment into the effects on municipal finances of the crisis

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[2] https://www.rijksoverheid.nl/onderwerpen/financien-gemeenten-en-provincies/financieel-toezicht-gemeenten-en-provincies/artikel-12-gemeenten

[3] https://www.rijksoverheid.nl/actueel/nieuws/2019/05/27/extra-geld-voor-jeugdzorg-en-geestelijke-gezondheidszorg

at municipal real-estate companies (e.g. Deloitte 2013). Findings from these reviews were partly instrumental for the decision taken to extend the period in which municipal budgets need to be balanced from the standard 3 years to up to 10 years (with a possibility for further extension) in the case that a municipality's deficit is due to problems with its real-estate portfolio (Commissie BBV 2019).

Additional FSIs

In addition to the *Wet Fido*, other relevant legislation in relation to FSIs is included in the BBV (*Besluit Begroting en Verantwoording Provincies en Gemeenten*—Decision Budget and Reporting Provinces and Municipalities). The BBV came into effect in the financial year (FY) 2004 following some changes in the political structure of Dutch LGs, which also resulted in changes to municipalities' budgeting and reporting regulations. Following the 2008 financial crisis, a widespread need was felt to strengthen financial scrutiny of municipal councils. This resulted in a review of the BBV in 2014 by an advisory commission appointed by the VNG. Several of the commission's recommendations have subsequently been incorporated into a revised BBV, published in 2015 (see BZK 2015); including the requirement for Dutch LGs to report financial ratios in their budget documents from 2016 onwards and in their annual reports since 2015. By providing a uniform calculation basis, the ratios, listed in Table 4, facilitate easier comparisons amongst municipalities and aim to enhance insight into a municipality's financial position, especially for council members.

In line with recommendations made by the VNG appointed advisory commission, the ratios are not externally standardised. As shown in Table 5, the Interior Ministry and the provinces have agreed on signal values, which are divided into three categories—A, B and C—with A indicating least risk, and C most risk (Joint Provinces 2020). To improve comparability and transparency, the Interior Ministry also developed an online and publicly accessible database containing all municipal (and provincial) financial ratios since 2018, as included in both their budget documents and annual accounts.[4] However, both the Interior Ministry and the provinces have abstained from developing explicit norms and have made it the responsibility of local councils to decide upon how to use the ratios and whether to standardise them internally. Whilst this liberal approach resembles the wider Dutch subnational accounting framework, the absence of explicit standards has restrained the active use of ratios in municipal policymaking (Van Rees 2017).

To enhance the role of FSIs, several tests have been developed in recent years. These tests should help municipalities to better interpret their financial position by providing more guidance for important ratios. This is especially important for local councillors amongst whom there is limited financial expertise. Most of these tests use the obligatory ratios from the BBV, often combined with additional ratios. An example is the financial condition index developed by the VNG, which uses the

[4]See Findo – Financial Data Subnational Governments (*Data Financiën Decentrale Overheden*): https://www.findo.nl/

Table 4 FSIs in use in the Dutch system—signal values between brackets, if applicable

Main regulations—Local Government Law (*Gemeentewet*) (1851/1994) & Law on the Financing of Subnational Governments (*Wet Fido*) (2000)	BBV ratios (compulsory since 2015)	Ratios Association of Dutch Municipalities (VNG) (available since 2013)
Structurally balanced budget (*non-compliant if budget is unbalanced in 3-year forecasts*)	Structural operating result (*if % ↑, risk ↓*)	Structural operating result (*if <0% in at least one of two FYs preceding current FY + current FY, risk ↑*)
Interest risk norm (*non-compliant if annual refinancing debt is >20% of total exploitation costs*)	Net debt quote (*if % ↓, risk ↓*)	Net debt quote (*if >130%), risk ↑*)
Cash limit (*non-compliant if short-term debt is >8.5% of total exploitation costs*)	Net debt quote corrected for all externally issued loans (*if % ↓, risk ↓*)	Effective net debt ratio (*individualised signal value*)[a]
	Solvency ratio (*if % ↑, risk ↓*)	Solvency ratio (*if <5%, risk ↑*)
	Unused tax capacity (*if % ↓, risk ↓*)	Unused tax capacity OZB (*if OZB tariff >140% of the weighted average rate of all municipalities in preceding FY, risk ↑*)
	Land exploitation (*if % ↓, risk ↓*)	Fast increasing debt (*if net debt quote, effective net debt ratio, solvency ratio and structural operating result exceed signal values, risk ↑*)
		Short-term liquidity ratio (*if >20%, risk ↑*)
		Grant dependency ratio (*if >70% of total income, risk ↑*)
		Net investment quote (*if <1% OR >5%, risk ↑*)
		Net consumer expenses per inhabitant (p/i) (*signal values differ for categories of municipalities—category 1 municipalities, if > EUR 1.751 p/i, risk ↑; category 2, if > EUR 2.135 p/i, risk ↑; category 3, if > EUR 2.983 p/i, risk ↑*)[b]
		Sustainability quote—indicates cuts required in bad weather scenario for sustainable finances (*if >26%, risk ↑*)

Source: Own composition

[a]Due to large interlocal differences in the amount of externally issued loans and municipal stocks held, the VNG test does use municipal specific signal values to calculate the effective net debt ratio, which are then confronted with the municipality's net debt quote. For further details, see VNG 2019

[b]The categories rest on those developed by the Interior Ministry. They are based on the municipal social structure and whether it fulfils a regional function

Table 5 Municipalities under preventive supervision in 2018 (upper part of table), and with lowest score on VNG financial condition index (bottom part of table), all figures relate to 2018 annual accounts

Province	Municipality (population size)	Reason to be placed under preventive supervision	Net debt quote Cat. A: <90% B: 90–130% C: >130%	Net debt quote corrected for all externally issued loans A: <90% B: 90–130% C: >130%	Solvency ratio A: >50% B: 20–50% C: <20%	Structural operating result A: >0% B: 0% C: <0%	Tax capacity A: <95% B: 95–105% C: >105%	Land exploitation A: <20% B: 20–35% C: >35%	Score LG on VNG financial condition index (1=very poor to 10=outstanding)
National municipal average			56.5%	48.2%	34.9%	1.3%	101.9%	13.7%	8.0
Groningen	Ten Boer (7,292)	Negative general reserves following Section 12 allocation	69.3%	67.4%	-8.3%	1.5%	124.1%	14.8%	n/a
Overijssel	Almelo (72,629)	Since 2016 due to materially non-balanced budget	83.0%	73.0%	5.0%	-2.0%	108.0%	18.0%	7.5
	Twenterand (33,903)	Since 2018 due to materially non-balanced budget	58.7%	39.2%	29.5%	-0.5%	93.9%	13.6%	7.0
Limburg	Sittard-Geleen (92,956)	Since 2018 due to materially non-balanced budget	111.0%	107.0%	12.0%	1.0%	102.0%	3.0%	7.5
Zeeland	Middelburg (48,303)	Since 2016 due to materially non-balanced budget	113.4%	105.2%	15.8%	-1.0%	92.0%	36.9%	7.5

(continued)

Table 5 (continued)

Province	Municipality (population size)	Reason to be placed under preventive supervision	Net debt quote Cat. A: <90% B: 90–130% C: >130%	Net debt quote corrected for all externally issued loans A: <90% B: 90–130% C: >130%	Solvency ratio A: >50% B: 20–50% C: <20%	Structural operating result A: >0% B: 0% C: <0%	Tax capacity A: <95% B: 95–105% C: >105%	Land exploitation A: <20% B: 20–35% C: >35%	Score LG on VNG financial condition index (1=very poor to 10=outstanding)
	Vlissingen (44,485)	Since 2016 due to materially non-balanced budget	84.0%	85.0%	-55.0%	-1.9%	117.0%	4.0%	5.0
Financial ratios of municipalities with failing score based on VNG financial condition index									
Groningen	Groningen (202,810)		136.6%	100.5%	13.0%	0.4%	102.8%	7.3%	4.5
Gelderland	Arnhem (157,223)		85.2%	75.8%	16.4%	-2.0%	100.0%	5.4%	5.5
Utrecht	Eemnes (9,112)		80.0%	47.4%	25.5%	0.3%	101.3%	4.1%	5.0
North Holland	Oostzaan (9,735)		146.2%	143.4%	13.2%	0.0%	118.4%	0.5%	4.5
South Holland	Rijswijk (52,208)		164.3%	162.3%	9.5%	0.0%	98.0%	92.4%	5.0
South Holland	Schiedam (77,907)		162.8%	154.4%	14.6%	2.4%	103.6%	1.5%	4.0
Limburg	Vaals (9,874)		96.0%	95.0%	16.0%	-1.9%	96.0%	24.0%	4.5

Sources: Municipal accounts, BZK website, VNG index, CBS (for population statistics)

BBV ratios combined with six additional ratios (see Table 4). All ratios are perceived as significant determinants of the budgeting flexibility of Dutch LGs. Each ratio links to a signal value, with the municipality's score on each individual ratio calculated on the basis of three different scenarios: (1) a trend scenario where income and expenditure remain constant, (2) a 'bad weather' scenario where income reduces whilst expenditure increases, or (3) an individually chosen scenario. The municipality's scores on the individual ratios are then combined into an overall score that, using a traffic light score methodology, results in either a green (low financial risk), amber (medium risk) or red (high risk) overall score. The use of the VNG stress test has become increasingly widespread amongst Dutch LGs. In many cases, external consultancy firms support the implementation and translation of results into strategic municipal actions (Schilder and Bouwmeester 2016).

Both the BBV ratios and most municipal stress tests emphasise the impact that debt may exert upon a municipality's financial position. In line with this, the Dutch Council for Public Administration has emphasised that intergovernmental regulators should apply explicit debt norms. Therefore, LGs and municipal council members should develop greater awareness of financial risks and face stronger incentives to reduce debt levels if their municipality exceeds the regulator's norm. The Council also advised the Interior Ministry to use a municipality's debt quote as an additional criterion when deciding on the allocation of Section 12 support, since, so the Council stated, the ability of municipalities to absorb future setbacks is greatly determined by their debt burden (Rfv 2015).

3.4 FSIs and Recent Cases of Intensified Supervision

If a municipality is unable to present a structurally balanced budget, or provincial supervisors are not convinced that the budget forecasts are attainable, the provincial authorities are legally obliged to put the municipality under intensified supervision. Under this regime, the municipality must acquire prior approval from the province for any budget changes it intends to make during the budgetary year. The financial position of LGs placed under intensified provincial supervision is clearly considered to be in need of adjustment. However, is this reflected also in the FSIs of these municipalities? In 2018, six municipalities spread across four Dutch provinces faced intensified provincial supervision. Table 5 lists those municipalities, together with the Dutch municipal average for reference purposes. For most ratios, the municipalities under intensified supervision underperformed compared to the average of the Dutch municipalities. Looking at the municipal debt ratios (in both measurements), however, only two out of six municipalities showed debt ratios that were not Category A—low risk. Compared to the national municipal average, these municipalities performed worst regarding their operating result, which is unsurprising

given the fact that the operating result constitutes the provinces main criterion for deciding upon a municipality's supervision status.[5] Regarding the tax capacity ratio, four of six municipalities had a rating of either A or B, indicating that they still had space to increase their tax revenues by increasing rates (and they would need to utilise this tax space should they wish to apply for Section 12 support). Risks attached to real-estate investments (indicator 'land exploitation') were of limited relevance to LGs under intensified supervision, as all municipalities except Middelburg had a category A rating.

When including the financial condition index developed by the VNG, most municipalities under intensified supervision showed a remarkably high score of seven or above, indicating ample resilience. When we list municipalities with an insufficient/failing financial condition score (below 6) according to the VNG index, which totalled eight based upon the 2018 accounts, only Vlissingen appears subjected to intensified provincial supervision. The lack of overlap between municipalities placed under intensified supervision and those failing the VNG's sustainability test indicates the different weight put on various indicators. In particular, the VNG test gives greater weight to municipal debt, which is reflected by a significantly higher average of debt held by municipalities that failed the VNG's test compared to those under intensified provincial supervision.

4 Conclusions

A body of recent international literature on FSIs has emphasised their contingent nature, arguing that a 'one-size-fits-all' approach cannot work due to different governments operating in quite dissimilar circumstances (Jacob and Hendrick 2012). The comparison of England and the Netherlands shows this in practice.

At a national level, England and the Netherlands exhibit some fundamental similarities in the context of LG finances, but, despite this, different fiscal rules result in contrasting approaches to the development of FSIs. English and Dutch LGs are both highly dependent on fiscal transfers from central government, driven by an emphasis on equity of service levels amongst LGs. However, fiscal rules governing LG financial management are substantially different: in England LGs are forbidden either to budget for a deficit in their general funds or to borrow for their annual budgets, resulting in an emphasis on reserves to ensure balancing income and expenditure. In the Netherlands the requirement to set a structurally balanced budget (i.e. over 3 years) and the ability to borrow to support that budget result in more flexibility. Therefore, Dutch FSIs emphasise debt levels and liquidity.

[5]Sittard-Geleen reports a positive operating result in its annual accounts for 2018–2019 (1.0%); however, it is the *budgeted* operating result that is the focus of provincial supervision, and Sittard-Geleen forecasted a negative operating result in its budget for 2018–2019 (-1.0%), explaining the intensification of provincial supervision. Ten Boer reported negative operating results in both its budgets and annual accounts prior to receiving Section 12 emergency support.

Although important intergovernmental arrangements remain in place to ensure the local level complies with fiscal rules, both countries put increasing emphasis on the responsibility of local actors to incorporate financial sustainability considerations into local decision-making processes. Subsequently, the use of FSIs has become more common. In England, the primary FSI is the requirement for each LG to ensure that budgeted expenditure for any single year does not exceed the total of the revenue it intends to raise during the year and the revenue reserves that it has at the beginning of the year. If an LG looks likely, via forecasting, to breach this indicator, action must be taken by the LG to correct the projected imbalance. If suitable action is not taken, external intervention by central government can be triggered. This strict approach reduces the risk that an English LG body cannot meet its liabilities. The emphasis of FSIs (such as the current CIPFA resilience index) has consequently been to highlight where the possibility of an imbalanced budget situation might develop—hence the emphasis on reserve levels and the ratio of 'inflexible' spend (including debt servicing) to net revenue/spending. In the Netherlands, in contrast, the emphasis is on ensuring LGs' borrowing and borrowing costs remain sustainable by including related concepts of debt quotes, solvency and liquidity.

The history of FSIs between England and the Netherlands contrasts markedly. England saw the development of FSIs as part of the Audit Commission's annual comprehensive assessment of LGs in the 1990s and 2000s. However, the specific motivation was to foster continuous improvement in the economy, efficiency and effectiveness of LGs rather than financial sustainability defined in terms of a balanced budget. As such, the approach was abandoned in 2010 alongside performance management of LGs with the emphasis remaining on balanced budget indicators. In the Netherlands, however, the more liberal fiscal rules coupled with financial pressures post 2008 and growing criticism of municipal financial supervision as conducted by the provinces, led to rising interest in FSIs, resulting in their systematic development through the BBV by the Interior Ministry and the municipalities from 2015.

Currently, the use of FSIs is arguably more widely spread in Dutch compared to English LGs. This difference is likely due to the reporting of FSIs having become a legal requirement in the Dutch system, the monitoring of those indicators by the provinces and the supporting role of the Dutch Interior Ministry and local government association in the local use of FSIs. Nonetheless, the use of FSIs has remained controversial in both countries. In England, the approach of the Audit Commission before 2010 was unpopular due to the burden it placed on LGs participation in the annual assessment process and public resources consumed by the Commission. When the detailed evaluation of LG finances within the national system was abandoned, criticism followed, but the development of a system of FSIs by CIPFA since 2018 has itself been controversial. In the Netherlands, the local government community has been relatively supportive of the introduction of FSIs, however, on the condition that the indicators do not link to externally set norms. Whilst this approach fits well in the Dutch tradition of municipal autonomy and may better help to account for inter-municipal differences, it has reduced the signalling role of FSIs

and so restrained their active use by municipal councillors, that is, their primary intended user group.

Inter-local differences are particularly relevant when it comes to explaining scepticism about the utility of FSIs in England, given the large institutional heterogeneity in types of LGs, which is partly reflected in different financial conditions (De Widt 2021). More generally, the inherent inability of past information to predict the future is another source of controversy, that is also reflected in the international literature (Jacob and Hendrick 2012). Despite this controversy, the single case of an officially fiscally distressed LG in England suggests that FSIs, such as those published by CIPFA, could indeed be effective in providing an early warning. However, in the Netherlands, there is no correlation between LGs under intensified supervision and the VNG financial condition index, which equally raises questions about the efficacy of FSIs and the appropriateness of the traditional focus of regulators.

The differing approaches in England and the Netherlands mirror different perceptions of risk in each country as defined in the primary LG fiscal rules. In England, tough fiscal rules reduce the likelihood of an LG fiscal crisis. FSIs highlight the likelihood of the primary fiscal rule being breached if declining reserves, and limited scope to reduce spending, suggest it may become difficult to achieve the balanced budget rule. By contrast, in the Netherlands, where the primary fiscal rules allow annual deficits and borrowing within broad limits, FSIs focus on changes to deficits, debt and solvency levels with set thresholds in the VNG ratios. These aim to identify LGs where increasing deficits, debts and solvency measures suggest forthcoming fiscal stress.

Comparing England and the Netherlands to the international literature, they reflect the popularity of debt and short-term solvency-type indicators (i.e. can the LG continue to pay its bills?) and do not include longer-term and broader-type indicators such as sociodemographic developments underpinning long-term revenue and demand. Apart from England's 2018 NAO review, neither do the approaches consider service level indicators (indicating whether service levels are acceptable or are increasing/decreasing). Despite their relatively narrow focus, the comparison shows FSIs could play an important role in helping to translate and summarise relatively complex financial information in a more manageable format. FSIs provide helpful tools in identifying an LG's financial position, but the interpretation of figures, including their mutual coherence, is key and should be complemented by additional information. This should include broadly based and qualitative approaches, which can evaluate what is actually occurring in an LG and how current or past decisions can affect future sustainability (Jacob and Hendrick 2012).

A more fundamental challenge to the use of FSIs at the local level is which particular financial sustainability risk these indicators aim to capture. In the case of the corporate sector, the real presence of corporate insolvency gives a clear overall focus on financial ratios. Since Altman's (1968) pioneering work, a rich theoretical and empirical body of literature has emerged on corporate finance ratios. Despite their more pluralistic objectives and an opaque risk of insolvency, public sector organisations and their use of FSIs would benefit from more systematic and large-

scale empirical analyses. Similarly, research into how LGs use FSIs in decision-making processes in different country contexts is likely to carry great value for scholars and policymakers alike.

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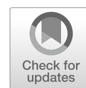
The Implementation of Fiscal Regulation: Insights from Germany



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Abstract The fiscal regulation of local governments has a long tradition in Germany and is, theoretically, rather strict. The municipal budget law of German states clearly prescribes balanced budgets, monitoring and enforcement instruments as well as a dense structure of supervision. Nonetheless, the implementation of fiscal regulation has proven to be difficult and insufficient and has triggered academic discussion and organisational reforms in recent years. This chapter explores the question of how financial regulation is implemented in German local governments and the related obstacles it has had to overcome. The empirical analysis in this chapter triangulates documentary analyses, financial data, expert interviews and surveys with local treasurers and regulators. Our analysis reveals patterns; however, it does not allow for clear causal conclusions, as financial regulation often takes a case-by-case character. Regardless, this research opens avenues for better implementation approaches, such as the training of regulators, more central organisational structures of regulatory bodies and a change in regulatory strategy shifting towards the early identification of budget crises.

1 Introduction

The financial situation of many German municipalities has been tense for decades. As in most European countries, the international financial and economic crisis of 2007–2009 considerably exacerbated the municipal budget crisis in Germany as well. The current positive macroeconomic conditions and financial assistance from the federal and state governments do, indeed, stabilise the majority of municipal

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budgets. Nevertheless, in particular structurally weak municipalities cannot escape their problematic budget situation (Boettcher et al. 2019).

The growing budget crisis of many municipalities has led to an increasing scientific examination of its causes. The relevant state of research in Germany shows that a mixture of structural, socio-economic and political-institutional factors is responsible (Bogumil et al. 2014). This is in line with the findings of international research. In addition to socio-economic causes, international research has identified numerous political-institutional explanatory factors for the municipal financial situation, such as the fragmentation of local government (Ashworth et al. 2005), election cycles (Geys 2007; Bastida et al. 2013), the political strength of local governments (Borge 2005) or political ideologies (Garcia-Sanchez et al. 2012). However, one relevant explanatory factor has been largely neglected to date: the implementation of state supervision of municipalities.

Fiscal regulation of local governments has a long tradition in Germany and is, in theory, strict. The municipal budget law of the German Länder clearly prescribes balanced budgets in planning and accounting. Monitoring and enforcing compliance with these rules are the task of state supervisory authorities. Due to the difficult financial situation of many municipalities, however, the regulatory bodies are under great pressure to act. In practice, the enforcement of the fiscal equalisation requirement under supervisory law proves to be difficult and insufficient. This periodically leads to criticism of the supervisory authorities and questions their raison d'être (Zabler et al. 2016; Holtkamp 2016). According to most severe criticism, they avoid strict application of budgetary law and tolerate permanent violations of budgetary regulations by the municipalities (Junkernheinrich et al. 2014; Gröpl et al. 2010).

The starting position of fiscal regulation is therefore anything but enviable. The identification of the causes of a municipality's budgetary situation is a complicated venture. Interaction of the causes is complex and sometimes unique to a specific case. This makes it difficult to take targeted countermeasures to overcome local budgetary crises. Systematic peculiarities that limit the authorities' scope for action occur on top of this: The subject of supervision is the legitimacy, not the appropriateness or efficiency of municipal budget policy. Financial supervision is a strictly legal supervision, rather than any technical supervision (with further powers to intervene). It can verify whether local authorities are acting lawfully, but its ability to specify contents is limited.

These frame conditions do not mean that budget rules, the organisation of supervision and its enforceability are irrelevant. There is a general consensus that the structure of supervision influences the financial conduct of local authorities (Holler 2012; Bogumil et al. 2014; Ebinger et al. 2017). In this context, it is assumed that different legal and organisational frameworks have consequences for the implementation of budget law by financial supervision (Ebinger et al. 2018). However, the role and impact of financial supervision, its formal structures and its enforcement practice have hardly been systematically researched so far. This paper therefore

examines the question of how financial supervision of municipalities is implemented in practice and what are the obstacles in implementing effective supervision.[1]

The empirical analysis rests on two pillars. On the one hand, we performed document analyses of the municipal codes of all German Länder (except city states) and examined financial data provided by the Federal Statistical Office to capture the formal structures and instruments of financial supervision and their repercussions on local budgets. On the other hand, we conducted more than 70 expert interviews as well as a questionnaire-based survey of employees of supervisory authorities and finance departments (N > 500) in three Länder (Hesse, North Rhine-Westphalia and Saxony) to examine the implementation practice of financial supervision (Ebinger et al. 2017; Ebinger et al. 2019b).

The article is structured as follows. In the second chapter, the formal organisational structure and the instruments of supervision are presented, and potential repercussions on municipal budget policy are discussed. In the third chapter, extensive empirical surveys are used to examine supervisory practice in more detail on the basis of three aspects of supervision: (a) the organisational design in the individual supervisory authorities; (b) the resources available; and c) administrative styles and political influence. The fourth chapter presents alternatives to the current structure of state supervision of municipalities in Germany.

2 Instruments and Organisational Structure

If the effectiveness of financial supervision is to be examined, classical regulatory and structural explanatory factors must be taken into account. On the one hand, the successful fulfilment of an organisation's tasks depends on its external organisational structure. On the other hand, the regulatory framework and the competences granted to the organisation play an important role. These two factors are therefore examined in more detail below.

Supervisory Competences

The municipal codes of the Länder codify the regulatory framework for budget supervision in each state. This legal framework provides the supervisory authority with specific rights of intervention based on defined facts and determines its strength. The supervisory authority has both preventive and repressive supervisory means at its disposal. In the field of municipal budgeting, the use of traditional supervisory means focuses on three aspects: (1) the presentation of the budget statutes, (2) the approval of loans in general and (3) the approval of cash loans. In particular, the reservations of approval regarding borrowing represent a preventive instrument for

[1] An earlier version of this contribution has been published as Ebinger et al. (2019b). The presented findings are derived from the research project 'Finanzaufsicht 2020' conducted at the University of Konstanz and later on at WU Vienna. The authors would like to thank the Bertelsmann Stiftung for the generous funding for this project.

monitoring municipal loan financing. A comparison between the Länder shows that there are considerable differences in the design of these competences. In addition, strong and often contrary changes in regulatory density can be observed in the recent past (Zabler et al. 2016; Bury and Feld 2018).

Opinions in the scientific debate on how to assess these changes differ. While some authors find a one-sided weakening of the supervisory framework (Gröpl et al. 2010), others observe a trend towards tightening rules over many years, which nevertheless goes hand in hand with increasing debt (Geissler 2009). In contrast, more recent studies point to a simultaneous tightening and softening of rules (Zabler et al. 2016; Holler 2013). Often, the reduction of rules merely traces the reality of implementation and bows to the normative power of the factual (e.g. abolition of approval reservations for cash advances). In contrast, the tightening of regulations, which can also be observed, represents an attempt to put a regulatory stop to the escalating debt.

Table 1 illustrates the above-mentioned differences between the Länder with regard to the point in time of the presentation of the budget statutes and the two forms of loan approval. For example, a high degree of heterogeneity can be observed with regard to the approval of particularly sensitive cash advances. Cash advances do not require approval in six Länder (Bavaria, Brandenburg, North Rhine-Westphalia, Rhineland-Palatinate, Saarland, Schleswig-Holstein). In the remaining Länder, thresholds are applied as to the limit above which cash advances need approval. In Baden-Württemberg, for example, cash advances must be approved if their volume exceeds one fifth of the ordinary expenditure of the profit and loss account. Similar regulations (with varying limits and reference values) are in force in Mecklenburg-Western Pomerania, Lower Saxony, Saxony, Saxony-Anhalt and Thuringia. Hesse is the only Land where the amount of cash advances has to be approved irrespective of specific thresholds.

The heterogeneity in the design and strictness of the legal requirements between the Länder is reinforced by the different, sometimes contrary development trends in recent years with regard to the tightening or softening of approval competences. In the context of this development, however, neither a one-sided weakening of the supervisory regulations (as partially noted in the literature) nor a nationwide tightening can be observed.

Stages of Supervision

Organisational structures influence both the manner and the performance of policy enforcement.[2] For financial supervision, this primarily concerns the structure of the chain of command within the state administration.[3] This raises the question of who is

[2]For analyses of the impact of different organisational models in German state administrations, see Ebinger and Richter (2016) and Ebinger (2013).

[3]In all Länder, responsibility for municipal supervision lies with the Ministry of the Interior, which is responsible for municipal affairs. In addition, the Ministry of Finance can exert influence, as it oversees the municipal financial equalisation and, in part, special rehabilitation programs.

Table 1 Powers of the financial supervision in the municipal budget and its amendments since 2002

Land	Powers in the municipal budget		
	Statutes	Loans	Cash advances
Baden-Württemberg	1 month	1	>20% of ordinary expenses
Bavaria	1 month	2	/
Brandenburg	1 month	3	Indication
Hesse	1 month	3	Total amount (+)
Mecklenburg-Western Pomerania	At the outset	2 (+)	>10% of current receipts from administrative activities (+)
Lower Saxony	1 month	2	>16.7% of the revenue entered in the operating budget
North Rhine-Westphalia	1 month	/	/
Rhineland-Palatinate	1 month	3	/
Saarland	At the outset	1 (−)	/(−)
Saxony	1 month	1	>20% of ordinary expenses
Saxony-Anhalt	After resolution	1	>20% of cash received from current administrative activities (−/+)[a]
Schleswig-Holstein	After resolution	2 (−)	/(−)
Thuringia	1 month	3 (+)	>16.7% of the revenue entered in the operating budget

Source: Zabler et al. (2016: 8)
Explanations:
The column *Statutes* notes the time when the budget statutes adopted by the municipalities must be submitted to the supervisory authority. '1 month' indicates the adopted budget has to be submitted at least 1 month before entering into force
The figures in the column *Loans* indicate whether and how borrowing can be restricted in general. The numbers/symbols have the following meaning: / = not available; 1 = restriction only possible according to § 19 StabG (Law on the promotion of economic stability and growth (StabG) of June 8, 1967) or 'by law'; 2 = restriction possible according to § 19 StabG and another regulation; and 3 = many possibilities of restriction
The column *Cash advances* indicates whether and under which conditions these loans are subject to approval
(+) = Strengthening of supervisory authorities since 2002
(−) = Weakening of supervisory authorities since 2002
[a]Abolished in Saxony-Anhalt in 2003, re-introduced in 2014

specifically entrusted with the operational supervisory function, i.e. day-to-day business (control of budgets/budget execution, sanctioning of violations of rules) and which body is responsible for the overall supervision of the lower supervisory authorities. The latter are responsible for legislation (ordinances, directives, decrees, handouts) and uniform application of the law, control and coordination of subordinate authorities, provision of information and expertise and implementation of stricter sanctioning measures.

Table 2 Stages of supervision

Institution	Official responsibility	Operational supervision
State Ministry of the Interior	Supreme supervision for all municipalities	In principal, no operational supervision Operational tasks only in those five states without district administrations
In 8 out of 13 states: District administration (*Regierungsbezirk, Regierungspräsidium, Landesverwaltungsamt*)	Lower supervision authority for counties (*Landkreise*) and municipalities not belonging to a county *(kreisfreie Städte*) Upper supervision authority for municipalities belonging to a county	Operational supervision for counties and municipalities not belonging to a county
County administration (*Landkreis*)	Lower supervision authority for municipalities belonging to a county (*kreisangehörige Gemeinden*)	Operational supervision for municipalities belonging to a county

Source: own presentation based on Brüning and Klaus (2009)

In practice, different models have become established in different Länder. Depending on the administrative structure, a distinction can be made between two-tier and three-tier systems (see Table 2).[4] The operational supervision of municipalities belonging to a county is usually the responsibility of the county administration. In contrast, counties and independent cities are either directly supervised by the Ministry responsible for local government (two-tier system) or by a state resource agency (three-tier system), which is subordinate to the Ministry of the Interior. The Ministry of the Interior always remains the supreme supervisory authority (Zabler et al. 2016).

Within the scope of their organisational sovereignty, the heads of the authorities are responsible for the allocation of resources and the specific organisation of work processes within the county administrations. This leads to a high degree of variance in capacities and structures (especially in the organisational integration of the supervisory authority within the county administration) and may also lead to a politicisation of supervision in the sense of external influence (Person and Niemann 2016). This raises the question of whether the establishment of supervision at the county level makes effective financial supervision more difficult, since political and personal interdependencies between the county administration as the supervisory authority and municipalities belonging to the county as those affected by supervision can make the implementation of painful reforms in the course of budget consolidation politically unattractive (Person and Zabler 2017: 3).

[4]In Länder exhibiting a two-tier system, the district administration level is missing. Thus, supervisory competences are shared by the state and the county level. In three-tier systems, some supervisory responsibilities are assigned to the district level.

These concerns were taken quite seriously by the state governments. In fact, since the turn of the millennium, some Länder have centralised financial supervision tasks (Zabler et al. 2016: 9-10). This *up-zoning* took place either as part of general administrative structural reforms or selectively with the introduction of a municipal debt relief program. This shows that structural changes can be observed, although improving municipal finances were not always the central motivation of the reforms. In no case, however, were competences decentralised. This seems remarkable, since extensive responsibilities have been shifted to the municipal level in many other, originally state-run administrative areas (Ebinger and Bogumil 2016; Ebinger et al. 2019a; Bogumil and Ebinger 2019). The state governments are obviously convinced that a higher level of supervision—originally that of the state—is better suited to strictly enforce the necessary budgetary supervision in times of crisis, even against local political resistance (Dreßler 2012: 290-291). Potentially negative effects of the greater distance, in particular a lack of understanding of the situation on the ground, seem to be given lower weight in these decisions. Person and Zabler (2017) consider the effects of this up-zoning on the basis of a survey of supervisory staff and treasurers. As expected, the estimates are divided into two parts: while at the county level, up-zoning is viewed critically, as it is associated with a loss of information due to the greater distance from the objects of supervision, employees of higher supervisory authorities emphasise the advantages of greater uniformity in the application of the law and the greater ability of higher supervisory authorities to enforce it. It is noteworthy that municipalities that participate in a municipal debt relief program and therefore are subject to stricter supervision are more positive in their assessment of up-zoning than non-participating municipalities.

Fiscal Effects of State Financial Supervision

Zabler et al. (2016) examine the fiscal effects of different forms of supervisory powers and the organisation of supervisory authorities. Looking at total debt per capita, Fig. 1 shows a trend towards higher debt, with the strongest increases in Hesse, North Rhine-Westphalia, Rhineland-Palatinate and Saarland. On the other hand, budget consolidation can be observed in Bavaria, Schleswig-Holstein and the eastern German Länder.

In this respect, it is interesting to note the impact of reforms of the supervisory framework: changes in the organisational structure of the financial supervisory authority in the sense of up-zoning (solid line), the introduction of stricter rules in the area of investment credit approval (dashed line) and the weakening of these rules (dotted line) *appear to* have partial effects. However, this is purely descriptive evidence, which does not necessarily have to be causal.

In Hesse, municipal debt has stabilised slightly following the introduction of the municipal debt relief program, while the increase in debt has at least slowed down somewhat in North Rhine-Westphalia. However, the reference to up-zoning is unclear, as this change in trend occurred at the same time as the granting of consolidation aid. In Mecklenburg-Western Pomerania, Lower Saxony, Saarland, Saxony and Saxony-Anhalt, there is no change in the respective trend in municipal debt as a result of the change in responsibilities.

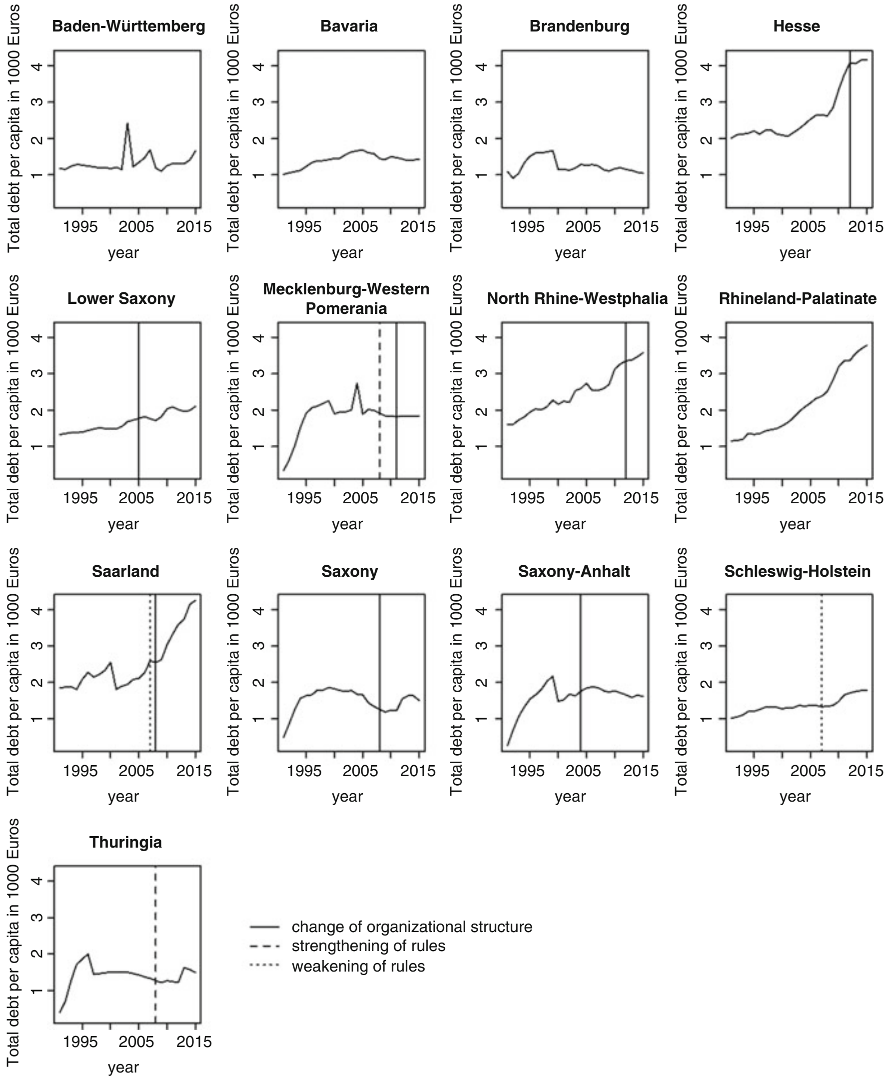

Fig. 1 Development of per capita total debt in the municipalities of the German Länder 1991 to 2015. Source: own presentation. Explanations: Vertical lines indicate changes to the supervisory structure and credit approval rules

The development of cash advances (Fig. 2) shows a similar picture: the strongest increases in cash advances can be observed in Hesse, North Rhine-Westphalia, Rhineland-Palatinate and Saarland. Cash advances are also increasing in the remaining Länder (with the exception of Baden-Württemberg, Bavaria, Saxony and Thuringia), albeit more moderately. Neither changes in the supervisory structure nor tightening or weakening of the licensing rules lead to systematic breaks in the

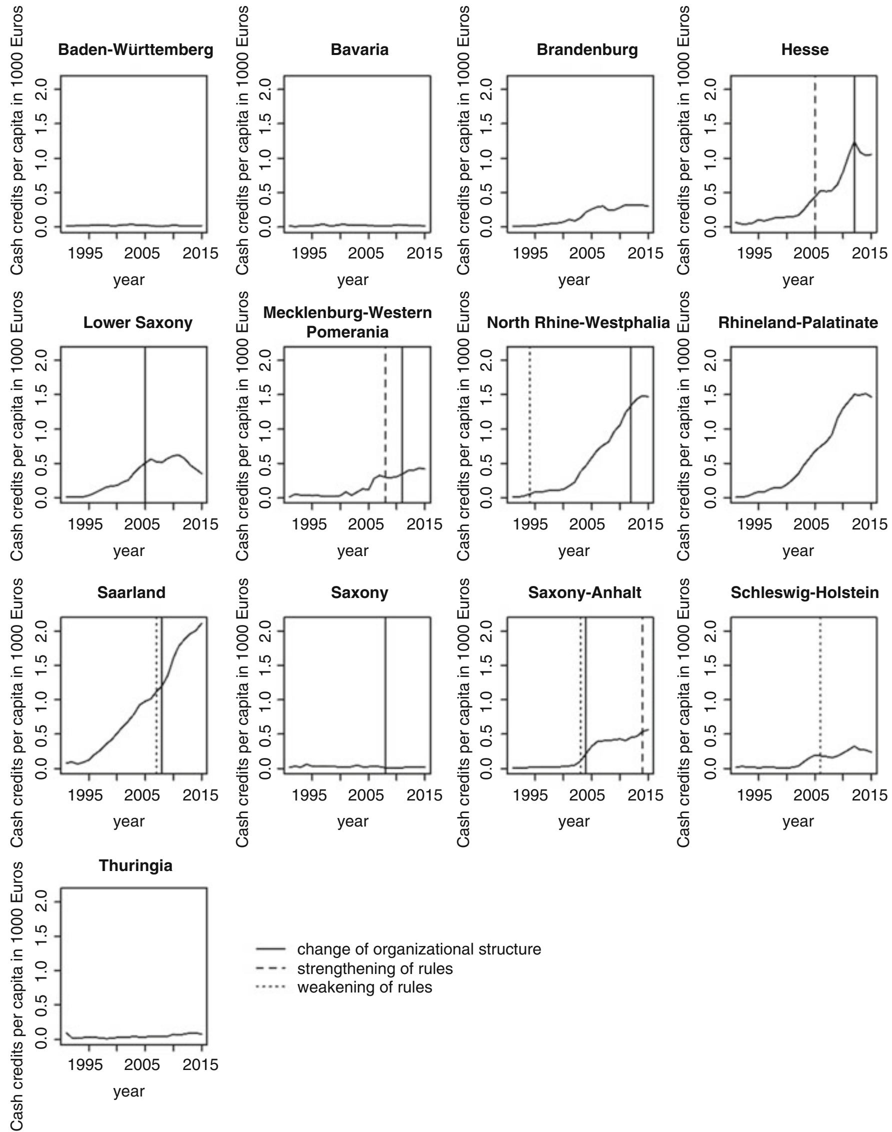

Fig. 2 Development of per capita cash advances in the municipalities of the German Länder 1991 to 2015. Source: own presentation. Explanations: Vertical lines indicate changes to the supervisory structure and credit approval rules

prevailing development trends. Only Hesse shows a slight reduction in cash advances as a result of up-zoning. In this case, however, it is unclear whether this is due to the change in the supervisory structure or the parallel allocation of consolidation aid.

In summary, no conspicuous change in trend can be observed either in the context of changes in the approval of loans or after the upgrading of supervisory competences on the basis of these descriptive findings. It therefore remains questionable whether the formal organisational structures and legal frameworks of supervision have a relevant influence on the municipal budget situation. The results are in line with Holler (2013), who is also unable to demonstrate a reliable correlation between the budgetary framework and the amount of municipal cash advances. Even Gröpl et al. (2010) ultimately do not discover any resilient effect of the abolition of approval reservations on the level of short-term debt. Christofzik and Kessing (2018) come to a contrary conclusion by implementing a quasi-experimental approach in an observational study covering the introduction of accrual accounting in North Rhine-Westphalia: the possibility of showing a one-off, notional equalisation reserve in the opening balance sheet has de facto suspended the enforcement of the debt rules temporarily until the reserve is used up. The authors show that many municipalities have taken advantage of this opportunity to take on debt. They conclude that budgetary rules are not effective without appropriate enforcement mechanisms. Bury and Feld (2018) also argue that different budgetary regulations of the Länder have a systematic influence on municipal budgets. Conclusive empirical evidence that can resolve questions of causality does not yet exist, however. The empirical evidence is therefore mixed: the work of supervision authorities may possibly be relevant to limiting debt. At the same time, these findings indicate that, in addition to considering the formal legal framework, a closer look at the implementation practice of these standards appears necessary, since the best rules are useless if they are not implemented. For this reason, supervisory practice will be examined in more detail below.

3 Supervisory Practice

Beyond regulation and formal structures, enforcement practice is an essential factor for the effectiveness of budgetary supervision. First results indicate a high degree of heterogeneity in supervisory practice and the application of the law, which could ultimately have a stronger explanatory power than the legal situation itself. Three factors are considered in more detail here: (1. the organisational design of supervision within the county administration, (2) the resources in terms of personnel and qualifications and (3) political influence on supervisory decisions.[5]

Organisational Design of Supervision in the County Administrations

The operational units of the lower supervisory authorities, i.e. primarily the county administrations, can take the central organisational decisions autonomously within the framework of their self-administration law. The Länder hardly make any

[5]Ebinger et al. (2017) deal with other factors such as the self-image and internal coordination between supervisory units.

specifications in this respect. Accordingly, the county authorities are responsible for the highly heterogeneous implementation framework. The chosen organisational models have grown historically but also reflect the personal preferences of the heads of the county authorities. In most cases, financial supervision is located together with general municipal supervision at the legal office or directly assigned to the head of the county as a staff unit. A settlement at the finance department or the audit office is rarer. It seems sensible to locate the office at the legal office, as the tasks of general municipal supervision and financial supervision cannot be strictly separated. In addition, this organisational structure allows all services for the municipality to be provided from a single source. However, this may lead to a dominance of legal rationality in supervisory decisions and to economic aspects not being sufficiently taken into account. On the other hand, an affiliation with the finance department or the audit office offers the advantage of a greater specialisation of the staff with regard to budgetary and economic issues and allows closer cooperation with other administrative staff specialised in budgetary economics. However, conflicts of interest can arise here, as decisions taken in the context of the county budget have direct repercussions on municipal budgets, which must, however, be monitored by the supervisory authority. This may call into question the neutrality of the supervisory authority and is occasionally perceived as a burden by supervisory staff. The direct settlement with the head of the county authority is also to be assessed ambivalently. On the one hand, the greater proximity to the head of the county authority allows for closer coordination, facilitating hierarchical support, especially in the case of disputed supervisory decisions. This gives more weight to the enforcement of unpopular measures and makes them easier to implement, provided that the head of the county authority is fully behind his supervision. However, this settlement can be problematic, as this form of organisation allows the head of the county authority to exercise greater control over supervision. This can lead to a situation where political objectives and rationality of purpose override supervisory decisions, while legal and economic justifications take a back seat. This may undermine the political independence of the supervisory authorities. In summary, each individual variant of organisational design has advantages and disadvantages that can facilitate but also hinder effective financial supervision (Person and Niemann 2016).

Resources: Staff and Qualifications

In addition to the organisational structure of the supervision, the staffing of the supervision and the level of qualification of the staff are likely to be key elements for the effective exercise of its tasks. In this context, it is argued that a lack of human resources capacity causes insufficient use of the legal framework by the supervisory authorities and requires a one-sided focus on short-term budgetary balance rather than being guided by the goal of long-term structural budgetary consolidation (Stolzenberg and Heinelt 2013 475; Geissler 2009: 71).

In principle, the variation in staffing levels between and within Länder is enormous: for example, the counties in Hesse offer between 0.4 and 3.0 full-time equivalents (FTE), those in North Rhine-Westphalia between 0.7 and 3.5 and

those in Saxony between 3.7 and 6.0. A larger number of staff is to be found at the level of district administrations. In these intermediate authorities, the staff capacity is between 4.4 and 12.0 FTE in Hesse, between 6.0 and 13.4 in North Rhine-Westphalia and between 2.7 and 4.8 in Saxony. While the county level is better staffed in Saxony, the district administrations have a higher staffing level in Hesse and North Rhine-Westphalia. This is probably due to the fact that, in the course of the municipal debt relief programs in both Länder, supervisory competences were shifted to these intermediate authorities. The heterogeneity becomes even clearer when looking at the supervisory margins, which reflect the ratio of municipalities to be supervised in relation to the staffing of the respective supervisory authorities: in Hesse, it is between 7.2 and 42.5 at county level, in North Rhine-Westphalia between 3.0 and 22.9 and in Saxony between 6.2 and 10.8. For the intermediate authorities, the supervisory margin in Hesse is between 4.0 and 9.1, in North Rhine-Westphalia between 1.7 and 5.0 and in Saxony between 0.8 and 1.9 (Ebinger et al. 2017).[6] Although the majority of supervisory staff consider the staffing levels to be adequate, the high heterogeneity of staffing levels and the associated variance in supervisory spreads are likely to impact supervisory practice, as they directly imply different supervisory intensities and could create the risk of unequal treatment of the objects of supervision (in the sense of unequal application of the law) depending on the respective staffing levels (Niemann et al. 2017). In light of this, minimum staffing targets for supervisors could be helpful to ensure consistent and effective financial supervision. However, these would inevitably come into conflict with the local self-government law of the counties with regard to their internal organisational structure (Person and Niemann 2016: 411-412).

With regard to the qualification of the employees, the personnel structure is strongly influenced by legal regulations. The overwhelming majority of employees have a classical administrative education or a law degree. Economic or interdisciplinary competences and practical experience in local authorities, especially finance departments, are rare. There are also hardly any specific training and further training opportunities focusing on the tasks of supervision. As a consequence, the personnel are qualified mainly through 'learning by doing' and the introduction of colleagues within the framework of 'training on the job'. It is therefore not surprising that supervisory staff often wish for more tailored training and further training that is geared to the actual needs and requirements of financial supervision and meets its interdisciplinary nature. This could at the same time contribute to a more effective implementation of the supervisory task (Person and Niemann 2016: 413).

Administrative Styles and Political Influence

The administrative style of financial supervision and the intensity and direction of political influence are also potential determinants of supervisory performance. Administrative style describes the way administrations usually handle their tasks.

[6]The differing supervisory margins might reflect different average sizes of municipalities (in terms of inhabitants) between the three Länder. Larger municipalities go hand in hand with more complicated budgets which are potentially harder to supervise.

This concerns not only routines of action but also general orientations with which organisations deal with their environment (Grohs 2019). Administrative styles influence the outcomes of administrative actions as much as formal structures and should therefore be taken into account when attempting to explain the effectiveness of financial supervision. It has long been known that the administrative styles in the German Länder differ (Ebinger 2013: 61 et seqq.). The variance became particularly apparent in the wake of reunification, when the new Länder adopted elements of the administrative styles of their West German sponsor Länder with all their advantages and disadvantages (König 1997).

In the course of the survey of supervisory staff and supervisory addressees in Hesse, North Rhine-Westphalia and Saxony, it became apparent that there are differences in self-image, strictness and enforcement practice. On the part of the supervisory authorities, however, the answers draw a complex and sometimes inconsistent picture. For example, one third of the North Rhine-Westphalian and half of the Hessian supervisory staff at the middle level complained that the multitude of undefined legal terms in municipal budget law made supervisory activities more difficult and that less discretion or clearly defined legal consequences would be helpful. In Saxony, none of the respondents chose this answer option. However, a look at the statements from the counties dispels the expectation of a Land-specific response behaviour: in all three Länder, about 40% of the respondents agree with this statement. Similar inconsistencies are found in the definition of one's own role (as advisor/partner or controller/supervisor) or in the perceived political desirability of strict supervision. Therefore, no significant differences between Länder can be identified in the self-perception of supervisory staff with regard to the strictness of financial supervision.

In contrast, the survey of supervisory addressees reveals Land-specific patterns. In general, it is noticeable that the respondents in Saxony show a more reserved response behaviour with regard to political aspects of supervision than their West German counterparts. This may have different causes but could indicate a fundamentally different (power) relationship between supervisors and supervised entities. A systematic pattern can then be found for many items concerning the cultivated administrative style, with North Rhine-Westphalia on one side of the spectrum, Hesse in a middle position and Saxony on the other (see Table 3).

The data thus reveal rudimentary patterns of different administrative styles in the supervisory practice of the Länder. However, it is not possible to state across the board that individual Länder generally have a stricter or more lax supervision in the self-perception of the actors—the framework conditions and the influences of recent regime changes are too different. From the point of view of the administrative staff, there is certainly some variation in administrative styles. However, this is much more pronounced between supervisory levels and authorities *within* a Land than between Länder.

As a further factor that negatively influences the enforceability of supervision, the strength of external (political) influences is discussed in the literature. On the one hand, supervisory decisions can be influenced within the organisation by the political

Table 3 Management styles of financial supervision from the point of view of the finance departments

Item	NW ($n = 129$)	HE ($n = 155$)	SN ($n = 79$)
The supervision shows understanding for the difficult financial situation of my community	58.9%	52.6%	43.8%
Financial supervision is first and foremost legal supervision. Considerations of economic expediency do not play a role in supervisory decisions	42.7%	36.1%	29.1%
The non-approval of a municipal budget or strict checks are not politically desired by either side	47.2%	41.8%	30.4%
Depending on the size and political importance of the municipalities, the impression of unequal treatment of the municipalities by the supervisory authority cannot be avoided	22.5%	16.8%	8.8%
If supervisory authorities were more politically independent, they could work more effectively	33.9%	30.1%	21.5%
The Land government has no interest in a politically independent financial supervision	24.2%	22.2%	7.6%
Over the duration of a budget consolidation concept, the budget balance can always be shown	49.2%	32.3%	9.1%

Source: own survey
Explanations: The percentages represent the proportionate approval of the respective statement

principals of the supervisory staff (head of the county, president of the district administration), who can intervene directly in the supervisory process and steer it according to their respective (political) preferences. On the other hand, financial supervision can also be politically influenced outside the organisation. It is therefore often subject to indirect pressure and effects from outside, e.g. from higher-level supervisory authorities, Land and local politicians and the regional press. This can lead to supervisory decisions being taken in directions that are not relevant to the subject matter and cause unequal treatment of those affected by supervision (Timm-Arnold 2011: 7; Ebinger et al. 2018: 169-170). A survey among supervisory staff members showed that the majority confirms that they are, on the whole, able to work politically independently. This independence is also confirmed, albeit to a lesser extent, on the part of the addressees of supervision. Employees in the intermediate authorities see a slightly higher risk to their independence than those in the counties. This effect is likely to result from different areas of responsibility: budgetary problems are accumulating in the large cities served by the intermediate authorities. In addition, local politics is more effective here and has considerable potential to influence Land politics. However, the postulated independence generally knows limits: the vast majority of respondents are aware of the political limitations of supervision (80% for district administrations, 65% for counties) (Ebinger et al. 2017). In view of these findings, it can be concluded that supervision at all levels is far from truly independent. This is probably due to its integration into the general administrative structure. At the same time, political influence is not as omnipresent

as is sometimes suspected. It appears less in regular operation, but only when relevant, politically critical decisions are made.

Alternatives to the Current Structure of Financial Supervision

Germany's experience to date shows that the current design of financial supervision has not been able to prevent the emergence of local budgetary crises. For this reason, alternative design options and potentials for optimisation are outlined below. An alternative regulatory approach can be found, for example, in Austria, which is also a federal state with a tradition of local self-government. In Austria, too, municipal budgetary sovereignty is limited by the state's supervision of municipalities. In contrast to Germany, however, the Länder are not only responsible for financial supervision. All of them are also the enforcement authorities, either via decentralised districts or the respective Länder governments. In addition, the supervisory authorities also carry out an efficiency control in addition to the legality control: every 5 years, the organisational structure, the economic situation and individual decisions of the municipalities relevant to the budget are subjected to an intensive review. This additional supervisory instrument enables more comprehensive information on the financial performance of municipalities and generates knowledge that can be used profitably in supervisory decisions. In addition, the Austrian financial supervision system is much stricter. Investment loans must be approved individually. Cash advances are subject to strict percentage restrictions, and, in most cases, repayment obligations in relation to the financial year, which, unlike in Germany, prevent a permanent increase in cash advances. All in all, the competences of supervision are more comprehensive, and its tasks are more closely intertwined. This forms the basis for a more rigid supervisory regime that limits disincentives to action by municipalities and supervisory authorities, allows for smaller-scale control of municipal budgets and promotes healthy municipal finances (Niemann and Ebinger 2017). In addition, municipalities with budgetary problems are not only more strictly regulated but also receive considerable support for their rehabilitation through the allocation of special grants, a path that has only recently been taken in Germany with the introduction of debt relief programs (see the contribution by Person and Geissler in this volume).

A further strategy for improving financial supervision lies in an alternative institutional design and organisational location of the supervisory authorities. In this context, the close personnel and political links between supervisory authorities and supervisory addressees have proved problematic in the past from the perspective of several Länder governments. These interrelationships are particularly pronounced at the local level between the counties and the municipalities belonging to them and can create scope for political influence on supervisory decisions. In order to address this problem, some Länder transferred supervisory competences to higher levels of administration (Dreßler 2012). This was intended not only to harmonise supervisory practices vis-à-vis municipalities with difficult budgetary situations and to increase the hierarchical monitoring and control by the supreme supervisory authority but also to strengthen the independence of the operative supervisory authorities and enable them to enforce unpopular budget consolidation measures, even against local

resistance. However, there is criticism that the supervisory authorities are too far away from the municipalities concerned in terms of both facts and space and have insufficient information about the specific situation on the ground. However, individual treatment of the specific case in question, taking adequate account of local conditions, requires particular geographical and personal proximity to the addressees of the supervision. There is also the danger that local political resistance will simply be transferred to the higher level and that political pressure from Land politics will be applied at this level (Person and Zabler 2017: 3).

In order to guarantee the independence of supervision without giving up the advantages of decentralised task fulfilment, a complete reorientation of supervision is occasionally discussed. This calls for the transformation of the existing supervisory authorities into new, politically independent supervisory bodies, which are to be removed from the existing administrative hierarchy and endowed with far-reaching powers of intervention and political independence, but which could still be located in the area in a decentralised organisational form. The organisational design of the federal and Land courts of auditors and their institutional relationships with the general administration at the federal/state level might serve as a model. It would also be conceivable to locate the auditing of municipal budgets in upgraded Land courts of auditors or audit offices, whereby their supervisory and intervention competences would have to be significantly expanded (Junkernheinrich et al. 2014: 91-92; Glöckner and Mühlenkamp 2009: 414 et seqq.). A corresponding institutional and organisational design of supervision would have the charm of maintaining the factual and geographical proximity to the problems while at the same time giving the supervisory authorities greater personal and professional independence than in the current system. In particular, the close political-personal ties within the county could be broken up and the resulting conflicts of objectives avoided. However, if these units can act autonomously and have strong rights of intervention due to their political independence, the question inevitably arises as to the democratic legitimacy of such interventions in local self-government and the accountability of these units.

4 Conclusion

It is undisputed that budgetary supervision plays a role in limiting municipal debt. However, the system of financial supervision contains an almost unmanageable spectrum of factors that potentially influence the ‘success’ of supervisory activities and the budget situation of local authorities. This chapter briefly systematises these factors and discusses the empirical evidence on the impact of the regulatory framework and implementation practice, especially for the case of Germany. The analyses sometimes reveal interesting patterns but do not allow for clear causal conclusions. The implementation of financial supervision often has a case-by-case character. Accordingly, simple, monocausal, institutional ‘patent remedies’ are unsuitable for achieving more effective supervision or even for solving all budgetary problems.

Nevertheless, a look at implementation practice opens up starting points from which conclusions can be drawn about quality and thus also about potential improvements of financial supervision: these are in staffing, training and further education, organisational setup or supervisory instruments, where the bundling and expansion of supervisory competencies can not only facilitate the early identification of problem situations but also the consistent implementation of measures. Such early identification of budget imbalances allows for timely intervention and thus avoiding the implementation of costly bailout measures (the relationship between bailouts and early intervention is examined in more detail in the chapter of Allers and de Natris in this volume). Obviously, effective supervision and limitation of debt require the interplay between structural factors and enforcement practice in the area. Accordingly, institutional factors are undoubtedly an important factor, but the best rules are not effective if they are not adequately implemented or if the structural framework conditions make effective implementation difficult. Strict political leadership, political independence and adequate resources are therefore important prerequisites for successful supervisory activities.

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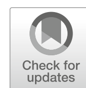
Fiscal Supervision and Party Politics: Lessons from Austria and Germany



Felix Roesel

Abstract Models of effective fiscal supervision usually assume neutral and benevolent overseers. In reality, fiscal supervisors often lack such independence. If overseers and supervised officials are partisan, party favouritism and politics may replace other objectives. The two case studies discussed in this chapter show empirically how political alignment influences fiscal supervision. Austrian and German state authorities continuously and tightly supervise local governments, but fiscal supervisors are affiliated with political parties. In some Austrian federal states, the law explicitly allocates left-wing mayors to a left-wing member of the state government as fiscal supervisor and right-wing mayors to a right-wing overseer. This chapter presents evidence that such a setting induces collusion and contributes to less sustainable budgeting. In Germany, the influence of party politics in fiscal supervision of local governments is more subtle but still sizable. It is furthermore evident that fiscal supervisors in both countries use supervision policies to realise their party agendas.

1 Introduction

Credibility is among the key preconditions for effective supervision. Supervised agents are more likely to comply if they believe that overseers monitor fairly, derive reasonable conclusions, and take consistent actions. One way to bolster the credibility of supervisors is maintaining their independence from political influence. The director of the International Atomic Energy Agency (IAEA), Yukiya Amano, emphasised in March 2019 that the IAEA "undertakes analysis and takes action in an impartial, independent and objective manner"[1] when it comes to the Iran nuclear deal. In the very same month, Ignazio Angeloni, member of the Supervisory Board

[1]See the IAEA Director General's Introductory Statement to the Board of Governors by IAEA Director General Yukiya Amano, held on 4 March 2019 in Vienna, https://www.iaea.org/

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of the European Central Bank (ECB), states when talking about the supervision of European banks as a new task of the ECB that "supervisory independence is necessary but also very difficult to put into practice".[2] Indeed, one key challenge to effective supervision is mitigating the political connections between political agents and their overseers, which can lead to harmful collusion. One prominent example is fiscal supervision in the European Union (EU). The European Commission monitors public budgets of EU member states in order to guarantee compliance with European budget rules. However, both EU commissioners and governments are affiliated with parties. Studies have shown that commissioners tend to gratify governments headed by a member from the same European party group (Killermann 2016). Very similar concerns apply to the subnational level. Many governments have implemented authorities that can monitor, veto, or even suspend fiscal policies by local governments (see Geissler et al. 2019). However, similar to the European Union, these fiscal supervisors often lack independence because they are members of political parties, a factor which may encourage favouritism and gives leeway to impose their party politics via fiscal supervision.

In this paper, I present two case studies in which political parties have captured fiscal supervision. Though Austrian and German federal state authorities continuously and tightly supervise local governments, their fiscal supervisors are politically affiliated. In some Austrian federal states, law explicitly allocates left-wing mayors to a left-wing member of the state government as fiscal supervisor and right-wing mayors to a right-wing overseer. In Germany, the impact of party politics in the fiscal supervision of local governments is more subtle but still sizable. In this chapter, I discuss both cases in detail and show that political alignment may well undermine the effectiveness of local government regulation in both countries. The effects depend on the institutional setting. In Austria, fiscal supervision is carried out by state authorities, and my analysis shows that supervisors favour their fellow party members. By contrast, in Germany, fiscal supervisors are directly elected and more interested in realising party preferences via supervisory actions.

2 Theory

Models of fiscal supervision typically assume that overseers are neutral and benevolent, which supposedly allows them to correct unfavourable decisions by local governments. Depending on the institutional setting, fiscal supervisors can monitor, veto, or even suspend fiscal policies by local authorities. One main reason to justify

newscenter/statements/iaea-director-generals-introductory-statement-to-the-board-of-governors-4-March-2019

[2]See the speech by Ignazio Angeloni, member of the Supervisory Board of the ECB, at the ECB colloquium "Challenges for Supervisors and Central Bankers" on 22 March 2019 in Frankfurt am Main, https://www.bankingsupervision.europa.eu/press/speeches/date/2019/html/ssm.sp190322~c231d57793.en.html

such interventions is soft-budget constraints. If central governments have the legal obligation to bail out local governments in fiscal distress, they are well advised to implement dense supervision regimes (Carlsen 1998). Early interventions aim at counteracting disincentives for unsustainable local budgeting at the cost of the central government. Reputation spillover may also justify preventive state supervision (Epple and Spatt 1986). However, to be effective, fiscal supervision requires that supervisors are loyal agents of the central government and strictly follow their objectives. Party membership of fiscal supervisors challenges this loyalty. Most importantly, if overseers are third-party players who act on behalf of the central government, substantial conflicts of interest and opportunities for collusion potentially arise when supervisors are affiliated with the party of the local government to be supervised (or the opposite party).[3] In this case, it is unclear whether supervisory authorities still solely serve the central government or if they rather follow their party objectives.

Adverse effects resulting from politically aligned supervisors are very likely to exist; however, their direction is not entirely clear from a theoretical point of view. On the one hand, supervisory authorities might be tempted to tolerate unsustainable budgeting by their fellow party members. For example, politically aligned supervisors may delay or suspend necessary interventions in exchange for intraparty support (co-partisan favouritism). However, party connections can also work in the opposite direction. Studies have shown that the performance of parties in local and national elections is closely interconnected (Frei et al. 2020). Good or bad governance on one level of government spills over to the reputation of other levels of government. Therefore, politicians at different levels of government might be well advised to take actions consistent with party manifestos (Jones et al. 2000). This theory of consistent party politics implies that politically embedded supervisors may use their discretion to implement local fiscal policies according to their political agenda. For example, if a supervisor is fiscally conservative, one may well expect lower deficits than under a supervisor preferring expansive fiscal policies. This behaviour is more likely if fiscal supervisors are accountable in local elections and therefore have an incentive to signal a clear political agenda. In the remainder of this paper, I discuss both theories and provide empirical evidence for the different institutional settings.

3 Country Case Studies

I chose Austria and Germany as two meaningful cases in order to study the effect of party politics in fiscal supervision. Both countries have rich traditions of close and comprehensive monitoring of local governments by state authorities. Supervisory authorities are powerful veto players that can intervene into local decisions.

[3]On principal-agent with models with colluded supervisors, see the seminal contributions by Tirole (1986) and Laffont and Tirole (1991).

Moreover, party politics is an issue in both countries—explicitly codified in Austria and more subtle in Germany. Finally, institutional reforms in both countries have aimed at reducing disincentives in supervision by breaking the (overly) tight link between supervisors and supervisees. However, there are also clear differences between both countries (see also Niemann and Ebinger 2017 for a comparison) which allows me to test the two theories outlined above.

3.1 Austria

Austria is a federal state with three levels of government: the federal level, nine states (*Länder*), and around 2100 municipalities (*Gemeinden*). Municipalities enjoy a great deal of fiscal autonomy and can file for bankruptcy. However, in order to prevent any fiscal distress, state authorities also tightly supervise the municipalities (*Gemeindeaufsicht*). Supervision rules are designed by the federal states and usually include, for example, state grants, reporting obligations, monitoring, auditing, and a large set of approval requirements (Geissler and Ebinger 2019). Most importantly, municipalities have to submit their budgets to supervision authorities for notification, and receiving municipal loans for capital spending usually requires approval by supervisory authorities. In some federal states, there are exceptions for large cities and for loans not exceeding a particular threshold (e.g. in the states of Styria and Lower Austria, loans accounting for less than 2% of the total budget do not require approvals by state authorities). Procedures and supervision rules are codified in state law (municipal codes, *Gemeindeordnungen*) and vary to some extent across federal states.

Supervisory authorities in all Austrian states are afforded large discretion, but different institutions are responsible for fiscal supervision of municipalities. In seven out of eight federal states (the city state of Vienna is a single-municipality state and not subject to any fiscal supervision), the state government monitors and supervises local governments. Only in the state of Tyrol does an appointed regional public official of the state administration (*Bezirkshauptmann*) supervise the budgets of municipalities. In four out of the other seven remaining states, the secretary for local government of the state government is responsible for monitoring all municipalities. However, three Austrian federal states—Upper Austria, Lower Austria, and Styria—split the responsibility to supervise local governments in a rather unique and remarkable way (Häußl 2010). According to the constitution, all three states used to have an all-party-government, always including at least one secretary from the leading left-wing party of the social democrats (*SPÖ*) and one secretary being a member of the ring-wing conservative party (*ÖVP*).[4] Until 2009, state law in all three states explicitly codified that a right-wing (*ÖVP*) member of the state government supervises all local governments led by right-wing (*ÖVP*) mayors and

[4]Styria replaced the all-party-government by a majority-based government in 2015.

a left-wing (*SPÖ*) secretary all left-wing mayors (*SPÖ*). However, after media reports uncovered numerous scandals of excessive local budgets which had managed to avoid scrutiny by co-partisan supervisors, the government of the federal state of Styria reassigned fiscal supervision of left-wing mayors to the right-wing member of the state government and vice versa.[5]

I utilise this particular change in roles to quantify the effect of co-partisan influences in fiscal supervision. To do so, I employ the synthetic control method (SCM) and use local government debt as output variable. The SCM was developed for comparative studies in political science when the number of treated units is small or even as low as one (see Abadie et al. 2010, 2015). This method allows one to construct a synthetic counterfactual to the treated unit (in our case, the state of Styria) from a donor pool of untreated units (here all other Austrian states). The synthetic counterfactual is a simple weighted average of all other Austrian federal states with weights chosen in a way that the counterfactual reproduces the pre-reform trend in local government debt in Styria best and weights sum up to one. One can then compare real (observed) Styria with the reform to a second, *synthetic* Styria which has not adjusted the partisan alignments of mayors and fiscal supervisors.

Figure 1 shows the results. The weights are derived from the SCM implemented in a statistical software.[6] The bold black line represents local government debt per capita in Styria, which was at around 400 euros before the reform in 2009. Thin grey lines represent the seven other Austrian states. The figure excludes debt of public enterprises and of large cities with different fiscal supervision regimes in order to make data comparable across states. The vertical dashed line indicates late 2009 when Styria changed its system of local government supervision. The black dashed line reports counterfactual local government debt if Styria would not have changed its supervision regime. This synthetic Styria without the reform consists of 16% Carinthia, 51% Lower Austria, and 33% Tyrol, with all other states having a weight of 0%. The pre-reform trends of real and synthetic Styria are well synchronised, and further characteristics such as total population and population density are also rather equal.[7] Thus, pre-reform trends match well, and the post-reform difference between real and synthetic Styria has a meaningful interpretation: Without the reform, Styria would have reached substantially higher local government debt levels of around 500 euros per capita. Real Styria, by contrast, recorded debt levels at around 450 euros after the reform. It can thus be concluded that the change of supervisor party reduced local government debt by a substantial 50 euros per capita (indicated by small black arrows). The reform effects decrease to some extent in 2014, which may have been an anticipation effect of the announcement of a large-scale

[5]See, for example, ORF.at, Rot und Schwarz tauschen Gemeindeaufsicht, 27 October 2009, http://stmv1.orf.at/stories/399110

[6]I use Stata's "synth" command.

[7]The synthetic control method allows matching over further covariates. I use total population, total area, and population density.

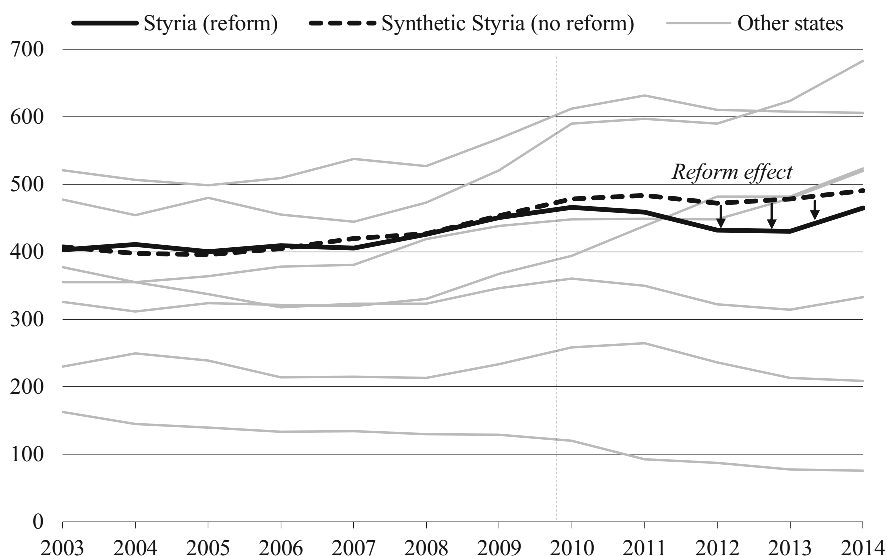

Fig. 1 The effects of fiscal supervision reform in Styria, Austria. The figure shows local government public debt per capita in Styria (black bold line) and seven other Austrian states (thin grey lines). Public debt excludes debt of public enterprises and of large cities with different fiscal supervision regimes. The vertical dashed line indicates late 2009 when the federal state of Styria changed its system of local government fiscal supervision. The bold dashed line is the synthetic counterfactual to real Styria, derived from the SCM as the weighted average of the seven other Austrian states which fits the pre-reform trend in Styria best. Synthetic Styria consists of 16% Carinthia, 51% Lower Austria, and 33% Tyrol; all other states have a weight of 0%. The difference between Styria and synthetic Styria describes the reform effect. Data is from Statistik Austria

municipality merger reform in Styria in 2015.[8] However, the fiscal supervision reform in Styria appears to have paid off—local public debt came down as soon as partisan supervisors changed roles.

Austria is probably an extreme case of legally codified partisan influences in local government supervision, as it includes monitoring, regulating, and mandatory budget approvals by state authorities. In two states (Upper Austria and Lower Austria), state law still allocates the supervision of mayors to government secretaries of the same party. The state of Styria changed this co-partisan system of supervision in 2009 and assigned left-wing mayors to a right-wing supervisor and vice versa. Results based on the synthetic control method have shown that supervision of a mayor by an overseer of the opposite party can indeed reduce local government debt, a finding consistent with the theory of co-partisan favouritism. In all other federal states, one local government secretary of the state government or an appointed

[8]Studies have documented that local governments set to be merged with their neighbours increase debt right before amalgamation ("common pool effect"; see Gendźwiłł et al. 2020).

official supervises municipalities. Specific exceptions apply to large cities where fiscal supervision is less tight than in smaller municipalities, a factor which would make an interesting case for future consideration.

3.2 Germany

Germany is a federal state consisting of a federal level, a state level (*Länder*), as well as two layers of local government: counties (*Landkreise*) and municipalities (*Gemeinden*).[9] German local governments enjoy a great deal of local autonomy in designing local bylaws, budgets, and local tax rates. In contrast to Austria, bankruptcy of local governments is ruled out by federal and state law. Quite the contrary, state governments have the obligation to bail out municipalities in case of fiscal distress. In order to prevent disincentives from this obvious soft-budget constraint, all federal states implement tight supervision regimes, which are sometimes far stricter than the regulatory rules in Austria. In almost all German states, annual local budgets require the approval by supervision authorities, who are therefore major veto players. Supervision policies also include reporting and notification obligations, monitoring, and inspections. If state governments grant bailouts to local governments, further restrictions to local autonomy and additional approval requirements apply. In extreme cases, states can even dismiss and replace elected local officials with bureaucrats. However, all interventions are at the discretion of the supervisory authorities.

Despite very strict legal rules, public debt has drastically increased in many local governments all over Germany during the 1990s and 2000s. The Economist (2011) labelled German local governments as "Hundreds of mini-Greeces" and questioned the effectiveness of supervision authorities in some federal states. One key feature of local government supervision in Germany was of particular concern: political alignment between supervision authorities and local governments. In almost all federal states, the fiscal supervision of municipalities is carried out by officials at the second level of local government at the county level; directly elected county administrators supervise directly elected mayors.[10] Both incumbents usually belong to political parties, which brings up a large set of delicate issues. First, the county administrators often head the county branch of the party, the mayor, and the municipality branch. For re-election as local party leader, county administrators may require backing by a sufficient number of municipality party branches and therefore the support of the mayors they are tasked to supervise. In this case, supervisors can hardly be considered independent, as they may have clear incentives to relax the fiscal supervision of their fellow party members. In federal states like

[9] Some states have implemented further layers of local government between the county and the state level.

[10] Most states have direct elections of mayors and county administrators.

Schleswig-Holstein or Baden-Württemberg, the county administrator is not directly elected, but rather appointed by the county council, which is elected every 5 to 6 years by the local population. However, many members of the county council are also mayors, who therefore are granted the opportunity to select their own fiscal supervisor. Again, this induces a number of concerns regarding the independence and effectiveness of fiscal supervision. Based on these contextual factors, one may expect co-partisan favouritism similar to Austria.[11] However, in contrast to Austria, supervisory authorities monitor only a few local governments, and county administrators are often directly elected. Thus, fiscal supervisors may have more interest to act in line with party preferences in order to ensure that the local party branch delivers on its manifesto. One may therefore also expect that fiscal supervisors use their discretion to further their political agenda (theory of consistent party politics) rather than in the interest of favouritism.

Two studies have investigated this rather delicate setting of politically aligned supervision authorities. One study is Roesel (2017). The author investigates the case of the state of North Rhine-Westphalia where direct elections of both county administrators (supervisory authorities) and mayors were introduced in 1999. Panel regression results show that the party affiliation of both the mayor and the fiscal supervisor has an effect on budget outcomes. County administrators affiliated with a left-wing party (mainly the social democratic *SPD*) tolerated more short-term debt than their right-wing counterparts (the conservative *CDU*). There were no such effects in the long term where strict legal rules applied and fiscal supervisors had less discretion. Thus, in the case of North Rhine-Westphalia, collusion between co-partisan mayors and supervisors did not seem to play a big role. Short-term debt increased when left-wing mayors were under the supervision of left-wing supervisors. However, the opposite holds true for right-wing mayors, who tended to reduce debt more when supervised by right-wing oversight. This finding follows the theory of *consistent party politics*, that is, supervision authorities implement policies according to their political agendas.

A second study on fiscal supervision in the German state of North Rhine-Westphalia was published by Christofzik and Kessing (2018). The authors exploit that the fiscal supervision of municipalities was relaxed during the transition from cash-based to accrual budget accounting in the late 2000s. Once supervision was relaxed, local governments increased budget deficits and short-term debt. The authors conclude that fiscal supervision has a causal effect on budget discipline. In an earlier working paper version, the authors have also tested whether political alignment plays a role (Christofzik and Kessing 2014). The findings are very similar

[11]There is anecdotal evidence for such actions. For example, an independent local councillor poses the rhetorical question whether the local left-wing supervisor will apply his strict supervision policies equally to right-wing and left-wing local governments. Original in German language: "Es wird interessant sein zu erfahren, ob diese stringente Gesetzesauslegung von Landrat Arnold und der ihm unterstellten Kommunalaufsicht nur gegenüber der bürgerlichen Koalition in Karben postuliert wurde oder auch gegenüber seinen eigenen Parteigenossen Anwendung findet". See Wetterauer Zeitung, "Unerlaubte Kassenkredit-Überschreitungen", 11 June 2010.

to Roesel (2017); effects of relaxed fiscal supervision are similar for politically aligned and non-aligned fiscal supervisors; however, left-wing supervisors tolerate larger deficits. Again, the party affiliation of the fiscal supervisor seems to influence budget outcomes of the supervised municipality, but favouritism does not play a big role. County administrators seem to consider fiscal supervision of municipalities as a second channel through which to realise their party preferences in fiscal policy.

German state governments are well aware of the political bias in fiscal supervision by locally elected county administrators. In order to reduce partisan cycles in supervision, many German states in recent years have shifted the responsibility of municipal fiscal supervision from directly elected local officials to regional or even state level authorities. Saarland was the first federal state to centralise fiscal supervision in 2007, replacing county administrators with a central state authority to supervise the local budgets of all municipalities. However, Saarland is only a small state, and anecdotal evidence reports that local governments' connections to supervisory authorities at the state level are still strong or possibly even stronger than before this reform was implemented.[12] Thus, there is very little reason to believe that upscaling fiscal supervision has had any effect in Saarland. North Rhine-Westphalia, a state much larger than Saarland, has since 2011 transferred the fiscal supervision of local governments receiving bailouts from county administrators to the state administration. Similarly, the state of Hesse has centralised supervision for local governments receiving financial aid from the state, citing the "too close" connections between county administrators and mayors as reasons for the reform.[13] More and more German state governments are following suit; in order to take control of the supervision of local finances and to reduce incentives for lax supervision arising from delicate principal-agent constellations, fiscal supervision is increasingly being assigned to central authorities rather than local politicians. Future research may evaluate in more detail whether this change in supervisory authorities has indeed reduced the impact of partisan politics or whether Germany is rather moving closer to the Austrian model of co-partisan favouritism between local and state authorities.

[12] A former mayor (Fritz Decker) reported in a local newspaper that supervision authorities should have refused many of the local budgets they had approved. In one case, a highly indebted municipality led by a right-wing mayor (CDU) aimed at putting up a new gymnasium. The fiscal supervisor stopped it, but the mayor was ultimately allowed to build the gym after meeting with the prime minister. According to Decker: "This is quite usual." Original in German language: "Die Kommunalaufsicht hätte in den letzten Jahren viele Haushalte nicht genehmigen dürfen", sagt Decker. Er erzählt gerne die Anekdote einer hochverschuldeten CDU-regierten Gemeinde, die sich trotz fehlender Mittel eine neue Mehrzweckhalle leisten wollte. Als die Kommunalaufsicht den Haushalt der Gemeinde deshalb stoppte, sei der Bürgermeister eben zur Staatskanzlei gegangen - und habe die Halle bauen dürfen. Das sei üblich." Saarbrücker Zeitung, Mauschelei statt strenger Aufsicht - Wie manche Kommunen mit Hilfe der Parteien Spar-Auflagen des Landes unterlaufen, 27 February 2015.

[13] See, for example, the protocol of the state parliament of Hesse: Hessischer Landtag, Plenarprotokoll 18/105 vom 08.05.2012, p. 7236.

3.3 Other Countries and Layers of Government

Traditionally, Austria and Germany have employed comparably tight and very intense measures of fiscal supervision of local governments. Other countries have implemented similar rules and institutions in order to improve the fiscal performance of their local governments (e.g. Rattsø 2002 and Geissler et al. 2019 provide cross-national comparisons). Even highly decentralised countries such as Switzerland and the United States, where central governments credibly rule out bailouts to lower levels of government, have started experimenting with more hands-on measures such as monitoring or approval requirements (Spiotto 2013). However, though the optimal design of supervisory authorities is increasingly of great interest around the globe, studies investigating the political alignment between municipalities and central governments are still rare.[14]

In contrast to the small amount of evidence on the lowest level of government, the political alignment between the national and the first subnational layer of government (mainly federal states) has been studied in several papers. Rodden (2006) and Khemani (2007a, b) show that deficits in German and Indian states are higher when state government are led by a party supporting the national government. Delgado-Téllez et al. (2017) show that in Spain, regional governments which are politically aligned with the central government comply significantly less often with fiscal targets. However, other studies in Brazil and Italy have found no fiscal impacts resulting from party connections between state and national governments (Rodden 2006; Hallerberg and Stolfi 2008). In conclusion, the findings for the first subnational layer tend to corroborate that political alignment reduces incentives for sustainable budgeting. However, keeping in mind that interventions of national governments into policies of federal states happen very infrequently, effects may work through bail out expectations rather than through preventive measures.

4 Conclusion

In this paper I have discussed the adverse effects of politically aligned fiscal supervisors. Evidence from Austrian and German local governments has shown that party connections between supervisors and supervisees indeed play a role and can serve to reduce the effectiveness of supervision. Both countries recognise this issue and have already begun to take steps towards reforms which shift the fiscal supervision of local governments from politically or locally aligned supervisors to more independent authorities.

However, it still remains unclear whether independent supervisors are suitable solutions or whether they will actually worsen the situation. One factor to consider is

[14]More studies have focused on the impacts of political alignment on intergovernmental grants. See, for example, Grossman (1994) or Curto-Grau et al. (2018).

that supervision usually means intervening upon democratic decisions made by politicians elected by a local majority of voters. Ongoing debates on central bank independence in many countries show that trading off independence and democratic accountability is challenging. Another factor is that, even when abstracting from democracy issues, theoretical studies have also shown independent supervisors often perform worse than reputation-oriented partisan supervisors (Fox and Van Weelden 2010). One of the main reasons behind this is that politically aligned supervisors have an interest to appear competent in order to bolster their own re-election probabilities. In other words, technocrats are not always the better politicians (Alesina and Tabellini 2008; Pilny and Roesel 2020), and in the interest of democracy as well as efficiency, it is not always clear whether independent supervisors are really superior to partisans. More empirical research is clearly needed in this regard. In particular, future research may compare politically aligned to independent fiscal supervisors and exploit close election outcomes to identify causal effects of political alignments more properly.

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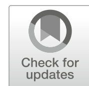
Part II
Bailouts and Insolvency

Preventing Local Government Defaults: No-Bailout Policy and Its Alternatives



Maarten Adriaan Allers and Joes Gordon de Natris

Abstract Fiscal decentralisation introduces the risk that subnational governments may act in a fiscally irresponsible manner in the belief that a higher tier of government will bail them out if they run into trouble. The economic literature, therefore, prescribes a strict no-bailout policy. We survey fiscal rules and fiscal policies concerning subnational governments in 20 European countries and find wide discrepancies, both between the theory and practice and between the rules and actual policies. Countries with a no-bailout rule often do bail out subnational governments, sometimes on a large scale, while countries lacking such a rule sometimes do not, or only sparingly. The fiscally responsible behaviour of subnational governments seems to depend upon a balanced mix of policy measures, notably providing sufficient funding, adequate fiscal supervision, early intervention mechanisms and bailout rules that are sufficiently unattractive. A no-bailout rule is neither necessary nor sufficient.

1 Introduction

It is a cherished principle in the literature on fiscal federalism that tasks should be executed at the lowest suitable level of government. Fiscal decentralisation enables public services to be tailored to local needs and preferences as well as possibly reducing costs (Oates 1972; Boadway and Shah 2009).

However, fiscal decentralisation comes with two complications. First, central governments may have made local governments legally responsible for the implementation of certain policies without providing sufficient funding (unfunded mandates; Eyraud and Gomez Sirera 2015). Subnational governments levy taxes and may have access to their own other revenue sources, but these seldom suffice to finance all their activities. Local tax autonomy is limited in many countries, and municipalities in poor areas may have shallow tax bases. Such vertical fiscal

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imbalances require the use of intergovernmental transfers. However, if funding falls short, local governments may be forced to spend more money than they receive.

Second, intergovernmental transfers may weaken local governments' incentives to operate efficiently (Smith et al. 2019). After a higher level of government (hereinafter referred to as "central government") has indicated its interest in certain policy goals, a lower level of government (hereinafter referred to as "local government") may expect to be bailed out in the event that financial problems were to arise, which would preclude achieving these goals (Allers 2014; Goodspeed 2002).

Defining exactly what we mean by "bailout" is not easy. Following Pettersson-Lidbom (2010), we define a local government bailout as a situation where a central government extends more resources ex post to a local government than it was prepared to provide beforehand. Often, this is an unexpected necessary transfer of funds to a local government or the assumption of local debt, in order to save a local government from financial problems. However, bailouts have been known to occur in situations where local governments did not seem to be in a fiscal crisis. Furthermore, bailouts may be implicit and be disguised as discretionary grants or the relaxing of accounting rules that give local authorities more fiscal leeway. Examples will be provided below.

Based on Kornai (1980), the economic literature stresses that, once it is clear that a central government is willing to bail out local governments, local authorities have an incentive to overspend or to take excessive risk (Garcia-Milà et al. 2001; Bordignon and Turati 2009; Pettersson-Lidbom 2010). Moreover, decentralisation leads to an asymmetric information problem between higher and lower levels of government because the local government level has better knowledge of the costs of implementing policy. This means it can credibly pretend to have insufficient funding since it is difficult for central government to recognise bad fiscal policy. As soon as the credibility of a no-bailout policy is lost, the risk of fiscally imprudent behaviour increases.

Therefore, another cherished principle in the literature on fiscal federalism holds that higher levels of government must maintain a credible no-bailout policy to avoid fiscal crises and insolvencies among local governments. In the economic literature, this is often claimed to be the only reliable policy which can avoid local government profligacy in fiscal federations (Rodden 2006; Pettersson-Lidbom 2010; Dovis and Kirpalani 2020). A credible no-bailout policy gives local governments a strong incentive to be fiscally prudent. Moreover, it gives potential lenders an incentive to assess the risk associated with lending to a local government. When financial profligacy makes this risk too large, the jurisdiction will face prohibitively high interest rates.

Within Europe, Switzerland is hailed as an example of such fiscal fortitude and success, as it adheres tightly to the no-bailout principle. However, it is not self-evident that a no-bailout policy is the only way central governments can maintain fiscal discipline among local governments. Despite the good academic pedigree of the no-bailout principle, the empirical and comparative research to support it is scarce. There seem to be two major discrepancies between what we think we know about bailouts in Europe and what is actually going on.

First of all, there are large discrepancies between legal rules on the one hand and the actual policies on the other. National governments with an official no-bailout policy often do implement bailouts (e.g. Hungary). Meanwhile, although Switzerland maintains a credible no-bailout policy in practice, Swiss law does not forbid bailouts. A credible no-bailout policy is difficult to maintain because central governments are often seen as responsible for policy that is implemented at lower levels of government. Therefore, both citizens and local governments can expect higher tiers of governments to step in in the case of a fiscal crisis. For instance, cessation of public services in such areas as education and health care may be seen as unacceptable, thus reflecting badly on the central government, even if local governments have failed. Central government often funds a significant share of local government expenditure. This may be seen as an admission that it takes an active interest in the pursuit of local policy (Rodden 2006).

Second, we will show that several European countries, for example, Denmark, hardly ever need to implement bailouts even though they have a de jure or de facto bailout policy. Fiscally responsible behaviour may be fostered by other means. Voters may punish politicians who mess up, a formula-based equalisation grant may ensure sufficient funding, fiscal rules may prevent risky behaviour, and bailouts can be made unattractive by attaching conditions. Even in Switzerland, these policy mechanisms seem vital. This is important because soft budget constraints could improve efficiency. For example, Besfamille and Lockwood (2008) argue that hard budget constraints may lead local governments to underinvest. Dietrichson and Ellegård (2015) suggest that conditional bailout grants may induce more fiscal discipline than a hard budget constraint.

This paper aims to further our understanding of how central governments incentivise fiscally responsible behaviour among local governments. To do so, we first describe current policies concerning local government insolvencies and bailouts in 20 European countries. Then we present a more detailed overview of the tools that governments have at their disposal to induce fiscally responsible behaviour besides a credible no-bailout policy and give examples of their use in European countries. We use this overview to show the discrepancies between de jure and de facto bailout policy, and between the theory on bailouts and the empirical data of successful fiscal federalism in the absence of a no-bailout policy. We draw lessons that may help central governments to successfully avoid local government fiscal crises and profligacy, without ruling out bailouts.

2 European Insolvency and Bailout Policies

We now turn from theory to practice: how do countries handle fiscal distress among local jurisdictions? We surveyed 20 European countries, listed in Table 1. We studied the literature, and we asked country experts for information (see Appendix). In some countries, policies differ by state. For example, the German federal states (Bundesländer), Belgian regions and Swiss cantons have substantial autonomy to

Table 1 Bailouts and bailout policies in European countries and states

	A no-bailout clause is enshrined in law	Neither a bailout nor a no-bailout clause in law	Bailouts are formally regulated
No bailouts in at least 25 years		Switzerland Flanders France Austria	
Rare bailouts	Portugal	Czech Republic England Ireland Poland	Denmark Estonia Greece The Netherlands
Many bailouts	Hungary Spain	Sweden Wallonia	Bulgaria Finland Germany Italy

shape fiscal policies regarding local governments. Like local authorities, such states may also experience fiscal distress themselves, but we limited our analysis to local governments. Where, for simplicity, we refer to “central government”, in federations this may apply to state government.

Only in five of the countries we surveyed are municipal insolvencies legally possible: Austria, Bulgaria, Hungary, Italy and Switzerland. In Hungary, no less than 45 municipalities have become insolvent since 1996 but none since a nationwide bailout in 2011–2014. In Switzerland and Austria, however, municipal insolvencies are very rare. Austria saw its last case in the 1930s and Switzerland in 1998.

In other countries, municipalities cannot technically become insolvent, but there may exist similar mechanisms. In England, for example, councils may issue a so-called section 114 notice. This is effectively an admission that a jurisdiction lacks resources to meet current expenditure, that its financial reserves are depleted and that it has little confidence that it can bring spending under control in the near future. This is quite exceptional; in 2018, Northamptonshire was the first local authority to issue a section 114 notice in two decades (The Guardian 2018).

Regardless of the legal possibility of insolvency, fiscal crises may occur, and without an adequate response, municipalities may become insolvent. Table 1 provides a quick and simplified overview of bailout policies among European countries. Interestingly, some countries have a formal no-bailout policy, while in practice local governments have been bailed out. Moreover, countries in which bailouts are (de facto) possible do not necessarily suffer from endemic local government profligacy, contrary to what the economic literature predicts. Whether explicit bailout regulation exists or whether higher government tiers bear formal responsibility for lower-level governments in trouble does not seem to matter much for the frequency with which local governments are rescued.

Three countries officially rule out bailouts: Hungary, Portugal and Spain. They illustrate the difficulty of upholding such a rule. Portugal saw a few municipal bailouts during the crisis years around 2010; this was before bailouts were formally

ruled out by the central government in 2013. Nevertheless, nowadays it maintains a fund to finance municipalities in fiscal trouble, which is financed by other municipalities. No bailouts have occurred since 2013. This paradox in Portuguese bailout policy makes it difficult to predict whether bailouts will occur often in the future. An extreme case is Hungary, which assumed all debt of all local governments in 2011–2014, even though there were no financial problems at the sector level (Vasvari 2018). Spain, too, witnessed widespread explicit bailouts and also large-scale implicit bailouts through discretionary grants (Velasco 2019; Foremny and Solé-Ollé 2016). In other words, two out of the three cases in our sample with a no-bailout policy evidence frequent bailouts.

Meanwhile, in four countries in our sample that allow bailouts but lack formal rules regulating bailouts, bailouts do not occur. Of these, Switzerland is the best-known case. Following the insolvency of the municipality of Leukerbad, the Swiss Supreme Court in 2003 decided that there was no obligation for the canton of Valais to bail out its highly indebted municipality. Prior to this court ruling, this had been unclear, as the law does not oblige cantons to bail out municipalities but it does allow them to do so. Creditors seemed to believe that cantons would step in if needed because, after Leukerbad, which confirmed the no-bailout commitment, cantonal risk premiums fell by about 26 basis points (Feld et al. 2017).

For Austria, there is no record of explicit municipal bailouts, although provisions for this exist (see below) and municipalities can unconditionally obtain loans from the Federal Financing Agency (Vielhaber 2014). In Flanders, no bailouts have taken place in 25 years. It is true that the Flemish government recently offered to take on municipal debt in exchange for municipal consolidation. However, this was on a minor scale and part of a deliberate policy to encourage municipal scale enlargement, so according to our definition, this does not constitute a bailout. In France, departments facing a state of insolvency may be bailed out, but municipalities do not seem to receive any additional funding if they face a state of insolvency.

In four countries, bailouts are not formally regulated but occur rarely. In some cases, these bailouts are implicit, for example, in the form of discretionary intergovernmental grants. Implicit bailouts do take place, for example, in England, where government ministers have substantial discretionary freedom to adjust grant allocations (De Widt 2016). This may be used to prevent local fiscal crises. Moreover, in the 2018 Northamptonshire case referred to above, central government allowed the county council to spend a large share of the cash received from the sale of its brand new headquarters on funding day-to-day services, in conflict with accounting rules (The Guardian 2018). Although technically not a bailout—no money flowed from the central government to the council—this prevented the council falling into insolvency.

In three other countries without formal bailout regulations, bailouts are similarly rare. In the Czech Republic, the case of the bailout of the municipality of Rokytnice nad Jizerou is remarkable because normally this country solves local financial troubles by the involuntary sale of municipal property (Ponce 2019). Ireland has bailed out one local government (Sligo County Council) since 2010. Poland maintains a fund for municipalities in fiscal crisis, and in 2004 several local governments

received a loan to avoid insolvency (Kopanska 2011, p. 122), but in 2018 it rejected a request for help from the municipality of Ostrowice.

However, in two cases, bailouts are not formally regulated but do occur regularly. In Sweden, 88 municipalities were bailed out between 1998 and 2005 through two different programmes. These have always been conditional bailouts with recovery plans attached to them. In the Belgian region of Wallonia, bailouts are a regular phenomenon. In 2015, for instance, around 20% of municipalities were undergoing a financial recovery process in exchange for which they received financial support.

Of the countries in Table 1, eight have rules to regulate municipal bailouts. These rules may determine who pays for bailouts and whether they are a grant or a loan (see Table 3). Four countries in this group have only witnessed a few bailouts. Denmark saw one bankruptcy in 2002 (Mau 2015). Estonia has seen eight bailouts since 2005. In Greece, there were three bailouts in 2016. Twelve municipalities were bailed out in the Netherlands between 1998 and 2019. On the other hand, four other countries with specific bailout regulations have witnessed many bailouts: Bulgaria, Finland, Germany and Italy.

3 Tools to Prevent Fiscal Difficulties

Why have many countries without a credible no-bailout policy not suffered from endemic fiscal crises among local governments, as the theory predicts? This has received little attention in the literature (see, however, Allers 2014 and Mau 2015). There are several policy options for countries to prevent local fiscal troubles.

3.1 Sufficient Funding

The first way to limit the need for bailouts is to ensure that local governments have sufficient funding to fulfil their regular duties and tasks. In such cases, bailouts are only needed in the event of financial mismanagement or unforeseen scenarios. Thus, local governments should be allowed a sufficiently large and stable tax base and sufficient tax autonomy. This enables local jurisdictions to cope with setbacks. A possible reason for the lack of bailouts in Flanders is that Flemish municipalities possess great tax autonomy and source a major part of their revenues from local taxation. This means that adverse financial shocks are more easily absorbed than in, for example, the neighbouring Netherlands, where local taxation is too insignificant to save municipalities in grave trouble.

Furthermore, central governments can provide grants to local governments to supplement their own revenues. At the macro level, any grant amount should be sufficient, together with tax revenue, for local governments to provide basic public services. Moreover, grant allocation should be formula-based and aimed at equalising differences in spending need and revenue capacity. Jurisdictions with,

for example, many children, or adverse climate conditions, may need a grant that is relatively higher than other jurisdictions to fulfil their tasks. The same applies to jurisdictions with low tax capacities. A formula-based grant system may make a no-bailout clause more credible compared to other grant systems, as it provides funding based on relatively objective standards, thus enhancing transparency and accountability (Boadway and Shah 2009).

Of the countries listed in Table 2, only Greece does not seem to have a fiscal equalisation system. It does, however, have several grants that take into account the peculiarities of municipalities, such as location on an island or in the mountains. The extent to which differences in fiscal capacity are equalised differs greatly among countries. In Hungary, tax capacity is equalised, and municipalities receive grants to cover deficits (Raffer 2019). The Netherlands, on the other hand, boasts a complicated and ambitious equalisation system aimed at enabling all municipalities to provide similar service levels when opting for a standard tax rate (Allers and Vermeulen 2016). It is difficult (if not impossible) to quantify the "quality" of fiscal equalisation systems, and no such attempt has been made here.

3.2 Pressure from Stakeholders

Central governments are not the only stakeholders when it comes to preventing local government fiscal crises. Perhaps voters or even creditors may help induce responsible fiscal behaviour. In the case of local government insolvency, citizens face significant and painful disruption in service provision. Local politicians' fiscal imprudence can be checked by voters who may punish such behaviour. However, this requires voters to be able to pin the blame on the correct culprit. Moreover, voters should carry enough of the costs to care. Voters may consider a bailout a free gift from national taxpayers to local voters, something hardly worthy of punishment. Indeed, in the Netherlands, this mechanism to ensure fiscal prudence does not seem to function properly, as voters do not punish local politicians for fiscal irresponsibility or fiscal crises (Allers 2014).

Creditors are also hurt by a local government default. Therefore, they may put a brake on fiscal recklessness by charging interest rates that depend on credit risk. The last column of Table 2 shows that in several countries, loans to municipalities are provided by public institutions. These may include publicly owned banks but, sometimes, also the national treasury. In such cases, the market mechanism to control local government debt may not actually function. However, borrowing from private lenders is also widespread. In seven countries in our sample, municipalities may *only* obtain loans from private sources. Still, this does not necessarily mean that, in these countries, private investors will punish fiscal profligacy, as bailout expectations disrupt this market mechanism.

Table 2 Fiscal regulation in European countries

Country	Average municipal size (inhabitants)[a]	Fiscal equalisation	Balanced budget rule	Absolute or relative debt limit	Debt only for capital spending	Loan or budget or annual report requires approval	Borrowing from private banks or public sources?
Austria	4166	Yes	Yes	Yes	Yes	Yes	Private
Belgium	19,177	Yes	Yes	Yes	Yes	Yes	Private
Bulgaria	26,702	Yes	Yes	Yes	No	No	Private and public
Czech Republic	1688	Yes	Yes	Yes	No	Yes	Private
Denmark	58,459	Yes	Yes	Yes	Yes	Yes	Private and public
England	167,898	Yes	Yes	Yes	Yes	No	Private and public
Estonia	16,657	Yes	Yes	Yes	Yes	Yes	Private
Finland	17,670	Yes	Yes	No	No	No	Private and public
France	1885	Yes	Yes	Yes	Yes	Yes	Private
Germany	7449	Yes	Yes	In some states	Yes	Yes	Private and public
Greece	33,181	No	No	Yes	No	No	Private and public
Hungary	3088	Yes	Yes	Yes	No	Yes	Private
Ireland	151,078	Yes	Yes	No	Yes	Yes	Private and public
Italy	7617	Yes	Yes	No	Yes	No	Private and public
Netherlands	44,816	Yes	Yes	No	No	No	Private and public
Poland	15,507	Yes	Yes	Yes	Yes	N/A	Private
Portugal	33,524	Yes	Yes	Yes	Yes	Yes	Private and public
Spain	5720	Yes	Yes	Yes	Yes	Yes	Private and public
Sweden	34,218	Yes	Yes	No	Yes	No	Public
Switzerland	3768	Yes	Yes	Depends on canton	No	Depends on canton	Private and public

[a]Data for 2016. Sources: OECD (2018) and SNGWOFI (2019)

3.3 Fiscal Rules

All countries employ fiscal rules to avoid fiscally reckless behaviour on the part of local governments (see also Turley et al. in this volume). These may, for example, require a balanced budget, allow debt only to be used for capital investments, set absolute or relative maximum levels of debt or limit spending. In all countries in our sample with the exception of two, municipalities are subject to some kind of balanced budget rule. However, what a "balanced budget" actually means varies. In the Netherlands, for example, the balanced budget requirement does not rule out borrowing because municipalities use the accrual method of accounting (Allers 2014). Therefore, expenditures to acquire assets do not appear on the budget in the year of acquisition but are spread out over the economic life of the assets, in the form of interest and depreciation. In Spain, a balanced budget rule exists but does not seem to be enforced. In practice, borrowing by municipalities occurs in all countries in our sample.

Over half the countries in Table 2 have debt limits for municipalities as well as several German states and Swiss cantons. These limits may be absolute or relative and sometimes apply to certain kinds of debt (e.g. only to short-term debt). As with balanced budget rules, enforcement of debt limits differs greatly between countries. In the Netherlands, there is no upper limit to what a municipality can borrow but a ceiling related to the term structure of its debt, which aims to prevent interest rate risks. In 13 countries, a so-called golden rule applies, which restricts borrowing to funding capital expenditure.

Fiscal rules limit local autonomy, which comes at a cost. By limiting borrowing capacity, spending capacity or increases in tax levels, local governments can respond less freely to changing circumstances. Absolute limits to borrowing may make capital investments insufficient. Meanwhile, limits to increases in tax levels and spending, such as used by Denmark, restrict local democracy as they make it hard for a municipal council to set its own course.

3.4 Supervision

To be able to punish transgressions, adherence to fiscal regulation needs to be supervised. Indeed, supervision itself may already improve behaviour if it makes local administrators more alert. All the countries in our sample do monitor whether local governments comply with fiscal rules. The literature on regulation distinguishes between four types of supervision: traditional oversight, competition, mutuality and contrived randomness (Lodge and Wegrich 2012).

In most countries, municipalities have to provide standardised fiscal information at regular intervals to higher government tiers. This falls under traditional oversight. In some cases, the budgets that are monitored must span multiple years, in which medium-term threats to financial stability need to be addressed. Usually, financial

supervision also entails regular deadlines to submit financial documents. In roughly half the countries in our sample, loans, budgets and annual reports do not require ex ante approval by higher tiers of government. In the other countries, at least one of these three requires approval from a higher level of government. In roughly one-third of the countries and some Swiss cantons, individual loans require approval by a higher tier of government.

A more competitive approach to supervision may include, for example, making municipal budgets accessible and easily understandable to the wider general public, enabling the public to make informed decisions in municipal elections (e.g. in the Netherlands, via www.waarstaatjegemeente.nl). This might persuade politicians to compete over prudent fiscal policies (yardstick competition). Alternatively, a central government may let public auditors compete over municipal auditing jobs, looking at their previous performance (e.g. Poland). This could lead auditors to be stricter towards municipalities.

It is also possible to foster close professional relationships between individuals at the municipal level and the national level. These relationships can provide municipal agents with useful information, training and feedback as well as fostering closer cooperation between different levels of government (e.g. Ireland). Alternatively, in some countries, municipalities are collectively punished for fiscal malpractices among individual municipalities (e.g. Denmark). This might lead them to monitor each other more closely, to share best practices and to discuss each other's policies. In the Netherlands, a bailout is in effect financed by all other municipalities, which makes administrators of the municipality receiving a bailout grant unpopular among their peers. These examples are based on an approach called "mutuality".

In some countries, public auditors are selected randomly (e.g. Italy), so no one knows in advance who will audit a specific municipality. This way corruption, which depends on close ties between individuals who trust each other, may be reduced. Similarly, it may not be known in advance which elements of a loan or budget will be particularly scrutinised (e.g. Ireland). Detailed regulation is often difficult to enforce; by randomly scrutinising specific elements, it is possible to encourage municipalities to comply with all the details of the regulation.

3.5 Early Intervention

To prevent major fiscal problems, central governments often try to intensify supervision or intervene before major problems occur. More than half of the cases in our sample have had a policy for some form of pre-emptive intervention for more than 10 years, and an additional four have implemented such measures since the 2009 financial crisis (Finland, Hungary, Italy and Portugal).

In Denmark, the Ministry of Economic Affairs and Interior does not require a local fiscal crisis to force a local government into a fiscal consolidation programme. Such a procedure starts automatically when a local government breaks the balanced

budget rule. Contrary to the other countries, Bulgaria, Spain, Sweden and Wallonia have never implemented an early intervention procedure.

Italy has three levels of increasingly burdensome obligations when it comes to a fiscal crisis: re-balancing, pre-default and insolvency. Under the re-balancing scheme, local governments come under increased scrutiny, retain their autonomy and can decide themselves on how to increase taxation and cut expenses. However, in the scenario of insolvency, the national government will step in and freeze debt and interest payments, liquidate assets and increase taxes.

3.6 Costly Bailout

The final tool to discourage the need for bailouts is to make them unattractive. Bailouts may be accompanied by forced fiscal consolidation, loss of local autonomy or personal (criminal) accountability for local politicians or administrators (Allers 2014; Boadway and Shah 2009). In all countries in the sample, breaking fiscal rules, causing a fiscal crisis or needing a bailout are to some extent punishable.

Table 3 shows that all countries we surveyed restrict local autonomy in the case of a bailout. In practice, local politicians perceive a credible loss of autonomy as a grave threat. After all, they lose the ability to shape policy in accordance with the preferences and ideals of the local council. This may have sufficient repellent force so as to make bailouts very unattractive to local politicians (Allers 2014).

Another way to make bailouts and fiscal crises unattractive to local politicians is making politicians personally (criminally) accountable for their actions. In less than half the countries in our sample, politicians or auditors may lose their job or be replaced in their role by central government officers in cases of severe fiscal crisis or rule-breaking. In theory, this count should include Spain, but this regulation does not seem to be enforced in practice. Of course, in all countries, financial fraud is punishable in the courts. The personal implications resulting from fiscal malpractice come in different forms. For instance, in Finland, local politicians may lose their position as the municipality may be forced to amalgamate. Specifically, in the case of a local fiscal crisis, an expert group will be instituted to guide the local government towards fiscal stability. If the local government defies these financial recommendations, amalgamation may follow (Moisio 2015). In countries such as Austria, Estonia and Switzerland, legal sanctions may follow in cases of gross negligence or breaking of the law. In Flanders this also used to be possible; however, it has recently been abolished. In England, auditors can lose their license in cases of rule-breaking.

Table 3 Bailout regulations

Country	Who funds the bailout?	Is the bailout a loan or a grant?	Preventative intervention possible?	Forced fiscal consolidation?	(Preventative) loss of autonomy?	Personal liability?[a]
Austria	National government and states	No bailout	Yes	Yes	Yes	Yes
Belgium	Region	Wallonia: grant Brussels: loan Flanders: no bailout	Flanders: yes Wallonia: no	Yes	Yes	Flanders: no Wallonia: no
Bulgaria	National government	Loan	No	Yes[b]	Yes[b]	No
Czech Republic	National government	Grant	Yes	Yes	Yes	No
Denmark	National government	Both	Yes	Yes	Yes	No
England	Depends (see text)	See text	Yes	Yes	Yes	Yes
Estonia	National government	Grant	Yes	Yes	Yes	No
Finland	National government	Grant	Not until 2015	Yes	Yes	Yes
France	National government	No bailout	Yes	Yes	Yes	No
Germany	States	Grant	Yes	Yes	Yes	Yes
Greece	Other municipalities	Loan	Yes	Yes	Yes	No
Hungary	National government	Both	Not until 2012/2014	Yes	Yes	No
Ireland	National government	Grant	Yes	Yes	Yes	No
Italy	National government	Both	Only implemented after 2011	Yes[b]	Yes[b]	Yes
Netherlands	Other municipalities	Grant	Yes	Yes	Yes	No
Poland	National government	Loan	Yes	Yes	Yes	Yes
Portugal	Local governments	Grant	Since 2013	Yes	Yes	No
Spain	National government	Both	Since 2012/2013	Yes[b]	Yes[b]	No

Sweden	National government	Grant	No	Yes	Yes	Yes
Switzerland	Canton	No bailout	Yes	Yes	Yes	Depends on the canton

[a] Fraud is punishable by law in all countries. Here we refer to the possibility of facing legal sanctions or losing one's job or position as a result of breaking fiscal regulation without fraudulent activities

[b] In some countries, it is not clear how strictly formal regulation is applied. This makes it difficult to assess whether fiscal consolidation and a loss of autonomy are in fact enforced

4 Successful Policy Mixes

Although the economic literature stresses the importance of credible no-bailout rules to prevent local government fiscal crises, local government bailouts are quite rare in many countries lacking such rules. We have presented a range of tools available to countries that seek to limit fiscal irresponsible behaviour of local governments. This section describes how the Netherlands, Austria, Denmark, Flanders and Switzerland have been successful in preventing the need for frequent bailouts. From this overview, it appears that no single rule or approach can achieve success. Rather, there are different sets of policies that together may increase local fiscal responsibility. In line with the findings of Eyraud and Gomez Sirera (2015), all successful countries ensure sufficient funding for regular duties and tasks, be it through an extensive tax base or sufficient fiscal transfers between the levels of government. Other rules that may feature in a successful policy mix are strict fiscal discipline, making bailouts unattractive through attached requirements and early intervention.

4.1 Bailouts in Practice

In the Netherlands, a clear bailout rule exists; it is enshrined in law and is commonly referred to as Article 12. Bailouts conforming to Article 12 occur regularly. Dutch municipalities know that they can expect a bailout if they have a structural budget deficit that they are unable to fix unaided, even if they brought this upon themselves. Yet the number and costs of these bailouts are a far cry from the deluge that is to be expected according to the economic literature. Between 1998 and 2014, ten different municipalities were bailed out and received bailout grants for an average of 3 to 4 years per municipality. Typical bailout grants varied between EUR 150 and 400 per inhabitant per year (Allers 2014). In 2015–2019, two more municipalities were bailed out. Currently, out of a total of 355 municipalities (in 2019), there is less than 1 bailout per year occurring.

In contrast to the Netherlands, Austria has no rules governing the bailing out of municipalities. However, a municipality may receive special grants, or *Bedarfszuweisung II*, in order to help it balance its budget. These grants are conditional: they imply tighter fiscal supervision and a strict consolidation programme. This means that Austria, in a way, does bail out municipalities after all. Unfortunately, there does not seem to be publicly available data on how often this happens and how much is paid in such grants.

The Austrian and the Dutch approach, in turn, bear quite a resemblance to the Danish approach. Since 1988, 30 Danish municipalities have been put under administration, with the last case occurring in 2011 (Mau 2015). In roughly 80% of these cases, the municipalities received supplementary grants, for 1 to 3 years, of around EUR 80–100 per capita per year. This is roughly a quarter to half as much as Dutch municipalities received in bailout grants (EUR 150–400; see above).

A further interesting case is the Belgian region of Flanders. In contrast to the region of Wallonia, Flanders does not have explicit regulation governing bailouts of municipalities, nor has it bailed out a single municipality in the last 25 years (Leroy 2018). However, as Belgian regions are responsible for local government finance and supervision, the feeling is that Flanders would step in if needed.

Differences in the legal framework concerning bailouts notwithstanding, we observe that actual differences in social costs due to bailouts and fiscal crises may be small. Austria, Denmark, Flanders and the Netherlands are four examples of countries in which higher tiers of government are expected to bailout municipalities in trouble, yet in none of the countries do we observe widespread fiscal problems among local governments. Outcomes do not differ very much from those in Switzerland with its celebrated no-bailout policy.

Even in Switzerland, a credible no-bailout policy may not be the main tool to encourage local fiscal responsibility. After all, before the 1998 Leukerbad default, Switzerland's no-bailout policy had never been tested. Although the 1947 federal law absolves cantons of responsibility for local fiscal crises, it does allow cantons to bail out municipalities. Creditors, in fact, seemed to expect bailouts (Blankart and Klaiber 2006). This may also be concluded from the fall, by 26 basis points, in cantonal risk premiums after the Leukerbad debacle made the no-bailout commitment credible (Feld et al. 2017). Yet, between 1947 and 2019, only Leukerbad went into insolvency. This makes it doubtful that its no-bailout policy is *the* key to Switzerland's success. So, what do Switzerland and other successful European countries have in common to limit local government profligacy?

4.2 How to Avoid Bailouts

The main reason bailouts are rare in the Netherlands seems to be that the requirements are sufficiently unattractive to prevent municipalities from abusing the system (Allers 2014). The bailout procedure temporarily robs Dutch municipalities of their fiscal autonomy. During the entire bailout period, on average 3 to 4 years, the municipality is under forced administration. It cannot decide to increase spending or reduce revenues, except when not doing so would lead to unacceptable problems. Such exceptions need prior approval from the Dutch central government. The municipality must cut back on spending in order to regain a structural budget balance within several years. The bailout grant amount is tailored to enable the municipality to do this without making cuts that would lead to unacceptably low service levels. An inspector from central government oversees this process. Consequently, local politicians have very little leeway to put their political programmes into practice.

Bailouts also carry a stigma. Fellow Dutch municipalities bear the burden, as bailout grants are paid out of the municipal fund that feeds the equalisation grants to all municipalities. Administrators and civil servants are likely to feel peer pressure to avoid such a situation. Furthermore, municipal finances are monitored by the Dutch provinces, which look at medium-term budget projections. Provinces intensify

supervision if financial troubles loom. This makes it hard for municipalities to break the medium-term budget balance rule without any repercussions. Meanwhile, we can rule out several other potential explanations in the Netherlands (Allers 2014). For example, there are no binding rules that restrict municipal borrowing. Moreover, as a result of the bailout system, a local government does not need to behave in a fiscally responsible manner in order to remain creditworthy. Furthermore, fiscal mismanagement does not end Dutch political careers prematurely.

Austria, meanwhile, relies on restrictive regulation and tight supervision. Austrian municipalities are obliged to balance their budget. Austrian states generally restrict local borrowing to funding capital spending, and borrowing is subject to state approval. The states limit short-term credit through strict ceilings, and municipalities usually have to pay back such loans within the fiscal year. If a municipality is not able to do so, the budget is not balanced, and the supervisory body can demand that balance is restored within the next fiscal year, through spending cuts or revenue increases. Ultimately, in case of severe fiscal crisis and rule-breaking, a state may dissolve a municipal council.

Denmark also severely restricts the fiscal autonomy of its municipalities, including a balanced budget rule as well as expenditure and tax limits. Current revenues fund most of municipal investment. Borrowing is allowed for utilities that are fully financed by user fees. Apart from that, municipalities can only borrow to finance investments by special permission from the Danish central government. In order to smooth temporary discrepancies between revenue and expenditure, Danish municipalities may utilise short-term credit on the condition that the annual average of these deposits is positive over the last 365 days. Violation of this *Kassekreditreglen* will trigger an automatic process aimed at preventing the need for a bailout. The national government then will place the municipality under administration and monitor it closely as it carries out a fiscal consolidation plan. As fiscal autonomy is very limited and tax rates cannot be raised at will, this implies spending cuts. However, the municipality may also receive discretionary grants to help its recovery. Although the Danish government does not seem to consider this a bailout, by our definition, it is.

Flemish municipalities must adhere to a balanced budget rule. Borrowing is limited indirectly through the *autofinancieringsmarge*, which ensures that debt servicing can be financed out of current revenues. Municipalities have a large tax base, which includes tax on property values and personal income, which are not strongly pro-cyclical, so in times of economic downturn, Flemish municipalities are assured of sufficient funding. In cases whereby a local decision does not comply with fiscal regulation, the state can suspend or nullify it. Breaching the balanced budget rule will lead to a suspension of local autonomy, regardless of whether this also leads immediately to a fiscal crisis or not.

The legal framework in Switzerland is not that dissimilar from the countries described above. Like Flemish municipalities, Swiss municipalities have a large tax base from which to draw and are not heavily dependent on fiscal transfers. Nevertheless, all cantons may reduce differences in fiscal capacity through fiscal equalisation schemes. Like that of municipalities in the other successful European

countries, Swiss municipalities, therefore, have sufficient funding. Moreover, municipalities are supervised by their cantons, they must comply with a balanced budget rule (at least for the medium term), often they can only borrow for capital investment purposes or to cover short-term deficits, and they need to reduce their deficits at specified rates in many cantons. Cantons scrutinise annual reports to monitor whether municipalities are complying with the rules. Moreover, in some cantons, municipalities require dispensation for individual loans. Eighteen cantons can reject budget proposals if they do not comply with fiscal regulation.

Additionally, in all Swiss cantons, financial statistics are published for the wider public and media, and in 22 cantons independent local auditing commissions scrutinise financial statements and budgets. All cantons can intervene and take over municipal government in the case of rule violations, even in the absence of a fiscal crisis, with several levels of escalation, ranging from demanding specific behaviour or changes in legislation to acting on behalf of the municipality. Lastly, insolvency is very unattractive to local governments as it leads to a major loss of autonomy. Courts may also prosecute individuals if they are found personally guilty of enacting illegal fiscal policies. For instance, in the case of Leukerbad, the municipal president was sentenced to prison for 5 years for fraud leading to the insolvency of the municipality (Neue Zürcher Zeitung 2004).

Again, the similarities between these countries most likely explain their common success when it comes to limiting local government profligacy. The lack of a no-bailout rule in most of these successful countries is strong evidence that such a rule is not strictly necessary to maintain acceptable levels of local fiscal discipline. However, these countries do have other things in common. First of all, they all ensure that municipalities can obtain or receive sufficient revenue to carry out the tasks they have been assigned. This generally avoids fiscal crises caused by a lack of funding to provide basic public services (Eyraud and Gomez Sirera 2015). Second, their central or state governments aim to intervene well before major fiscal problems arise. They require municipalities to maintain a balanced budget, at least in the medium term. The importance of such rules in reducing debt levels is also found in studies of American states (Eyraud and Gomez Sirera 2015). Third, these countries make bailouts or insolvency unattractive, through a loss of autonomy, forced fiscal consolidation and even the loss of one’s job or personal liberty. It appears that maintaining a no-bailout rule is harder than maintaining an unattractive bailout rule.

4.3 How Not to Do It

So, what causes widespread fiscal crises and bailouts in other European countries? To start with, Bulgaria, Finland, Hungary, Italy, Portugal, Spain, Sweden and Wallonia all lack (or lacked) early intervention systems. This means that these governments were unable to intervene in municipalities when problems were starting to arise, for instance, in cases of mounting but still manageable deficits. In some

cases, early intervention systems were introduced, but the enforcement of strict adherence to fiscal rules appeared to be absent (e.g. Italy and Spain).

German states do have the option of early intervention, nevertheless there are widespread fiscal problems among municipalities. However, it seems that German municipalities received too little structural funding to carry out their duties and tasks (Heinelt and Stolzenberg 2014). While welfare spending increased, tax income was reduced by the financial crisis, which depended upon business profits to an important extent. States were forced to step in to ensure municipalities had sufficient funding. Moreover, in some states, the original oversight body, the Ministry of the Interior, was seen as being too close to local governments. In these states, the Ministry of Finance assumed supervision of cutback programmes. Also, politicians seemed reluctant to force municipalities to cut expenses in light of increasing health care and welfare costs. This is a problem from which more countries are suffering.

Besides formal rules, a more intangible characteristic is of equal importance, namely, the political will to enforce fiscal regulation or to uphold a no-bailout clause. For instance, in Italy, fiscal regulation for local governments is constantly changing. Responses to fiscal crises differ a lot over time and in each case, as do the consequences of receiving a bailout. In Spain, much of the fiscal regulation does not seem to be enforced. Meanwhile, Hungary in 2011–2014 assumed all debt of all local governments, irrespective of any fiscal need, seemingly purely for political motives (Vasvari 2018). Without political commitment to maintain fiscal responsibility and to avoid bailouts and fiscal crises, any regulation, however good it looks on paper, is doomed to fail.

5 Conclusions and Discussion

We have provided an overview of bailout rules, policies and the institutions governing local fiscal responsibility in 20 European countries. Moreover, we have examined how institutions influence fiscal responsibility among local governments. Contrary to the common argument that only a credible no-bailout policy can prevent local government profligacy, we find that many European countries manage to do this through other means. Moreover, the one European country boasting a credible no-bailout policy, Switzerland, may in fact not enjoy a low level of local fiscal irresponsibility as a result of that policy. It seems likely that the Swiss success is due to fiscal rules and practices that are also employed in other countries, which are similarly successful. Another conclusion is that formal bailout rules almost bear no resemblance to actual policies. Countries that legally rule out bailouts do in fact bail out local governments, while some countries without such legislation do not.

One of the main theoretical reasons to have multiple levels of government is to enable policy differentiation (Oates 1972). Ironically, we see that local fiscal autonomy has to be limited to some degree to prevent local profligacy. Fiscal decentralisation turns a national government into a common pool resource that can be

exploited. To prevent this from happening, local autonomy is circumscribed in combination with monitoring of local fiscal policy.

However, in some countries, local autonomy may be limited to an unnecessary degree. Compare, for instance, the cases of the Netherlands, Flanders and Denmark. In Flanders, municipalities have a broad tax base but relatively strict debt limits. In the Netherlands, municipalities have a relatively limited tax base, but they can borrow relatively freely. Meanwhile, in Denmark, it is very difficult to increase tax levels and borrowing is limited. The Netherlands, Flanders and Denmark could probably all increase local autonomy without imperilling local fiscal responsibility. Denmark and the Netherlands could allow their municipalities more tax autonomy, as Flanders does. Meanwhile, Flanders and Denmark could allow their municipalities to borrow more easily, as their Dutch counterparts can.

All in all, this is a positive message to countries in which local governments often have fiscal crises. For most countries, it was never feasible to become like Switzerland. A credible no-bailout policy is difficult to maintain, and it is likely that Switzerland only manages this because of its long tradition and acceptance of local autonomy and responsibility. However, it is possible to design a system of fiscal regulation that prevents widespread, large-scale, recurring problems. Becoming like Denmark, Austria, Flanders or the Netherlands is more feasible, by providing sufficient funding, timely supervision of local budgets, limiting local budget autonomy and making bailouts politically costly. However, without the political will to enact and enforce fiscal rules, all this will be futile.

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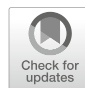
Municipalities and Excessive Debt: Local Insolvency Regimes as an Alternative to Bailouts?



Christian Person

Abstract In many countries around the world, local governments have considerable fiscal autonomy. They are able not only to raise revenues or spend money on their own but also to incur debt. However, the right to borrow inevitably implies the risk of insolvency and bankruptcy, which can have tremendous negative repercussions on service delivery by municipalities, endanger their proper functioning and create severe externalities for other jurisdictions within a federation. In principle, higher tiers of government have two options to deal with local debt crises: they can either implement bailouts or provide a mechanism to restructure municipal debt within a well-structured procedure. Therefore, this chapter discusses the role of local insolvency regimes as an alternative to municipal bailouts. First, the advantages and disadvantages of local insolvency regimes will be discussed from a theoretical perspective. Subsequently, empirical evidence from existing local insolvency regimes in Europe and the USA will be presented and examined. On this basis, core features and requirements, which a well-designed local-level insolvency framework should exhibit, will thereby be derived from this examination.

1 Introduction

In recent decades, decentralisation has provided local governments (LGs) around the world with substantial fiscal autonomy, including the capacity to issue debt. However, the impact of the financial crisis of 2008–2009 on local government finances points to the flip side of this capacity: the risk of local insolvency as an inevitable consequence resulting from the right to borrow (Canuto and Liu 2013, pp. 1–3). Local defaults can have tremendous effects. Not only do they disturb the proper functioning of LGs and prevent them from providing essential public services, but they also generate negative externalities for other jurisdictions such as higher borrowing costs in the aftermath of a municipal default and threats to the overall

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financial stability (Herold 2018, p. 4). Therefore, central governments develop frameworks to prevent unregulated municipal defaults and maintain the long-run sustainability of local borrowing (Canuto and Liu 2013; Rodden et al. 2003). Consequently, insolvency procedures for municipalities may constitute an important element of regulatory regimes concerning local public finances as they contribute to the enforcement of rule compliance with budgetary laws. When designing such regulatory frameworks, governments must harmonise differing objectives: safeguarding the provision of public services; guaranteeing the functioning of LGs; limiting interference with local self-governance; balancing divergent interests of creditors, debtors and citizens; facilitating debt restructuring; maintaining access to capital markets; and preventing moral hazard (Canuto and Liu 2013, p. 18; Herold 2018, pp. 17–18).

In general, central governments have two main options to deal with local debt crises: (1) they can implement bailouts or (2) provide procedures to restructure the local debt. As each option has its peculiarities, there is an ongoing debate on the benefits and pitfalls of municipal bailouts and insolvencies (Rodden et al. 2003; Oates 2005, p. 360; Canuto and Liu 2013). In practice, countries have addressed the problem quite differently. While most European states have some kind of bailout mechanism for municipalities, local insolvency regimes are rare. Moreover, there is no coherent picture concerning these regimes in Europe. Comparative studies are scarce (the exceptions being Liu and Waibel 2009; Canuto and Liu 2013; Herold 2018). Thus, we know little about such regimes from a comparative point of view. This chapter addresses this research gap by providing an overview of local insolvency regimes in Europe and discusses local insolvency procedures as an alternative to municipal bailouts.

The remainder of the chapter is structured as follows. The second section discusses the benefits and pitfalls of local insolvency procedures from a theoretical point of view. Section 3 provides empirical evidence on local insolvency regimes in Europe, thereby identifying similarities and differences across countries. The USA is considered as an additional case because it has the most elaborate local insolvency regime that often serves as a role model. The final section draws a conclusion.

2 The Benefits and Pitfalls of Local Insolvency Procedures from a Theoretical Perspective

In many countries, LGs have considerable fiscal autonomy. Municipalities are allowed not only to raise revenue or spend money autonomously but also to issue debt. However, the right to borrow implies the risk of insolvency. If LGs implement unsustainable fiscal policies, this behaviour endangers their debt service capacity, threatens the permanent provision of public services and unleashes negative repercussions on the economy, which could make interventions by higher tiers of governments necessary (Canuto and Liu 2013, p. 2).

Superordinate governments have different options when it comes to action at their disposal to deal with local fiscal crises: (1) they can accept an unregulated default, (2) provide discretionary financial assistance by implementing a bailout or (3) provide mechanisms to restructure local debt within an insolvency procedure. However, unregulated insolvency is associated with incalculable risks, negative externalities, contagion effects and high uncertainty. Bailouts also can be afflicted with severe problems, for example, high financial costs or moral hazard (Brand 2013, p. 89; Canuto and Liu 2013, p. 4; for a discussion of bailouts, see Allers and de Natris as well as Person and Geissler in this volume). Therefore, insolvency procedures are discussed as an alternative, allowing municipalities to restructure their debt within a regulated process and offering them a fresh start (McConnell and Picker 1993, p. 470).

In doing so, legislators must balance the tension between the creditor's interests in debt obligation contracts and the special circumstances of public debtors, for example, the right of self-governance, fiscal autonomy and impossibility of liquidation (De Angelis and Tian 2013, pp. 312–313; Canuto and Liu 2013, p. 5). The insolvency of municipalities strongly differs from the insolvency of private organisations. While private corporations can be dissolved and their assets liquidated, the dissolution of public authorities in light of factual insolvency is difficult. Their duties and tasks must be fulfilled regardless, and asset liquidation is limited because "a seizure of municipal property could prevent the city from performing its essential governmental functions" (McConnell and Picker 1993, pp. 431–432). Thus, the satisfaction of creditor claims finds its limit in the maintenance of government's core functions. Reorganisation is at the heart of an insolvency mechanism for public entities (Liu and Waibel 2009, p. 345).

Proponents of local insolvency regimes argue that ex ante rules are not sufficient to prevent municipalities from accumulating debt. They must be supplemented by ex post mechanisms that make the violation of ex ante regulations painful. The mere existence of ex post mechanisms strengthens the effectiveness of preventive regulations because all the actors know that any infringement of ex ante rules unleashes negative consequences (Canuto and Liu 2013, p. 4). Thus, an insolvency procedure fosters the commitment of LGs to fulfil their debt service obligations and hardens their budget constraint, thereby solving the credibility problem of higher-level governments that want to credibly rule out the possibility of municipal bailouts and the associated moral hazard (Herold 2018, p. 5).

Therefore, an insolvency regime is seen as a means to maintain the fiscal discipline of municipalities through the disciplining effect of capital markets. As lenders face the danger of losing money in the case of risky investments, they fully price in the risk of municipal default. Consequently, higher debt leads to higher interest rates reflecting larger risk premiums that make it more difficult for indebted municipalities to issue debt. The efficient pricing of municipal debt would reflect the risk of default and discipline the fiscal behaviour of municipalities (Rodden et al. 2003, pp. 18–20; Oates 2005, p. 362).

Furthermore, LGs should have strong incentives to avoid a declaration of insolvency. On the one hand, municipalities declaring insolvency would suffer from

economic stigma effects and could be excluded from credit markets for years. On the other, there could be political stigma effects as the electorate may hold local decision-makers accountable for the jurisdiction's insolvency (De Angelis and Tian 2013, pp. 332–334).

Therefore, market-based solutions that do not allow for political ad hoc intervention are supposed to be superior compared to legal ex ante rules that are deemed to be ineffective due to political interventions (Brand 2013, p. 87). To sum things up, insolvency procedures should have primarily pre-emptive, deterrent effects – their mere existence ought to contribute to the avoidance of sovereign default by creating budget discipline. Thus, a "system of bankruptcy law can be called successful if there is no need to apply the actual procedure at all" (Nunner-Krautgasser 2014, p. 244).

If LGs nevertheless accumulate too much debt, an insolvency procedure offers a way to handle the situation. It provides LGs with court protection from legal actions by creditors, offers a short rest period to deal with fiscal problems while not having to deal with creditors' claims simultaneously and leaves room to negotiate a debt restructuring plan within a well-structured process and to continue the provision of public services (De Angelis and Tian 2013, pp. 312–313). Without an insolvency framework, creditors and debtors would have to resort to ad hoc negotiations (Canuto and Liu 2013, p. 7). They would face high uncertainty as nobody would know which measures should be taken. Chaotic reactions and opportunistic behaviour might be possible and could intensify the crisis (Nunner-Krautgasser 2014, p. 246). In contrast, the availability of an insolvency mechanism establishes predictability and reliability, thereby minimising discretion and increasing legal certainty (Brand 2013, p. 92; Herold 2018, p. 10).

Moreover, an insolvency procedure facilitates the involvement of creditors in the solution to the problem. As creditors are jointly responsible for the indebtedness of the debtor, due to imprudent lending and as they receive interest on the debt, it is justified that they also become involved through some form of loss, if the debtors cannot repay their debt to prevent moral hazard (Brand 2013, p. 93). Otherwise, creditors could lend out money recklessly, without assessing the risks properly, since they know they will not lose their money in a default scenario. Thus, an insolvency procedure allows for the sharing of fiscal burdens between creditors and debtors.

Nevertheless, there are also doubts concerning local insolvency regimes. Firstly, some authors worry about possible contagion and spillover effects. If one municipality files for insolvency, lenders might update their expectations about the likelihood of municipal defaults and demand higher interest rates or restrict access to credit. Thus, local insolvencies could undermine the creditworthiness of other jurisdictions and trigger an increase in borrowing costs (McConnell and Picker 1993, p. 460; Yang 2019, p. 157; Chirinko et al. 2019).

Secondly, potential moral hazard problems are discussed concerning strategic defaults. It is feared that the procedure could be abused, namely, that LGs would initiate the process without making serious efforts to solve fiscal problems on their own beforehand (McConnell and Picker 1993, p. 426; De Angelis and Tian 2013, p. 315). Thus, municipalities would fail to repay their obligations due to a lack of

political will to take unpopular austerity measures, not fiscal incapacity. In light of expected punishment by voters, evading debt repayment by filing for insolvency could be an attractive alternative for local decision-makers, at least if they assume that voters would sanction unpopular austerity measures more strongly than the municipality's insolvency. Another form of moral hazard emerges if local politicians expect state governments to be afraid of negative externalities associated with local insolvency. To avoid these externalities, states might consider implementing a bailout but attach harsh conditions to prevent moral hazard. Therefore, local decision-makers could threaten to file for insolvency to attain a bailout with better conditions (Gillette 2012, pp. 281–283).

Thirdly, insolvency processes are costly and resource intensive. Legal and financial professionals are needed to administer the process. LGs have to comply with complex legal requirements when negotiating debt restructuring. Moreover, as is typical for legal proceedings, the outcome is highly unpredictable (De Angelis and Tian 2013, pp. 333–334).

Fourthly, there are doubts about the procedure's sustainability. It is questionable whether an insolvency procedure would help to overcome long-term structural problems such as tax base erosion, decaying infrastructure or structural change of the local economy (De Angelis and Tian 2013, pp. 334–335; Kimhi 2010, pp. 380–381). Moreover, chronic fiscal problems could indicate dysfunctional political processes. However, insolvency courts often are not allowed to enforce unpopular but necessary budgetary measures or initiate institutional reforms. Thus, municipalities can continue past practices that guarantee the perpetuation of fiscal distress in the future. Offering the municipality a fresh start is insufficient so long as the causes of fiscal crisis and governance dysfunctionalities are not addressed (McConnell and Picker 1993, p. 472; Gillette 2012, pp. 284–285). To be effective, an insolvency mechanism requires interventions in local autonomy (Brand 2013, p. 91), thereby suspending democratic decision-making. However, temporarily displacing democratic decision-making by receivership under the auspices of higher-level government could be beneficial "if democratic decision-making [sic] has proven incapable of making ends meet" (McConnell and Picker 1993, pp. 472–473).

3 Local Insolvency Regimes in Europe and the USA

Empirical analysis[1] reveals that European countries deal quite differently with local budget crises (see Table 1). To address fiscal crises, the majority of European states in the sample (17 out of 21) have some kind of bailout mechanism for

[1] For this chapter we conducted a qualitative analysis of the case studies published by Geissler et al. (2019), supplemented by desk research and interviews with country experts. Thus, we were able to

municipalities.[2] Although regulatory frameworks usually do not stipulate formal bailout duties, there are often implicit bailout expectations. Thus, most countries provide discretionary financial assistance to municipalities in fiscal distress.

Compared to the broad application of municipal bailouts, insolvency procedures for LGs are rare. Only three European states (Hungary, Italy and Switzerland) formally offer LGs the possibility to declare insolvency. However, there are differences concerning eligibility, initiation of the process, measures to be implemented and assets to be liquidated (see Table 2). Moreover, these countries do not exclusively rely on local insolvency frameworks to solve municipal budget crises but also provide the option of municipal bailouts (except for Switzerland). Thus, local insolvencies and bailouts are not mutually exclusive strategies.

Austria represents a special case. Although not providing a specific local insolvency regime, general insolvency law can be applied to municipalities. However, this approach is demanding, as there are no special norms considering the extraordinary situation of municipal debtors. Moreover, practical importance is low. The last incidents of local insolvencies took place in the 1930s (Nunner-Krautgasser 2013). All other countries deny municipalities the option of declaring insolvency. Nevertheless, two countries experienced unique incidents of municipal insolvency, although being formally ruled out by law: France and Estonia. In 1997, the French city of Argenteuil declared itself insolvent; in 2005, the same happened to the Estonian town of Püssi.

A different pattern is observable when comparing European regulation with that of the USA. According to data from De Angelis and Tian (2013) and the PEW Charitable Trusts (PEW 2013), a majority of US states (27 out of 50) allow LGs to declare insolvency based on federal bankruptcy law; 23 states deny this option. In contrast, only 15 states have statutory rules for providing fiscally distressed LGs with emergency financing (e.g. no- or low-interest loans, grants or credit guarantees), thereby constituting some kind of bailout. Moreover, three states follow an ad hoc interventionist approach, granting assistance on a case-by-case basis (PEW 2013, pp. 15–19). Compared to Europe, local insolvency regimes are more common in the USA, while bailouts feature less prominently. Moreover, both strategies are often seen as mutually exclusive. While only 8 states (16%) provide the possibility of local insolvency and emergency financing simultaneously, 19 states (38%) rely exclusively on local insolvency regimes and 7 states (14%) on bailout mechanisms. 16 states (32%) provide LGs with the option to declare neither insolvency nor bailouts.

The following will provide more information about local insolvency procedures in Europe. The analysis focuses on those three European countries that have specific

gather information on 21 European countries and the USA. The countries included in the sample are listed in Table 1.

[2]With regard to four countries (England, Ireland, Slovenia and Switzerland), we were unable to identify bailout mechanisms for municipalities. Switzerland is a special case, since the cantonal fiscal equalisation schemes foresee compensatory grants for hardship cases (*Härtefallausgleich*), e.g. LGs in economic trouble but only if fiscal problems are caused by exogenous factors.

Table 1 Overview of local insolvency regimes and municipal bailouts

Country	Insolvency regime	Bailout?
Austria	[Yes]	Yes
Belgium	No	Yes
Bulgaria	No	Yes
Czech Republic	No	Yes
Denmark	No	Yes
England	No	No
Estonia	[No]	Yes
Finland	No	Yes
France	[No]	Yes
Germany	No	Yes
Greece	No	Yes
Hungary	Yes	Yes
Ireland	No	No
Italy	Yes	Yes
Netherlands	No	Yes
Poland	No	Yes
Portugal	No	Yes
Slovenia	No	No
Spain	No	Yes
Sweden	No	Yes
Switzerland	Yes	[no]
USA	Yes	Yes

Source: Own compilation based on Geissler et al. (2019)

local insolvency regimes. Additionally, it includes a description of the US system, one of the most elaborated frameworks that often has served as a role model for other countries.

3.1 The USA

The American local insolvency regime, regulated in Chapter 9 of the US Bankruptcy Code, was developed during the Great Depression when thousands of LGs defaulted on outstanding debt. It aimed at allowing municipalities to effectively restructure their debt and deal with the holdout problem, a situation when individual creditors demanded preferential treatment and threatened to sabotage a negotiated debt restructuring between municipalities and the majority of creditors (Liu and Waibel 2009, p. 337). According to Chapter 9, only municipalities can declare insolvency. They cannot be subject to involuntary bankruptcy petitions, enforced by creditors (McConnell and Picker 1993, p. 455). The term "municipality" is defined as "a political subdivision or public agency or instrumentality of a state" (De Angelis and Tian 2013, p. 315).

To declare bankruptcy, a municipality must fulfil specific requirements. Firstly, it must be insolvent, that is to say, it must be currently unable to pay its debts when due or unable to repay debt being due within the next 6 months. Insolvency is assessed by a cash flow insolvency test, not a balance sheet insolvency test (De Angelis and Tian 2013, p. 318). Secondly, municipalities require state authorisation to file for bankruptcy. In order to respect state sovereignty over LGs, the states decide if LGs are to be granted access to Chapter 9 (McConnell and Picker 1993, p. 457). Special authorisation by state law rests on the assumption that Chapter 9 proceedings can only be effective if accompanied by state oversight. Thus, it will complement, not replace the state's attempts to restore municipal finances (Moringiello 2014, p. 409). Thirdly, before filing, LGs must make serious efforts to resolve their problems autonomously. They must try to find a solution together with their creditors, namely, to develop a plan to deal with their debt or fail to do so despite negotiations in good faith, or such negotiations must be impracticable (McConnell and Picker 1993, p. 455). Courts can dismiss petitions that are not filed in good faith. The good faith requirement prevents municipalities from harassing their creditors (De Angelis and Tian 2013, p. 315). Thus, LGs are subject to stricter rules than other debtors to prevent strategic default (Liu and Waibel 2009, p. 355). However, these rules can make creditors and debtors worse off if the declaration of insolvency is postponed and municipal finances continue to deteriorate (McConnell and Picker 1993, p. 456).

After the bankruptcy court accepts the petition, an automatic stay ensues, offering the municipality protection from legal actions by creditors (Kimhi 2010, p. 355). During this period, the municipality is not obliged to make payments on general obligation bonds. However, debt obligations derived from special revenue bonds are to be serviced if there are sufficient revenues from the project after payment of operating expenses (De Angelis and Tian 2013, pp. 318–319).

Subsequently, the municipality will negotiate with its creditors concerning debt restructuring and develop a debt adjustment plan. Within the plan, the municipality can assume beneficial contracts and reject contracts that are burdensome (Moringiello 2014, p. 411). The bankruptcy court will evaluate the plan and determine if the plan is fair, equitable and feasible and in the best interests of the creditors. Feasibility refers to the municipality's ability to carry out the plan (De Angelis and Tian 2013, pp. 319–320). The best interest test requires that the plan is better than the other alternatives available to creditors. It will eschew plans that privilege municipalities at the expense of their creditors (McConnell and Picker 1993, p. 480). The plan will be approved if at least 50% of the creditors representing at least two-thirds of the claims in each class of claims accept it. If these majorities are reached, the bankruptcy court can approve the plan even in light of a dissenting minority and make it binding (cramdown provision). After approval, the municipality will be relieved of its debt accumulated before filing, except that which is assumed under the plan (De Angelis and Tian 2013, pp. 319–320).

Due to its sovereignty, the municipal debtor faces fewer constraints than private entities during an insolvency procedure. The municipality retains the right to manage its internal affairs. Its day-to-day business is not subject to court control (Liu and Waibel 2009, p. 353). Moreover, it has the exclusive right to submit a debt

adjustment plan to the court. As Chapter 9 respects the state's control over municipalities, the jurisdiction of bankruptcy courts is limited. They may not interfere with the political and governmental activities of the debtor. They cannot impose tax increases, demand spending cuts, order the seizure or sale of assets or appoint a trustee to manage the city's affairs. Thus, courts are less active in managing the process compared to bankruptcy proceedings in the case of private entities (McConnell and Picker 1993, pp. 462–463; De Angelis and Tian 2013, p. 314). Compared to the strong position of the debtor, the creditor's rights are limited. They are unable to enforce involuntary filings, to propose debt restructuring plans, to challenge municipal budgetary decisions or to appoint trustees (Kimhi 2010, p. 357). Therefore, some authors argue that Chapter 9 gives municipal debtors too much power and demand a strengthening of the bankruptcy court's role (Gillette 2012; McConnell and Picker 1993). However, Chapter 9 leaves the rights of intervention according to state law untouched. States can exercise as much control as they want. The state authorisation requirement offers them a gatekeeper function. They decide under what conditions municipalities are allowed to file for bankruptcy. Thus, they can condition bankruptcy filings upon the debtor's participation in a state oversight programme. The involvement of the states seems appropriate because Chapter 9 only provides debt relief, whereas state intervention can address the roots of the fiscal problems, albeit at the price of interference with local self-governance. However, many states do not combine bankruptcy authorisation with fiscal oversight. Only a few states have multi-step procedures in which filing for bankruptcy is either the final point after several stages of continuously intensifying fiscal oversight or the starting point of tighter supervision (Moringiello 2014; Kimhi 2010).

3.2 Hungary

The Hungarian local insolvency framework emerged in response to various municipal budgetary crises in 1994–1995 (Wetzel and Papp 2003, p. 415). Until 1995, local borrowing was unregulated and municipalities borrowed recklessly. Consequently, increasing numbers of LGs faced serious debt problems and demanded bailouts. As there was no framework to deal with subnational defaults, the Hungarian central government faced a dilemma. Thus, in 1995, several municipalities received one-time emergency assistance. However, due to the associated moral hazard problems, the central government simultaneously developed a local insolvency framework (Canuto and Liu 2013, p. 16; Jókay 2013, pp. 265–267). This framework was to achieve several goals: the prevention of unregulated municipal defaults; the establishment of a transparent, rule-based debt restructuring process; the imposition of hard budget constraints on municipalities; the reduction of the moral hazard; the discouragement of irresponsible borrowing and lending; as well as the maintenance of essential public services (Jókay 2013, p. 279; Wetzel and Papp 2003, p. 415).

The local insolvency framework is based on Act XXV of 1996 on Municipal Debt Adjustment. It covers only LGs. Corporate entities owned by municipalities are subject to corporate insolvency law. The process consists of seven procedural steps (Jókay 2013). The first step is the initiation of the insolvency procedure. It can be initiated by a municipality or its creditors. If a municipality does not pay an outstanding debt or pending invoices within 60 days after becoming due, the mayor must notify the city council and petition the bankruptcy court. Creditors may also petition the court if municipal debtors are more than 60 days in arrears (Wetzel and Papp 2003, p. 416).

At the second stage, the court examines the request. If it agrees that conditions of insolvency are met, it initiates the insolvency procedure and publicly announces its decision. The court can also reject the petition if it believes that obligations can be paid from existing assets and cash flows (Jókay 2013, p. 280).

The third step consists of the appointment of a trustee by the court and the formation of a debt adjustment committee within 8 days. The committee is chaired by the trustee. It is composed of the mayor, the chief administrator, the chair of the finance committee and one further council member (Jókay 2013, p. 282).

Subsequently, the municipality must prepare an emergency budget within 30 days after the procedure has been initiated (step four). Within this budget, the municipality may only fulfil mandatory duties and tasks. Budgetary decisions must be approved by the trustee who implements the emergency budget, monitors business operations and guarantees service provision. Moreover, the trustee examines all decisions that have contributed to the fiscal crisis and, if necessary, recommends criminal or civil prosecution. He or she also informs creditors and government agencies about the progress of the debt adjustment process (Jókay 2013, pp. 282–283). Furthermore, all debts are due. Creditors must file their claims against the municipality within 60 days; otherwise they cannot enforce their claims until 2 years after completion of the procedure. Simultaneously, all foreclosures and lien enforcement stop. Additionally, the municipality is not allowed to issue new debt or service debt assumed prior to the insolvency process, except for debt explicitly entailed in the debt adjustment plan (Wetzel and Papp 2003, p. 418).

At the fifth stage, the debt adjustment committee develops a reorganisation and a debt workout plan that shall be the basis for negotiations with creditors within 150 days. If the municipality fails to do so, creditors can propose an alternative (Wetzel and Papp 2003, p. 418). Both documents must be approved by the council. The reorganisation plan is to include a report on the municipality's financial situation, enumeration of assets to be involved in the debt settlement and proposals for measures to accelerate the debt settlement (Jókay 2013, p. 284).

The sixth step comprises debt agreement negotiations. The trustee provides all creditors with the reorganisation and the debt adjustment plan and invites them to negotiations. Debt restructuring is feasible if at least 50% of the creditors representing two-thirds of the claims accept the proposal (Jókay 2013, p. 284). If the negotiations succeed, there is a written plan including the compromise accepted by all creditors, measures to be implemented, control routines, adjustment of deadlines, remission or cancelling of liabilities and obligations as well as all measures

considered to be relevant to restore the municipality's solvency. The plan is submitted to the court, which must approve it, conclude the procedure and publish its decision (Wetzel and Papp 2003, p. 419).

The liquidation of assets forms the final step if no agreement is reached. If the debt negotiations fail, the trustee will inform the court, which will request an inventory of municipal assets. The trustee prepares a report listing which assets are necessary to carry out mandatory services and which may be liquidated. This report is then submitted to the court, the municipality and the creditors for review to which adjustments can be made. Subsequently, the court will approve the liquidation plan. The trustee then prepares a list of creditor's claims according to priority (within 30 days). Within 60 days, assets are liquidated and creditors paid out according to priority and proportion of their claims. The outcome is published, and the court will then terminate the insolvency procedure (Wetzel and Papp 2003, pp. 419–420). In the worst case, if debtor and creditors do not reach an agreement within 210 days after the procedure has been initiated, the court can request the national parliament to dissolve the city council and call for elections (Jókay 2013, p. 284).

3.3 Italy

The possibility of LGs declaring insolvency was introduced into Italian law in 1989 and is applicable to municipalities, provinces and metropolitan cities (not to regions and other forms of subnational governments). Nowadays, Italian law distinguishes between three types of financial distress for LGs: (1) the rebalancing procedure (*procedura di riequilibrio*), (2) the intermediate pre-default (*predissesto*) and (3) default/insolvency (*dissesto).* The rebalancing procedure was introduced in 2012 as an alternative to the insolvency procedure to help LGs confronted with structural fiscal imbalances that could not be solved autonomously. Municipalities must develop a budget consolidation plan that includes an analysis of the causes of the budgetary problems, consolidation measures and a time frame for implementation. In exchange, they will receive access to special revolving funds that have to be repaid later. Contrary to the insolvency procedure, the consolidation process is still managed by local politicians (Du Boys et al. 2014, p. 19; Ambrosanio et al. 2016, pp. 234–235; Padovani et al. 2018, p. 6).

The intermediate pre-default is a situation in which LGs are confronted with serious financial distress that could turn into default. Respective jurisdictions are identified by fiscal indicators indicating a severe budget disequilibrium. Consequently, they become subject to stricter control by central government. Spending is not allowed to pass certain thresholds. Additionally, they must raise service fees to reach a minimum level of cost coverage. In cases of non-compliance, central government grants may be reduced (Du Boys et al. 2014, p. 19; Capalbo et al. 2011, pp. 81–82).

A municipality is in default (*dissesto*) if it is no longer capable to fulfil core governmental functions or unable to repay its debt. Insolvency can be declared by

the municipality or by the Court of Auditors (*Corte dei Conti*). The declaration must be published in the national Official Gazette (Ambrosanio et al. 2016, p. 233).

The declaration of insolvency prompts an administrative separation of the management of the debt issued before and after the insolvency. It provides the municipality with a fresh start and restores its financial situation through the clearing of previous debt and eliminating the structural causes of fiscal imbalances. After the declaration of insolvency, payables and receivables are separated from other assets, extracted from the ordinary budget and transferred to an extraordinary one managed by a settlement committee (*organismo straordinario di liquidazione*), not the city council anymore. Moreover, an automatic stay ensues as parts of local debt and interest payments become frozen. No enforcement of claims is possible. However, the insolvency procedure does not cover all types of local debt. Long-term bank loans, cash advancements, bond repayments and all payables issued after the declaration of bankruptcy are excluded (Du Boys et al. 2014, p. 19; Padovani et al. 2018, p. 6).

Declaring insolvency goes along with a partial suspension of autonomy. The central government establishes a settlement committee that takes care of municipal assets, deals with payables issued prior to insolvency and is responsible for debt clearance. It consists of three members that can be chosen from the Court of Auditors, officials from central government's administration, provincial and municipal accounting experts or professional accountants (Du Boys et al. 2014, p. 19). The committee has three functions: (1) the assessment of local debt and liabilities; (2) acquisition, management and liquidation of assets; and (3) repayment of debt according to a formally approved recovery plan (Ricci and Civitillo 2015, p. 242; Capalbo et al. 2011, p. 84). First of all, the committee must verify all debt and liabilities assumed before insolvency and determine all assets available for repayment. Creditors must declare their claims within 60 days, which are then assessed by the committee. The assessment should take no longer than 180 days. After verification of claims, the committee renegotiates existing debt and develops a debt repayment plan aiming at satisfying creditors' claims on a proportionate basis. The plan must be approved by the Ministry of the Interior. To repay existing liabilities, the committee can liquidate assets that are not necessary to carry out core governmental functions if current revenues are insufficient. To speed up the process, the committee can propose a friendly settlement to creditors in exchange for a reduction of claims. If such an offer is accepted, the sum is paid immediately to the creditor who agrees to abstain from future claims. If the offer is refused, the committee then makes proportionate repayments (De Luca vs. Italy, no. 43870/04, ECHR 2013). The procedure has serious repercussions on providers of short-term loans, who could lose up to 60% of their credit (Du Boys et al. 2014, p. 19).

In contrast, debt not covered by the procedure is still managed by the municipality. Moreover, the city council is also responsible for assessing and dealing with the causes of the insolvency, the management of the current budget and the fiscal recovery, namely, for implementing measures to consolidate the budget (Capalbo et al. 2011, p. 84; Padovani et al. 2018, p. 6).

After initiating the procedure, the municipality must develop a crisis budget in which all measures to solve the financial problems have to be formalised. The budget must be approved by the Commission on Finance and Personnel of the local government. Until the consolidation process is finished, the municipality is subject to constraints on revenue and expenditure management. It is obligated to strict cost containment, for example, it will face limits on operating expenses and will have to reduce staff numbers. Furthermore, it must take any opportunity to generate additional revenue. During the process, the issuance of debt is restricted (Capalbo et al. 2011, p. 84; Ricci and Civitillo 2015, p. 242). In total, the procedure should last a maximum of 5 years from the approval of the emergency budget onwards, with the possibility of an extension to 10 years.

3.4 Switzerland

The origins of the Swiss local insolvency framework dates back to the nineteenth century. In the 1880s, higher-tier governments had to bail out some financially troubled municipalities. Discussions about local insolvency procedures surfaced but did not make it into federal legislation. Attempts to regulate subnational defaults emerged once again during the 1930s and finally led to the enactment of the Federal Law on Debt Enforcement of Municipalities in 1947 (Herold 2018, p. 13).

According to Swiss law, a municipality can voluntarily declare insolvency if it is unable to meet its obligations when they fall due or if its fiscal crisis cannot be solved otherwise. The request, supplemented by a report on the municipality's financial situation, must be submitted to the cantonal insolvency authority. The insolvency authority then reviews the petitioner's financial situation and decides upon the request. After confirming the request, the insolvency authority may temporarily suspend debt enforcement and impose a provisional debt deferral (Herold 2018, pp. 46–48).

If the municipality declares insolvency, the authority can, upon the request of the debtor, its creditors or the cantonal government, mandate a supervisory commission (*Beiratschaft*) responsible for fiscal adjustments. Its mandate lasts a maximum of 3 years (with an optional extension of 3 years). The insolvency authority must specify its powers. In general, the appointment of the commission heavily restricts the powers of ordinary municipal organs as specific budgetary decisions (e.g. the introduction of new revenue sources, spending, sale of assets and issuance of debt) need the commission's approval. The insolvency authority can even transfer responsibility for financial management completely to the commission. Its main tasks are (1) to develop a consolidation plan, (2) meet debt obligations, (3) restructure the budget and balance the accounts and (4) cut spending and raise revenue. To reach these goals, it can increase existing taxes and charges, collect outstanding taxes and financial obligations, sell financial assets or introduce new taxes. Finally, the appointment of the commission implies an automatic stay – during its mandate,

obligations contracted by the municipality before the appointment are suspended from debt enforcement (Schaltegger and Winistörfer 2013, p. 44).

With regard to debt restructuring, the creditors themselves decide about such measures by holding a creditor's meeting. The insolvency authority manages the meeting and finally approves its outcome. Restructuring measures must be applied uniformly to all creditors exhibiting the same legal status. Interference with creditor rights requires a two-thirds majority of all claims represented at the meeting and at least a 50% majority of capital claims of capital in circulation. Possible intervention rights are the extension of the repayment period, payment deferral and the temporal reduction of or relief on interest payments. However, debt relief is not explicitly mentioned. Debt restructuring is only applicable to bonds. Statutory liabilities, salaries, pensions and other non-sizeable liabilities are exempted (Herold 2018, pp. 49–52; Schaltegger and Winistörfer 2013, p. 44).

Finally, concerning debt enforcement, the law clarifies that the liquidation of a municipality is impossible but the seizure of financial assets is feasible, for example, assets unnecessary for the operation of the municipality. Additionally, with the cantonal government's consent, facilities for public purposes, public forests, parks and alps are also sizeable. In contrast, seizure of administrative assets, for example, assets necessary to fulfil governmental functions and tax claims, is explicitly ruled out (Schaltegger and Winistörfer 2013, p. 44).

4 Conclusion

In order to deal with local debt crises, central governments can select from different options for action: (1) accept unregulated defaults, (2) implement bailouts or (3) provide local insolvency frameworks. As the empirical analysis reveals, most European states exhibit bailout mechanisms for fiscally distressed municipalities. In contrast, local insolvency regimes are rare, although they could be an alternative way of addressing excessive indebtedness of LGs. To do so, however, they must be compatible with the socio-economic, cultural, legal and constitutional context of a country. A simple policy transfer from one country to another is difficult as a one-size-fits-all approach does not exist (Canuto and Liu 2013, p. 27; Herold 2018, p. 5). Nevertheless, based on the information presented above, one may deduce core features that a well-designed local insolvency framework should exhibit.

The right of filing for insolvency should be assigned exclusively to the municipality to limit interference with its sovereignty. Moreover, it has the best knowledge about its financial situation and is highly qualified to judge the appropriateness of restructuring measures. However, decision-makers might have incentives to delay filing as they may be afraid of tarnishing their reputation. Thus, if certain conditions are met, requiring mandatory filing could increase the chance of initiating the procedure in a timely manner. Moreover, a narrow set of clear, transparent eligibility criteria indicating insolvency is crucial. Amongst others, these criteria should require

Table 2 Overview of core features of local insolvency procedures

	USA	Hungary	Italy[a]	Switzerland
General information				
Type[b]	Hybrid	Judicial	Administrative	Administrative
Subjects	Political subdivisions of states	Local governments	Municipalities, provinces and metropolitan cities	Municipalities
Initiating an insolvency procedure				
Right of filing	Debtor	Debtor, creditors	Debtor (self-declaration by LG), court of auditors	Debtor
Voluntary/ compulsory?	Voluntary	Both	Both	Voluntary
Insolvency criteria	LG unable to repay debt currently or in the next 6 months	Invoice or debt not paid or disputed within 60 days after becoming due	LG unable to repay debt or to fulfil core governmental functions	Municipality unable to meet its obligations as they fall due Fiscal crisis cannot be solved otherwise
Further eligibility requirements	State authorisation Pre-filing efforts to solve fiscal crisis	None	None	Filing for insolvency only if all reasonable measures utilised to avoid insolvency
Assessment of filing	Insolvency court	Insolvency court	None	Insolvency authority
Stay on enforcement	Automatic	Automatic	Automatic	Authority can temporally dispense enforcement; creditors can demand continuation
Debt restructuring				
Right of proposal	Debtor	Committee appointed by debtor but led by independent trustee	Debt settlement committee	Not specified. Creditors decide about debt restructuring
Right of veto	Court	Court	Ministry of the Interior	Insolvency authority
Voting rule	50% of creditors representing two-thirds of the claims	50% of creditors representing two-thirds of the claims	None	50% of creditors representing two-thirds of the claims

Source: Own compilation (based on Herold 2018; Liu and Waibel 2009)

[a]With regard to Italy, the focus is on the *dissesto* procedure

[b]There are three types of insolvency frameworks. In judicial frameworks, insolvency courts are pivotal actors and possess encompassing decision-making rights in the whole process. In contrast, administrative frameworks assign a stronger role to higher-level governments, whereas the role of courts is limited. In hybrid models, courts and higher-level governments play an important role

a thorough assessment of the petitioner's fiscal stance and credible pre-filing efforts to solve fiscal problems autonomously in advance to prevent strategic defaults and signal that an insolvency procedure is the last resort. The assessment of eligibility should be conducted by an independent, impartial arbiter such as insolvency courts to impede an irresponsible usage of the instrument.

With regard to debt restructuring, an automatic stay on debt enforcement and a suspension of legal proceedings seems to be appropriate. This provides the municipality with a short rest period to develop a debt adjustment plan while not having to deal with creditors' claims in lawsuits at the same time. However, offering creditors a right of veto or restricting the duration of the automatic stay might be useful to balance the rights of debtors and creditors and accelerate the process. Furthermore, the result of the debt restructuring process will be strongly influenced by the assignment of the proposal and the right of veto. To protect municipal sovereignty and guarantee maintenance of public services, the right of a proposal for the debt adjustment plan should be assigned to the municipality, albeit this approach weakens the rights of creditors. However, if the power of veto is assigned to a neutral arbiter such as an insolvency court that must approve the plan, the balance between the municipality and its creditors will be thereby restored. This might also help to legitimise potential interventions into creditors' property rights. Finally, to facilitate debt restructuring, it should be sufficient if a simple majority of the creditors agrees with the plan. However, they should represent a qualified majority of the claims so that the majority of claims cannot be overruled. Additionally, courts should be able to make the plan binding upon a dissenting minority (cramdown power).

However, simple debt restructuring is not enough to resolve local debt crises. Therefore, the insolvency procedure should require fiscal adjustments that will be monitored and enforced by higher tiers of government to correct fiscal mismanagement and overcome structural budget problems. Combining the insolvency procedure with the requirement of strict budget consolidation should deter debtors from easily filing for insolvency while at the same time contributing to a fair sharing of the burden between creditors and citizens.

Nevertheless, one must keep in mind that a local insolvency regime cannot compensate for an inadequate design of intergovernmental fiscal relations. Municipalities will only be able to borrow sustainably on their own if they have sufficient fiscal autonomy (Canuto and Liu 2013, p. 27). If local revenue and expenditure are largely determined by superordinate governments, an insolvency procedure will be of limited use to address local debt problems.

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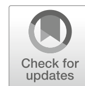
Four Decades of Municipal Bailouts in Germany



Christian Person and René Geissler

Abstract Despite the existence of strict budgetary frameworks and fiscal equalisation systems, municipal budget crisis has been a phenomenon in Germany for decades. As an institutional response, most German states implemented bailouts to restore local public finances. This chapter gives a brief description of the history of municipal bailouts in Germany. We begin with the first small bailout programme in North Rhine-Westphalia during the 1980s. In the aftermath of the global financial crisis of 2008/2009, bailouts reached their peak with a broad diffusion of programmes reacting to persistent budget deficits and escalating local debt. States designed those programmes as conditional bailouts, as they were aware of the moral hazard risks. In a second step, we explain the different institutional designs, timing and impacts of these bailouts. Regarding design, we categorise bailouts by two basic goals, different instruments and scopes. We find different explanations for designs and timing regarding the political attitudes, financial market pressure and state fiscal capacities. Finally, we assess the impacts of bailouts on municipal fiscal performance, state-local relationships and local democracy.

1 Introduction

In recent years, the general condition of local public finances in Germany has been sound. However, aggregate numbers disguise the fact that many cities have faced fiscal problems for decades. They have suffered from economic decline, rising welfare spending, inadequate funding and growing debt (Bogumil et al. 2014; Geissler 2019). The tremendous fiscal constraints these municipalities endure not only threaten the provision of public services but also endanger their overall functioning and self-government.

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At first glance, municipal budget crises in Germany might come as a surprise, since each German state (Bundesland) features a fiscal equalisation system, which provides municipalities with additional financial means. Moreover, local budgets are subject to a tight regulatory regime. Local governments (LGs) are subject to several fiscal rules, monitored by supervisory authorities who have a range of enforcement instruments at their disposal (Ebinger et al. 2018; Geissler 2019; see also the chapter by Person, Ebinger and Zabler in this volume). The system's underlying rationale is to prevent municipalities from fiscal profligacy and to overcome problems of soft budget constraints (Kornai 1986) inherent in multi-level fiscal relations (Baskaran 2017, p. 209ff.; Wildasin 2004, pp. 252–253).

Nevertheless, many municipalities found themselves in ongoing financial troubles. As an institutional response, state governments developed bailout programmes providing financial assistance to fiscally distressed municipalities (Heinelt and Stolzenberg 2014). Thus, municipal bailouts have been a reality in Germany for decades. This fits nicely with the picture drawn by Allers and de Natris in their contribution to this volume showing bailouts as an established and widespread instrument to deal with local budget crises in European countries.

According to Wildasin (2004, p. 253), a bailout is defined as the provision of exceptional financial transfers from superordinate to lower-level governments necessary to solve an imminent budgetary crisis created by poor fiscal choices[1] due to a soft budget constraint. Bailouts are discretionary policy choices (Baskaran 2017, p. 211) leading to "ad hoc additional funding that is provided when an entity would otherwise be unable to serve its obligations" (Litvack et al. 2003, p. 8). Moreover, the term bailout also includes the assumption of local debt by higher-level governments. Allers and de Natris argue that bailouts can also be implicit and disguised as discretionary grants or ease accounting rules, which provide LGs with additional fiscal leeway.

There is ongoing debate about the pros and cons of bailouts. Proponents justify bailouts because they secure the provision of public services during budgetary crises (Rodden 2002, p. 671) or avoid negative externalities, such as increasing borrowing costs in case of local defaults (Seitz 1999, p. 1). Moreover, bailouts are justified if jurisdictions have only minimal fiscal room to manoeuvre, cannot adjust revenues to spending needs and thus cannot be held responsible for their fiscal situation (Litvack et al. 2003, p. 11). In contrast, opponents argue that bailouts might be expensive and create moral hazard problems, as jurisdictions have fewer incentives to implement sustainable fiscal policies (Seitz 1999, p. 1). Furthermore, lenders also have less incentive to thoroughly monitor the fiscal performance and creditworthiness of debtors (Brand 2013, p. 89). Thus, bailouts disturb the capital market mechanism, as rising interest rates do not punish higher indebtedness. Markets do not function as efficient instruments of fiscal discipline (Seitz 1999, p. 1).

[1]This definition does not cover financial assistance provided to address fiscal imbalances that do not result from endogenous decisions of the receiver, but from exogenous shocks outside the recipient's scope of action.

Despite these concerns, most German states implemented bailouts, as previously mentioned. However, there is little research on the history of these municipal bailouts in Germany. Therefore, complementary to the institutional overview provided by Allers and de Natris, this chapter takes an in-depth look at the German case. The aim of this chapter is threefold. First, we describe the development of municipal bailouts in Germany. Second, we analyse the different kinds of bailouts, thereby identifying differing strategies to deal with local budget problems. Third, we explain why some states reacted to local fiscal crises by implementing bailouts, while others did not. Germany is a suitable case for such an undertaking, as the federal structure allows for the comparison of state policies in a rather similar institutional framework. Therefore, this chapter takes the step from a macro- to a micro-perspective of bailouts, highlighting institutional details and providing explanations of differing policies and impacts. Thus, the chapter contributes to scientific discourse in two ways. It illustrates different options of bailout design and analyses their impacts on municipal finances, state-local relations and local self-government.

The rest of the chapter is structured as follows: The second section provides an overview on municipal bailouts between 1980 and 2019. The third section discusses possible explanations of differing state practices and their consequences on municipal budget performance and local self-governance. We close this chapter with some concluding remarks.

2 Historic Overview of Municipal Bailouts

This section provides a synopsis of bailout practices in Germany. It covers both regular forms of discretionary emergency grants within fiscal equalisation schemes and special temporary programmes. Single-case decisions are not considered. To facilitate this historic overview, we distinguish four periods, as Table 1 shows.

2.1 1980–1991: First Municipal Bailouts in North Rhine-Westphalia

In the early 1980s, the terminus "cash-credits", short-term credits to bridge budget deficits, gained prominence in discussions about local public finances. Beginning with a minimal volume, these credits reached a nationwide peak of 1.2 billion euros in 1982, until then an inconceivable amount. The increase of cash credits mirrored the emergence of noticeable budget deficits, caused by the elimination of one important local tax, the "Lohnsummensteuer" (Held 1995, pp. 59–60; Diemert 2005, p. 78). This problem cumulated in the old industrial cities of North Rhine-Westphalia, which were affected by socio-economic decline anyway (Geissler 2009, pp. 16–17).

Table 1 Overview of municipal bailouts

	Type of bailout	Affected states
1980s	Extraordinary emergency grants for a few large cities within regular fiscal equalisation scheme	NW
1991–2009	Small-scale emergency grants within regular fiscal equalisation schemes Special temporary debt relief programme in Bavaria	All states excluding NW
2009–2017	Special programmes, depending on state emergency grants, interest subsidies, debt reduction	HE, MV, NI, NW, RP, SH, SL, ST
Since 2017	Second wave of special debt relief programmes, priority on debt reduction	BB, HE, MV, RP, SH, SL

Notes: *BB* Brandenburg, *HE* Hesse, *MV*, Mecklenburg-Western Pomerania, *NI* Lower Saxony, *NW* North Rhine-Westphalia, *RP* Rhineland-Palatinate, *SH* Schleswig-Holstein, *SL* Saarland, *ST* Saxony-Anhalt

The growing fiscal pressure caused the state to adjust the regulation on emergency grants and to open them for larger cities, which had previously been excluded (Held 1996, pp. 74–75). In 1987, any city fulfilling particular conditions on tax rates and deficit thresholds could apply for emergency grants to rebalance the budget. To receive the grants, cities had to formulate a *budget consolidation concept* (BCC) which obliged them to restore their budgets by implementing specified austerity measures. In total, seven cities used this option. However, the programme contained some peculiarities: Bailout grants were extracted from local funds and had to be repaid up to 50% after successful consolidation (Held 1995, p. 60; Held 1996, p. 74/75). Supervisory authorities had to approve the BCC but could not enforce its implementation. In the case of non-compliance, cities merely lost the grants (Geissler 2009, p. 20 f.). The programme showed mixed results, with short-term grants solving the most urgent fiscal problems. However, cities did not achieve a lasting, structural budget consolidation (Diemert 2005, p. 80).

In 1991, the state changed its policy in dealing with budget deficits from the provision of bailout grants to stricter fiscal rules and supervision, as the latter approach seemed to be more promising. The emergency grants were provided for the last time (LT-NW APr 11/65; Geissler 2009, p. 19ff.; Person and Geissler 2021). Additionally, the state granted a one-time bailout in the form of partial debt reliefs to a defined group of 22 small municipalities with exceptionally high debt. This was intended to ease their debt burdens and facilitate transition to the new regulatory framework (Held 1995, p. 61; Diemert 2005, p. 81ff.).

2.2 *1991–2009: Local Budget Crises Throughout Germany*

The second period of analysis spans almost 20 years, starting with the reunification of Germany. West German municipalities were directly affected by reunification: Since 1991, they were required to contribute noticeable shares of business tax

revenues to higher-level governments to refinance reunification. Since 1995, a second discharge was implemented to compensate states for changes in the federal equalisation scheme. The changes in fiscal federalism combined with economic stagnation and rising long-term unemployment resulted in growing budget pressure in several West German cities.

During this time, all states (except NW) addressed fiscal problems within their local equalisation schemes by providing discretionary emergency grants. However, systematic weaknesses were exposed (Geissler 2009, p. 67ff.): Grant funding was too small to generate effective support for the increasing numbers of municipalities with growing fiscal problems. States reacted by implementing stricter conditions and smaller quotations of demanded sums. Consequently, impacts declined and emergency grants increasingly proved inadequate. They could neither bridge growing deficits nor stimulate cutback measures. Nevertheless, only Rhineland-Palatinate abolished emergency grants (Geissler 2009, p. 51f).

As an analysis of parliamentary archives revealed, hardly any official discussions on municipal bailouts took place, except on the existing emergency grants.[2] One exception was Bavaria, which may be surprising, given the sound financial situation of most Bavarian municipalities. In 2006, the Bavarian government initiated a pilot project extending existing emergency grants (LT-BY Drs. 17/19457). Over a period of 4 years, 32 structurally weak, mainly small municipalities exhibiting fundamental budget problems received annual grants to reduce debt levels. In exchange, they had to develop a BCC, implement austerity measures and accept stricter fiscal oversight. They were also obligated to repay the transfers in the case of non-compliance. Participation was voluntary. Since the programme proved successful, by 2012 the state increased and incorporated those grants into the fiscal equalisation system.

With the exception of this incident, municipal bailouts were not on the political agenda prior to the global financial crisis. States reacted differently on fiscal stress by tightening fiscal regulation, enforcing cutback policies and putting supervisory authorities in a stronger position (Geissler 2009, p. 27 ff.). Consequently, complex, informal and non-transparent negotiation systems developed between municipalities and supervisory authorities to address fiscal problems. However, the increasing influence of the state and shrinking local autonomy provoked resistance among local politicians (Holtkamp 2010). Moreover, stricter legislation has not been consistent in every state. North Rhine-Westphalia serves as an example of volatile legislation. Faced with rising local resistance and growing deficits, the state eased fiscal rules several times, due to political reasons (Person and Geissler 2021). Rhineland-Palatinate also eased its fiscal rules due to politically motivated reasons. In 2005, the state government abolished the BCC, which it had introduced 9 years

[2]We conducted this analysis by using the parliamentary archive online databases of each of the 13 German states (without city states). We searched for the minutes of parliamentary sessions, the minutes of parliamentary committees, draft laws and special reports dealing with the situation of local public finances in general, local debt and local equalisation schemes, as well as bailout grants and programmes. The period covered spanned from 1980 to 2019.

earlier, with the intention of reducing red tape and strengthening local self-governance (Geissler 2009, p. 49 f.).

2.3 2009–2017: Municipal Bailouts in the Aftermath of the Global Financial Crisis

Local budget crises escalated in the context of the global financial crisis. In 2010, aggregate local deficits peaked (nine billion euros), and, as a result, cash credits achieved unprecedented heights (47 billion euros in 2012). Compared to the past, when crises and bailouts were rather rare, this period saw eight states react to the deterioration of municipal finances with new, specific and large-scale bailout programmes. This was a fundamental change of state policy. We call them *first-generation bailout programmes*. Some states chose striking names such as *pact for strengthening cities* (North Rhine-Westphalia), *pact for future* (Lower Saxony) or *protective shield* (Hesse). The design of these programmes differed strongly between states, as Table 2 indicates (cf. Arnold et al. 2015; Heinelt and Stolzenberg 2014). In comparison, five states saw no necessity for bailouts.

Participation was voluntary in all states (except North Rhine-Westphalia), but the range of potential participants was limited by indicators, e.g. cash credits, tax revenues, etc.[3] From the state's point of view, this procedure had advantages: Indicators demonstrated a transparent selection of the municipalities to benefit from the programme. Local applications generate higher motivation, demonstrate commitment and limit political resistance. However, given their dire fiscal situation, participation was hardly "voluntary" for most municipalities.

The affected share of state population could either reflect a widespread budgetary crisis across the state or the concentration of fiscal stress in select large cities. In any scenario, these shares are notable when taking into account repercussions of programme participation on local autonomy, tax rates and public services.

The same is true regarding the type of LGs entitled to programme participation. One must keep in mind the complex structure of the local level in Germany, which consists of municipalities, cities and counties (Geissler 2019). Not all LGs experience budgetary crises in the same way. Therefore, only half of the states (Hesse, Lower-Saxony, Saxony-Anhalt, Rhineland-Palatinate) opened their programmes for each local government. The rest restricted participation to municipalities. This political decision reflects the structure of budgetary crisis and available funding.

Additionally, table 2 displays notable differences between goals and types of support. Some states focused on balanced budgets and provided annual transfers to enable recipients to rebalance their budgets (e.g. Mecklenburg-Western Pomerania, North Rhine-Westphalia, Schleswig-Holstein). Others focused on debt reduction,

[3]Besides the option of voluntary participation, North Rhine-Westphalia obliged some municipalities with particularly disastrous budgets to participate.

Table 2 Municipal bailouts in the context of the global financial crisis (first generation)

	Participation	Affected share of inhabitants in % (2013)	Duration	Goal	Kind of support	Volume (in billion €)	Cash credits (in billion €)
HE	Voluntary	26	2013–2043	Debt reduction	Partial bailout of cash and investment credits (max. 46%) Interest subsidy	3.200	7.488 (2012)
MV	Voluntary	–	2012–2020	Balanced budget	Annual grants to balance budgets	0.100	0.549 (2011)
NI	Voluntary	20	2010–2016	Debt reduction	Partial bailout of cash credits (max. 75%) Interest subsidy	2.048	4.534 (2009)
NW	Mixed	29	2011–2020	Balanced budget	Annual grants to balance budgets	5.850	18.703 (2010)
RP	Voluntary	59	2012–2026	Debt reduction	Annual grants to repay cash credits	3.825	5.598 (2011)
SH	Voluntary	26	2012–2018	Balanced budget	Annual grants to balance budgets	0.420	0.766 (2011)
SL	Voluntary	64	2013–2019	Debt reduction	Annual grants to repay debt	0.120	1.872 (2012)
ST	Voluntary	92	2013–2018	Debt reduction	Rescheduling and partial bailout (30%) of long-term debt	0.513	3.317 (total debt, 2012)

Source: Own

For NI and ST, the given duration means the period of application, as programme duration varies individually by participants. In Hesse, duration refers to the period of annual amortisation payments by participants. In further states, duration is the period of annual grants by the states

either with cash credits (Lower-Saxony), long-term credits (Saxony-Anhalt) or both (Hesse). Bailouts were fundamentally conditional: Municipalities had to agree on a list of austerity measures (such as tax increases or spending cuts) to achieve structural budget consolidation and had to report extensively to supervisory authorities. Due to local autonomy, states could not dictate such measures, but gave recommendations and set, as an example, minimum tax rates, thereby allowing manoeuvre room for municipalities. The case of Lower Saxony is of particular interest. The state combined two urgent policies: to address financial crises and to overcome fragmented local structures. Therefore, bailouts happened under the unique condition of requiring municipal amalgamations.

Programme duration can refer to different meanings: the period of application, the period to rebalance budgets, the period of receiving special grants or the period to repay debt. For example, the duration of the North Rhine-Westphalian programme was 10 years. Within 5 years, cities had to rebalance their budget with the aid of bailout grants. During the next 5 years, they had to preserve the balanced budgets, while grants decreased. Hessian municipalities obliged themselves to pay annuities for 30 years.

In most states, the Ministry of the Interior decides about applications and the adequacy of cutback plans. In contrast to established supervisory structures, Hesse allocated the competence to the Ministry of Finance. There are two explanations for this decision. First, bailout programmes rooted in traditional emergency grants, which have always been a task of the Ministry of Finance. Second, according to expert interviews, the competence shift expresses mistrust in the capabilities of the Ministry of the Interior.

One feature of political sensitivity is the programme's funding. While the programmes achieved considerable fiscal volumes, state governments did not always bear the financial burden alone (as in Hesse, Mecklenburg-Western Pomerania, Saarland, Saxony-Anhalt). In North Rhine-Westphalia, almost 40% of the financial resources originated at the local level. The programme in Lower Saxony was funded equally by the state and the local level. The case of Rhineland-Palatinate was even more controversial. Bailout grants were funded equally by the state, local level in sum and participating cities, which meant a reduction in funding for non-participating municipalities. The programme of Schleswig-Holstein was also strongly financed by resources taken from the fiscal equalisation scheme.

2.4 Since 2017: A Second Generation of Municipal Bailouts

Discussions on local fiscal crisis eventually phased out in some states (Saxony-Anhalt, Lower-Saxony), either due to real improvements or because of long-existing programmes. In six further states (Hesse, Rhineland-Palatinate, North Rhine-Westphalia, Saarland, Mecklenburg-Western Pomerania, Schleswig-Holstein) discussion continued or gained new momentum, leading to further bailouts. In addition, one state (Brandenburg) created a bailout programme from the ground up. In order to

differentiate between the programmes developed immediately after international financial crisis, we call these "*second-generation* bailout programmes" (see Table 3).

Hesse, once again, went the biggest step. Having bailed out approximately 50% of cash credits with the first programme, Hesse established another programme to bail out the second half. By the end of 2018, the state had completely refinanced existing cash credits. Participation is voluntary and open to any municipality. State and local governments share repayment of debt over a period of 30 years. Additionally, the state adjusts fiscal rules and oversight to prevent the need for new cash credits.

In 2018, Mecklenburg-Western Pomerania set up a new programme aimed to foster debt reliefs. Municipalities can now apply for grants, which double own consolidation efforts. This programme allows the state to distribute additional federal grants. As opposed to other programmes, it is unlimited.

At the same time, Saarland also decided on a massive bailout of cash credits. By 2020, the state will take over half of local cash credits and repay them over 45 years, funded by additional federal grants. Municipalities oblige themselves to do the same with the remaining cash credits.

Rhineland-Palatinate reacted on growing local claims and limited success by extending the existing programme. From 2019 to 2028, the state will offer financial support for long-term debt restructuring and incentives for debt repayments. The programme, although minimal in volume (30 million € annually), is once again funded equally by the state and the local level. Participation is voluntary and limited to a small share of LGs.

Schleswig-Holstein developed a new programme exclusively targeting larger cities, which exhibit the highest budget pressure. Between 2019 and 2023, those cities can apply for a special emergency grant to consolidate their budget.

Brandenburg announced bailouts for the three highest indebted cities in 2018. The state takes over approximately half of their cash credits by debt reduction grants within 4 years.

Finally, the state government of North Rhine-Westphalia started a discussion on a major bailout programme of cash credits in 2018. However, given the large amount of cash credits held by municipalities, the state postponed its activities in anticipation of a potential bailout programme by the federal government. This strategy seems to have proven successful, given the official debate with central government, which began in mid-2019.

Again, the six "second-generation" bailout programmes differ widely in design. The only common detail is the voluntary participation. Beyond this, there is no homogenous pattern in the affected LGs, type of support, funding or duration. Nonetheless, there are some state programmes, which are more encompassing and ultimately fulfil the intention to overcome local budget crisis.

Table 3 Second-generation bailout programmes

State	Entitled LG	Duration	Goal	Type of support	Competence	Volume (billion €)	Cash credits (billion €)
BB	3 cities with county rights	2019–2023 (financial aid)	Debt reduction	Annual grants to reduce short-term debt, totalling 40% of volume	Ministry of the Interior	0.211	0.651
HE	All LG	2018–2048 (redemption payment)	Debt reduction	Total assumption of short-term debt by a state fund LGs pay annuities to refund approximately one third for up to 30 years	State Treasury	Ca. 5.000	5.642 (2017) 0.415 (2018)
MV	All municipalities	Since 2018 (unlimited)	Debt reduction	Annual grants to balance budgets and debt reduction grants Special focus on local housing companies	Ministry of the Interior	0.070 (2018/2019)	0.394
RP	94 LG	2019–2028 (financial aid)	Debt reduction	Interest subsidies to foster long-term debt restructuring	State Treasury	0.180	5.320
	52 LG			Grants as an incentive for own measures in debt reduction		0.120	
SH	4 cities with county rights	2019–2023 (financial aid)	Balanced budget	Annual grants to balance budgets	Ministry of the Interior	0.225	0.375
SL	All LG	2020–2065 (redemption payment)	Debt reduction	Assumption of 50% of short-term debt by a state fund Amortisation by the state within 45 years LGs have to amortise remaining short-term debt in the same period	State Treasury Ministry of the Interior	1.000	1.937

Source: Own

3 Discussion

3.1 Different Designs of Municipal Bailouts

As the overview in Sect. 2 reveals, the design and timing of bailout programmes differed strongly between states. Based on this information, we derived a typology of bailout schemes (see Table 4). These vary according to goals, instruments and scope. However, they have one commonality: they are conditional and require own local consolidation efforts. Although theoretically possible, there were no unconditional bailouts in an effort to restrict moral hazard.

Regarding their goals, we can distinguish two kinds of bailouts. First, there are bailouts to help recipients rebalance budgets. Then there are bailouts, which target debt reduction. While the former focus on current accounts, the latter are concerned with the recipient's balance sheet. Within the first category, one can differentiate two instruments: deficit reduction grants and interest subsidies. Deficit reduction grants (gap-filling transfers) cover either the whole budget deficit or a share of it, thereby leaving it to recipients to reduce the residual deficit on their own. While deficit reduction grants address the whole budget, interest subsidies focus on one spending

Table 4 Types of municipal bailouts

Goal	Instrument	Scope	Cases
Balanced budget	Deficit reduction grants	Partial	MV (1G) MV (2G) NW (1980s) NW (1G) SH (1G) SH (2G)
		Full	–
	Interest subsidies	Partial	HE (1G) NI (1G) RP (2G)
		Full	–
Debt reduction	Grants to repay debt	Partial	BB (2G) BY (2006) MV (2G) NW (1980s) RP (1G) RP (2G) SL (1G)
		Full	–
	Assumption of debt	Partial	HE (1G) NI (1G) ST (1G) SL (2G)
		Full	HE (2G)

Source: Own

category: interest payments. They relieve budgets from high interest expenditures to facilitate achieving balanced budgets.

When it comes to debt reduction, one can distinguish between two instruments, also. Recipients can either receive annual grants to repay their debt, whereby potentially restricting repayment to specific debt categories. This procedure disburdens the recipient's budget, since the annuities it must pay are reduced, but the residual debt remains on their books.

Another kind of help is the partial or full assumption of debt by other governmental entities, which takes the debt and associated risks (default, interest rate risk) off the recipient's books. Debt takeover can be unconditional or come with strings attached, e.g. the recipient's obligation to pay annuities or interests to the new owner, but typically at better conditions due to restructuring. Conditions can take various forms and exceed fiscal ones. Sometimes states used bailout programmes to pursue additional goals. For example, Lower-Saxony enforced municipal mergers to develop more efficient local government structures.

In most instances, bailout programmes relied exclusively on one instrument. Nevertheless, a combination of different measures is also possible. For example, the first North Rhine-Westphalian bailout programme provided not only deficit reduction grants but also a one-time grant to repay parts of local debt. The first Hessian bailout programme supplemented the partial assumption of local debt with the provision of interest subsidies.

Although most German states faced escalating local budget problems in the aftermath of the financial crisis, their reactions differed substantially. While some focused on rebalancing budgets and granted deficit reduction grants (Mecklenburg-Western Pomerania, North Rhine-Westphalia, Schleswig-Holstein), others highlighted debt reduction and provided grants to repay debt or partially took over debt (Hesse, Lower Saxony, Rhineland-Palatinate, Saarland, Saxony-Anhalt). Why do we observe such heterogeneous policy patterns? We argue that differing bailout designs refer to a combination of divergent problem pressure, perceived need for action and fiscal room for manoeuvre. The usage of the amount of cash credits in 2010 as a crisis indicator is obviously linked to the fact that most states exhibited above-average, strongly increasing cash credits, exposing them to serious interest rate risks and risks of debt rescheduling due to the short-term character of these loans.

In Mecklenburg-Western Pomerania, Saxony-Anhalt and Schleswig-Holstein, the per capita volume of these loans was below national average, with only a slight increase or even decrease (Boettcher and Junkernheinrich 2011). Thus, problem pressure resulting from short-term loans was less pronounced in these states. Consequently, they focused on promoting structural budget consolidation to prevent cash credits from becoming a serious issue (Mecklenburg-Western Pomerania, Schleswig-Holstein) or on reduction of long-term debt (Saxony-Anhalt).

In the other five states, the amount of short-term credits was problematic. Therefore, all of them (except North Rhine-Westphalia) addressed the problem of short-term loans and associated risks directly by debt reduction measures to shelter their municipalities from the negative repercussions of future interest rate changes on

their budgets. This strategy was viable, as the states' fiscal capacities were still able to manage the amount of cash credits. In North Rhine-Westphalia, the situation was different. Municipalities not only exhibited large amounts of cash credits but also massive structural deficits. Under these circumstances, a takeover of debt by the state government was useless. In addition, the pure volume of cash credits would have overstretched state's fiscal capacities. Consequently, North Rhine-Westphalia focused on structural budget consolidation as a first step to stop the escalation of short-term credits, thereby reluctantly accepting the danger of rising interest rates.

3.2 Explaining the Differing Timing of Municipal Bailouts

The empirics of bailouts show variation not only in design but also in timing. Why did some states react to the local fiscal crisis at given points in time by implementing bailouts while others did not? As Sect. 2 has shown, between 1980 and 2009, bailouts were rare and locally specific events. In the 1980s, local budget crisis was not a mass phenomenon, but concentrated in a few economically weak cities of North Rhine-Westphalia. Thus, it was the only state to begin a specific programme which was limited in time, volume and participants. After resolving the most pressing problems, the programme ended.

In the 1990s and 2000s, budget challenges intensified and spread throughout Germany. Most states experienced an increasing number of municipalities in deficit (Geissler 2009, p. 7f). However, despite these alarming trends, states did not discuss the option of large bailouts. Instead of experimenting with new instruments, state governments followed two alternative strategies. First, they tried to address budget problems by providing emergency grants, although the magnitude of problems had significantly increased and traditional reactions soon were overstrained (Geissler 2009, p. 67ff.). Second, they tightened budgetary frameworks and intensified the fiscal oversight for municipalities (Geissler 2009, p. 27ff.).

At this time, only Bavaria initiated a limited bailout based on local circumstances. The Bavarian programme (2006) aimed to improve the existing fiscal equalisation scheme. It was conceptualised as a pilot to develop a new type of emergency grants targeted at economically weak, demographically shrinking and peripheral municipalities struggling with serious budget problems. These municipalities were an obvious anomaly, given the overall sound fiscal stance of Bavarian LGs. The state did not intend to address the fiscal challenges of municipalities in general.

Compared to these rare bailout instances, we observe a broad, rapid diffusion of bailout programmes in the aftermath of the global financial crisis. The majority of states implemented bailouts to address soaring municipal fiscal problems. This paradigmatic shift, which became manifest in the first-generation bailout programmes, can be ascribed to several factors. First, societal discourse and normative positions about public debt changed. While public sector borrowing had seemed for decades to be less problematic, an increasing worry about its negative aspects emerged. Escalating debt and the surge of individual state and municipal budget

crises highlighted the necessity of budget consolidation (Schuppert and Rossi 2006, p. 5). Discussions about merits and pitfalls of public debt intensified during the global financial crisis (Holtfrerich et al. 2015). Consensus about the necessity of limiting public debt emerged across party lines, as legislation about the federal debt brake showed (BT-PlPr. 16/74, p. 7393ff.). The more critical stance on public debt was not restricted to Germany but was a pan-European phenomenon.

Second, within the banking sector, doubts about municipalities' creditworthiness increased. Previously, banks did not consider municipal loans to be at risk of default due to an implicit state guarantee (Schwarting 2014, p. 150). However, strong increases in cash credits and international municipal insolvencies (city of Detroit) ended in concerns which led to worse refinancing conditions (Brand 2013, p. 88). Many banks developed rating processes to review the debt sustainability of municipalities. Some capped the volume for municipal loans, increasingly allocated credits according to risk criteria or no longer extended loans to municipalities in budget crisis (Osman 2011; Elbers 2011). Thus, politicians feared the emergence of a credit crunch (LT-NW PlPr. 15/44).

Finally, fiscal problem pressure grew heavily during the 2000s. Neither the provision of emergency grants nor the intensification of fiscal oversight proved to be a viable strategy. The need for action was great, and states were forced to act resolutely. Earlier strategies of muddling through were not an option. Several states decided to address the problem via municipal bailouts, a strategy largely unknown up to that point in Germany.

Interestingly, we cannot identify partisan effects, neither in timing nor in the design of bailouts. Both left-wing and right-wing governments as well as mixed coalitions implemented bailouts, which reflects a general consensus across party lines. Moreover, it indicates policy diffusion, as discussions on municipal bailouts by some forerunners raised pressure on inactive states to develop equivalent solutions.

While in some states debates on bailouts phased out after the first generation, in other states discussions gained new momentum, inducing the development of further bailouts. There are different explanations for this second generation.

First, some states acknowledged that the first-generation bailouts could only be a first step to address immediate budget crises. The scope of these programmes necessarily had to be limited, as states themselves were hit hard by the global financial crisis and faced own consolidation needs regarding the upcoming debt brake implemented by the federal government and imposed on states. However, due to favourable macroeconomic circumstances during the 2010s, state budgets significantly improved. Moreover, the encompassing reform of fiscal relations coming into effect in 2020 promised additional revenues for the states. Both developments expand fiscal room for manoeuvre, which some states have used to set up further bailouts (Hesse, Saarland, Mecklenburg-Western Pomerania).

Second, state governments were increasingly concerned with interest rate risks associated with short-term loans. Given the ECB's low interest rate policy, some states perceived it as the right time to restructure local debt to eliminate interest rate risks. While Hesse fully bailed out remaining local cash credits, Saarland is going to

take over 50% of local cash credits in 2020. However, both states obligate municipalities to contribute to debt reliefs. Equivalent discussions are observable in North Rhine-Westphalia but have not yet ended due to the high volume of cash credits. In contrast, Rhineland-Palatinate offered interest subsidies and additional grants as an incentive to selected municipalities if they restructure short-term loans and achieve debt reductions autonomously.

The situation in Schleswig-Holstein is special. From the state's point of view, the first programme achieved its goals, except in large cities. Based on this, the state implemented some modifications and concentrated fiscal help on those municipalities. Another special case is Brandenburg. The state did not actually want to bailout the three programme participants but instead incentivise their amalgamation with surrounding counties. This plan failed, but the bailout was unstoppable. This background explains the origin, timing and limited scope of this programme, although there are several more cities in fiscal distress.

3.3 Impacts of Bailouts

Against the background of rising numbers of municipal bailouts in Germany, there is lively discussion about their impacts on municipal budgets and local politics. Evaluating their fiscal consequences faces several caveats. First, budgetary impacts are difficult to assess, as the improvement in fiscal indicators is also influenced by favourable economic trends and additional federal assistances. Second, one must balance amelioration in some indicators with counter effects in other relevant indicators (Boettcher et al. 2018).

In general, bailout programmes induced severe austerity policies in participating municipalities. Planned budget consolidation measures related to the first-generation bailout programmes have exceeded several billion euros throughout Germany. Approximately 50% are generated by revenue increases, the other 50% by expenditure cuts. However, necessary measures differ widely among state programmes and were most strict in North Rhine-Westphalia (Arnold et al. 2015, pp. 132–133).

A comparison of fiscal performance between "first-generation" programme participants and non-participants conducted by Boettcher et al. (2018) delivered mixed results. Participants experienced remarkable success in rebalancing their budgets and halting the growth of cash credits. Thus, the programmes showed positive effects on participant's budgets, which went beyond good economic development (Boettcher et al. 2018, pp. 595–596). However, the bailouts also had serious side effects. First, there was no consolidation effect in welfare spending. Instead, consolidation mainly referred to capital spending. Even before the programmes, there were remarkable investment backlogs, but bailouts increased this trend. While non-participants increased capital spending, programme participants had to implement further cuts. Similar discrepancies are observable for local tax policy. Before programmes started, property tax rates were equal between participants and non-participants. During the bailouts, different trends emerged as participants greatly increased property tax rates

(Rappen 2017, p. 27 f.). Despite the improvement of key budget figures, bailouts contributed to a deterioration of their competitiveness and endangered their long-term fiscal sustainability.

Moreover, although bailout programmes facilitate budget consolidation, compliance with long-term austerity commitments is questionable. It remains an open question if municipalities strictly implement consolidation plans when faced with changing macroeconomic or political circumstances. During periods of crises, it might be useless or even harmful to react with local cutbacks, e.g. the current corona pandemic. Therefore, critics argue that bailouts only postpone real solutions to municipal budget crises. Fundamental solutions require national action and would have to address issues of fiscal federalism, e.g. funding of welfare spending and equalisation of tax revenues, including reform of local public finances (Heinelt and Stolzenberg 2014, p. 237; Bogumil et al. 2014). Indeed, the central government began a discussion on national bailouts in mid-2019. However, major concerns were voiced, even among local governments, which has impeded concrete measures thus far.

Furthermore, bailout programmes also had repercussions on the systems of state financial supervision. Historically, local budget crises were partially caused by ineffective financial supervision; states were aware of this issue and used the programmes to change their systems. States and municipalities usually agreed upon bailouts and their conditions by contracts, which involved supervisory authorities in a consulting role. Monitoring and reporting were intensified, and enforcement instruments were strengthened. One fundamental change was the devolution of supervision for small municipalities from county to the higher district level to guarantee homogeneity of law enforcement. In some states, even state treasuries implement the programmes instead of the respective Ministry of the Interior. These changes addressed earlier failures in supervision and have been welcomed by municipalities (Ebinger et al. 2017; Person and Zabler 2017).

In addition to their fiscal and regulatory impacts, bailout programmes also effect local politics. Many local decision-makers felt overwhelmed by the extent of exogenous factors, which cause budget deficits (Bogumil et al. 2014, p. 615). Earlier measures were futile against such a background of persistent deficits, over indebtedness and economic weakness (Holtkamp 2010). State bailouts helped to overcome this ineffectiveness, spur new motivation and offer perspectives to rebalance budgets for the first time in many years. This new motivation created consolidation measures, which, up to this point, have been inconceivable for local politicians (Arnold et al. 2015, p. 124).

However, financial help exacted a high price: it was accompanied by strong interference with local autonomy. First, municipalities obliged themselves to long-term budget consolidation, which restricts local room for manoeuvre. This constitutes a serious constraint for subsequent generations of local decision-makers who were neither responsible for the fiscal situation nor had any say in the decisions concerning consolidation measures (Heinelt and Stolzenberg 2014, p. 236).

Second, consolidation measures often resulted from non-transparent negotiations between supervisory institutions and municipalities. Supervision authorities made

clear suggestions on necessary measures. From the electorate's point of view, it was unclear whom to hold responsible (Heinelt and Stolzenberg 2014, p. 236), thereby undermining democratic accountability. These negative impacts weigh even heavier, when considering the size of the population that has been affected.

Moreover, monitoring and control was intensified. Municipalities face drastic sanctions when found in non-compliance. In the most extreme case, state governments appoint a state commissioner who temporarily replaces municipal organs and implements austerity measures which require supervision, again, without voter input and without accountability. Critics argue that this instrument is not compatible with the normative minimum standards of local democracy (Holtkamp and Fuhrmann 2014). Thus, increasing the effectiveness of local budget consolidation came at the price of sacrificing a certain degree of local democracy.

4 Conclusion

In recent decades, German municipalities have faced severe fiscal problems. To address these problems, all states implemented various types of bailouts. This chapter described the history of bailouts starting in the 1980s in North Rhine-Westphalia, spreading slowly across Germany in the 1990s and 2000s, and reaching an unprecedented level with the global financial crisis. Based on this history, we can draw some general lessons.

First, the analysis reveals a spectrum of bailouts following different goals and scopes. Emergency grants as one usual kind are useful to deal with smaller fiscal problems limited to a few, small municipalities. They are a necessary feature of fiscal equalisation systems, as there always will be municipalities with exceptional challenges. However, these grants are not effective during periods of broad financial crisis affecting many municipalities simultaneously. Thus, exceptional crises require specific, temporary, comprehensive programmes. These experiences will be helpful in dealing with the upcoming economic and budgetary crisis, which will result from the corona pandemic.

Second, goals and designs of bailout programmes differ depending on the situation. While some focus on rebalancing budgets, others concentrate on debt reduction. To achieve these goals, several instruments come into play, e.g. interest subsidies, deficit reduction grants, annual debt reduction grants or the assumption of debt by the state. Any of these instruments can be used with full or partial scope. However, none of the instruments were used to their full scope, as they create issues of moral hazard and fairness. Instead, bailouts are designed as conditional financial assistance, requiring harsh austerity measures and own consolidation efforts by recipients to avoid moral hazard. They usually go hand in hand with an intensification of fiscal oversight to prevent municipalities from slipping into budget crisis again.

Third, several factors determine emergence and design of bailouts. Large programmes are only set up if fiscal pressure is high and state governments are

forced to react. Typical indicators for fiscal crisis are budget deficits, escalating debt levels, interest rate risks, risks of debt rescheduling and fears of a credit crunch for municipalities. Moreover, shifts in normative standpoints can also influence the likelihood of bailouts. In Germany, bailouts became more likely as states became aware of the risks of public debt and a general political consensus emerged.

Furthermore, policy diffusion enhances the probability of bailouts. Discussions on and implementation of municipal bailouts by forerunner states put pressure on inactive ones. Of course, states' fiscal capacities are relevant, too. If states develop a bailout, programme and concrete volume critically depend on a state's fiscal capacity.

An analysis of bailout results reveals a mixed record. Although the programmes led to noticeable improvements in key fiscal indicators, they generally showed negative fiscal side effects, which left fundamental drivers of budget deficits untouched and a weakening competitiveness among participating municipalities.

Moreover, bailouts often exist parallel to regular equalisation schemes, reducing their transparency and, eventually, contradicting them. State budgets suffer from transparency losses, too, as debt assumptions go hand in hand with new shadow budgets.

Finally, the associated intensification of fiscal supervision changed state-local relationships and limited local democracy in several ways. It remains an open question whether local governments are willing to accept fiscal and political constraints on a permanent basis and even in periods of poor economic conditions.

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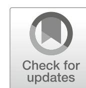
Part III
Local Public Finance in Times of Crisis

Global Crisis, Local Impact: A Comparative Approach to the Financial Crisis' Impacts on European Local Levels



Marcus Wortmann and René Geissler

Abstract The financial crisis did have tremendous effects on public sectors worldwide. While there is plenty of research on reactions at the state level and by single local governments, research on the particular impacts at local levels are scarce. This article evolves a framework of "direct" and "indirect" impacts covering 21 European countries. In referring to "direct" fiscal impacts, all local levels generated budget deficits in 2008/2009, and most faced significant increases in debt. The second category of so-called "indirect" impacts contains a qualitative assessment of structural changes made to the institutional frameworks at local levels, initiated by the states. Such measures affected grants, local structures or the allocation of functions between local levels and states. The most common "indirect" impact is the strengthening of fiscal regulation, which can be clearly traced back to the financial crisis and shows some effect of supranational EU legislation. This article exposes a great variance of fiscal trends and state measures as consequence of the financial crisis. Finally, consequences within institutional frameworks are more dramatic and lasting than fiscal ones. The financial crisis deeply affected state and local relationships through centralization.

1 Introduction

The financial crisis of 2008/2009 did have tremendous effects worldwide. There is a diverse body of research on states' economic and fiscal impacts, crisis decision-making and recovery strategies (Peters 2011; Raudla et al. 2015; Kickert et al. 2015; Kickert 2012/13; OECD 2011; Schick 2012). However, findings on the specific

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impacts on local levels are rare. Some research analyses local strategies to deal with cutbacks (Du Boys et al. 2017; Heinelt and Stolzenberg 2014; Barbera et al. 2017; Steccilini et al. 2017). While many local governments still struggle with the long-term financial damage the crisis has caused, others proved remarkably resilient.

However, local governments usually "are specific targets for restoring public finances in many countries" (Cepiku et al. 2016). Therefore, this crisis must have had consequences resulting from different austerity paths and reforms taken by the countries' policymakers. While local budgetary decisions in particular and local level functioning in general depend on such external factors, it is meaningful to take a deeper look at them (Cepiku et al. 2016; Jimenez 2013, 2014).

This article goes beyond existing research on the impacts of the financial crisis in three ways: We leave single local governments as units of analysis and focus on local levels in total. Analysing single local governments is of relevance to discover local impacts and strategies to cope, but it bears the risk of losing sight of broader trends. Second, we examine the financial crisis impacts beyond pure fiscal data, which might occur in relevant context data of local governments. The narrow focus on financial data, again, bears the risk to overlook relevant trends, which might be essential for the functioning of a local level. Finally, we explore the strategies used by the states to handle the financial crisis and discuss their long-term impacts on local governments.

International comparison of local level impacts is a difficult and yet widely unexplored field. Local levels operate in very diverse institutional settings, not only across countries but also within their own countries (Geissler et al. 2019). General impacts thus differ with the institutional framework of local authorities.

Against this backdrop, the present contribution gives an overview of general local level trends, which took place in European countries as consequence of the financial crisis. The rest structures are as follows: First, we explain the theoretical effects an economic crisis may have on local levels and present a framework of analysis (Chapter "Budget Institutions for Subnational Fiscal Discipline: Local Fiscal Rules in Post-Crisis EU Countries"). Chapter "Fiscal Rules at the Local Level: The Challenge of Enforcement" applies this framework to 21 European countries.[1] First, we analyse financial impacts, which build on cross-national comparable EUROSTAT data. Second, we present non-financial impacts, which we gathered from literature review and interviews with national experts. By doing so, we combine a qualitative with a quantitative assessment, which is not meant to be conclusive but intended as a starting point for additional comparative approaches and future research on the topic. The final chapter draws a conclusion and classifies results for academia and practice.

[1]Those countries are Austria, Belgium, Bulgaria, Czech Republic, Denmark, England, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, the Netherlands, Poland, Portugal, Slovenia, Spain, Sweden and Switzerland.

2 How Global Crisis Might Transmit into Local Governments

The global financial crisis, which originated in 2007 in the US real estate sector, caused a severe economic downturn around the world (OECD 2011, p. 16ff). This crisis took on various forms during various phases and had different effects on different countries (Kickert et al. 2015, p. 565). While some European countries, such as Ireland and Spain, experienced turmoil on their housing markets already in 2007, almost all EU member states experienced profound recessions in 2008 and 2009, which were caused by a serious erosion of confidence in the banking sector and a dry-up of credit supply. Most European governments reacted with unprecedented government stimulus programmes that drastically increased public sector debt levels and led to the sovereign debt crisis of the euro zone (Lane 2012). Budget balances ran negative, and with the increase in social transfers and the drop in tax revenues, debts accumulated on all governmental levels. Against this background, one can observe major adjustments in a majority of European countries which were unavoidable to restore public finance (OECD 2011, p. 31). At the same time, one has to see states' measures in conjunction with macroeconomic situations.

One particular EU-wide consequence was the comprehensive EU legislation on public finance during this period (Schnellenbach 2018). The fiscal compact generally obliged all member states since 2013 to enforce and supervise budgetary discipline in the public sector more rigorously. It also dominated the conditional financial aid programmes for deficit countries, which even contributed to a prolonged economic malaise in southern Europe, where some countries went into a double-dip recession.

Despite the partially severe immediate crisis impacts on expenditures and revenues, the "era of austerity" following the recession of 08/09 affected public management in a variety of ways and for many years. It has made spending cuts a longer-term "guiding principle" determined by three main kinds of cutback strategies: central prioritizing, decentralized "cheese-slicing" and efficiency gains (Pollitt 2010; Pollitt and Bouckaert 2017, p. 23f).

In this chapter, we are interested in obtaining a picture of the potential transmission channels of the financial crisis on local levels. For this purpose, as with any comparison of public administrative systems (Kuhlmann and Wollmann 2019), we start by developing appropriate criteria to capture the relevant and most commonly occurring developments across countries. Obviously, an economic and financial crisis will affect local finances. Those effects result, quasi automatically and without further actions, from the given setting of funding sources and expenditure functions. We call these "direct impacts". Another group of impacts refers to the states and their ability to adapt the institutional framework of local governments. Therefore, there is no automatic effect of the financial crisis; it requires the action by states. We call these "indirect impacts".

Figure 1 presents a schematic overview of theoretical direct and indirect effects and channels, which serves as a framework for the empirical analysis in Chapter "Fiscal Rules at the Local Level: The Challenge of Enforcement". While

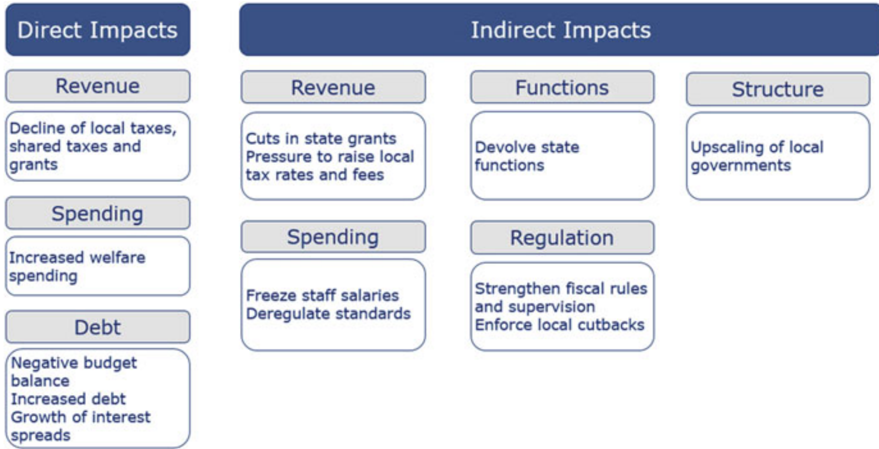

Fig. 1 Impacts and channels of financial and economic distress for municipal budgetary policy. Source: own

the direct budgetary effects of an economic and financial crisis certainly apply more generally to all levels of government (although with alternating channels), the indirect (longer-term) effects greatly depend on the specific national context and the states' willingness and chosen path to act.

Which "direct" impacts on local budgets can be assumed based on standard economic theory? On the one hand, economic downturns will create a shortfall of locally levied taxes. This drop will be more pronounced, the more local governments rely on corporate taxes. Nevertheless, an economic downturn will also affect income and value added taxes, which constitute parts of local revenues, be it as own local taxes or shared ones. Beyond this, economic downturns will also affect state grants. State tax revenues fund local grants, and by shrinking volumes, those grants decrease automatically in many systems. In addition, given the relevance of local grants for states budgets and states' dominance in cutting expenses, one can easily expect cuts in those grants (OECD 2011, p. 42ff). However, depending on the national structure of state grants, the opposite may also happen. State grants increase to counter local revenue losses or to create stimuli to counter economic decline. Nonetheless, this strategy can only work mid-term, as revenue losses affect states' budgets, too.

On the spending side of local governments, one might expect impacts in welfare services due to rising unemployment and poverty. Again, this effect can only occur in the case that the local level implements relevant services. Economic downturns will probably cause budget deficits and, therefore, the rising need to borrow, either on capital markets or by banks. Economic theory predicts some concerns on the market or banking sector regarding solvency of local governments ending up, for example, in spreads in interest rates. This effect will be stronger depending on the credibility of a state's liability for local debt. On the other hand, doubts in local solvency depend widely on the expectations of state bailouts. The probability of such

state measures are high and capital markets functioning is low, as empirics show (Rodden 2002; see chapter by Turley et al. on fiscal rules in this volume).

Again, we want to point out that all these impacts strongly depend on the given national institutional setting. The financial crisis will not have significant direct impacts in extreme cases, such as when local governments do not levy business-related taxes, do not implement welfare services and do not borrow on markets or by private banks.

As mentioned above, local governments exist in an institutional framework, which results from long-term developments of each national multi-level system. This framework covers revenue sources, functions, fiscal rules and even the structure of the local level itself. Central and local governments form a multi-level system, in which the higher level sets the rules. Local governments must accept some defiance from certain actors regarding participatory rights in political decision-making. Since the financial crisis hit state budgets hard, and states faced significant austerity needs, one can draw some hypothesis in reference to these measures. In other words, local governments "are usual and specific targets for restoring public finances in many countries" (Cepiku et al. 2016). However, in contrast to the crisis' direct impacts outlined above, official state action is required to decide and impose such measures. This is why we call these "indirect impacts". In general, states' plans to consolidate vary largely. This variation refers to the extent of economic pressure, national sociocultural conditions and supranational legislation (OECD 2011, p. 22ff; Kickert et al. 2015, p. 574ff).

International comparative work provides a long list of measures implemented on national levels to reconsolidate budgets (Kickert et al. 2015, p. 569ff; OECD 2011). In this article, we examine seven categories of usual state measures at the local level:

1. Cuts in transfers.
2. Impose increases in local tax rates.
3. Impose cuts in local expenditure (personnel).
4. Reduce local service levels.
5. Devolve state functions to local level.
6. Strengthen fiscal rules.
7. Reconfigure local level structure.

A state heavily affected by the financial crisis will cut transfers to local governments in order to relieve its own budget (Wagschal and Wenzelburger 2009, p. 97ff). States can increase local tax rates to bridge grant cuts or emerging deficits. Cuts in grants for capital spending usually are a priority to avoid limitations in daily services. On the spending side, austerity usually ends in public sector retrenchments; therefore, employment covers a relevant share of local budgets (Keller 2016). Indeed, an overview of state strategies in cutting personnel spending provides a notable range (OECD 2011, p. 42ff). In some cases, states could reduce service levels of local functions and, as a result, expenses. In any state, higher levels of government are in the position to define local levels' function. One option to restore state budgets is to devolve state functions to lower levels with or without inappropriate refunds (Bogumil and Ebinger 2018). States have the right and responsibility to regulate

local budgeting, respectively, to impose fiscal rules and enforcement mechanisms. Against the background of own fiscal challenges, the appropriate path of action is to strengthen fiscal rules and enforcement to avoid escalating local deficits (Geissler 2009, p. 100). Finally, we assume a seventh category of state measures in case of financial crisis. As with local functions, states can also configure the structure of local levels structure. In detail, states can merge local entities or create new tiers. The idea to foster local governments' efficiency in reaction to grant cuts or to prepare the local level to take over new functions might be a driver for those measures (Blesse and Baskaran 2016, p. 10ff).

Summing up, local governments are objects of state measures in consequence of financial crisis. Usually, there is a wide range of manoeuvre for the states, which will cause action beyond local control but with drastic impacts, not only budgetary.

3 Impacts of the Financial Crisis on Local Governments in European Countries

This chapter intends to provide an empirical overview of the diverse impacts that have taken place on the local level in 21 European countries. We start with a databased assessment of observable dynamics in financial aggregates that will especially allow for insights into the direct crisis effects on local budgets. Afterwards, we present a qualitative assessment of the structural changes to the institutional frameworks of local governments.

3.1 Direct Impacts

In the vast majority of European countries, we—somehow contra intuitively—document an increase in local revenue, at least in the first years following the crisis (Table 1).[2] Table 1 gives an about idea of revenue trends in the period 2007–2010. Only two countries show a rapid decline of revenue. Two further countries have seen a stagnation, and in three, revenue trends changed in both directions. Finally, the overall trend in 14 countries was a linear growth of local revenues in those early years of financial crisis.

This overall increase across European countries contradicts the expectation of automatically declining revenues as result of reduced tax bases in times of economic recession. It rather points to the fact that other sources of revenues, such as additional

[2]As Switzerland is not a member of the European Union, we took these data from the OECD, not EUROSTAT, OECD Fiscal Decentralisation Database and OECD Government at a Glance Dataset.

Table 1 Trends of local level revenues 2007–2010

	Revenue	Expenditure
Decline	Estonia, Ireland	Ireland
Stagnation	Hungary, Portugal	
Growth	Austria, Belgium, Bulgaria, Czech Republic, Denmark, England, Finland, France, the Netherlands, Poland, Slovenia, Spain, Sweden, Switzerland	Austria, Belgium, Denmark, England, Finland, France, Germany, Growth, Netherlands, Poland, Portugal, Slovenia, Span, Sweden, Switzerland
Volatile	Germany, Greece, Italy	Bulgaria, Czech Republic, Estonia, Greece, Italy

Source: EUROSTAT government finance statistics

state grants or an increase in local tax rates (or shares) had overcompensated this effect early on.[3] A good example is the Czech Republic, where corporate tax revenue shrunk (26% in 2009), but total revenues climbed until 2010 due to substantial asset sales and a rise in government transfers. In Austria, shared taxes decreased, while aggregate revenues grew constantly due to changes in state grant schemes. We will return to these indirect impacts in Sect. 3.2, where we analyse the policy responses to the crisis. We can draw one lesson from this data. The global financial crisis arrived on local levels with some delay. One explanation is the attempt of central levels to shield local levels from financial stress and to compensate local revenue declines. Of course, this strategy was limited in many cases by central level budgets. However, one must this first impression by aggregated data with some caution. First, although revenues continue rising, its dynamic can be lower than in the pre-crisis period. Second, revenue increase can be short-term and unsustainable.

Regarding local expenditure, we observe a slightly different picture during the period 2007–2010 (see Table 1). Only one country suffered a decline in expenditure. We did not find stagnation in any country. Compared to revenue trends, volatility of expenses was higher. Finally, the trend of growth was even stronger in expenditure than in revenues. In many cases, this was a continuation of previously established trends (e.g. in Denmark and Germany). Given the usual growth rate of public expenditures, stagnation and a nominal decline usually speak in favour of real cuts in services, cuts and delays in investments or cuts in employment and salaries.[4] A further growth in expenditure dynamics generally can refer to economic stimuli to overcome financial crisis (as in Germany). However, this central level strategy cannot explain a permanent long-term growth. Obviously, the financial crisis affected national economics and budgets to different extents. Some states managed to get back on earlier trends soon after (e.g. Germany, Denmark, Netherlands and Sweden); others took a lasting hit (e.g. England, Ireland, Greece, Portugal).

[3]The only country to weather the global financial crisis without economic decline or stagnation is Poland. Therefore, one cannot expect state measures here.

[4]On the other hand, stagnating or declining local expenditures can mirror a recentralization of local services, outsourcing of services or stable services in a deflationary situation.

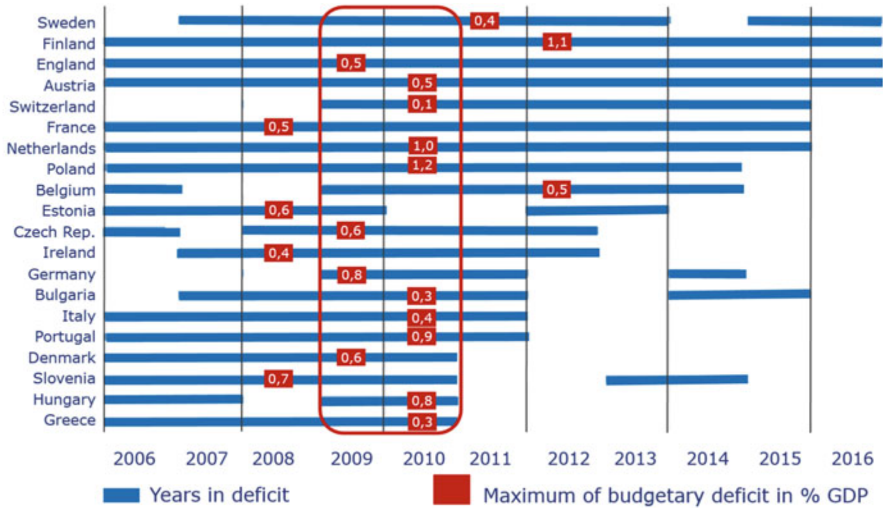

Fig. 2 Local level budget deficits in context of time and GDP. Source: EUROSTAT government finance statistics

As increases in expenditures in most countries exceeded that of revenues, budget balances deteriorated in almost all countries under investigation. In 2009, literally every national local level did run deficits, in 2010 Estonia was the exception (Fig. 2). The only country that did not see deficits on the local level during the entire period 2007–2016 was Spain.[5] In addition to the duration of deficits, Fig. 2 shows the height of deficits in the percentage of GDP for the particular year. Local levels in the Netherlands, Finland and Poland experienced the highest deficits.[6] These heights mostly occurred in 2009, with four countries reaching this level already in 2008.

As we can see from the timelines, the majority of countries needed years to restore balanced budgets. While half of the countries, including the Troika-states Ireland, Portugal and Greece, were able to reach a balanced budget by 2013, the other half experienced budget deficits even longer. Certainly not all these deficits were new (15 out of 21 had deficits in 2006) or clearly linked to the crisis or its indirect responses. Nevertheless, the fact that budgets heavily deteriorated nearly everywhere after 2006 shows the expected direct impact of falling revenues and rising expenditures. The explanation of those budget deficits not only refers to revenue losses but also to revenue increases, which cannot keep up with even stronger expenditure increases. One must acknowledge that the development of GDP itself also affects the height of deficits in relation to GDP. Several countries suffered a decline in GDP, which mathematically increases budgetary deficits measured in GDP.

[5]Which is not included in Fig. 2 for this reason.

[6]Referring to national experts, large deficits of Polish local level in the years 2009–2011 rather mirror the high level of capital spending in metropolitan cities than overall budget crisis (Geissler 2020, p. 169).

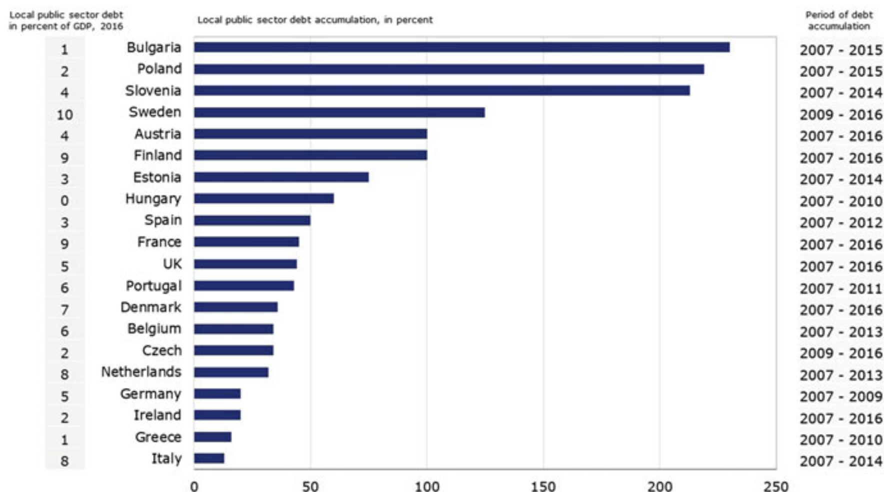

Fig. 3 Post crisis debt trends of local levels, in percent. Source: EUROSTAT government finance statistics

The findings above are clearly linked to the dynamics of local public debt accumulation since the crisis (Fig. 3). As an example, the height of local levels' debt in Bulgaria was in 2015, when local governments held a 230% higher debt than in 2007. Nevertheless, local level debt in Bulgaria in relation to the national GDP was still very low in 2016 (left on the graph).

Almost all countries saw significant if not drastic increases in local debt levels after the crisis, which peaked in most cases between 2014 and 2016. After that, 15 out of 21 countries slightly reduced their debts; the others remained at high levels, making them vulnerable for any future economic recession. Remarkably, only four countries returned to pre-crisis debt levels by 2016, these are Czech Republic, Ireland, Greece and Hungary. The latter two have seen substantial state bailouts.

However, we must keep in mind that due to the aggregate data level, we cannot distinguish between the types of credit and the structure of debt here, which makes it difficult to draw conclusions about causality. The significant increase in Sweden, for instance, refers to a rise in local investment activity starting in 2010, independent from the immediate crisis. Moreover, it is important to consider the level of local debt as a share of GDP, which is not always as critical as the extent of accumulation suggests (see left side of Fig. 3). For instance, in Bulgaria, Slovenia and the Czech Republic, the absolute volume of local debts was and still is very low. However, whereas the local share of national debt on the EU total has slowly been shrinking since the financial crisis, Bulgaria, Poland and Slovenia have seen a significant increase. This observation might indicate a state strategy to shift debt burden downwards. Of course, numbers link to the general extent of fiscal decentralization in European countries. One must combine this with the local share in revenue and spending (Geissler et al. 2019, p. 249).

3.2 Indirect Impacts

This section will describe the "indirect impacts" of the financial crisis on local levels, which have been decided by the states. It builds on literature review and multiple interviews with national experts.[7] As in any qualitative comparative research, it bears the risk of potential gaps. Therefore, we do not claim for completeness but want to show variance of state measures.

We start with revenues and spending in Table 2. The majority of states, 16 out of 21, changed revenue streams of local levels in one or another way. The most prominent measure was a decline of state grants, which happened in eight countries (BG, E, EE, EL, IE, IT, PT, ES). As expected, this is the easiest and most direct way to relieve the own state budget. In contrary, nine states substantially increased their grants to shield local governments from direct crisis effects (AT, CZ, DN, DE, HU, IT, SL, ES, SW, CH). Sweden and Germany are distinct examples of this strategy. In Germany, the financial crisis marks the starting point of stronger and ongoing federal involvement in local finances. Sweden responded to the financial crisis with a 3-year increase in per capita grants. Some countries chose both directions of an increase and cuts in grants (EL, IT, SL, ES). Spain had to change its policy with the crisis. Short-term, national government reacted countercyclical. With increasing effects of the crisis on the own budget, Spain was forced to change track.

However, states have room to manoeuvre beyond grants. In reaction to the fiscal crisis, states were given the opportunity to adopt systems of local taxes, respectively, tax sharing, which we can observe in six cases (BG, E, IE, IT, PT, SL). Again, we find both directions. Some countries broadened local tax bases and created new funding sources, sometimes to rebalance cuts in state grants. An extreme case is England, where the state cut grants and reduced taxation autonomy at the same time, leaving local governments with the only option to cut services. Regarding troika countries (IE, PT, EL, ES), one must highlight that those measures were largely designed by the European Commission, the European central Bank and the International Monetary Fund (troika). Two more state actions benefitting local levels are worth mentioning: In Austria and Germany, financial crisis favoured refunding welfare spending by federal governments. In some states, bailing out debt was a direct result (DE, EL, HU, IT). Among those four states, Hungary, forced by financial markets and the risk of local insolvency, reacted most strongly. In contrast, bailouts in Germany, Greece and Italy affected a smaller share of local governments.

A remarkable number of nine states were active concerning local spending (DK, FI, EL, IE, IT, PT, SL, ES, SW). The most prominent channel addressed employees in the way of wage cuts and recruitment freezes (FI, EL, IL, IT, PT, SL). A few countries began experimenting with limits in local level spending and spending growth (ES, SWE). For example, Denmark introduced limits years in advance, but the financial crisis made it possible to link noticeable sanctions.

[7] All information in this chapter taken from Geissler et al. (2019).

Table 2 "Indirect Impacts" on revenue and spending by local levels

Name	Revenue	Spending
Austria	Federal level refunds some welfare services	/
Belgium	/	/
Bulgaria	More rights to enforce tax payment Higher maximum tax brackets Decrease in state grants	/
Czech Republic	Increase in state grants	/
Denmark	Increase in state grants	Strict spending limits
England	Decrease in state grants Local tax caps New regulation on council and business tax, housing subsidies	/
Estonia	Decrease in state grants	/
Finland	/	Cuts in employment
France	/	/
Germany	Federal level reimburses some welfare services Bailouts in some states New federal grants for capital spending	/
Greece	Decrease in state grants State bailouts	Employee layoffs Wage cuts Recruitment embargo
Hungary	State bailouts	/
Ireland	Property tax reintroduced Decline of state grants Charges, commercial rates up	Staff level reduced Recruitment embargo
Italy	Decrease in state grants Reintroduction of property tax State bailouts	Staff level reduced
Netherlands	/	/
Poland	/	/
Portugal	Decrease in state grants Loss of taxation autonomy	Employment freeze Wage cuts
Slovenia	Income tax share reduced Investment grants freeze Increase in state grants	Wage cuts
Spain	Short-term additional grants as stimuli Decrease in state grants later	Expenditure limits
Sweden	Increase in state grants	Employment cuts
Switzerland	Increase in state grants	/

Source: own

The extent to which states were hit by the financial crisis and therefore in need of cuts appears to be a self-evident explanation for measures on revenue and spending. Indeed, this assumption holds true for the cases of England, Greece, Ireland, Portugal, Italy and Spain, which suffered greatly from the financial crisis. Others wintered this storm less affected. Switzerland, Denmark, Poland and Sweden showed minor GDP drops. There was no urgent need to cut local grants and sufficient volume to rebalance local budgets by additional transfers.

Table 3 shows states measures on local functions and local level structure. It is useful to discuss both measures in parallel because in many cases, changes in structure and changes in functions are complementary. Referring to functions, one would expect a devolution of state functions to local level based on the intent to relieve one's own budget. Scaling up local entities might be a necessary precondition.

We find seven cases of essential changes in the allocation of functions (BE, E, EE, FR, EL, HU, IE, NL). Most of them show the expected behaviour. States devolved functions to local level. Four countries acted in the opposite direction and took over local functions (EE, HU, IE, and NL). Ireland took a drastic step when the state nationalized water services. The other three states (Hungary, Estonia, the Netherlands) took over parts of local functions. Hungary established a new and additional governmental tier. Estonia reduced one. The Netherlands are an interesting case, as both directions of reallocating functions happened at the same time. Obviously, policy reasons rather than general austerity needs caused those reforms. The only state out of 21 fulfilling the theoretic assumption is, once again, England. State austerity was a crucial driver in devolving state functions to local level. Merging local authorities and establishing new forms was the precondition. Given those data, one could argue that the theoretic assumption of central behaviour was wrong. We would argue differently. Devolution of functions is a crucial measure in multi-level systems. These decisions cover various aspects, e.g. quality of services or central control, which might lead to different solutions. Central level austerity obviously was not dominant in most states. The English case is special because of a second measure. It is the only one in which the state deregulated local functions according to the objective to reduce local spending. Both of those measures, austerity-driven devolution and deregulation, mirror the particular Anglo-Saxon understanding of local public services, which is not found in any other European country.

Changes of local level structure are one of the most drastic actions a state can undertake. Nonetheless, it happens constantly. EUROSTAT statistic shows a clear trend of shrinking numbers of local government entities over time. Among the 21 countries covered by this research, 10 implemented programmatic structural changes in the years since 2007 (Geissler 2020, p. 35f). A further four did see an intensive political discussion about restructuring (BG, SL, ES, FI). In Italy, one can observe a reversal in the earlier trend of growing numbers of local governments to a slight decrease.

However, in most cases the link to the financial crisis for functional as well as for structural reforms is hard to define. On the one hand, states had planned reforms

Table 3 Impacts of financial crisis on local level functions and structure

Name	Functions	Structure
Austria	/	2015, municipal mergers in one state
Belgium	2011 Decentralization of state functions to local level (economics, employment, family)	/
Bulgaria	/	Discussions
Czech Republic	/	/
Denmark	/	/
England	Since 2011 Decentralization of state service to combined authorities	2008–2011 Merging municipalities and counties to unitary authorities Creation of combined authorities
Estonia	2017/2018 Dissolution of counties and takeover of some functions by the state	2017/2018 Merging of 213 municipalities into 79 Liquidation of counties
Finland	/	Implementation of regions cancelled in 2019
France	2015 State devolved regional cohesion policy to regions	2015 Merging of regions from 22 to 13
Germany	/	2007–2011 Merging of municipalities and counties in three eastern German states
Greece	2011 Decentralization of one prefect's functions to local level	2011 Merging of municipalities from 1034 to 325 Creation of 13 administrative regions from former state districts
Hungary	2013 Newly established state districts take over some county tasks (e.g. education, welfare)	/
Ireland	2014 Nationalization of water service	2014 Reduction of local authorities from 114 to 34, nationalization of water service
Italy	/	2014 Merging of cities and provinces to metropolitan cities in 14 cases
Netherlands	2013 Nationalization of police forces 2015 Devolution of several social services	2013–2018 Nationalization of local police service Merging of local health associations from 63 to 25 Dissolution of eight metropolitan regions
Poland	/	/

(continued)

Table 3 (continued)

Name	Functions	Structure
Portugal	/	2013 Merging of municipalities
Slovenia	/	Discussion
Spain	/	2013 Legislation on rationalization of local administration
Sweden	/	/
Switzerland	/	/

Source: own

years earlier, with implementation occurring during the respective period by chance (Denmark, some German states). In other countries, the financial crisis was the starting point, but planning took several years. Estonia and France may belong to this group. A third group of countries held discussions but decision-making respectively implementation failed (BG, FI, SL, ES). Finally, some states implemented structural and functional changes on the local level for reasons other than the crisis, e.g. general governance or service quality (NL, FI, EE). Nonetheless, wherever structural changes took place, they were of one dominant direction: scaling up local governments. The number of local bodies shrinks and their territorial size and populations grow. The only country to introduce a new local tier was Greece. However, it went along with massive mergers.

Regardless of these limitations, we see four countries having implemented massive structural changes undoubtedly tracing back to the financial crisis. In the case of the troika countries Greece, Ireland and Portugal, this reform was agreed upon in the *Memorandum of Understanding on Specific Economic Policy Conditionality* (MoU); it was not of their own choice.[8] The fourth one was England.

As local levels deliver essential public services and fund extensively by state grants, the regulation of local finances is a government task every country faces. Following our assumption, financial crisis will drive states to intensify regulation. This, in consequence, means more budgetary pressure for local governments. As those regulatory regimes consist of different components (fiscal rules, monitoring, enforcement, organization), an intensification can take place in various ways. Table 4 gives a brief overview on state actions in the policy of regulation. Referring to this policy, we find 14 out of 21 countries as being active.

One clearly observes all countries strengthened fiscal regulation of local governments. The most prominent trend is stricter fiscal rules (BG, CZ, EE, FI, EL, HU, IT, PL, PT). Several states introduced specific recovery programmes for over indebted local governments, which has become a widespread phenomenon in many states in

[8]As an example, the Portugal MoU from May 17, 2011, states on page 16: “Reorganise local government administration. There are currently 308 municipalities and 4259 parishes. By July 2012, the government will develop a consolidation plan to reorganise and significantly reduce the number of such entities”.

Table 4 Impacts of financial crisis on local public finance regulation

Name	Adoption of the regulation of local public finance
Austria	/
Belgium	/
Bulgaria	2014, Public Finance Act, strengthening fiscal rules (balanced budget, limits of annual debt payments) 2016, financial recovery programme
Czech Republic	2017, new debt limits, financial watchdog 2008, monitoring scheme
Denmark	2012, sanctions for exceeding spending and tax limits
England	2015, decentralization of monitoring fiscal rules
Estonia	2017, centralization of supervision Since 2009, introduction of debt limits
Finland	2015, strengthening recovery programme Limiting spending growth
France	2013, establishing a new agency for local borrowing
Germany	Since 2010, establishing new bailout programmes in some states
Greece	2010, introducing debt limits 2013, new organizational structure for monitoring and enforcement, recovery programme
Hungary	2012, new debt limits and debt approvals 2013, new decentralized organization of monitoring
Ireland	/
Italy	2016, introducing balanced budget rule and stricter monitoring
Netherlands	/
Poland	2014, new debt limits
Portugal	Since 2012, stricter debt limits, balanced budget rule, recovery programme
Slovenia	/
Spain	2012, new federal legislation on prevention and recovery
Sweden	/
Switzerland	/

Source: own

the aftermath of the financial crisis (BG, FI, DE, EL, PT, and ES). Again, in the case of troika countries, policies of regulation have not been voluntary. Interestingly and in contrast to Portugal and Greece, Ireland was not active in this field. Referring to talks with national experts, this observation explains by the small, newly consolidated and transparent local level, which did not cause any financial damage to the state of Ireland. Thus, the existing regulatory regime was sufficient.

Generally, one must keep in mind the role of European Union legislation. The EU initiated the adoption of fiscal regulation for all member states (Schnellenbach 2018). Countries were obligated to implement national debt limits, which break down in different ways to local governments, and, secondly, countries were obligated to create new independent agencies in charge of monitoring debt rules. As this is a common and not nationally motivated policy, we excluded those from our observation in Table 3.

In contrast to state measures in functions and local structure, activities in regulation clearly trace back to the financial crisis. The pure number and direction of changes is a sound indication. Indeed, the European Commission Fiscal Rules Strength Index verifies this finding. These data show a significant rise in balanced budget and debt rules since 2012.[9] At first glance, timing might be a counter argument. However, the financial crisis hit countries in different years and to different extents. In many cases, states were charged with ad hoc activities short-term, absorbing capacities for broader reaction.

4 Conclusion

The exploration of the financial crisis' impacts on European local levels exposes a great diversity of trends and measures. When it comes to "direct" financial impacts, there are some commonalities. As expected, every country was affected by local budget deficits in the years 2008/2009. Some local levels were in deficit years prior to the crisis and quite frequently. However, deficits have not been a general trend in this pre-crisis period. Because of the financial crisis, local debt increased, reaching its peak in most cases around 2016. Beyond this, we find diversity in fiscal trends, depending on economic and institutional frameworks. One further constraint lies in the fiscal data itself. One must keep in mind the institutional context of state-local relationships and the aggregate volume, which overlook single local governments.

Indirect impacts, respectively state measures focusing on local levels, contradict some expectations. Given the variance of national policies, those measures touch the whole span of state-local relationships, from adopting funding and functions to local structures and fiscal regulation. Strengthening fiscal regulation proves to be the dominant and common trend of state measures. This trend also partially refers to supranational EU policy.

Another dimension of impacts is timing. Short-term in the immediate context of financial crisis states' measures may vary when compared to mid-term ones. There are some reasons for differences: limited capacities to keep short-term measures alive (balancing grants, stimuli), necessary time to designing, decide upon and implement comprehensive institutional measures. Therefore, impacts may vary depending on the time span covered.

This article attempts to explore and understand financial crisis' impacts on local levels, which is of high relevance for citizens but thus far was missed by research. Results provide an impression of manifold crisis transmission channels towards local government fiscal performance. Nevertheless, considering the crisis' impacts should not stop here, as there are further impacts, which may be even more dramatic and,

[9] European Commission fiscal rules database (https://ec.europa.eu/info/business-economy-euro/indicators-statistics/economic-databases/fiscal-governance-eu-member-states/numerical-fiscal-rules-eu-member-countries_en#database-on-numerical-fiscal-rules).

most notable, permanent. Therefore, even if local finances have recovered, or at least stabilized in most countries, local levels find themselves in a "new normal" of less local autonomy. If there is one central term to summarize "indirect" impacts of financial crisis, it is centralization. The financial crisis deeply affected state-local relationships. This finding is backed by broader research on local autonomy, which observes a long period of increasing autonomy followed by a stagnation (for a remarkable number of countries even a decline) since 2010 (Ladner et al. 2015, p. 61f). There is little reason to believe that this trend of centralization could turn around in the years to come. Future research should focus particularly on the economic and social impacts of this trend.

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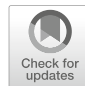
Fiscal Consolidation in German and Greek Local Governments: Reform Attempts, Supervision and Local Measures



Maria-Artemis Kolliniati, Philipp Stolzenberg, and Nikolaos-Komninos Hlepas

Abstract Fiscal consolidation in Greek and German local governments differs for many reasons. While some German local governments experienced a long period of austerity, driven by economic decline and federal and state measures, the global financial crisis and 'troika' programme caused the need for harsh austerity measures in Greece. In addition, there is a different institutional context for local governments in both states, accompanied by different revenue autonomy and state influence. Therefore, local options in Greece were limited, and local governments had to focus on spending cuts, whereas German local governments largely relied on increasing tax rates. The one commonality is in the field of regulation, when both states strengthened fiscal rules and supervision and established a bailout programme. However, intense monitoring, the implementation of fiscal rules and the 'top-down' actions of supervisory bodies in Greece fundamentally exceed German practice. Finally, fiscal consolidation in Greece was much more difficult and went hand in hand with minor local discretion.

1 Introduction

General characteristics of the financial crisis and its long-term impacts on municipal finance differ between countries, regions and specific municipalities. Whereas some German cities are affected by a long-term fiscal crisis, the Greek local level was forced to apply consolidation measures, despite the fact that several Greek municipalities were not indebted (Kolliniati et al. 2017). In 2001, prior to the financial crisis, funding—in particular interest rates—dropped with the integration of the common euro currency in Greece. However, by 2008, Greece had slipped into an economic recession and, in 2010, applied for financial assistance through the IMF,

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ECB and European Union ('troika'). Based on a memorandum of understanding (MoU), the 'troika' granted a first tranche of emergency loans to Greece on the condition that the government implement a detailed list of austerity measures. Subsequently, the fiscal situation of Greek local governments dramatically worsened. The national government has restructured its territorial shape as well as its fiscal rules and supervision over the last several years. In contrast, the German economy and public finance quickly recovered following the financial crisis and reforms at the local level have been incremental. Varying socio-economic circumstances alone cannot explain the different policies in these two countries. Different institutional contexts are also relevant. Nevertheless, there is a 'common challenge' of fiscal consolidation at the local level, which makes a comparison between Greek and German local government feasible. Hence, the goal of our paper is to discuss how different reform attempts and the role of supervision in Germany and Greece shaped fiscal consolidation of local government. Moreover, we scrutinize specific municipal fiscal consolidation strategies referring to 15 case studies conducted in a German-Greek research project (Kolliniati et al. 2017; Stolzenberg et al. 2016)[1] and subsequent research (Kolliniati 2019; Stolzenberg 2018).

2 Comparing Local Government (Finance) in Germany and Greece

Taking into consideration different typologies summarized by Heinelt and Hlepas (2006) as well as Sellers and Lidström (2007), Greek local government compared to its German equivalent has fewer functions and lower discretion (Kolliniati 2019). As opposed to Greece, German local governments provide several public (welfare) services and have a strong constitutional role. The German local level differs within the country, as it is subordinate to 13 different states. These variations do not exist in the Greek unitary state. The revenues and expenditures of local levels are clearly higher in Germany than in Greece. Moreover, German municipalities levy business taxes as well as property tax and receive a share of income tax. The Greek local level mainly depends on the non-earmarked 'Central Autonomous Grants' and the 'Earmarked Investment Grants', which come from the central government. Consequently, Greek local governments can hardly consolidate their finances in terms of revenue.

However, the need for consolidation at the Greek local level did not derive from self-created accumulated debt. Local government debt as a percentage of GDP as

[1]The REPOS research project (Reformability of Political Systems in Times of Crisis) was financed in 2014–2015 by the German Federal Ministry for Education and Research and the Greek Ministry of Education, Research and Religious Affairs as part of the Bilateral R&D Cooperation in social science between Germany and Greece and extended by the German Federal Ministry for Education and Research for 2016.

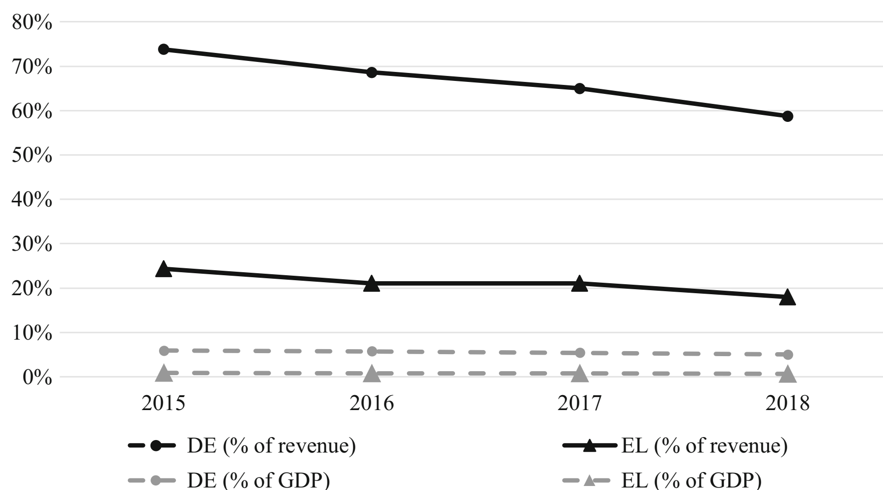

Fig. 1 Local government debt as percentage of GDP and as percentage of local government revenue (own calculations based on Eurostat 2020)

well as a percentage of local government revenue is clearly higher in Germany than in Greece (see Fig. 1). Municipal debt was not necessarily a cause of the debt crisis in Greece.

Local level liabilities are concentrated in some German states and in urbanized regions in Greece. In Germany, short-term borrowing (*Kassenkredite* or *Liquiditätskredite*) constitutes a remarkable share of debt at the local level (almost 40% in 2015). De jure, short-term borrowing is limited to compensate for short-term variations of revenues. The Greek equivalent is overdue liabilities towards private suppliers and contractors. Moreover, in both countries, the debt of municipal companies was non-transparent (for Germany approximately 50% of municipal debt; see Bogumil et al. 2014) until new public statistics were introduced. In both countries, exogenous reasons mainly cause fiscal challenges for local governments which they can hardly influence (i.e. socio-economic conditions or decisions by upper level governments). However, in Germany there are also endogenous reasons for fiscal problems which are related to local failures (Bogumil et al. 2014).

3 Reform Attempts and Fiscal Measures at State and National Levels

Policymakers at the upper levels, Greek national government and international agreements, and the German federal government, shape the fiscal situation of local levels to a great extent. In these terms, policymakers at the upper level have various options to improve (or worsen) the fiscal situation at the local level. Territorial

reforms, short- or medium-term conditional financial assistance, the extension of taxation rights and (re-)allocation of grants are possible alternatives. Furthermore, upper levels can redefine fiscal rules and change the practices of fiscal supervision over local governments. During the last several years, most of these policy options have been used in both countries, but extent and direction of these measures was remarkably different.

3.1 Territorial Reforms

In Greece, the 'Memoranda' policies shaped the fiscal situation to a great degree. The MoU, signed by Greece in 2010, mentioned explicitly that 'parliament should adopt legislation to reform public administration at the local level, notably by merging municipalities, prefectures and regions with the aim of reducing operating costs and wage bill' (Chortareas and Logothetis 2016). Consequently, the so-called Kallikrates programme (Law 3852/2010) was passed and changed local and regional government fundamentally, by not only changing their population and spatial size but also reforming their structure and responsibilities (Hlepas 2012). The existing 54 prefectures were reorganized into 13 administrative regions (Ministry of Interior of the Hellenic Republic 2013), which became part of local government and the Greek equivalent to German counties (in larger spatial and population size). However, territorial reform of the municipal level was more important. The number of municipalities reduced remarkably (from 1034 to 325 and then to 332 with Cleisthenes' Law), and as a result, the median population of Greek municipalities today is much higher than in Germany (see Table 1) and among the highest in Europe. The majority of Greek municipalities merged with others, and only a minor share retained their spatial and population size.

The remaining 332 municipalities distribute among 6 different categories. According to Law 4555/2018 passed in 2018, the so-called Cleisthenes programme, these municipal categories are taken into consideration for the allocation of 'Central Autonomous Grants' and any other sort of funding specified for municipalities.

As opposed to Greece, the German national (federal) government cannot decide on territorial reforms at the local level. The responsible states implemented only a few limited territorial reforms (e.g. Rhineland-Palatinate, Saxony-Anhalt and Mecklenburg-Western Pomerania) focusing on smaller municipalities and counties. In contrast, some recent endeavours even failed due to enormous public resistance (the states of Thuringia and Brandenburg). Since the given reforms did not affect highly indebted medium and larger cities, limited positive fiscal effects could have been possible at the most.

Table 1 Number and median size of municipalities in 2014 (Ladner et al. 2019)

	Germany	Greece
Number of municipalities	11,040	332
Median size (population)	7335	33,515

3.2 Changes in Allocation of Functions and Grants

During the last few years, states in Germany and Greece allocated new functions to local governments that the upper levels should have adequately compensated financially. In both countries, constitutions anchor this obligation: in Greece by the national Constitution and in Germany by state constitutions (so-called *Konnexitätsregel*). However, these provisions were circumvented to different degrees.

In Greece, the 'Kallikrates programme' decentralized additional functions to insular municipalities and municipalities of continental Greece, mentioning that particular legislation, namely, the *'ELL.A.D.A'* programme, should financially compensate municipalities for these new responsibilities (Hlepas 2012). However, the *'ELL.A.D.A'* programme was never implemented, and adequate additional funding was not allocated for those new functions (Kolliniati et al. 2017). Following up on provisions of the MoU, the national government reduced 'Central Autonomous Grants' to the municipalities by approximately 60% from 2009 to 2016 and the 'Earmarked Investment Grants' by more than 80% from 2009 to 2017 (Central Union of Municipalities in Greece 2017). Moreover, through the MTFS 2013–2016 and Law 4093/2012, the national government obliged local governments to cut municipal employees' salaries (a salary cut of approximately 40%), to freeze municipal recruitment, to merge municipal companies and to dismiss personnel in those municipal services that the central government had abolished (school guards and municipal police).

Similar measures are inconceivable in Germany, since neither national nor state governments can exercise this kind of hierarchical steering towards local government. Consolidation measures were much less drastic; German supervision authorities enacted recruitment freezes for highly indebted municipalities, whereas the above-mentioned measures had to be implemented horizontally in all Greek municipalities, including those in good fiscal condition. As in Greece, additional tasks delegated to local governments were not always compensated adequately in Germany. Federal and some state legislation caused a continuous increase of local government spending for mandatory social services. Nevertheless, opposing trends became more common during the past years. The recommendations by a commission on municipal finance (*Gemeindefinanzkommission*; see Zimmermann 2012 and Niespor 2013) and political pressure at the local level persuaded the federal level to (partly) take over expenditures in various social policy fields (e.g. welfare for elderly and partial invalids, integration assistance for handicapped people, housing costs for welfare recipients). Financial relief for local governments was possible because the economic and fiscal situation in Germany quickly recovered following the financial crisis and the federal government benefited from exceptionally high tax revenues. More systematically, some states changed the allocation of grants. Thus far, the federal constitution obligates states to share some of their revenues with local levels in the form of grants. Recently, some states have chosen a new approach (e.g. Hesse, Thuringia and Saxony-Anhalt). They reformed fiscal equalization schemes to

calculate the amount of grants in relation to the specific tasks of local government and their estimated costs, instead of a specific share of their revenues. It remains disputable if revenue is adequate to fulfil the given tasks. Nevertheless, compared to their Greek equivalents, German local governments received remarkable and rather predictable support from the upper levels.

3.3 Fiscal Supervision and Bailout Programmes

Despite the general institutional differences of both local government systems, fiscal supervision at the local level is comparatively strict in both countries (Sellers and Lidström 2007). Greece and Germany do not have rules pertaining to the insolvency of local governments, which makes fiscal control and supervision from state authorities necessary to prevent bailouts.

In Greece, there was a complex system of state supervision by various local authorities, which was party-politicized and inefficient. Consequently, one of the objectives of the ‘Kallikrates programme’ was to implement a fundamental change of supervision (Hlepas 2012). Today, there are mainly three supervising authorities: (a) the ‘Court of Audit’, which audits all Greek public agencies; (b) the ‘Observatory for Financial Autonomy of Local Government Organizations’ (‘Observatory’), which monitors the budgets; and c) the ‘Independent Supervisory Authority’ (a regionalized part of the Ministry of the Interior), which is headed by the ‘Auditor of Legality’; this authority is responsible for disciplinary control and control of legality (Kolliniati 2019), but in practice it was never activated.

In Germany, state ministries of the interior are responsible for supervision, but usually delegate this task to deconcentrated state authorities or in smaller municipalities, even to counties. The German states’ courts of audit have exclusively watchdog-functions and are not supervision authorities, as in Greece (Glöckner and Mühlenkamp 2009).

Balanced budget rules for local governments exist in Greece as well as in all German states. In 2013, a new balanced budget rule for the Greek local level was introduced which also includes municipal company budgets. Furthermore, according to the ‘Kallikrates programme’ (a), the debt of a municipality should not exceed 60% of annual regular revenues, and (b) interest payments should not be higher than 20% of annual regular revenues. Municipalities, which do not fulfil these criteria, don’t receive credit approval. However, according to the ‘Cleisthenes programme’, there are exceptions for loans, which include measures to improve the energy efficiency of their facilities, machinery or vehicles and general investment projects. These measures should result in reduced operating costs, and savings should cover interest payments.

If municipalities or regions do not comply with one of these debt limits, they can apply for the special ‘Fiscal Consolidation Plan’[2] (*Ειδικό Πρόγραμμα Εξυγίανσης*; see Law 3852/2010, Art. 262). The ‘Kallikrates programme’ also established this plan, which aims to consolidate the budgets of municipalities and administrative regions.

Moreover, the ‘Kallikrates programme’ introduced the ‘Independent Supervisory Authority’, which is headed by the ‘Auditor of Legality’ and has two main tasks. First, it is responsible for disciplinary control of political leadership, and second, it checks the legality of local acts. According to the ‘Cleisthenes programme’, the auditor is in charge of reviewing the legality of municipal decisions, among others of projects of more than 60,000 euro, obligatory expropriations and loans. In the case of illegality, the auditor can retract such decisions (Hlepas 2012). In implementing the second MoU, the Greek government established the ‘Observatory’ by Law 4111/2013 and the so-called Financial Assistance Account of Local Government, which is an overdue liabilities programme (Kolliniati et al. 2017). The ‘Cleisthenes programme’ made subsequent amendments.

If municipalities agree to fixed consolidation agreements, in practice this programme transfers municipal debt to the central level (Hlepas 2015). The ‘Observatory’ belongs to the Ministry of Interior and is responsible for monitoring local finances and accounting for real-time budget execution. It controls the implementation of budgets on a quarterly basis with the aim that they are balanced and realistic. As specified by the ‘Cleisthenes programme’, budget evaluation by the ‘Observatory’ takes into account the aims and limits set by the central government budget and the current ‘Medium Term Fiscal Strategy Framework’ (MTFS). If quarterly budgetary targets have a negative deviation of more than 10%(compared to the provisions of the Article 4E of the Integrated Action Plan – *Ολοκληρωμένο Πλαίσιο Δράσης – Ο.Π.Δ.*), the ‘Observatory’ steps in. It informs the respective municipality, the responsible supervisory authority and the minister of interior. Moreover, the ‘Observatory’ drafts an opinion report on the methods of budget implementation or of setting realistic objectives. It may also scrutinize liabilities for loans, in particular focusing on overdue liabilities: own revenues in relation to its total revenues, the rate of change in total borrowing and the rate of change in total overdue liabilities.

At the end of each quarter and financial year, the ‘Observatory’ drafts a report on the results of budget implementation, which each local authority must publish. This report portrays the main financial situation of each local government and its legal entities and, in case of participation, the account statement by the ‘Financial Assistance Account of Local Government’. The ‘Financial Assistance Account of Local Government’ was established by Law 4111/2013 and amended by the ‘Cleisthenes

[2]The ‘Fiscal Consolidation Plan’ (or ‘Special Economic Recovery Program’/*Ειδικό Πρόγραμμα Εξυγίανσης*) should not be confused with the ‘Financial Assistance Account of Local Government’ (*Λογαριασμός Οικονομικής Ενίσχυσης Ο.Τ.Α.*). The former is a ‘programme’; the latter is an ‘account’. Moreover, the ‘Fiscal Consolidation Plan’ was established by the Ministry of Interior, whereas the ‘Financial Assistance Account of Local Government’ was established by the Consignment Deposits and Loans Fund.

programme'. It aims to support municipalities, in emergencies, to obtain balanced budgets. This Account funds by the Central Autonomous Funds (*ΚΑΠ*) and was established by the Consignment Deposits and Loans Fund. Local governments can take part in this programme upon request and after fulfilling certain requirements (Ministry of Interior of the Hellenic Republic 2013). Furthermore, the Court of Audit controls local governments, as all Greek public agencies (Greek Constitutional Law, Art. 98). Under these terms, it applies a preventive and ex post control on expenditures (Hlepas 2014; Ministry of Interior of the Hellenic Republic 2013). Every municipal contract of more than 200,000 euro is controlled by the Court of Audit (Hlepas 2014).

As in Greece, German supervisory bodies usually must approve municipal budgets plans, but also investment and short-term borrowing. If German municipalities do not follow the balanced budget rule, a consolidation concept must be submitted which contains measures for balancing the budget in the following years (Geissler 2009). Supervisory bodies must approve these concepts. If they deny approval, emergency budget management rules will (*Nothaushaltsrecht*) apply. In this case, local fiscal autonomy is minimal, and only expenses for legal or contractual obligations are permitted. Although legally provided only for exceptional situations, several municipalities, mainly in North Rhine-Westphalia, had to be governed under these rules for several years. As a last resort, the supervision authority can appoint a state commissioner to take over the tasks of the mayor and the local council. In a similar vein to Greece, there is a trend to strengthen fiscal rules for local governments. However, supervision differs between countries.

German supervision acts less in a top-down manner, but there are remarkable variations between the states. According to critics, some German supervision authorities have a laissez-faire attitude, since they do not want the state to be publicly blamed for the fiscal problems of local governments and want to avoid litigation risks (Gröpl et al. 2010; Herrmann 2011). Nevertheless, there is some evidence that supervisors control budgets stricter and increasingly make use of hierarchical interventions (see chapter by Ebinger et al. in this volume) (Ebinger et al. 2018; Holtkamp 2006).

Conditional consolidation programmes for the local level expanded the powers of supervision in Germany (see chapter by Person and Geissler in this volume). Balanced budget rules, essentially disregarded for many years in some states, were once again enforced. Moreover, the institutional framework of supervision partially changed. For smaller municipalities participating in these programmes, supervision shifted from counties to state authorities (e.g. in Hesse and North Rhine-Westphalia), which meant that fiscal rules should be more strictly enforced and more uniform (Person and Zabler 2017). However, stricter control was accompanied by new advisory structures, such as the ministry of finance in Hesse or court of audit (*Gemeindeprüfungsanstalt*) in North Rhine-Westphalia (Stolzenberg 2018). In any case, states established consolidation programmes as a 'help for self-help' and offered conditional grants or debt relief in return for consolidation efforts by the municipalities (and to some extent, counties). Local government associations participated in designing these programmes, which reduced resistance by the local level.

The allocation and sources of funding were partly disputed, whereas the local level mainly accepted the conditions (Stolzenberg 2018). Approximately 19% of German municipalities participated in such programmes. Heinelt and Stolzenberg (2014) show that the type (grant or debt relief) and amount of financial assistance as well as their sources, the number of participating municipalities, the specific conditions and possible sanctions for non-compliance vary remarkably between states. Generally, municipal councils decide if their municipality should participate in these programmes and choose detailed consolidation measures. Supervising authorities monitor compliance and apply sanctions if necessary. In a few smaller municipalities in North Rhine-Westphalia, supervision authorities installed state commissioners who enacted fiscal consolidation measures in the place of municipal authorities (Holtkamp and Fuhrmann 2014). These sanctions were a strong signal towards local governments (in North Rhine-Westphalia). In general, German municipalities still emphasize good cooperation with supervision and observe an interplay between consulting and control (Ebinger et al. 2018).

In 2019, the federal government also began preparations for a debt relief programme to reduce short-term loans to local governments. However, as negotiations with states have proven difficult, nothing has yet been determined. In addition, there are constitutional challenges (Mehde 2020).

In Greece, until recently the ‘Independent Supervisory Authorities’ did not play a crucial role in practice because the ‘Auditor of Legality’ was not activated. Under these terms, the seven deconcentrated administrations played a supervisory role. Furthermore, one can claim that Greek municipal fiscal policy had become the subject of ‘unprecedented centralization’ abolishing the political discretion of local authorities. As a result, an appeal was lodged to the high administrative court (‘Council of the State’) against acts of the ‘Observatory’, but was rejected.

Compared with Germany, new monitoring and control mechanisms in Greece have more short-term direct and in-depth access to fiscal data and e of harsh formal sanctions is still rare and cooperation between supervisions and local government remains the rule.

3.4 Local Fiscal Consolidation Measures

The sections above describe the varying degrees of discretion local government enjoys in both countries. Nevertheless, in-depth case studies of eight Greek and seven German cities with guided interviews and further document analysis showed that there are variations of fiscal consolidation strategies within the two countries. Actor-related and other specific local factors explain such differences.[3]

[3]The case studies and empirical methods are described in detail in Stolzenberg et al. (2016) and Stolzenberg (2018).

In the German case, all selected municipalities were medium-sized cities (110,000–340,000 inhabitants) taking part in consolidation programmes. Most of these cities implemented fiscal consolidation measures at remarkable financial expense. German municipalities used their taxation rights to a significant degree. Under these terms, nearly all the investigated German cities and most of the municipalities, which participated in the consolidation programmes, increased their property taxes. Business tax increases were rare and less extensive, since local actors were concerned about negative economic effects for their cities (Arnold et al. 2015, p. 133ff). Consolidation measures on the expenditure-side revealed great variation between German cities. Horizontal cutbacks but also attempts at efficiency gains usually showed only limited fiscal effects, but there are also deviating cases. Local actors pointed out that after decades of fiscal consolidation, it was difficult to reach further efficiency gains. Therefore, despite tax increases, the investigated German cities relied on selective cutbacks to different policies, which shows that they had some discretion in fiscal consolidation policies. There is a variation among the priorities of German local actors. Some focussed on attracting (and keeping) businesses and/or new citizens, whereas others concentrated on limiting the negative social effects of consolidation.

These case studies indicate that fiscal consolidation success also depends on the commitment by local actors and the states' bailout programmes. Some of the selected cities suffered budget deficits for decades, and municipal debt reached such astronomical amounts that it made own consolidation efforts without external support pointless. The German local actors interviewed mainly blamed upper level governments and economic circumstances for getting them into such a futile situation (*Vergeblichkeitsfalle*). Few local actors opposed consolidation programmes, and some tried to benefit from windfall profits. The latter was only possible when consolidation programme conditions were less strict, and an explicit balanced budget rule was lacking (Rhineland-Palatinate). However, several local actors used the consolidation programmes as an opportunity to escape the situation; there are some initial signs of successful fiscal consolidation. After many years, several of the selected cities have reached balanced budgets. Most cities have not (yet) been able to reduce their debt levels, despite the direct effect of the debt relief provided by some consolidation programmes. Furthermore, one must consider that the German local level benefited from very good economic circumstances and high tax revenues in the years following the financial crisis. If German municipalities reach a sustainable fiscal position, one can evaluate when the programmes will run out and when economic conditions might get worse.

As in Germany, one can observe variations between municipalities, despite the fact that the Greek national government implemented a bailout of overdue liabilities at the local level. The Greek case studies were conducted in medium-sized and larger cities (50,000–660,000 inhabitants). Some of those cities concentrated on debt restructuring by implementing the overdue liabilities programme, which massively reduced local government debt. Other municipalities focused on a more effective collection of their own revenues, a higher absorption of EU funds or management reforms. In some municipalities, actors pointed out that they mainly introduced new

procurement systems, cost-benefit analyses for major services, zero-base budgeting and strengthened corruption prevention as well as opportunities for extrajudicial compromises with creditors. Furthermore, since the central government implemented ad hoc decreases in grants, municipalities had to react every year with ad hoc consolidation measures. Hence, strategic long-term measures were nearly impossible, and cutbacks mainly targeted staff and investment spending. Moreover, a cautious assessment, including negative impacts of consolidation measures, reveals several limitations, such as infrastructural problems, understaffed and underfunded services and societal inequalities.

4 Conclusion

Analysing recent trends in local fiscal consolidation in German and Greek local government exposes major differences in state and local measures. This article explains the reasons for those differences, which refer not to economic data, alone. Different institutional contexts regarding local autonomy and the intensity of fiscal supervision are of higher relevance.

In Germany, local debt volumes clearly exceed Greek numbers. Local government debt was not a driver of public debt in Greece. However, local governments faced fiscal consolidation requirements in both countries. In Greece, national government and international institutions imposed decisions on fiscal consolidation quite suddenly; in Germany, federal and state governments shaped and worsened the fiscal situation over the long-term. The state reformed Greek local government thoroughly reformed during the past years. The ‘Kallikrates programme’ fundamentally changed the population and spatial size, but also structure and responsibilities of local and regional governments. Moreover, the Greek national government imposed harsh cutbacks on grants and made top-down decisions on comprehensive fiscal consolidation measures. In contrast, following the financial crisis, German federal government reduced the financial burdens of local governments in certain social policies, and some states reformed their fiscal equalization schemes in favour of the local level, thus benefitting from the improving economic situation. German reform attempts have been incremental because of the federal system, the strong institutional role of local government and less dire fiscal and economic circumstances.

Both countries decided upon similar strategies for fiscal regulation and bailouts. The Greek national government and German states implemented fiscal rules more rigorously during the past years and established conditional bailout programmes. However, the Greek ‘Kallikrates programme’ introduced a new complex supervisory system, which is very strict and performs top-down fiscal micromanagement. In Germany, conditional bailout programmes also offered additional grants or debt relief to local governments and expanded the powers of fiscal supervision. However, compared to Greece, the cooperative aspect of supervision is still more important.

Given this broad picture of consolidation driven by institutional aspects, there are also different local strategies within both countries. German municipalities decided on selective cutbacks in different policy fields and set different priorities. Some focused on limiting negative social effects of consolidation, whereas others concentrated on attracting businesses or new citizens. Nevertheless, fiscal consolidation remains a permanent challenge, since there are still several heavily indebted municipalities. In Greece, there are also variations between priorities of local actors. For example, some municipalities relied mainly on the implementation of the overdue liabilities programme; others tried to collect fees, or they focused on a higher absorption of EU funds or on management reforms. In other Greek cities, actors concentrated on new procurement systems, zero-base budgeting, on corruption prevention and on opportunities for extrajudicial compromises with creditors.

Overall, measures at the national and local level in Greece largely exceeded those in Germany. We can explain this in the timing of external pressure and different economic trends following the financial crisis, by the limited constitutional status at the local level and the limited revenue autonomy for local governments. Finally, state supervision got different roles as well as competencies, too.

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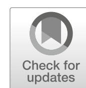
Financial Decisions, Intergovernmental Grants and Regulatory Instability: The Case of Italian Municipalities



Emanuele Padovani and Céline Du Boys

Abstract Because of the global financial crisis, central states implemented a range of recovery plans, austerity measures and cutback strategies, which created significant challenges to local governments. This article examines the influence of (adverse) national adoptions in the fiscal regulatory framework on local revenues and expenditures. Building on economic theory, we evolve a set of hypotheses on local fiscal policies. To test these, we use panel regressions of more than 1000 Italian municipalities between 2008 and 2015. Italy is a particularly suitable case for this research, since the financial crisis strongly affected the country and the central government implemented multiple changes to the institutional framework, which created great instability for local governments. In general, Italian municipalities have shown a specific pattern of financial decision-making as a reaction to revenue grants, i.e. positive effects on current and capital expenditures and on own revenues. We also found that changes in the legal and financial framework influenced patterns for capital and personnel expenditures, suggesting that certain patterns of reaction are more contingent than other ones. Moreover, this article contributes to the understanding of regulatory instability on local level decision-making and shows that instability cancels the influence of some usual determinants.

1 Introduction

The global financial crisis began with the collapse of the US mortgage market in 2007 and rapidly expanded to all Western economies in 2008. As governments implemented recovery measures in response, public debt and budget deficits increased, which led to the 2010 fiscal crisis (Kickert 2012). The global crisis thus

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turned from a financial and banking crisis to a state fiscal and debt crisis, as defined by Bordo and Meissner (2016), leading most Western governments into a new era of public spending cutbacks and austerity (Kickert 2012; Pollitt and Bouckaert 2017). The range of recovery plans, austerity measures, cutback strategies and institutional reforms implemented by central governments following the crisis, and the factors that have influenced them, have been widely studied and documented (Cepiku and Bonomi Savignon 2012; Kickert 2012; Klase 2011; Lodge and Hood 2012; Raudla et al. 2013; Schick 2011, 2012). The crisis also presented a significant challenge to local governments (LGs) because they were specific targets in the drive for austerity and also affected by state policies (Cepiku et al. 2016; Kuhlmann and Bouckaert 2016; Medir et al. 2017; OECD 2009). As suggested by Pollitt and Bouckaert (2017), austerity makes reforms more difficult because of the lack of money, but a sense of crisis makes it easier to consider radical changes. This paradox explains the range of fiscal policies implemented by central governments for LGs, from the UK's strong austerity measures to the softer approach of France or the conflicting measures adopted by the Italian state.[1] Although the influence of state measures on the financial decisions by LGs has been examined, less attention has been devoted to the effect of changing or conflicting measures during periods of crisis. In this chapter, we seek to shed light on LG decisions concerning revenue and expenditure in those cases in which the national government made changes to fiscal and financial regulation, thus adversely affecting them. In particular, we are interested in the effects of diverse grants to LGs and in the consequences of dependency—in varying degrees—to those grants.

In this context, the case of Italian LGs in the post-crisis period is of particular interest, as several successive conflicting measures and reforms have been implemented. These have resulted in considerable institutional uncertainty and a weakening of LGs (Raffer and Padovani 2019). We identified three periods of conflicting austerity measures between 2008 and 2015. We try to determine if factors evolved which influenced municipal financial decisions during these periods, especially since LG confidence in state decisions decreased at the same time (ANCI-IFEL 2017). We question if LGs adjust their own revenues and various expenditures differently during these periods as a reaction to a change in state grants or according to their level of dependence to state grants. Using panel regressions, we examine the influence of state grants and financial dependency on expenditure and revenue decisions taken by Italian municipalities with over 10,000 inhabitants, during the three periods between 2008 and 2015.

Our study sheds light on Italian financial decisions in the post-crisis and austerity period. We investigate further the 'flypaper effect', i.e. that body of literature that studies the relationship between government grants and LGs financial decisions, showing grants have a positive impact on expenditures and own revenues. We also investigate the influence of financial autonomy on financial decisions and highlight

[1]For a comprehensive study on the impacts of the central government's austerity policies at the local level, see the article by Wortmann and Geissler in this volume.

Italian specificities. One original result of this study is also to show the effect of instability in the legal and financial framework on the determinants of financial decisions and notably on expenditures.

The paper is structured as follows: Section 2 discusses the influence of state grants and dependency on financial decisions by LGs. Section 3 presents the Italian case and identifies three periods of conflicting reforms. It discusses the likely influence of this institutional instability on expenditures and revenues. Section 4 outlines the method used for the quantitative study. Section 5 presents and discuss the results, and Sect. 6 draws some conclusions.

2 Conceptual Framework and Hypothesis Development

2.1 LGs Revenues and Expenditures Decisions in Times of Crisis

Following the 2008 crisis, many countries, most notably in southern Europe, have promoted policies of austerity and spending cuts in LGs. If financial decisions are a key aspect of municipal strategic choices and play a central role in crisis management (Cepiku and Bonomi Savignon 2012; Klase 2011; Levine 1978; Raudla et al. 2013), LGs may not have the opportunity to adjust expenses and revenues if they lack institutional but also financial autonomy (Medir et al. 2017). A decrease in grants and political pressure to reduce budgets has particularly impeded LG decisions.

We draw on the literature on cutback budgeting based on the seminal work of Levine (1978) and reviewed by Raudla et al. (2013) and on austerity management in local governments (Cepiku et al. 2016), which provide insight into the effects of crisis on revenue and expenditure decisions.

Financial shocks have a complex impact on financial balances. On the one hand, the level of severity and length of a crisis means an external effect on revenue through tax base reduction as expenditure via an increase in demand for services (Dunsire and Hood 1989; Pollitt 2012; Raudla et al. 2013). Notably, the provision of some financial resources is decided by the state and other upper-tier governments, such as regions. These may be reduced during periods of financial crisis. The central government may not only withdraw grants but also limit the ability of municipalities to impose, raise or modify local taxes.

On the other hand, expenditure and revenue (such as municipal taxes, share of state taxes and service fees) are important leverages in crisis management. Municipalities may react in several ways to crisis (Baker 2011; Cromwell and Ihlanfeldt 2015). They may increase revenue in reaction to decreases in state grants. This holds especially true during the early phases of crisis, when the ‘tooth fairy syndrome’, following the idea that cutbacks are not needed, may influence decision-makers (Levine 1979) or where cutbacks implemented are smaller than the reduction of state grants. Municipalities also retain the ability to set the price for fee-paying services.

A significant body of literature focuses on the pattern of expenditure cutbacks (Raudla et al. 2013). Capital spending is the most likely cutback scenario during crises (Levine et al. 1981; Dunsire and Hood 1989), although not necessarily the most effective strategy in the long term (Scorsone and Plerhoples 2010). Some authors document dual strategies which incorporate both cost-cuts and investment spending in some promising projects (Ladner and Soguel 2015). A freeze on personnel hiring is also frequently adopted, as it reduces expenditure without unpopular layoffs (Levine 1978; Rubin 1985). Finally, the reduction of operating expenditure via cuts to programmes or efficiency measures may be another option. Scorsone and Plerhoples (2010) suggest that strategies to cope with crisis evolve over time, with different combinations of tax increases, spending cuts and drawing on 'rainy-day' funds.

2.2 State Grants Influence on LGs' Expenditure and Revenue Decisions

Numerous internal and external factors influence LGs' expenditure and revenue decisions (Anessi-Pessina et al. 2016; Benito and Bastida 2004; Ladner and Soguel 2015; Overmans 2017; Overmans and Timm-Arnold 2016; Raudla et al. 2013). Financial decisions and austerity strategies are a function of environmental and organizational factors (Raudla et al. 2013). Revenue grants are a determinant factor, which represents the linkage between LGs and their higher tiers of governments.

A perspective examined by the literature is the effect of intergovernmental grants on municipal financial policy decisions, notably expenditures and own revenues. Classic literature suggests that the increase in spending by LGs and their local citizens on goods and services reflects only the preferences and utility functions of the latter (Bailey and Connolly 1998). Thus, the classic theory of public finance suggests that grant income is returned to local taxpayers either directly via rebates or indirectly via reduced local taxes. But, contrary to what these theories describe, empirical evidence has shown that grant increases tend to have a stimulatory effect on spending and not on taxes and that LGs react differently to grant and economic tax windfalls (Bailey and Connolly 1998; Heyndels and Van Driessche 2002). These observations are part of the 'flypaper effect' that appears to operate in both directions (Gamkhar and Oates 1996). Studies also report an 'asymmetric effect', where governments do not react to an increase in grants in the same way as to a decrease (see Gramlich 1987; Heyndels 2001; Heyndels and Van Driessche 2002; Mehiriz and Marceau 2014 for examples outside the USA). The controversial effects of a variation in grants have been studied by several researchers to understand the reasons for this. For example, Slack (1980) found that an increase in unconditional grants results in an increase in local expenditures. Mehiriz and Marceau (2014) tend to protect investment spending in the case of grant reduction, but that effect varies with the type of grants (conditional or unconditional). Deller and Maher (2005)

document that grant increases have an impact on spending that varies significantly by expenditure category.

Grant-induced spending growth is usually less than the full grant amount (Nguyen-Hoang and Hou 2014). A traditional explanation suggests that grant recipients use a portion of grant money to reduce local property taxes (Duncombe and Yinger 2001). In times of crisis, the same negative relation could appear as suggested by the so-called tooth fairy syndrome. According to this, an increase in local revenues as a reaction to a decrease in state grants may occur especially in the early phases of crisis, when the idea prevails that cutbacks are not needed (Levine 1979). Gramlich (1987) observed that LGs respond to cutbacks in grants by increasing their own taxes to maintain existing levels of spending. Discretionary savings may be used to cover noncurrent outlays during booms and to offset spending cuts during recessions (Nguyen-Hoang and Hou 2014), lowering the need for an increase in own revenues. Following these elements, we formulate the following hypotheses H1:

H1a: There is a positive relationship between the grants received by a LG and its expenditures (personnel, other current and capital).

H1b: There is a negative relationship between the grants received by a LG and its local own revenues (taxes and fees).

The financial autonomy of LGs towards state grants also influences financial decisions. Overmans and Timm-Arnold (2016) show that LGs' financial autonomy and their degree of control over their finances influence their type of austerity plan. Municipalities with a high degree of control over local finances tend to use more fiscal leverage and cut expenditure less. Anessi-Pessina et al. (2012) show that financial autonomy has a negative influence on capital expenses, but no influence on operating spending. Municipalities in better financial condition seemingly require smaller midyear adjustments, presumably because they enjoy greater degrees of freedom during the initial budgeting process. One often-used measure of financial autonomy is the grants proportion of total revenues. Financial autonomy contributes to a better financial situation for the LGs and a lower risk of default (Buendía-Carrillo et al. 2020; Navarro-Galera et al. 2015), whereas dependency is seen as a factor of vulnerability (Barbera et al. 2019).

Thus, at the individual level, it is likely that a LG subject to a greater dependency on grants will tend to improve its financial situation by increasing its own revenues more strongly by increasing fees or local taxes and decreasing expenditures to balance budgets. Following these elements, we formulate the following hypotheses H2:

H2a: There is a negative relationship between the financial dependency of a LG on state grants and its expenditures (personnel, other current and capital).

H2b: There is a positive relationship between the financial dependency of a LG on state grants and its own local revenues (taxes and fees).

The effects of grants on own revenues and expenditures depend on the types of grants and of expenses but also on contingencies. Lundqvist (2015) tested the

question of the 'flypaper effect' using a unique dataset of control and treatment governments in Finland. The treatment group received a temporary increase in unconditional aid, while the control group did not. Findings indicated long-term evidence of a 'flypaper effect' from the increase in grants. In conclusion, Lundqvist raises the question of why LGs acted the way they did, pointing to mental accounting, i.e. the different values people give to money (Thaler 1985), and political considerations as two possibilities to understand the paper's results. Under this latter perspective, one possibility is the issue of the temporary nature of the increase in grants as raised by Deller and Maher (2006). Deller and Maher introduced the idea of uncertainty surrounding the future of intergovernmental transfer programmes. Their argument was that uncertainty regarding the future of intergovernmental transfer programmes increases. Local officials were more likely to increase local revenue sources to offset declining intergovernmental transfers. Cepiku et al. (2018) note that the uncertainty the central government created in Italy by independently changing the rules of the game every year during the post-crisis period made it difficult for LGs to determine long-term strategies. This uncertainty stimulated overspending in LGs and favoured short-term decision-making and seems to distract LGs strategically from ensuring permanent and sustainable cost reductions. In the USA, the late federal budget appropriation (e.g. as occurs with shutdown) creates funding uncertainty and shows negative effects for agencies, provokes cutbacks, causes extra costs, delays in hiring and has a tendency to short-term employment (Joyce 2012). These studies suggest that in times of uncertainty, LGs take their decisions differently and have short-term vision. Thus, we suggest that uncertainty in regulations or in funding may change the determinants of financial decisions. The influence of factors such as grants or financial autonomy might have a different or null influence in periods of regulatory uncertainty. Thus, we propose the following hypotheses H3:

H3a: Uncertainty in state regulations and grants for LGs makes H1a unstable.
H3b: Uncertainty in state regulations and grants for LGs makes H1b unstable.
H3c: Uncertainty in state regulations and grants for LGs makes H2a unstable.
H3d: Uncertainty in state regulations and grants for LGs makes H2b unstable.

The specific context of Italian municipalities in the post-crisis period gives an opportunity to better understand the effect of uncertainty in the form of different regulations and on financial decisions, but also to better explore the effects of regulatory instability.

3 Regulatory Instability for Italian Municipalities after the Crisis

Central government grants a certain level of fiscal, financial and organizational autonomy to Italian municipalities. However, the central state imposed several changes to the legal and fiscal framework between 2008 and 2015, the period

considered in this analysis. They have had a relevant influence on the financial decisions made by municipalities to cope with financial crisis. In particular, (1) national austerity policies have cut resources to municipalities and the possibility to spend via the several fiscal consolidation mechanisms available; (2) the modification of local fiscal rules by the central government caused instability of local revenues; and (3) the evolution of default regulation coupled with transparency mechanisms have increased the accountability of financial decision-makers, i.e. elected officials. These influences are briefly discussed below.

At the beginning of the global financial crisis, the most important fiscal consolidation mechanism was the Internal Stability Pact (*Patto di stabilità interno—PSI*). The PSI was a fiscal rule for budget discipline applied to municipalities and determined by the central government to ensure that macroeconomic objectives were aligned with the European Maastricht Treaty. It outlines that the balance between final revenue and final expenditure must increase over time, based on specific targets in relation to historical balances. This mechanism remained quite stable until 2016, when a new fiscal consolidation mechanism was put in place. However, this apparent stability is only part of the overall story because the central government enacted heavy 'spending review' policies via grant reductions. The magnitude of overall cuts to municipalities was somewhat soft between 2008 and 2010; very harsh between 2011 and 2013, when the technocratic government of Prime Ministry Mario Monti adopted policies in response to the severe financial crisis that affected the Italian sovereign debt; and then settled to lower levels in 2014–2015 (see Table 1). Fiscal consolidation mechanisms, together with personnel turnover across the period considered, have de facto introduced a severe fiscal discipline which has improved the balance between revenues and expenditures. This particularly holds true from 2011 onwards, when the Italian local level showed a positive balance (it was negative in the years previously, Raffer and Padovani (2019)). In other words, local governments have spent less than would have been possible in the past with a similar level of revenues.

In terms of local fiscal rules, municipalities were provided with a stable local fiscal framework until 2011: revenue came from property tax, except on main residences, additional income tax, waste management fees and other municipal services and fees and grants received by state and other governments. Between 2012 and 2013, the municipal fiscal framework was reformed several times: property tax was extended to main residences in 2012 and then exempted in 2013; municipalities were able to increase income tax levels starting in 2012; waste management fees were modified starting in 2013. Finally, a new system of fiscal equalization (*Fondo di solidarietà comunale*) was introduced which linked grants to actual fiscal needs, rather than historical levels defined in the 1980s and marginally modified over time. This situation of instability and stop-and-go may have caused a certain difficulty to take financial decisions on local taxation in 2012–2013. If local officials wanted to raise own revenues, the only possibility was to increase local service fees, which would have been hard to do with any significance. As consequence, limited financial decisions based on own revenues were possible during 2012–2013.

Table 1 Evolution of overall cuts and main modifications to local fiscal rules and default regulations

<table>
<tr><th></th><th>2008</th><th>2009</th><th>2010</th><th>2011</th><th>2012</th><th>2013</th><th>2014</th><th>2015</th></tr>
<tr><td>Relevant periods</td><td colspan="3">1. Soft austerity and re-centralization</td><td colspan="3">2. Acute austerity with fiscal uncertainty and accountability increase</td><td colspan="2">3. Aftershock</td></tr>
<tr><td>Overall cuts by fiscal consolidation mechanisms[a]</td><td>0</td><td>1.46</td><td>1.03</td><td>3.01</td><td>5.19</td><td>3.16</td><td>0.04</td><td>0.85</td></tr>
<tr><td>Main modifications of local fiscal rules</td><td colspan="4">Property tax not applied to main residences, replaced by state grant; no possibility to raise shared income tax</td><td>New property tax extended to main residences; possibility to increase shared income tax</td><td colspan="3">Exemption of main residences for property tax; different modifications for waste management tax; new system for fiscal equalization via the Fondo di solidarietà comunale</td></tr>
<tr><td>Default regulations and financial accountability</td><td colspan="3">No changes (default status self-declared by municipal council, with political influence)</td><td>Default status declared also by court of auditors</td><td colspan="4">Rebalancing procedure added to default procedures; publication of important financial information, including the financial reports and the duration of payment, in a standardized section of the institutional homepage; administrative mandates final financial report to the court of auditors</td></tr>
</table>

[a]Source: ANCI-IFEL, National association of Italian municipalities (in billion euros)

Italian municipalities are subject to bankruptcy procedures. Bankruptcy regulations were modified in 2011 to allow auditors to declare the default status of municipalities, which had previously been the domain of the municipal council and was subject to political influence; this meant it was rarely enacted. Because several municipalities fell into financial distress and were at risk of default, in 2012 the central government introduced a ‘rebalancing’ programme (*procedura di riequilibrio*) which allows municipalities to avoid default status if they agree to specific long-term management plans. In 2012, the state authorized the court of auditors to hold public officials accountable for financial decisions, i.e. by barring them from re-election for 10 years. From 2013 onwards, municipalities were required to be more transparent with the publication of important financial information, including financial reports and duration of payment. Starting in 2011, a series of reforms introduced a higher level of accountability of elected officials, both in terms of higher transparency and responsibility for financial issues. This may lead to a different approach to financial decision-making, especially if grants or expenses are to be reduced.

Our study covers the fiscal years between 2008 and 2015. We identify three periods during this timeframe: (1) soft austerity and re-centralization of fiscal policies, from 2008 to 2010; (2) acute austerity with fiscal uncertainty and

accountability increase, from 2011 to 2013; and (3) the aftershock period, in 2014 and 2015. Table 1 shows the details.

4 Method

The case of Italian municipalities during the period 2008–2015 offers a great opportunity to test our hypotheses H1, H2 and H3.

4.1 Sample and Variables

We used a panel data set of 1219 Italian municipalities with over 10,000 inhabitants[2] representing 15% of all Italian municipalities and 65% of the population during the period 2008–2015. We corrected the sample by winsorizing the variables at the 1% level in each tail to reduce the effect of outliers.

Table 2 presents the variables used to test our hypothesis. The dependent variables are the main municipal financial decisions measured by own revenue and current and capital expenditure. The two independent variables are the municipal financial dependency on other governments and the grants evolution. We also used a set of control variables that are identified as factors which influence financial decisions and linked to the financial situation (Lee et al. 2009; Pollitt 2012): budget flexibility (Klase 2011), surpluses (Barbera et al. 2016) or debt level. External control variables are size (Buendía-Carrillo et al. 2020; Ladner and Soguel 2015) or wealth of the population and national conjuncture (GDP).

To select the appropriate accounting information, we adopted the validity and legitimacy criteria developed by Bouckaert (1993). Validity refers to understandability, accuracy and credibility, while legitimacy reflects the idea that the accounting information is considered as valuable by its recipients (i.e. policymakers in municipalities). As such, we used obligation-based accounting when it was relevant, but we also used cash-based accounting to measure current revenue from municipal fees and taxes based on fair value (IPSASB 2001, 2006) since it is considered by managers (Cimbolini and Moriconi 2008) and auditors (Corte dei Conti 2016) as a measure of fair value of current revenue. Moreover, capital expenditure is computed considering cash-based accounting because, considering accounting technicalities, cash outflows of capital expenditure were accounted for when a new asset (e.g. new road, new school building, etc.) was made available.

Financial and economic data were collected through Aida PA by Bureau van Dijk—A Moody's Analytics Company, a dataset of all information contained in

[2]This represents 99% of all municipalities with 10,000 inhabitants or more. It excludes Rome and municipalities for which financial information was missing.

Table 2 Variables

Name	Measure
Independent variables	
POLICYGRANT	Change in current grants from other governments[a] (*Titolo 2 – Entrate da contributi e trasferimenti correnti* of revenue, obligation-based accounting) received by the municipality between *N* and *N*–1
FINDEP	Current grants from other governments[a] (*Titolo 2 – Entrate da contributi e trasferimenti correnti of revenue*, obligation-based accounting) ÷ Total current revenue[b] (*Titolo 1* + *Titolo 2* + *Titolo 3* of revenue, cash-based accounting) in year *N*–1
Control variables	
BUDRIG	Budget rigidity: Personnel expenditure (*Titolo 1 – Intervento 1* of expenditure, obligation-based accounting) ÷ Total current revenue[b] (*Titolo 1* + *Titolo 2* + *Titolo 3* of revenue, cash-based accounting) in year *N*–1
GOB	Gross operating balance: [Total current revenue[b] (*Titolo 1* + *Titolo 2* + *Titolo 3* of revenue, cash-based accounting) – Current expenditure (*Titolo 1 – Intervento* 1 of expenditure, obligation-based accounting)] ÷ Total current revenue (*Titolo 1* + *Titolo 2* + *Titolo 3* of revenue[b], cash-based accounting) in year *N*–1
DEBT	Stock of debt at year's end ÷ Total current revenue[b] (*Titolo 1* + *Titolo 2* + *Titolo 3* of revenue, cash-based accounting) in year *N*–1
ECOVAR	Relative growth* of total individual income within jurisdiction between *N*–1 and *N*–2
INCOME	Individual income within jurisdiction ÷ population in year *N*–1
POPVAR	Jurisdiction's relative population growth* between *N* and *N*–2
GDPVAR	Relative GDP growth[c] between *N*–1 and *N*–2
Dependent variables: Decisions on revenue and expenditure	
MOVVAR	Variation of municipal own revenue: Relative growth* of total municipal current revenue from taxes and fees (*Titolo 1* + *Titolo* 3 of revenue, cash-based accounting) between *N* and *N*–1
PEVAR	Variation of personnel expenditure: Relative growth* of personnel expenditure (*Titolo 1 – Intervento 1* of expenditure, obligation-based accounting) between *N* and *N*–1
CUREXPVAR	Variation of other current expenditure, excluding personnel expenditure: Relative growth* of current expenditure for service and goods provisions (*Titolo 1, Intervento* 2 + *Titolo 1, Intervento* 3 of expenditure, obligation-based accounting) between *N* and *N*–1
CAPEXPVAR	Variation of capital expenditure: Relative growth* of capital expenditure (*Titolo 2* of expenditure, cash-based accounting) between *N* and *N*–1

[a] Current grants from other governments = *Titolo 2 – Entrate da contributi e trasferimenti correnti' of revenue, obligation-based accounting*

[b] Total current revenue = *'Titolo 1'* + *'Titolo 2'* + *'Titolo 3' of revenue, cash-based accounting*

[c] Relative growth is computed as (variable year *N* – variable year *N*–1) / variable year *N*–1 (or *N*, *N*–1 and *N*–2 where applicable)

municipal financial reports (plus annexes); individual income comes from the Ministry of Economy and Finance and GDP from ISTAT (national statistics office). All data retrieved 1 May 2017.

4.2 Statistical Methodology

To analyse the panel dataset, we use a fixed-effect model, i.e. a linear regression model in which the intercept terms vary over the individual unit. Let i be the variable index for the unit ($i = 1, \ldots, N$), the municipality, and t the variable index for the time period ($t = 1, \ldots, T$), the year; the specification of the fixed-effect model is:

$$y_{it} = \alpha_i + x'_{it}\beta + \epsilon_{it}$$

where α_i captures the effects of those variables for the unit i and are constant over time, x_{it} is the vector of explanatory variables and ϵ_{it} is assumed to be independent and identically distributed over municipalities and time with zero mean and variance σ^2_ϵ. Moreover, it is usually assumed that all x_{it} are independent of all ϵ_{it}. The fixed-effect model requires the exclusion of the variables that are time-invariant for multicollinearity problems. For each dependent variable, we ran three fixed effect models, taking into consideration the three different time periods, with time-fixed effects since the null hypotheses of no time-fixed effect is rejected. Fixed effects were chosen over random effects based on the Hausman test (Hausman 1978) for each dependent variable. In addition, we used robust standard error estimates, since the related test has confirmed heteroscedasticity. R^2 interpretation is not possible (Verbeek 2004).

5 Results and Discussion

Figure 1 shows the evolution across time of our dependent variables: Italian municipalities have increased their municipal revenue and expenditure, apart from personnel and capital expenditure, which has decreased.

Table 3 shows the results of the panel regressions on each of the four dependent variables for the three relevant periods.

Our empirical analysis indicates a positive relation between revenue grant variations (POLICYGRANT) and our four dependent variables. The only exception is capital expenses (CAPEXPVAR) during the last period, where the relation is not significant. These results support the H1a hypothesis, which stated a positive relation between grants (POLICYGRANT) and expenditures (CUREXPVAR and CAPEXPVAR), but also supports the H3a hypothesis, since this relation may become non-significant after a period of conflicting reforms.

In contrast, no empirical support was found for the H1b hypothesis, as we observe a positive relation between grants (POLICYGRANT) and own revenues (MOVVAR) that does not drastically change over time (thus rejecting H3b). These results suggest that contrary to previous literature, reactions in Italy were different when it comes to own revenues. The highly instable municipal fiscal regulatory framework across the periods covered may provide an explanation for

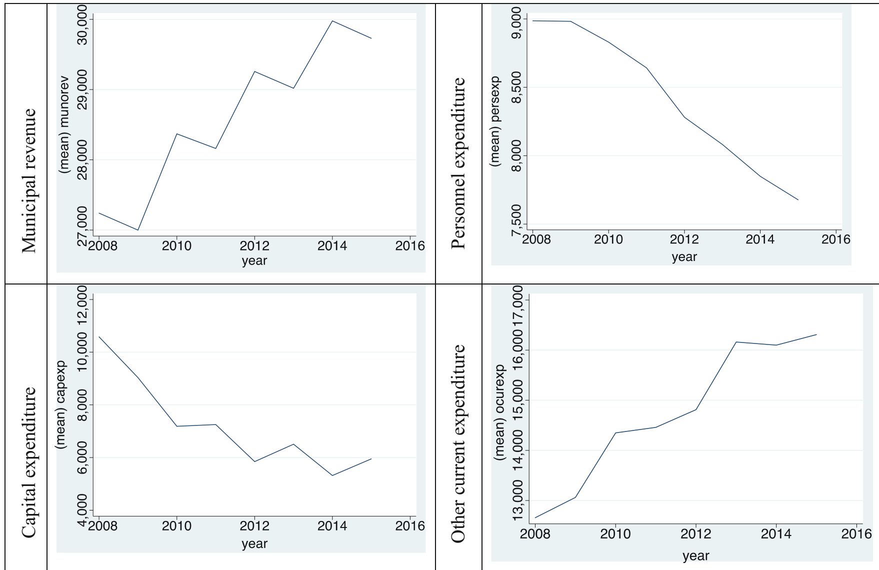

Fig. 1 Evolution of average municipal own revenue, personnel expenditure, other current expenditure and capital expenditure from 2008 to 2015 (in thousand euros)

this. Instability did not permit LGs to rely on taxes; therefore decision-makers preferred to adjust expenditures according to the level of grants received. LG revenue offices have experienced difficulties in forecasting the effects of new rules and thus have not been able to redress financial decisions made to a great extent by central, regional and other governments. Our results also suggest that after a long period of instability and austerity, LGs tend to separate their capital expense decisions from state and other governments decisions, in terms of grants. In fact, LGs cannot postpone spending after a certain amount of time, especially capital expenditures. Restrictions began with the PSI mechanism, well before the impact of the crisis, in early 2000 and have been particularly harsh since the financial crisis and the accompanying austerity policies (see Fig. 1). This singles out the interaction with other regulatory frameworks which have an effect over a longer period. In this case, the 'flypaper effect' mechanisms observed in periods one and two may have become unstable in period 3, due to a long-term policy of capital expenditure reduction. This has caused the urgent need for new investments, such as maintenance of roads and public buildings, vehicle renovation and new infrastructures which have been stalled and cannot be postponed any longer. This shows that certain 'flypaper effect' mechanisms have limits, i.e. the reduction of expenditures; the responsibility of public officials to provide services to their constituents makes it impossible to exceed these limits.

Our results indicate a positive but instable relationship between financial dependency (FINDEP) and our four dependent variables. This supports the H2b hypothesis, since we observe that when LGs are more dependent on other governments

Table 3 Panel regressions results

	MOVVAR			PEVAR			CUREXPVAR			CAPEXPVAR		
	2008–2010	2011–2013	2014–2015	2008–2010	2011–2013	2014–2015	2008–2010	2011–2013	2014–2015	2008–2010	2011–2013	2014–2015
POLICYGRANT	0.0795***	0.0173***	0.0242**	0.0302***	0.0064***	0.0072**	0.118***	0.0364***	0.0472***	0.126**	0.0313**	
	[0.0126]	[0.00323]	[0.0106]	[0.00562]	[0.00110]	[0.00324]	[0.0156]	[0.00460]	[0.00970]	[0.0531]	[0.0155]	
FINDEP	0.836***	0.532***	0.627***	0.131**			0.533***	0.188***	0.362***	1.359***	0.666**	
	[0.123]	[0.0601]	[0.224]	[0.0618]			[0.134]	[0.0729]	[0.121]	[0.515]	[0.293]	
GDPVAR	−1.196***	1.095***	−2.117**	0.269***	0.450***		−0.952***		1.119*	3.027***	−3.620*	23.52***
	[0.112]	[0.400]	[1.056]	[0.0423]	[0.125]		[0.140]		[0.590]	[0.538]	[1.873]	[3.698]
ECOVAR	0.660***	0.684***		0.254***	0.205***	0.338**	0.638***	0.638***	1.141***	1.768***	1.180**	
	[0.129]	[0.120]		[0.0602]	[0.0445]	[0.142]	[0.156]	[0.153]	[0.411]	[0.568]	[0.557]	
INCOME	−0.0038***	−0.0036**		−0.0026***	−0.0014***	−0.0041***	−0.0042***		−0.0094***	−0.0149***		
	[0.00134]	[0.00150]		[0.00054]	[0.00049]	[0.00126]	[0.00154]		[0.00326]	[0.00544]		
POPVAR												
BUDRIG	1.949***	2.190***	2.688***	−1.269***	−0.512***	−0.398***	3.226***	3.105***	2.406***			−3.064**
	[0.210]	[0.180]	[0.495]	[0.0909]	[0.0531]	[0.0886]	[0.264]	[0.294]	[0.396]			[1.445]
GOB	−0.393***	−0.203***		−0.230***	−0.103***	−0.0593**	1.308***	0.948***	0.787***			−0.843**
	[0.0745]	[0.0565]		[0.0271]	[0.0160]	[0.0252]	[0.0850]	[0.0824]	[0.104]			[0.409]
DEBT								0.00138**				
								[0.00058]				
CONST				0.590***	0.265***	0.566***	−0.747***	−0.639***		1.356**		5.896*
				[0.0693]	[0.0593]	[0.159]	[0.198]	[0.232]		[0.680]		[3.181]
Year fixed effect	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
N	3621	3604	2351	3621	3604	2351	3621	3604	2351	3621	3604	2351
Within R^2	0.36	0.317	0.511	0.274	0.113	0.049	0.204	0.221	0.224	0.05	0.035	0.097

All variables have been included in all regressions but for more readability, only significant results have been included in the table, similar to Buendía-Carrillo et al. (2020)

The standard errors in brackets represent * $p < 0.10$, ** $p < 0.05$, *** $p < 0.01$

(FINDEP), they tend to counteract this dependency by increasing autonomy by increasing their own revenues (MOVVAR). But contrary to the H3d hypothesis, this mechanism is stable across periods and does not vary with conflicting regulations on local taxes.

We also observe a positive effect of financial dependency (FINDEP) on LGs expenditures (PEVAR, CUREXPVAR, CAPEXPVAR), despite instability across the three periods, which rejects our H2a. The instability of the relationships across the three periods is limited to personnel expenditures (PEVAR) and capital expenditures (CAPEXPVAR), which provides partial support to the H3c hypothesis. The rejection of H2a suggests a different relationship in Italy than what the literature suggested. The positive and stable relationship between financial dependency (FINDEP) and current expenditures (CUREXPVAR) may be explained by outsourcing, since it is accounted for in current expenditures. The more dependent on state grants, the more municipalities relied on outsourcing, which is considered more flexible than regular personnel expenses. It resonated with the growth in municipal outsourcing during this period, as a response to the central government's severe hiring policy restrictions.

Concerning the positive influence of FINDEP on personnel (PEVAR) or capital expenditures (CAPEXPVAR) only during the first periods, it can be argued that LGs felt more confident with a large part of their revenues provided by grants, since own revenues were considered uncertain following the crisis and were also affected by instable local fiscal rules. Our results suggest that the more a LG depended upon grants, the more it considered to increase personnel expenditures or capital spending. During the first and second periods, higher capital expenditures due to more financial dependency can be explained by the PSI mechanisms. Financial resources provided by grants were considered more reliable than the credit risk of own revenues and thus would have also increased investment. However, instability makes this less true following period one for personnel expenditures and from period three for capital expenditures, which supports our H3d hypothesis. This may relate to the long-term policy of capital expenditure reduction and personnel expenditure restrictions that created such an urgent need, as mentioned above. Following a period of austerity, a LG will use the resources available to hire personnel or invest, whether funding comes from own revenues or grants.

6 Conclusion

We have examined expenditure and revenue decisions taken by Italian municipalities to cope with the global financial crisis from 2008 to 2015. During three periods characterized by different sets of national reforms targeting LGs, we found that Italian municipalities follow specific patterns of financial decision-making in reaction to revenue grants: (a) a positive effect of grant variation on current and capital expenditures, (b) a positive effect of grant variation on own revenues, (c) a positive effect of financial dependency on own revenues and (d) a positive effect of financial

dependency on expenditures but not stable for capital and personnel expenditures. The latter suggests the use of outsourcing when personnel policies are restricted by the national level. We also found that changes in the legal and financial framework imposed by the central state have influenced (a) and (d) patterns for capital expenditures or (d) for personnel expenditures, which suggests that certain patterns of reaction are more contingent than other ones. After the crisis, and in a period of austerity, our results suggest that the influence of grants on expenditures is more unstable than on own revenues. Following a period of regulatory instability and austerity, LGs tend to separate their expenditures, notably their personnel and capital expenditures from state grants, without considering the differences between tax and grant revenues.

Our research contributes to the literature examining financial decision-making in times of austerity and the factors explaining its evolution post-crisis. It sheds light on the influence of state grants and dependency on grants and offers an example of the 'flypaper effect' in Italy. This research also contributes to the understanding of regulatory instability on decision-making. Contradictory reforms may disconnect LGs from the usual determinants of their decision-making processes. It would be interesting to extend this study to municipalities in other countries, which have experienced relative instability caused by their central governments in the attempt to cope with austerity. It would also be of interest to look at how LGs cope with other types of crisis characterized by conflicting measures implemented by the state, which affect their financial resources and expenditures. The dramatic effect of the COVID-19 pandemic on the financial situations of LGs and the (clear or confusing) decisions that states will make to cope with the financial consequences will be of interest.

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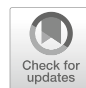
Insights from City Financial Realities: Comparing and Learning Across Borders



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Abstract Improved financial management and the sustainability of local governments is a key ingredient to future growth and the prosperity of countries, especially in an era where crises require countries to be prepared for resilience. However, a significant barrier to improvement in this regard is the insufficient exchange of knowledge from practitioners across borders. The contribution of this chapter is twofold. Firstly, we aim to provide insights from the frontline of local finance management based on the work carried out within the European City Economic and Financial Governance (CEFG) Group. The CEFG Group is a community of practice among eight European cities, wherein cross-border city level fiscal and financial management issues are discussed with city CEOs and CFOs. Secondly, we put emphasis on accounting, as this is the part of the regulatory framework that consistently influences financial sustainability, how local governments perceive themselves and how they are perceived by others. The CEFG Group represents an interesting and unique cross-border experiment to examine the threats and opportunities of measuring and comparing the financial health and sustainability of local governments. Also discussed in this chapter is the CEFG Group's own framework known as the *financial health template*, which contributes to cross-border comparability and demonstrates that comparison of local financial performance is possible despite the different accounting, regulation, legal and administrative contexts.

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1 The Need for Cross-Border Learning Among Cities to Foster Financial Sustainability in the EU

In Europe, 67% of the GDP is produced within metropolitan regions. With cities therefore acting as hubs of economic development, their progress determines the future of territorial, socio-economic and spatial developments, in Europe and worldwide (Jacobs 1984; United Cities and Local Government 2016). The growth and prosperity of cities critically depend on the way the evolving challenges and resources of city governments are managed. This creates the need for entrepreneurial urban governance based on competitiveness and the benchmarking of cities.

The ideas introduced in the early 1990s by the New Public Management (NPM) paradigm (Hood 1995) have gradually moved the attention from traditional disciplines such as space and design to the financial aspects of city management (e.g. Lapsley et al. 2010). Benchmarking financial management best practices as well as failures and challenges is extremely helpful, as it might be a source for out-of-the-box ideas. At the same time, maintaining the comparability of accounts remains central for key purposes such as transparency, accountability, participatory budgeting and credit risk assessment by banks and financial institutions. The latter is also highly important for the financial management of cities, as lenders' credit policies are usually based on the financial performance of local governments and the level of disclosure of their financial reports. They then charge a risk premium to those municipalities in poor financial conditions or those who have provided less information (e.g. Padovani et al. 2018a). Considering the ever-increasing globalization of financial markets (OECD 2014), it is clear that international comparability of city governments' financial health presents the next challenge for the management of cities.

Managing and accessing the financial sustainability of municipal governments and comparing them to similar entities has been an issue widely discussed when the comparison takes place within a single country, but less attention has been paid to comparisons across national boundaries where differing administrative contexts and accounting systems complicate the effort. In this chapter, we report the main findings of a close partnership of eight major European city governments in eight countries, namely, Amsterdam (NL), Barcelona (ES), Bordeaux (FR), Hamburg (DE), London (UK), Milan (IT), Trondheim (NO) and Vilnius (LT).[1] Working collaboratively, the City Economic and Financial Governance (CEFG) Group[2] has developed a

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[1]When referring to the City of Bordeaux, we also refer to the Metropolitan Area of Bordeaux (Bordeaux Métropole), which belongs to the CEFG Group. The CEO and CFO of the City of Bordeaux are also the CEO and CFO of Bordeaux Métropole. With regard to the City of London, we refer to the City of London Corporation, the municipal governing body of the City of London, which is the historic centre of London and the location of much of the UK's financial sector (the 'City'), which is the specific local government member participating in this partnership.

[2]The City Economic and Financial Governance (CEFG) Group stopped working in the beginning of 2020. European Cities for Sustainable Public Finances (CSPF) was officially launched under the auspices of KDZ on 26 June 2020 (www.cspf.eu).

cooperative environment of idea exchange and a framework that facilitates cross-national comparisons of financial sustainability. It is supported through active participation by the European Commission and Eurostat. Having established itself as a reference group in Europe for sound financial management, the CEFG Group also participates as an 'observer/stakeholder' in the EC Eurostat EPSAS Working Group.

Following a short introduction of the CEFG Group's goals and work, the first part of this chapter presents key insights from financial management topics which comprise the most 'burning issues' addressed by the group. The second part deals with the development and results of standardized financial reports and a financial health template, both of which have been developed by the group in order to compare local financial performances. It demonstrates that although the comparison of local financial performance is a challenging endeavour due to the wide variance in accounting, regulatory, legal and administrative contexts, it is indeed possible and beneficial.

2 The CEFG Group and Its Burning Issues

The CEFG Group was initiated in 2014 by the City of Barcelona in collaboration with the European Institute of Public Administration in Barcelona (EIPA Barcelona). The intention was to create a space for mutual learning in the field of economic and financial governance,[3] to improve the comparability of financial data among European cities and to enhance and advocate the effectiveness, efficiency and accountability of local public sector management. It initially included the city governments of Barcelona (ES), Dublin (IE), Hamburg (DE), Milan (IT), Vienna (AT) and the City of London Corporation (UK), a sample that represents approximately 30 million metropolitan area inhabitants. The CEFG Group was enlarged in 2016 to include Amsterdam (NL), Bordeaux (FR) and Vilnius (LT), while Dublin and Vienna chose to leave the group. Trondheim, which joined in 2019, is the newest member.

The eight CEFG Group member cities reflect diverse European contexts and realities in terms of geographic location (spanning South to North), city size (ranging from 0.3 to 1.8 million inhabitants), density (ranging from 41 inhabitants/km^2 to nearly 16,000 inhabitants/km^2), socio-economic situation, competences and organizational structure (e.g. number of subsidiaries ranging from 16 in Trondheim to 380 in Hamburg). They furthermore display high diversity concerning administrative traditions and financial regulatory frameworks, including the rules of central governments and their possible restrictions (e.g. the obligation to break even or requirement of surpluses/prevention of these by politics). Some of these aspects are depicted in Table 1.

[3]More information is available at www.cefg.eu

Table 1 Composition of the CEFG Group

City government	Pop. mlo.	Pop. density	Administrative tradition[a]	Accounting system[b]	Accounting maturity[c]	No. of relevant subsidiaries
Amsterdam AMS (Netherlands)	0.83	3806	German	Accrual (domestic)	Medium (58%)	n/a
Barcelona BCN (Spain)	1.6	15,686	French/Napoleonic or German[a]	Accrual	High (68%)	45
Bordeaux BDX (France)	0.76[d]	1316	French/ Napoleonic	Accrual (domestic)	High (84%)	ca. 20
Hamburg HAM (Germany)	1.8	2383	German	Combination of accrual and cash	Medium (58%)	380
London CoL (United Kingdom)	8.4[d]	5356	Anglo-Saxon	Accrual	Very High (95%)	n/a
Milan MIL (Italy)	1.3	7143	French/ Napoleonic	Combination of accrual and cash	Low(30%)	18
Trondheim TRD (Norway)	0.3[d]	41	Scandinavian	Modified-cash/modified-accrual	n/a	16
Vilnius VLN (Lithuania)	0.55	1359	Eastern European	Accrual (IPSAS)	High (88%)	339

[a]Classification according to Loughlin (1994); Ongaro (2010) considers Spain within the Napoleonic administrative tradition
[b]See Sect. 3.2
[c]Accounting maturity as proximity to IPSAS principles according to PwC (2013: p. 36)
[d]For London, the population and population density portrayed in the table refers to the whole city of London, as the number of residents is not significant and does not reflect the role of this city government (City of London Corporation). Similarly, the metropolitan population is also given for Bordeaux and Trondheim, as the city and the metropolitan areas share broadly the same administrative structures

Since its foundation, the CEFG Group as a high-level partnership or *community of practice* has worked on a wide range of topics related to the financial management and financial sustainability of cities. These include topics such as budget practices, accounting practices, the European Public Sector Accounting Standards (EPSAS), the European System of Accounts (ESA), national accounts, financial planning, financing (smart city) infrastructure, accounting and fiscal rules, the role of CEOs and CFOs, good financial management guidelines and risk management (see Fig. 1).

Several important issues of financial management practice have become clear throughout the discussion of these different topics over the last 6 years. In the remaining part of this sub-chapter, we highlight the following three topics which constitute what can be described as the CEFG Group's key 'burning issues':

Fig. 1 CEFG Group roadmap 2014–2019

1. Financial strategies and risk management for infrastructure investments.
2. Assessing the level of revenue risk of cities.
3. General financial risk management for cities.

It is important to note that all three burning issues relate mainly to risk assessment and management, thus giving evidence to its pivotal importance to sound public financial management (Drennan et al. 2014).

The particular contexts, similarities and differences among the city members explained above and outlined in Table 1 are of utmost importance in order to understand the concrete challenges of each city and the type of and reason for the respective approaches used by their local managers.

2.1 *Financial Strategies and Risk Management for Infrastructure Investments*

Different aspects of financing public infrastructure were discussed in various CEFG Group meetings, which shows the importance cities assign to this factor. City governments provide primary infrastructure such as roads, transportation, parks, bridges, social housing and social equipment. These often constitute huge financial pressures and risks such as budget overruns, increasing maintenance costs or the collapse of related revenues. Regarding the financial sustainability of infrastructure projects, the cities use a mix of different strategies and instruments, including negotiations with the central government, debt impact monitoring, self-financing and analyses of future scenarios and risks.

Barcelona, Milan and Vilnius use only a single strategy, while the remaining city members use several approaches for ensuring financial sustainability. Barcelona, Bordeaux and the City of London focus on self-financing by operating surplus, thus indicating their strong financial health and financial power, while the City of Milan considers the impact of the concrete infrastructure on its debt. The City of Vilnius,

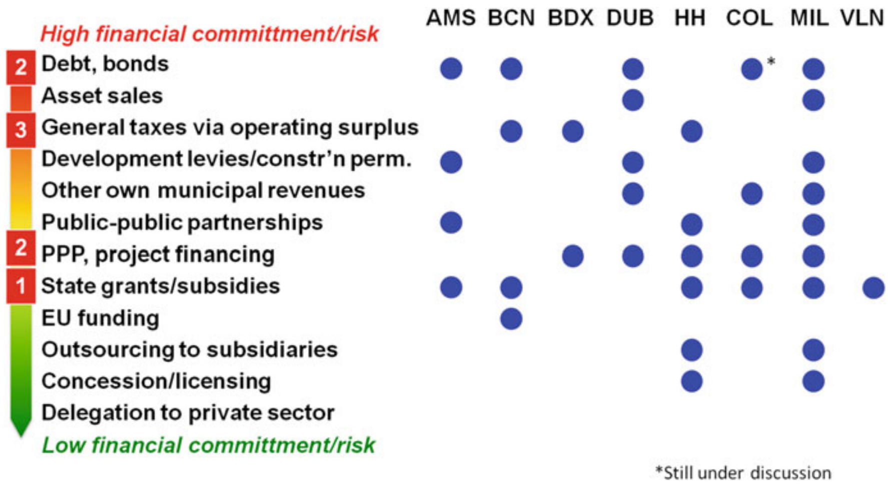

Fig. 2 Funding of city infrastructure projects

on the other hand, often negotiates with the central government for financing. Only three cities (Amsterdam, Hamburg and the City of London) include scenarios and risk analysis in their repertoire for assessing the financial sustainability of their infrastructure projects.

In terms of funding infrastructure, the majority of the partner cities cover their infrastructure projects through state grants/subsidies, bonds or debt and *public private partnerships* (PPPs), as displayed in Fig. 2.

The CEFG Group cities also follow different approaches of risk sharing because of the local contexts and legislation to which they are subjected. The new football stadium in Bordeaux is an example of how the city managed to transfer the revenue risk based on an agreement with the local football club and the French broadcast group M6. The football club made an advance for the rent in order to receive access to the stadium, while the broadcast group provided the rent guarantee. In another situation, the City of London Corporation combined a public school for music and drama with apartments in order to ensure the facility ran successfully and financially sustainable. This was largely due to the design of the investment plan, which relied heavily on the fundraising activities of the school.

2.2 Assessing the Level of Revenue Risk

Revenue generation in the partner cities was examined closely during the sixth CEFG Group meeting in 2016. The comparison of the financial health indicator

'Financial Autonomy'[4] of the group's standardized financial health template showed substantial variations among cities, from a minimum of 32% in Amsterdam to a maximum of 91% in Hamburg and Vilnius (2015 figures). For analysing revenue risk, the main revenues were further investigated in terms of which governmental level decides on the base and rate of revenues (city, state, external or mixed), the perceived level of elasticity and the perceived level of volatility for each single main revenue item. Revenue elasticity is the change in revenue given a change in the economy. Revenue volatility occurs when there is a mismatch between expected and actual revenues.

When looking at the different city revenues, the exchange of city practices demonstrates that the type of local service provision and its related revenues depend on the political consensus and decisions of each city, which are mostly shaped by historical developments and show a certain path dependency. For instance, a strong difference in administrative culture and thus practices could be observed in this regard in the City of London Corporation and the City of Amsterdam. The City of London Corporation displayed more of a commercial orientation for its own revenues due to the fact that it runs, for instance, an Animal Reception Centre at the Heathrow Airport and thus generates income from the 'Passport for Pets' scheme and other animal health welfare services. In contrast, the City of Amsterdam can only use public buildings for public functions and is thus restricted in its ability to generate revenues from public property.

2.3 General Financial Risk Management for Cities

General financial and operational risk management was a focus of the most recent CEFG Group meeting in Vilnius in November 2019. Strategic differences between Barcelona and Hamburg are noteworthy in this case; while Barcelona builds its financial risk management upon strong financial discipline through accounting and audit, Hamburg concentrates on compliance, fraud prevention and financial resilience capacity.

The insights from the CEFG Group's work confirm that city governments' financial management and financial sustainability is strongly shaped by their varying socio-economic situations, competences, organizational structures, administrative traditions and financial regulatory frameworks, as well as their political and managerial decisions. Despite these differences, comparing local financial management practices across borders is important, as it enriches cities' abilities to address common challenges. With this considered, the next section will introduce the CEFG Group's approach to comparing local financial performance on a European scale using their own unique, standardized system of reporting and comparison.

[4]The financial health indicator 'Financial Autonomy' is defined as the ratio of a city's own revenues total divided by its current revenues. See Indicator 1 in Sect. 3.

3 A Nearly Harmonized Financial Health Template for the Local Government Level

Accounting is a piece of the regulatory framework which consistently influences how local governments perceive themselves and are perceived by others in terms of financial sustainability (Mussari 2014). The CEFG Group represents an interesting and unique cross-border experiment to examine the threats and the opportunities on how to measure and compare the financial health and sustainability of local governments, especially when the accounting systems and bases of information of city governments differ across countries. As a measure to make the comparison of financial sustainability indices possible, the CEFG Group has developed its own financial health template, which will serve as the focus of this section.

3.1 Background Considerations for the Template

Previous research has focused on contrasting the differences between government financial reporting and the information obtained from government statistics, data sets which typically have very different aims and scopes (e.g. Jorge et al. 2014; Dasì et al. 2016). The dichotomy between traditional cash-based accounting and accrual accounting, and the conditions under which these methodologies can be used as effective bases of knowledge, has also been widely discussed (e.g. Lapsley et al. 2009, more recently Caruana et al. 2019). The conclusion of this research is generally that while accrual accounting is preferred, other traditional accounting systems often coexist with it and may even be more useful at times. In addition, there is extensive literature concerning the various techniques and approaches other than accounting that can be used to measure the financial sustainability of a city based on different perspectives of what is relevant and useful (Padovani and Scorsone 2011). Our approach to combining these various streams of research has been affected by four *accounting policy dilemmas*, which we will describe in detail in this section.[5]

Dilemma 1: Government Financial Statistics Versus Government Financial Reporting

The reporting of public finances—city governments included—is at the cornerstone of two competing approaches to accounting: *government financial statistics* (sometimes called *national statistics*) and *government financial reporting*. The accounting system for the former aims to represent the economy and its subsectors as a whole and is therefore macro in nature. The accounting system for government financial

[5]The CEFG financial health template was also presented and applied to other cities in Padovani et al. (2018b).

reporting, by contrast, is more micro in nature, as it is based on entity accounts for which the unit of analysis is a single public sector organization, such as a city government.

These different approaches to compile and use accounting information reflect the interests and objectives of two competing communities: statistic offices on the one hand and a range of private actors, professional standard setters, professional accountancy bodies and audit firms, on the other. In this regard, it should be noted that accounting technologies are often altered when they are transferred from one domain to another (Kurunmäki et al. 2010). This alteration inevitably results in hybridization, where the prevalence of one perspective or another usually reflects political power and governing actions (Mennicken and Miller 2012).

Dilemma 2: Traditional Accounting Systems Versus New Public Management Approaches

For purposes of government financial reporting, the International Public Sector Accounting Standard Board (IPSASB) has provided a set of standards (IPSAS) that are followed by many countries around the world. At the core of IPSAS is the use of accrual accounting, and its adoption in government financial reporting has been considered one of the pillars of the New Public Management paradigm (Hood 1995). As a result, it has become an important goal for public sector organizations, and many city governments have moved towards accrual accounting, even though it presents difficulties for some (Lapsley et al. 2009; Pina et al. 2009). One consequence is that different countries have used contrasting approaches to achieve the implementation of their new accrual accounting systems (European Parliament 2015). Another consequence is that, despite their accrual nature, the new systems are not necessarily improvements for managerial and accountability purposes, mainly because they do not fit with the informational needs of managers and stakeholders (Padovani and Young 2012). The differences among alternative types of accounting systems have not only presented a deterrent to improved city management (Olson et al. 1998; Guthrie et al. 2005), they also have had a negative effect with regard to the quality of information used for decision-making. In Europe, with the exception of the UK and some Nordic countries, municipal governments have introduced accrual accounting without using it for decision-making (Pina et al. 2009). As a result, there has been little incentive to push for high-quality data, so much so that the resulting accrual information produced is poor and impedes reasonable cross-border comparisons.

Dilemma 3: Contrasting Measures of Financial Sustainability in Local Governments

The term *financial sustainability* has a variety of meanings, which has led to a wide diversity of approaches to how audit bodies assess local governments throughout the

world (Padovani 2016). However, it is generally accepted that several measures can be used to assess local governments' financial sustainability (Andersen and Mortensen 2010; Levine et al. 2013). These measures include basic approaches, such as using accounting information and financial reporting analyses (Kleine et al. 2003). In addition, there are qualitative analyses from audit report reviews, annual reports and/or information gathered from discussions or regional workshops (Honadle 2003), as well as more sophisticated statistical modelling approaches (Murray and Dollery 2005).

Overall, there are four generally agreed-upon indicators of financial sustainability: cash solvency, budget solvency, long-run solvency and service-level solvency (Groves and Valente 2003). Cash solvency measures a local government's liquidity and effective cash management and its ability to pay current liabilities; budgetary solvency refers to the ability of the government to generate sufficient revenues to fund its current or desired service levels; long-run solvency refers to the impact of existing long-term obligations on future resources; service-level solvency identifies the ability of the government to provide and sustain the services its citizens want and need. Nevertheless, there is still no general agreement on a set of measures that might be used to assess the financial sustainability of municipalities (Levine et al. 2013), especially when the goal is to make comparisons among cities in different countries and with different accounting systems.

Dilemma 4: The Jurisdiction Perimeter and Consolidation of Accounts

The fourth dilemma relates to what has been called the *jurisdiction perimeter* covered by accounting information. This issue has arisen during the last 20 years with the emergence of a new trend in public service provision, namely, the externalization of public services through corporatization, contracting out, PPPs and privatization (Torres and Pina 2002; Bovaird 2004). This transformation of public service provision has taken place at all governmental levels. A public service can be delivered by a government department, an autonomous entity belonging to the government, or by one or more other jurisdictions. It also can be provided by a collaboration between public entities or between public and private partners or by contracting out the service to a private organization (either a profit or a non-profit entity). Moreover, a public service can be fully privatized, resulting in the complete exclusion of public responsibility (Savas 1987).

When a city government makes use of subsidiaries, the assessment of financial performance and conditions should be extended via a consolidation of accounts to the *municipal group*, i.e. the city government plus its subsidiaries (Grossi 2009). Legal perimeters can differ from operational perimeters in this regard because of differing interpretations among municipalities, which can serve to impede the comparison of municipal financial sustainability performances. Moreover, when considering the accounting differences across different national systems, any attempt towards a valid cross-national comparison becomes extremely complex.

3.2 Accounting Systems Used and the Reporting Perimeter

In order to develop a comparative template,[6] it is first necessary to understand the use of the different types of accounting systems applied in each city government. To classify the different accounting systems, we used the definitions by the International Federation of Accountants (IFAC 2008) and distinguished four systems: cash accounting, modified cash accounting, modified accrual accounting and accrual accounting.[7]

This heterogeneity of the sampled accounting systems created several issues in terms of comparative financial performance. For example, where multiple accounting systems existed, politicians and stakeholders tended to use contrasting information from the different systems to inform their discussions. The result was the use of information more for political than managerial purposes (Van Dooren et al. 2015).

With regard to the reporting perimeter, all but one city had relevant subsidiaries ranging from a minimum of 8–10 (Dublin) to a maximum of 380 (Hamburg). London, which had no subsidiaries, was the only exception in this regard. Not all city governments wanted to collect financial information about their subsidiaries or even record how many of their subsidiaries existed, as they considered this to be outside their legal perimeter. Out of six cities analysed, only three provided a consolidated report of their financial statements.

In overall, the CEFG Group analyses revealed a fragmented patchwork of subsidy accounting, as depicted in Table 2. Information varied from an unknown number of subsidiaries and no consolidated report to a precise list of subsidiaries and the preparation of a consolidated report on their performance on an accrual basis.

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[6] At the time the CEFG Group built the financial health template for 2014–2015, the following city governments were part: Barcelona (ES), Dublin (IE), Hamburg (DE), the City of London Corporation (UK), Milan (IT) and Vienna (AT).

[7] A *cash accounting system* is 'a basis of accounting that recognizes transactions and other events only when cash is received or paid' (IFAC 2008, p. 926); it measures financial results for a period as the difference between cash receipts and cash payments; cash flow statements and cash balances are the most common documents.

A *modified cash accounting system* recognizes transactions and other events on a cash basis during the year, but it also takes into account the unpaid accounts and/or accounts receivable at year's end, since the books are held open for around a month after year end (IFAC 2000).

A *modified accrual accounting system* recognizes transactions and other events on an accrual basis, but certain classes of assets or liabilities are not recognized, e.g. the expensing of all non-financial assets at the time of purchase (IFAC 2000).

An *accrual accounting system* is 'a basis of accounting under which transactions and other events are recognized when they occur (and not only when cash or its equivalent is received or paid); therefore the transactions and events are recorded in the accounting records and recognized in the financial statements of the periods to which they relate' (IFAC 2008, pp. 32–33).

Table 2 Comparing the six city governments' accounting systems and reporting perimeters (as of 2015)

City	Type of accounting implemented and used[a]					Perimeter	
	Cash	Modified cash/ accrual	Accrual (domestic)	Accrual (IPSAS principles)	Other	No. of relevant subsidiaries	Consolidated report (accrual)
Barcelona	●	●		●⊙	●	34	Yes
Dublin			●⊙			8–10	No
Hamburg	●		●⊙		●	380	Yes
London				●⊙		n/a	No
Milan		●⊙	○⊙			18	Yes
Vienna		●	○⊙			Unknown	No

[a]○ implemented and not used, ● implemented and used, ⊙ implemented by law (Ernst and Young 2012)

3.3 Comparing Across the Borders: The CEFG Group's Financial Health Template

Given the heterogeneity of approaches discussed above, it was clear that no single system of the six cities could be used as a template for the others to follow. Rather, there was a need to reach a consensus as to the kind of information that would be helpful to many cities, not just these six, for the purposes of assessing their financial health and comparing it with others. A consensus was developed regarding the following four principles:

1. The need for hybridization of accounting approaches and systems, so as to base the comparison on the accounting information used. For example, the inclusion of cash or modified-cash/modified-accrual information, as they are usually used for public finance regulations.
2. Accrual accounting as the basis for accounting information. However, the representation of accounting information does not follow the regular *profit and loss plus balance sheet* approach. For example, the operating performance statement is a hybridization of the profit and loss and the financial flows caused by current operations, while the balance sheet is replaced and expanded by information contained in the other statements; the ratio is used to present statements that are relevant for decision-makers and, at the same time, contain relevant information to assess financial health.
3. The set of ratios include ten of the most important financial ratios used by city governments to assess their financial performance and condition. These ratios include only financial information and touch on several perspectives: revenue autonomy, balance between revenues and expenditures at different levels, debt burden and sustainability and short-term solvency. Those ratios that are relevant only for specific contexts have not been accepted.
4. Standardized accounting information and ratios present a simplified view. They must be used carefully as they may be influenced by national regulations and contextual differences, such as the inclusion of the pension system and the different type and scope of government (e.g. municipal versus regional).

Hybridization of Accounting Information

The structure of accounting information developed for the financial health template represents a hybridization of several recognized frameworks and principles. These include the European System of Accounts (ESA) and International Public Sector Accounting Standards, as well as the International Monetary Fund (2014) and World Bank (2014) approaches. All of this information is based on accrual accounting standards.

The template comprises the following five financial statements: (1) operating performance, (2) capital operations, (3) financial flows, (4) cash flows and (5) debts. These statements are linked to one another, since the elements used to compute the accounting information need to balance to guarantee coherence of accounting information.

- The *operating performance* (OP) *statement* shows revenues and expenditures generated by current operations. City governments levy taxes, earn revenues from service fees and charges and receive grants and shared revenues from higher-level government authorities. These revenues are used to cover current expenditures, including personnel costs and interest on debt. After these costs of doing business are paid, the amount left over is called the *gross operating balance*, which, after depreciation has been deducted, results in the *net operating balance*.[8] In the case of a positive net operating balance, the amount is available in future years to make additional investments, while a negative net operating balance means that current citizens have not fully paid for the services they received.
- The *capital operations statement* is composed of two subsections. The first, *the capital financial flows* (CF) *statement*, shows the financial flows generated by the disposal of fixed assets, the receipt of capital grants from other entities and other capital revenues designated for the acquisition of fixed assets and/or grants to other entities. The difference between inflows and outflows indicates the capital financial capacity or need. The second subsection, the capital creation or consumption (CC) statement, shows the gross creation of fixed assets which, when reduced by depreciation, shows the net increase in fixed assets.
- The *financial flows* (FF) *statement* addresses two commonly used financial figures in public sector accounting: the net lending or borrowing (computed by adding to the capital financial capacity or need of the capital financial flows statement the gross operating balance) and the overall financial flows (the balance of all financial flows).
- The *cash flow statement* and the *debt statement* report address three important elements of a city's financial situation: cash flows during the year (CS), short-term (or pending) payments (PP) and long-term debts or liabilities (LD).

Each item in the above five statements is accounted for by using accrual accounting, except those included in the capital financial flows (where inflows and outflows are accounted for when the credit or liability arises) and the cash flow statement (where inflows and outflows are accounted for in terms of cash). Where appropriate, each item has a specific definition to help city governments fill in the specific financial item with the expected information. The financial information is provided in relation to the legal perimeter of each city and does not consider any external subsidiaries.

[8]The distinction between net operating balance and gross operating balance is important because some city governments do not account for depreciation.

Key Financial Ratios

The financial statements which have been described are complemented by a set of key financial ratios which can be useful in making financial health comparisons. The ten ratios that emerged from the CEFG Group's work are the following:

1. *Financial Autonomy*. This ratio is designed to answer the question 'To what extent is the city independent from other governments?' It is computed by dividing the city's own revenue by its total revenues. The higher the ratio, the more independent the city.
2. *Overall Financial Flows Balance*. This ratio addresses the question of 'How big (relatively) is the city's overall surplus or deficit?' It is computed by dividing the overall financial flows balance by the current revenue amount. If it is high, future generations will receive benefits from old generations; if it is low, the current generation is paying more than it receives in services.
3. *Net Lending or Borrowing Capacity*. This ratio helps to answer the question 'How big (relatively) is the surplus or deficit generated by current and capital operations?' It is similar to the second ratio but excludes financial operations.
4. *Operating Balance*. This ratio focuses on whether there is a balance between current resources and structural expenditures. It is computed by dividing current revenues by current expenditures and debt repayment (principal) excluding extraordinary repayments. If it is greater than 100%, new capital assets may be purchased in the future without incurring new loans; if it is below 100%, there is a potentially dangerous imbalance.
5. *Cost of Debt*. This ratio shows how much the cost of debt takes from the current economic capacity (current operating revenues). It is computed by dividing the cost of interest and other debt-related costs by current revenues. The lower the ratio, the more a city is able to cover its debt-service obligations.
6. *Debt Repayment Capacity*. This ratio is designed to answer the question 'How does the long-term debt compare to annual current revenues?' Similar to the European Maastricht Stability Pact's Debt/GDP ratio at the national level, it is computed by dividing the amount of debt at the end of the year by current revenues. The lower the ratio, the greater an entity's financial solvency.
7. *Debt Repayment Period*. This ratio addresses the question of how many years it will take to repay the existing debt at the current level of repayment. It is computed by dividing the amount of debt at the end of the year by the city's debt principal repayments (excluding extraordinary repayments). A low ratio means that the city has lower obligations for its financial future.
8. *Debt Pay-Down Capacity*. This ratio indicates the time needed to repay the amount of debt if all of the city's current surplus has been used. It is computed by dividing the amount of debt at the end of the year by the current revenues. The lower the ratio, the faster the debt will be repaid.
9. *Amount of Commercial Debts*. This ratio approximates the length of payment by answering the question 'Will the city encounter difficulty in paying its creditors?' It is computed by dividing the pending payments at the end of the year by

the amount of current and capital expenditures. The lower the ratio, the greater the city's long-term solvency.

10. *Cash Facility Burden*. This ratio addresses the fact than an excessive use of cash (e.g. overdrafts) may be a symptom of short-term solvency difficulties. It is computed by dividing receipts from overdrafts and other cash facilities by current revenues. The lower the ratio, the greater the city's short-term solvency.

Although these ratios define a common set of financial information as accurately and clearly as possible, they are limited in several regards. For example, in some instances, the rules of a central government and any restrictions it imposes, such as an obligation to break even, will clearly have an influence on one or more of the ratios. Similarly, the diversity of local socio-economic situations or the different competencies of different cities cannot always be reflected adequately in the respective ratios. For instance, the operating balance levels (indicator No. 4 of the key financial ratios mentioned above) of Vienna and Hamburg were triple those of Milan as the third highest ranked city. Among other considerations, this difference is due to the fact that Vienna and Hamburg are city-states supported by their regional jurisdictions and they thus manage a larger share of services and functions than the four other cities. In addition, both Vienna and Hamburg include pensions in their current expenditures, which is not the case in the other four cities. Again, this distinction distorts comparative analysis. It is also for this reason that the CEFG Group decided to complement the financial health template with so-called City Portraits that outline briefly the socio-economic background, competences, administrative profiles and financial regulatory limitations of each of the member cities.

From this exercise, some concrete applications and usages of the financial health template serve to point out its benefits for local governments: On the one hand, CEFG member cities very much appreciated being able to use this information internally to better explain their own decisions and financial position to other departments, allowing for better knowledge transfer and local managerial capacity building. Moreover, the insights of the financial health template served and fed directly into discussions of the Working Group on EPSAS (European Public Sector Accounting Standards) of the European Commission and Eurostat, the meetings of which a representative of the CEFG Group was regularly invited as an observer. Informing potential policymaking at the European level from a bottom-up perspective was highly appreciated.

Finally, the template has served well for comparative exercises between three selected local governments in Europe and the USA (Padovani et al. 2018a), in which it was argued that municipal financial viability (possibly identified through the use of the financial health template) could play a role in companies' siting decisions. Thus, the benefits of this approach go clearly beyond (local) government reporting, decision-making or statistics.

4 Conclusion and Perspectives

Cities' successes and financial health depend on how they are managed. In this context, the regulation of local public finances is a key governmental challenge, which varies in every country and must be addressed regardless of whether its structure is centralized or federalized. Still, according to the experience or 'reality' of the CEFG Group discussions, this is not the sole or dominant challenge.

When asked about the influence of different factors on the linkages between the financial management cycle (budgetary and reporting cycle) and the management control cycle (e.g. managerial activity that guarantees that operations are effective and efficient), all CEFG Group member cities admitted that they were strongly influenced by **regulatory frameworks**, as well as **managerial factors** to some degree. All acknowledged that though national or regional rules do have a strong effect, they closely followed or even surpassed by the skills of the (respective) city CFOs, the local government leadership and the existence of a managerial culture within the organizations.

If we observe their work over the last 6 years, this (managerial) factor becomes increasingly relevant, evidenced and decisive in their undertakings. In addition, when looking at an intra-national comparison of cities' financial health and economic progress, this argument is even more valid; some cities (such as Barcelona or Bilbao) are performing better than others comparable in size, socio-economic situation, competences and administrative tradition, despite the existence in principal of the same national legal boundaries. However, they may differ in managerial factors and perform better regarding, for instance, stronger local financial rules for gross savings, the installation of various internal and external accounting schemes, the location of crucial departments such as the budgeting department or the internal control department within the city organigram or the existence of risk analysis and scenario planning.

Correspondingly, excellent local public governance and management are *the* determinant factors for financial health and sustainability. This includes the development of holistic and sustainable strategies at the city level, which are solid, but at the same time flexible organizational structures, as well as reformed and harmonized public sector financial systems.

The CEFG Group is an example of this approach. All member cities—in diverse formats albeit with similar philosophies—consider win-win deal/agreements between politics and management as a must. This so-called 'Politics and Management Deal (PMD)' model or approach, which currently inspires all the CEFG Group cities, can be defined as a comprehensive and structured system that embraces a wide range of tools and concepts including the whole of government and its administration, from management to finance, from definition to execution of strategy, from alignment to innovative and creative orientation and from results-oriented trends and practices to resonant and emotional leadership. The PMD approach stems from and inspires a combination of two schools of thought: Kaplan and Norton's 'Alignment (Kaplan and Norton 2006)—Using balance scorecards' and Boyatzis and McKee's

'Resonant Leadership' (Boyatzis and McKee 2005) where 'High-Performance organizations ensure that the top priorities of the CEO/CFOs are also the top priorities of the employee three times zones away and three management layers below'.

The accounting systems which we have dealt with extensively in this chapter show prominently that an important element in this described setup is feeding in the best information at the right time to the various actors. The more modernized or harmonized with the new international standards the system is, the better it allows its actors to exchange information and to interpret it for further use in decision-making and/or sustainable policy actions. Such established sound performance and management/control systems have improved transparency, accountability and intergenerational equity in the CEFG Group's cities. In the end, it depends on local government leaders who together with their politicians are managing public funds, develop and evaluate strategies to ensure sound (financial) management and accountability for their public authorities and enterprises. The existing knowledge, capacities and skills of their leaders to design public strategies align them with political priorities as well as to 'lead by example' remain the most important success factors of any local government.

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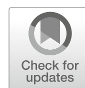
Taking Stock: The Role of the Institutional Context for Local Government Financial Resilience



Iris Saliterer, Sanja Korac, Carmela Barbera, and Ileana Steccolini

Abstract Financial resilience describes the ability of local governments to anticipate, absorb and react to shocks affecting their finances and service delivery. Resilience is the result of interactions in-between environmental conditions (institutional, economic and social context) local governments operate in as well as internal capacities (i.e. anticipatory and coping capacities). This chapter looks on mechanisms of how the institutional context influences local government's ability to anticipate, absorb and react to financial shocks. Drawing upon empirical research on governmental financial resilience, the authors take stock of lessons learned from case studies in eleven countries as well as a large-scale quantitative survey of local governments in three major European economies (Germany, Italy and the UK) following the global financial crisis. The concise overview adds to the understanding of how rules, regulations and (austerity) policies of upper-governmental levels influence different dimensions of local government financial resilience and why the latter may play out very differently within a given country. The findings support a more general understanding of how local governments face shocks and crises and thus may offer initial clues on local government financial resilience in the global COVID-19 pandemic.

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1 Introduction

A healthy financial condition is key to a local government's ability to deliver services in a stable, uninterrupted manner and to meet the demands of its citizens. Public financial management scholars have therefore put forward an abundance of frameworks that are aimed at measuring the financial condition, financial health or, conversely, the fiscal stress of a local government (e.g. Carmeli 2002; Cabaleiro et al. 2013; Zafra-Gómez et al. 2009). Global financial crisis not only hit national governments but also produced risks to the financial condition and service delivery of local governments. Research in the field during the last decade has been dedicated to answering the question of how local governments have reacted to the financial shock of declining revenues and subsequent central austerity measures while facing the challenge of maintaining or even expanding their levels of services (e.g. Overmans and Noordegraaf 2014; Overmans and Timm-Arnold 2016).

The authors of this chapter, together with colleagues, have put forward, explored and operationalized the governmental financial resilience framework throughout a series of empirical studies. The framework captures the (interplay of) external conditions, vulnerabilities and internal capacities that shape financial resilience, i.e. the ability of local governments to anticipate, absorb and react to shocks affecting their finances and service delivery (Barbera et al. 2015, 2017; Davoudi et al. 2013; Linnenluecke 2017; Steccolini et al. 2017; Sutcliffe and Vogus 2003).

Building on previous research on governmental financial resilience, this chapter outlines its dimensions and concisely discusses its relationships. In accordance with the overarching theme of this volume, emphasis is put on the role of the institutional context by taking stock of the findings on how the latter—in particular—influences different financial resilience dimensions and thereby adds to the understanding of why rules, regulations and policies of upper-governmental levels may play out very differently within a given country.

The chapter is organized as follows. In the subsequent section, we briefly describe the background and the evolution of research on governmental financial resilience and present the framework that underpins the empirical studies on the patterns and the various dimensions of governmental financial resilience before describing the latter in more detail. The third section of the chapter then takes stock of lessons learned from various case studies that highlight different patterns of financial resilience found across local governments in eleven countries as well as from a large-scale quantitative survey that was carried out with local governments in Germany, Italy and the UK. The discussion particularly highlights the role and influence of the institutional context (i.e. the system of rules, regulations and policies set by upper governmental levels) on (i) the impact of crises that affect local governments' finances, (ii) vulnerabilities, (iii) anticipatory capacities, (iv) coping capacities and (v) local governments' coping strategies. Conclusions are drawn in Sect. 4.

2 A Resilience Perspective on Financial Shocks

Resilience can be defined as the ability to deal with shocks and uncertainty and to 'learn how to do better through adversity' (Wildavsky 1988, p. 2). The concept of resilience first emerged in the fields of physics and engineering, later also in the field of psychology as well as the social, organizational and management sciences.

It transgressed a 'purely' engineering view of resilience in term of the ability to withstand an external force or shock, to react and absorb the impact in order to bounce back to the situation before the shock. A more evolutionary approach describes individuals, groups or organizations thrive from crisis and bounce forward by anticipation and quick adaptation to new challenges and an altered environment, often *before* circumstances force them to do so, *bouncing forward* (Gunderson and Holling 2002; Hamel and Välikangas 2003). While the concept of resilience has drawn interest from scholars in the fields of disaster management and high reliability organizational science throughout the last two decades, first attempts to apply the resilience perspective to the broader field of (public) management were—surprisingly—made only recently (Barbera et al. 2015, 2017).

In the recent past, local governments worldwide were challenged by various shocks and crises that affected their financial condition and their ability to maintain, or—depending on the type of crisis—alter their service level in order to cope with the consequences. While at the time of writing, economies and societies, business and public institutions struggle to find a way out of the global COVID-19 pandemic, the impact of the global financial crisis and the following austerity policies are still on the agenda of academics and practitioners alike.

Over the last several years, financial management literature has shown a strong focus on the classification as well as the description of different types of reactions to 'the' crisis (CIT) while devoting less attention to the role of internal or organizational contexts, conditions, capacities and histories (or developments over time) (Barbera et al. 2017). Only a few public management studies (e.g. Boyne and Meier 2009; Meier and O'Toole 2009; Meier et al. 2010; O'Toole and Meier 2010) have investigated the role of management capacities in facing shocks, threats, uncertainties, crises or turbulence. Hence, scholars have called for multi-disciplinary approaches or alternative frameworks that may enhance our understanding of the underlying processes and capacities which allow governments to anticipate and respond to crises (e.g. Bozeman 2010; Pandey 2010; Grossi and Cepiku 2014).

The authors of this chapter and colleagues from an international network of researchers have responded to this call and, throughout a series of empirical studies, proved the conceptual lens of resilience. This work is useful in contributing to and integrating the perspectives offered by different streams in literature having sought to explore, describe und understand how governments deal with shocks and crises affecting their financial condition and service level over time (Barbera et al. 2015, 2017, 2019; Steccolini et al. 2018).

2.1 Evolution of (Empirical) Financial Resilience Research

The first study that took a resilience approach in exploring the capacity of a government to face and absorb external shocks affecting public finances (Barbera et al. 2015) drew upon case studies of English municipalities in the aftermath of the global financial crisis. The contribution emphasized that governments need to combine different capacities and reactions to be financially resilient in the context of (external) shocks, which affect their finances. As such, the authors proposed a framework that captures the ‘logic’ of bouncing back (e.g. by increasing taxes and fees; deferring investments; reducing the costs, scope or size of the organization; and selling assets; see Barbera et al. 2017; Steccolini et al., 2017) and bouncing forward (e.g. by transforming and repositioning, redefining the modes of service delivery and core activities, improving existing services or supplying new ones).

A following study that extended the financial resilience approach to 12 European local governments across three European countries with different administrational traditions (Barbera et al. 2017). This study delivered a more nuanced view on the interplay of different resilience dimensions (see Fig. 1) and identified five main *patterns of financial resilience*: self-regulation, constrained or reactive adaptation and contented or powerless fatalism. The multiple case studies identified and operationalized the dimensions of financial resilience and highlighted that the patterns are the result of the interplay and development of different internal and external dimensions over time. Consequently, the financial resilience framework (Barbera et al. 2017, 2019) proved useful not only in considering the actions and

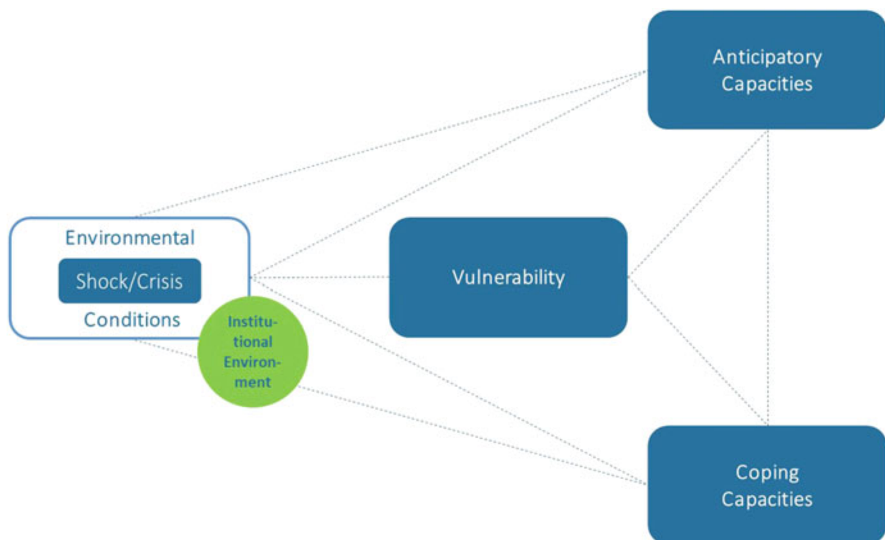

Fig. 1 Governmental financial resilience, dimensions and relationships (Barbera et al. 2017; Steccolini et al. 2018)

reactions to shocks and crises but also in capturing the capacities needed to cope. The empirical findings emphasized that the environmental conditions that (local) governments operate in and the internal capacities (i.e. anticipatory and coping) already in place are relevant dimensions to understand how these entities respond to shocks and crises and address their vulnerabilities. Further support for the financial resilience framework was provided through an edited volume (Steccolini et al. 2017), which presented evidence from 45 local government case studies across eight European and three non-European countries (i.e. Austria, the UK, France, Germany, Greece, Italy, the Netherlands, Sweden) and three non-European (Australia, Brazil, Michigan, the USA) on how local governments were affected and how they were able to anticipate, absorb and respond to shocks. This larger study consolidated previous research and revealed similar resilience patterns across countries; however, not all patterns can be found in each country, but each pattern can be found in more than one country (Steccolini et al. 2017).

The main organizational capacities identified across the case studies are anticipatory and coping capacities and were later operationalized through a survey, which was conducted between 2017 and 2018 across over 600 municipalities in Germany, Italy and the UK (that provided the basis for a financial resilience toolkit available in Steccolini et al. 2018). In contrast to the previous findings from multiple case studies, the stratified sampling in this large-scale quantitative survey assessed the make-up and the level of financial resilience dimensions, as well as their relation to financial and non-financial local government performance within and across three European countries. It also traced some interesting differences in local government financial resilience between the surveyed country contexts (Steccolini et al. 2018; Barbera et al. 2019).

We will go into more detail on the findings from the qualitative and quantitative studies and particularly emphasize the role of the institutional context (i.e. the system of rules, regulations and policies set by upper governmental levels) in section four. The following sections, however, first present the framework that underpins the empirical studies and contain a more detailed description of the dimensions of governmental financial resilience.

3 Resilience Framework and Dimensions

Governmental financial resilience is the result of the interaction between environmental conditions and internal capacities (see Fig. 1). Table 1 provides an overview of the financial resilience dimensions (i.e. environmental conditions, shock and crisis, vulnerability, anticipatory capacities, coping capacities).

It is important to stress the dynamic aspects of this framework, which—depending on the research design—not only assesses the types and level of resilience dimensions and investigates their relationships as well as their impact on organizational outcomes (i.e. performance, strategies) (see Steccolini et al. 2018; Barbera

Table 1 Dimensions of governmental financial resilience defined (Barbera et al. 2017; Steccolini et al. 2018)

Dimension	Definition
Crisis	Shocks and crises are events that have significant impact on (local) government finances and service delivery and vary in their nature, likelihood, timing, scale and potential impacts. The impact of a shock or crisis can be direct, e.g. eroding tax bases, or indirect, e.g. due to changes in central government policies as a response to crisis. Crises act as a 'magnifying glass' that allows to identify and explore the dimensions of financial resilience and their interplay
Environmental conditions	Environmental conditions comprise the institutional, economic and social context in which local governments operate. The context may be characterized by varying levels of munificence, dynamism, complexity and/or predictability. These conditions not only influence the level and sources of vulnerabilities but may also amplify or buffer shocks and crisis
Institutional context	The institutional context encompasses the system of (fiscal and financial) rules, regulations and policies set by upper governmental levels and under which local governments operate
Vulnerability	Vulnerability represents the exposure to (potential) shocks that may affect local government finances, and service delivery is the result of external (e.g. low financial autonomy, undiversified or unstable revenues) and internal (e.g. high debt level, low level of reserves) sources. Being at the interface between the environment and the organization, it can be influenced by both (i.e. by environmental conditions or anticipatory and coping capacities). The sense of being able to control the vulnerability and/or influence its sources affects the way shocks are interpreted and subsequently tackled (Maher and Deller 2007, 2011; Jimenez 2012; Barbera et al. 2017)
Anticipatory Capacities	Anticipatory capacities refer to the availability of tools and capabilities that enable local governments (a) to better identify and manage their vulnerabilities and to recognize potential financial shocks before they arise and (b) to understand their nature, likelihood, timing, scale and potential impacts. Anticipatory capacities are not limited to the presence of tools that allow to plan and monitor the environment and systems that assist in identifying and managing vulnerabilities as well as in controlling and managing risks. They encompass also cognitive capacities such as critical thinking, situation awareness and sense-making (e.g. Lengnick-Hall and Beck 2005; Weick and Sutcliffe 2006; McManus et al. 2007; Somers 2009; Boin et al. 2010; Linnenluecke and Griffiths 2013), as well as organizational (or organizational leaders') behaviour such as information exchange, information sharing and monitoring. The cognitive and behavioural capacities are enhanced by the existence and quality of technical anticipatory capacities (tools and systems), which, in turn, can be built up internally driven (as an effort of the local government itself) or externally driven (e.g. instruments required by upper governmental levels) (Barbera et al. 2017; Steccolini et al. 2018)
Coping capacities	Coping capacities refer to resources and abilities that enable local governments to face shocks and manage their vulnerabilities. Coping capacities lie dormant during times of order and are activated during times of crisis. The underlying capacities which enable local governments to cope (i.e. buffer, adapt, transform; see Barbera et al. 2017) include the ability to learn and

(continued)

Table 1 (continued)

Dimension	Definition
	apply new knowledge (adaptability), to adopt timely (rapidity of action) and innovative responses by putting together collective expertise and the possibility to rely on internal and external collaboration (Barbera et al. 2017; Steccolini et al. 2018)

et al. 2019). In addition, it identifies and captures different resilience patterns (Barbera et al. 2017; Steccolini et al. 2017).

4 The Role of the Institutional Context in Shaping Financial Resilience: Taking Stock

This chapter summarizes the lessons learned from various case studies that highlight different patterns of financial resilience found across local governments, as well as from a large-scale quantitative survey that was carried out with local governments in Germany, Ital, and the UK ($n = 600$). We put particular emphasis on the role of the institutional context (i.e. the system of fiscal and financial rules, regulations and policies set by upper governmental levels) in influencing (i) the impact of crises that affect local governments' finances, (ii) (financial) vulnerabilities, (iii) anticipatory capacities, (iv) coping capacities and (v) local governments' coping strategies. In accordance with the overarching theme of this volume, we do not consider broader political and administrative aspects, which influence the autonomy of local governments (see Ladner 2017 and Ladner et al. 2016).

Our previous case-study-based research on governmental financial resilience described above specifically looks at the global financial crisis as a major unexpected event of shock and crisis. While the financial crisis affected most countries in one way or another, the effects on local governments were not uniform, with some affected immediately and/or more substantially than others (see Wortmann and Geissler in this volume; Steccolini et al. 2017; Geissler et al. 2019).

This differing *impact* was partly due to the proximity of the crisis, the effects of pre-existing fiscal profiles and fiscal (intergovernmental) arrangements (i.e. the structure, basis and controllability of major revenue sources, debt rules, investment guidelines, tax limits) as well as national coping policies. For example, local governments in several countries (e.g. France, the UK, Italy, Greece, the Netherlands) had to deal with national governments intentionally *cutting back or delaying subnational transfers/grants* as a response to the financial crisis. In other countries, where a large share of local government revenues is based on (fixed) intergovernmental tax arrangements, a general decrease in major taxes (e.g. centrally collected value-added tax, income tax) automatically led to a reduction in revenues at the local government level in varying degrees (e.g. Austria; Michigan, USA). Such reductions were even more problematic in *contexts* where the *local level's fiscal autonomy*

(level of own revenue sources, tax base, tax scope) was described as *low* and *strict spending limits* as well as *debt rules* were in force, which put great pressure on local governments (e.g. the UK, Italy). The latter was particularly true for local governments where crisis-related factors (e.g. rise in unemployment, drops in home ownership) automatically triggered expenditure increases in areas where local governments are directly responsible, such as social care services (e.g. Italy). There were only a few cases in which the rise in expenditures was buffered through increased grants from the national level (e.g. in Sweden). More often, they had to be borne by local governments themselves (Italy, Germany), which even led to a decrease in own revenues (e.g. local taxes) and/or transfer payments.

Across cases, the sources as well as the level of financial vulnerability have strongly been influenced by *financial autonomy* (i.e. level and controllability of own revenue-shares). Particularly the *low flexibility in revenues* due to *tax limits* on, or removal of, local taxes mandated by upper government levels (e.g. in Australia, France, Germany and Italy) were identified as main *institutional challenges* that decreased the controllability of a local government's own funding stream and constrained its possible revenue-related responses or coping strategies. The perceptions of these specific sources of financial vulnerability prompted some local governments to take efforts to become more self-sufficient (e.g. cases in the UK) and therefore less dependent on central government grants to deal with (potential) shocks and crises.

The (more recent) quantitative survey of local governments in Germany, Italy and the UK provides support for the above-mentioned findings from the qualitative case studies. However, in addition to the global financial crisis, it highlighted the refugee influx and Brexit as major events impacting local governments' finances and service delivery between 2015 and 2017. Interestingly, it revealed that *changes in regulatory regimes* (e.g. changes in tax base, task devolvement) were among the highest rated external *shocks* or challenges in all three countries, peaking in Italy (Barbera et al. 2019). As such, unexpected or unforeseen changes in rules, regulations and policies (i.e. *changes* in the *institutional context*) *themselves* may even be perceived as *external shocks*.

Local governments examined mainly referred to the (negative) *impact of fiscal rules and regulations* on their financial autonomy as well as the challenges related to *centrally induced austerity measures. However,* local governments also mentioned the *uncertainty and dynamism related to central policies, rules and regulations* (in response to a crisis) as factors influencing not only their vulnerability but also their options in reacting to or coping with shocks and crises.

The presence of *anticipatory capacities* (see definition in Table 1) turned out to be a crucial factor, which allowed local governments to better anticipate and deal with challenges related to the uncertainty and dynamism of the *institutional context*. Strong anticipatory capacities were expressed by a high awareness of the local government's special sources of vulnerability or potential risks and cautious planning by both the political and administrative decision-makers. Instruments like embedded medium-term financial planning (i.e. with an actual impact on planning processes and annual budgets), risk assessments, long-term investment plans,

monitoring and control processes or scenario analyses supported local governments' capacity to anticipate developments. In consequence, they are better prepared for and able to cope with potential shocks and crises that could affect their financial condition and service delivery (see Korac et al. 2017). As such, anticipatory capacities are not only key to identify potential shocks and their consequences but also crucial to understand the government's different vulnerabilities as well as strategies to address them.

Along these lines, it seems that in some contexts, *regulations or guidelines* (e.g. mandatory monitoring systems) may have *fostered* the institutionalization of stronger *capacities* across cases that better equipped local governments *to anticipate* possible shocks (e.g. the UK, the Netherlands). Others demonstrated reverse effects (e.g. Brazil, Greece), where non-existing regulations or non-mandatory guidelines accounted for the anticipation of potential shocks and crises were seen as a matter of local governments' own efforts and (investments in) tools (Steccolini et al. 2017). Consequently, in some of those local governments, we found relatively fewer tendencies to take a proactive stance in building and developing comprehensive anticipatory capacities. In this regard, it is imperative to draw attention to the relationships between the dimensions of governmental financial resilience: all of the case research as well as statistical analyses suggest that *anticipatory capacities* and *coping capacities* are *complementary and reinforce each other* (see also Barbera et al. 2017). A comprehensive set of tools and systems, as well as decision-makers' awareness and sense-making—which reflect strong anticipatory capacities—proved to be important prerequisites for successfully coping with shocks and crises, i.e. being able to either buffer the impact or able to adapt or transform strategies in response to a crisis.

As Table 1 shows, *coping capacities* refer to resources and abilities that enable local governments to face shocks and manage their vulnerabilities (see definition in Table 1). While buffering capacities allow local governments to absorb shocks without changing structures and functions (e.g. through the use of reserves, by increasing debt, through a temporary reduction of services, or an increase in fees and charges), adapting capacities allow local governments to (quickly) implement incremental changes in their structure and functions (e.g. organizational restructuring, increasing collaborations/partnerships, task reviews, re-targeting services) to cope with shocks. Transformative capacities, however, comprise local governments' ability to implement radical changes (e.g. change relationships with society, change the local government's (economic) profile, develop/tap alternative main income sources, mergers, service-model reinvention) in coping with shocks, which results in fundamental changes to the local government's function, structure or even goals and values. While buffering may be used to quickly return to the status quo, it may also serve as a basis for implementing adaptive and/or transformative strategies (e.g. using reserves to implement changes in service delivery instead of covering eroding tax revenues). Consequently, buffering, adapting and transforming strategies may comprise a mix of financial, organizational and/or service-related measures. However, a glance at the examples of coping capacities already shows that

the institutional context (rules and regulations) may foster, or inhibit, the variety and scope of a local government's coping capacities.

However, this does not mean that strong anticipatory (or coping) capacities automatically act as a shield against crisis. There is compelling evidence of the role of the institutional context as a catalyst or amplifier for the impact of a shock or crisis, thereby shaping local governments' specific vulnerability sources and influencing the range as well as the intensity of possible (fiscal) responses. Cases from European and non-European countries show that the financial crisis led to a *reduction of transfers* from upper government levels (Saliterer et al. 2017; Steccolini et al. 2017, see also Ladner 2017), while obligations to deliver services remained the same or even increased. The latter however, rather than being attributable to the financial crisis alone, reflects a more general trend across countries, with local governments perceiving themselves increasingly deprived of the resources needed to maintain let alone expand their service level (see Ladner et al. 2016). In particular, in the multiple case studies in Austria, Italy, Germany, and the UK, local government decision-makers pointed at the challenges associated with the devolvement of tasks/ service responsibilities from the central or regional to the local level with inadequate or no funding at all (Korac et al. 2017; Papenfuß et al. 2017).

Nevertheless, some features of the institutional context were insufficient to explain the observed differences in resilience patterns within a country: although faced with a similar institutional (though not economic or social) context, local governments followed different paths in dealing with crisis. Some took a more proactive or adaptive stance with internal capacities playing a key role in addressing and managing vulnerabilities (capacity-driven patterns). In others, the financial crisis seemingly exceeded the threshold of local governments' existing capacities, which led to a perception of powerlessness and forced fatalism, while still others mainly relied on pre-existing wealthy environmental conditions, which made them less vulnerable to the financial crisis (context-driven patterns). Positioned at the interface of the environment (institutional, economic and social context) and the organization (organizational capacities, i.e. anticipatory and coping capacities), our research revealed that *vulnerability* was a *key factor* in explaining *resilience patterns* (see also Barbera et al. 2017).

5 Conclusion and Outlook

There has been a long-standing interest in the financial condition, financial health or, conversely, the fiscal stress of local governments. However, academia has—until recently—rarely answered the calls in literature to explore the wider complexities and nuances of responses to crises. Those answers should not only focus on political and policy perspectives but also provide a greater understanding of institutional effects and organizational practices, how these are changed and implemented and the outcomes they deliver (Boin et al. 2010; Lodge and Hood 2012; Peters 2011). Building on the concept of resilience, the authors of this chapter, together with

colleagues, have put forward, operationalized and refined the framework of *governmental financial resilience*, which captures the environmental conditions (institutional, economic and social context) that local governments operate in as well as their internal capacities (i.e. anticipatory and coping capacities). These give rise to different patterns which anticipate, absorb and react to shocks and crises that affect the finances of local governments.

Taking stock of the findings and lessons learned from 45 case studies from 11 countries worldwide, as well as from a large-scale quantitative survey, this chapter highlights the role of the institutional context (i.e. the system of rules, regulations and policies set by upper governmental levels) in enhancing or limiting (i) the impact of crises that affect local governments' finances, (ii) vulnerabilities, (iii) anticipatory capacities, (iv) coping capacities and (v) local governments' coping strategies. The chapter therefore adds to the understanding of why rules, regulations and policies of upper-governmental levels may play out very differently within a given country.

The findings reported in this chapter draw attention to the role of internal capacities (*anticipatory and coping capacities*) in identifying and managing a local government's vulnerabilities, identifying shocks and crises before they arise and taking actions or pursuing coping strategies in order to respond to shocks and crises by buffering, adapting or transforming in order to maintain, re-gain or attain a certain financial condition and maintain or expand their service level. However, it also unearths important findings regarding the *institutional context*: (centrally imposed) rules and regulations may prompt local governments to build and strengthen anticipatory capacities, but at the same time, fiscal frameworks and central policies such as austerity may drain local governments' coping capacities in fiscal (both on the revenue and the expenditure side), financial and service-oriented terms. Consequently, they may be able to anticipate and detect financial shocks early, but exhausted structures and tools for coping (e.g. financial reserves, efficiencies) will hamper precautionary measures, leaving local governments more financially vulnerable in a time of uncertainty and increasingly complex demand. This reflects the important role played by central policies in affecting local finances and services, as well as issues related to the devolution of tasks and administrative responsibilities to the local level which have taken or are taking place in several of the country contexts (see also Ladner 2017).

However, *(initial) research on governmental financial resilience* has specifically looked at how local governments anticipated and coped with the *global financial crisis*, showing that fiscal rules and regulations (i.e. the institutional context) have (has) a direct effect on the range as well as the intensity of *financial* measures or responses but not necessarily on organizational/service-related measures. Here, we expect that the current *global COVID-19 crisis* will more immediately impact local governments' modes of *service delivery*.

While the ongoing COVID-19 crisis has hit local governments by surprise, in applying the lessons learned from research on governmental financial resilience, we suggest that those local governments able to build on strong *anticipatory capacities*, such as monitoring, (external) information exchange, (internal) information sharing

and critical thinking, will more likely show a high level of awareness associated with the uncontrolled spread of the virus and its impact. First impressions from media reports show that early awareness of the latter was accompanied by a more proactive behaviour (e.g. cancellation of events, visitor guidelines and lockdowns in elderly care homes) in the early stages of the crisis. This observation is in line with the findings on capacity-driven patterns that characterize local governments with a proactive or adaptive stance (see above) among the case studies conducted in the aftermath of the global financial crisis.

When COVID-19 hit, strong *coping capacities*, such as human adaptability, quick action and internal and external collaborations, facilitated a quick response in certain local governments. The public sector staff quickly switched to remote work, made enhanced use of ICT to deliver public services and created an association of networks, voluntary organizations and other local actors to provide services (e.g. home shopping for elderly people, telephone hotlines for psychosocial support) in a timely manner. However, maybe even more than the financial crisis of 2007 to 2009, the current COVID-19 crisis highlights the importance of the *institutional context*, which may facilitate local governments' ability to deal with the crisis by offering prompt and clear information, loosening tight fiscal rules or moving away from austerity policies and even offering financial support (OECD 2020). Given that this specific crisis requires not only innovative fiscal and financial responses but also fundamental changes of *service delivery models*, it opens up a window of opportunity to shed light on further refining dimensions of governmental financial resilience. These include *social capital*-related aspects such as *intergovernmental relations and trust.* Moreover, *trust by and support from citizens* gains relevance. Be it as initiators of and participants in community actions or as co-producers of preventive measures (e.g. complying with rules).

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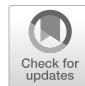
Local Government Tax Structure



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Abstract Designing the system of local funding implies the allocation of different tax sources to local governments. This challenge is of particular interest in times of economic recession since tax revenues can stabilise local revenues and therefore limit the need of fiscal regulation. International organisations promote a shift from labour taxes towards less growth-deteriorating consumption taxes. The recommendations for local governments aim at an increase of property taxation, which yields rather stable revenues over the business cycle. At first glance, this advice seems to describe a path of optimisation, minimising adverse economic effects and providing local governments with more reliable revenues. From this starting point, we analyse local tax structures across Europe with Eurostat data from 2004 to 2018. This study reveals that in times of economic slowdown, the share of potentially more growth-deteriorating local income tax revenue increased relative to the share of consumption tax revenue. Moreover, revenue from the current local tax basket is quite dependent on cyclical variations. Both imply that there is room for improving local government tax structures. However, although there are criteria for an optimal local tax structure, revenues should match the set of public services. As local governments provide quite heterogeneous sets, there is no one-size-fits-all solution.

1 Introduction

As local governments deliver a substantial share of public services in all European countries, the question of funding is essential. In general, local governments can build on grants, fees and taxes. All of them have pros and cons, and even the funding

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structure itself comes with consequences. Local taxes in particular are of high relevance, as they provide local governments with larger room of flexibility and autonomy. Due to the recession across Europe starting in 2008 and its fundamental consequences for government finances, academic and practical interest in optimal tax structures has increased over the past years. One approach to stimulate economic growth and revitalise labour markets was to dismantle excessive tax burden from employment and business activities (Brys et al. 2016; Mathé et al. 2015; European Commission 2015). In 2020 and the years to come, the COVID-19-related economic downturn will lead to renewed strain on public budgets at all levels of government. To find appropriate answers for local governments, it is crucial to analyse the impact of the previous crisis on their tax revenue situation and to draw conclusions for optimised tax structures in the future.[1]

According to optimal tax theory, the optimality of tax structures is different for local and central governments for at least two reasons: First, local government functions are different from those covered by the central government. Second, the taxation capacity of local governments is often more limited. For local government taxation, optimality criteria ground on sustainability and the ability to finance locally demanded public services. However, also at local level, these criteria have to be balanced with the requirement to keep local citizens and business free from growth-detrimental tax-induced behavioural incentives.

From this perspective, it is particularly interesting to examine how the European local governments' tax structures have changed during the past years. This chapter considers those changes in the context of economic fluctuations during the period from 2004 to 2018. The main observation is that in times of strong economic growth, consumption tax revenues increase relative to revenues from income taxation.[2] When the economy deteriorates, we observe the opposite development. One explanation for this is that economic downturns trigger changes not only in tax rates but also lead to tax reforms. Considering the bad fiscal situation of many European local governments due to COVID-19, a new wave of reforms of their finances is quite likely. Hence, this paper contributes to the empirical literature on local government tax structures in times of economic crisis.

Another finding is that tax revenues of European local governments fluctuate with the economic cycle. This calls for a stronger focus on more stable tax bases like property and supports tax reform recommendations of major supranational institutions like the OECD or the United Nations (OECD 2019a; UN 2009). The argument of revenue volatility links our analysis to the topic of this book since volatile revenues destabilise local government budgets and increase the risk of deficits. Local government fiscal regulation can be an alternative to the more fundamental

[1]This chapter deals with optimal taxation at the local government level. Following the ESA2010 convention, local governments in unitary countries are all governments below the central government level (European Commission 2013). In federal countries, local governments are all governments below the intermediate regional level. Hence, the employed concept of local governments in this chapter includes mainly municipalities but also counties, districts, etc.

[2]See Annex 2: European system of accounts (ESA) 2010, tax classification (European Commission 2013).

reform of tax structures.[3] At the same time, the configuration of local taxes is an essential part of local public finance regulation by itself.

This chapter is structured as follows: Part 2 provides a brief theoretical discussion on the optimality of local government tax structures; Part 3 presents the empirical analysis of Eurostat local government revenue statistics, and in Part 4, findings are discussed.

2 Optimal Taxation at Local Government Level

When writing about optimal taxation at local level, one must answer the question of what “optimality” means in this context. The idea of an optimal redistribution of income and wealth may be misleading, because social preferences for distributional outcomes can differ between societies and potentially also between local communities. In addition, local governments are poorly set up to achieve redistributive goals, because those who try to redistribute set an incentive for wealthier citizens and businesses to evade such redistribution (Glaeser 2013). For similar reasons, local governments should not engage in stabilisation policy. Instead, they can realise welfare gains by focusing on the provision of local public services corresponding to their citizens’ unique set of preferences (UN 2009).[4]

Since access to finance should be consistent with functional responsibilities, unfunded mandates are inadvisable, and revenue sources need to be decentralised, too (OECD 2019a). Local governments indeed seem to work best when residents self-finance local services on the basis of benefits received (Bird 2000; Geys et al. 2010). Ideally, the funding system comprises grants (in particular for services with service benefit spill-overs to other jurisdictions), tariffs and fees (for services with private good characteristics), tax revenues (for services with public good characteristics and those which redistribute income) and property income in a composition that matches the set of provided services (UN 2009).

2.1 On the Optimality of Dominant Tax Types

Adam et al. (2011) point to four characteristics of a good tax system for any given distributional objective and macroeconomic situation. First, negative effects of the

[3]Noting however that, for example, balanced budget rules may be problematic from a service delivery aspect if the revenue base is very volatile.

[4]Since the seminal contributions of Tiebout (1956) and Oates (1972), the fiscal decentralisation debate argues for re-assigning expenditure functions (and revenue sources) to lower tiers of government (see, e.g. De Mello 2000). Following Oates’ decentralisation theorem, local governments can provide public goods in a more efficient manner since they are closest to the citizens, which allows them to tailor services corresponding to their preferences.

tax system on welfare and economic efficiency should be minimised. Second, a good system causes low administration and compliance costs. Third, it should avoid discrimination and, fourth, it should be transparent so that taxpayers understand where their money goes to and for what the government uses it. Simple, neutral and stable tax systems provide favourable conditions to achieve these outcomes. Optimal taxation theory strives to identify a system that balances efficiency losses (and, in a wider perspective, administrative costs) against the local government's need to raise revenue. When evaluating different taxes within this concept of optimality, those taxes appear to be desirable that yield sufficient and stable revenue, cause less economic distortions and are easy/cost-efficient to collect. Moreover, an optimal tax should allow for horizontal equity and be easily relatable to distinct government services.

Corporate and Private Income Taxes

From a theoretical standpoint, corporate and private income taxes (CIT, PIT) can change incentives for economic agents in a quite fundamental way, no matter which government level levies them. Taxation of business income influences investment decisions by reducing after-tax return; this has adverse effects on productivity and long-term growth (Mathé et al. 2015). Taxation of private income instead impacts the labour market supply side by changing household decisions over the intensive and extensive margins of work and the demand side by altering firm decisions on the utilisation of labour as productive factor (Åsa 2016). Moreover, it may also affect investment in human capital by changing expected return to education (Mathé et al. 2015). One more argument is that the relation of corporate and personal income tax rates can foster (or deteriorate) entrepreneurial risk-taking (Lee and Gordon 2005). Empirically, corporate income taxes seem to be more detrimental to economic growth than personal income taxes (Arnold et al. 2011). However, much depends on the concrete tax rates. As Atkinson and Stiglitz (1976) showed in their seminal work, an optimal direct tax (like a PIT) can render indirect taxation (like a VAT) superfluous.[5] This theoretical result, however, neglects administrative costs or the risk of evasion. In practice, income taxes have high collection costs and are easy to avoid (Salanié 2011). From the perspective of local governments, taxation of income may seem particularly unappealing due to the fear of repelling business and wealthier individuals (Glaeser 2013).[6] However, when it comes to financing, public services with redistributive character like social housing or health services, some income-related local taxes like a surcharge on a national PIT are considered appropriate, because funding such services requires access to a relatively large tax base (Table 1). But still, since personal and especially corporate income taxes vary with the business cycle, they do not necessarily provide stable revenues. Hence, from the above-described perspective of optimality, except for services with redistributive character, income taxes do not seem to be the best choice when designing a tax

[5]For a comprehensive discussion of optimal taxation theory, see Salanié (2011).

[6]However, mobility of tax bases can have beneficial effects like efficiency gains and sorting of taxpayers, if preferences on the tax-service mix are heterogeneous.

Table 1 Tax assignment across levels of government

National	National/provincial	State/provincial	Local	All levels
Customs VAT CIT Resource rents/ profits Wealth/ Inheritance Carbon	Personal income taxes (residence based) Payroll taxes Excises on alcohol and tobacco	Single stage sales taxes Motor vehicle registrations Business Royalties Conservation charges	Property taxes Land taxes Betterment/ frontage charges Surcharges on PIT Parking fees	Sin taxes Taxation of bads (environmental pollution) Poll taxes User charges

The table shows appropriate tax types for each government level (OECD 2019a, p. 146)

system for local governments.[7] Table 1 provides an overview of appropriate taxes for each level of government.

Consumption Taxes

Prices for consumption goods are signals that guide the decisions of consumers, producers and workers. By driving a wedge between those prices paid by the buyer and those received by the seller, value added taxes (VAT) disrupt this signal, expose market participants to changing behavioural incentives, reduce quantities exchanged on the market and impose losses on both parties (Adam et al. 2011). In addition, consumption taxes can change labour-supply by decreasing the after-tax real wage (Åsa 2016). Although consumption taxes do not discourage savings and investments, experts discuss them as being distortionary to economic growth, too (however, less detrimental than income taxes). Locally set consumption taxes suffer from the same shortcoming as income taxes: consumers may just go shopping elsewhere, which would harm the local economy. Moreover, they are relatively costly to implement since decentralised sales transactions are not easy to monitor for a local government (Glaeser 2013). In practice, some minor consumption taxes like tourist taxes are rather common at the local government level.

Property Taxes

Free from the distortion by changing behavioural incentives is the taxation of economic rents that arise when a resource generates a high return relative to its next-best use. Since rent is commonly associated with the return to land (Adam et al. 2011), this makes a good argument in favour of property taxation. Governments levy property or real estate taxes on land, buildings or other physical capital like machinery (OECD/KIPF 2016). Due to their association with the location of the tax base, they have strong historical ties to local taxation (Adam et al. 2011). Moreover, property taxes show a close link between paid taxes and locally provided public services like the maintenance of the road leading to the dwelling and are therefore

[7]While transfer systems are not the topic of this paper, it should be noted that volatility of local government tax bases (and vertical fiscal gaps) can be at least partly solved with a transfer system that equalises both spending needs and revenue potential.

well suited for public services with public good character (OECD/KIPF 2016, UN 2009). In addition, property taxes do not seem to respond to the business cycle, which makes them a relatively stable revenue source for local governments (OECD/KIPF 2016).[8] Especially the tax on immovable property is considered efficient since the tax base is immovable and inelastic, which makes taxation hard to evade. The ownership of land, for example, is attractive to tax since the owner cannot move it elsewhere (Adam et al. 2011; Glaeser 2013). Less efficient is the taxation of physical capital where changes of tax policies are prone to discourage investment decisions (OECD/KIPF 2016). That is, taxing real estate instead of land may create incentives not to add value by building up (Glaeser 2013). Although economic arguments on property taxation are strong and widely accepted, implementing them is usually complicated because they are quite unpopular among citizens.

As for the fiscal federalism aspect of tax assignment across levels of government, the usual recommendation is that subnational government tax revenues should be mainly based on land or property taxes and user fees (Boadway and Tremblay 2012; Bahl and Bird 2018). But if the service menu consists of services with high spending needs, and if subnational governments are expected to finance a considerable share of their spending from their own revenue sources, it is likely that property tax bases and other user charge type of revenues are not sufficient to cover adequate levels of own revenue. In that case, subnational governments should be given some broad residence-based tax bases such as income tax, payroll tax or sales tax.

Each of these taxes, if given to subnational governments with some power to decide on tax rates, can have the explained side effects to mobility of households, business location and shopping. To avoid unwanted effects, it is usually recommended that subnational governments are given powers to choose rates but not to freely adjust tax bases. If subnational governments were able to adjust tax bases and set tax rates, the national redistributive objectives and equity of taxpayers in different subnational governments could be compromised. There would also be potential problems with vertical tax externalities[9] (Boadway and Tremblay 2012). Other taxes suitable for subnational governments include resource royalties, conservation charges, sin taxes, motor vehicle registration taxes, frontage charges and poll taxes (Table 1). In addition, subnational governments may be allowed to piggyback on national taxes on personal income (residence based), wealth and carbon taxes (OECD 2019a).

[8] Volatility depends on the frequency of updating property values as tax base. If it happens annually, property tax revenues decrease (c.p.) during a recession with falling property values.

[9] Vertical tax externalities refer to a situation where two or more different levels of government share the same tax base, which may lead to a situation where the different levels of government ignore the effects of their tax rate decision on the tax revenues of other levels of government.

2.2 How Should an Optimal Local Tax Structure Look Like?

Taxation of immovable property seems least detrimental to economic growth, and the property tax base provides an ideal source of revenue for local governments. Although it may be unpopular among citizens, it is relatively easy to levy and relatable to a wide set of local services. Moreover, it provides stable revenues. In addition, there are also some good arguments for the local taxation of consumption and income. A consumption tax like the tourist tax may be appropriate for an easy-to-monitor consumption of locally offered goods. A local income tax may be appropriate if local governments are responsible for local services with redistributive character (education, health, social services). Hence, an optimal local tax structure needs to balance this appropriateness for financing certain services with the described detrimental economic effects. Considering a high variation in the sets of public services provided by local governments across Europe, there is no one-size-fits-all optimal tax structure.

It is no surprise that supranational organisations like the OECD describe property taxes as the preferable instrument to bolster the financial situation of lower-tier governments without causing large negative economic side effects. Following the OECD, a land tax with a uniform tax rate across all types of property and property owners would be most favourable (OECD/KIPF 2016). In addition, the organisation supports a surcharge on personal income taxes for local governments (Table 1). Also, the UN describes property taxes as well-suited for financing local services with public good character (UN 2009). Although the European Commission recommends shifting taxation away from labour to less growth-deteriorating forms (Mathé et al. 2015), it admits that a local income tax is justified in some cases. As we will see later, depending on the concrete tax base, a property tax can be either an income or a consumption tax.

3 Local Government Tax Structures Across Europe

3.1 Local Governments' Tax Revenue

Given the discussion about tax structures at local government level, it is relevant to ask how the European local level governments' taxation structure has changed during the past years. This section considers those changes in the context of the economic fluctuations from 2004 to 2018.[10]

At the beginning, some technical aspects: First, by taxation structure we mean proportions of consumption and income taxes in total taxes. As defined by the

[10]That period was chosen because there is comparative data available for all European countries in the sample.

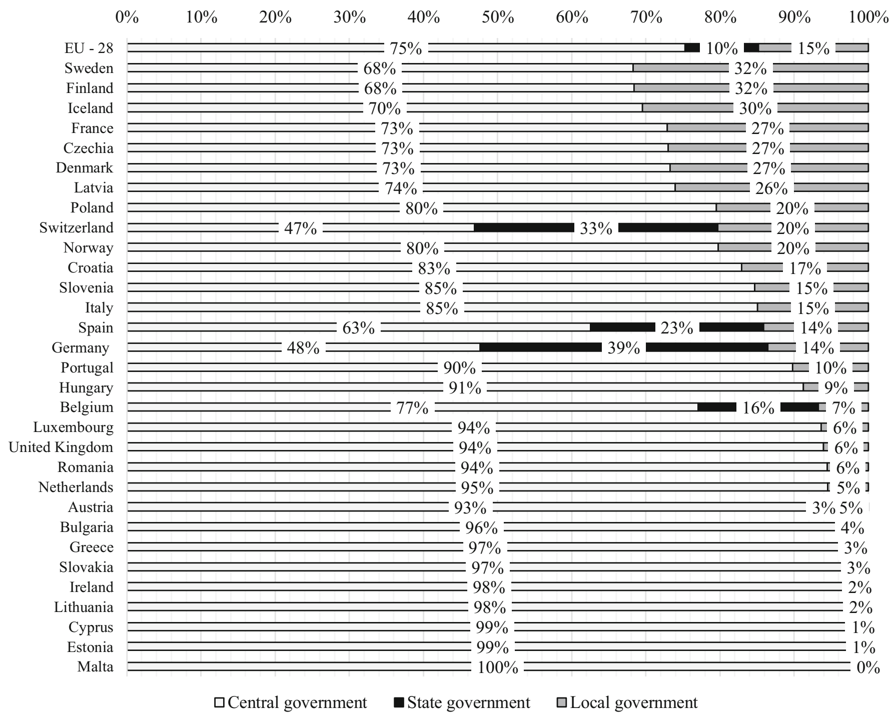


Fig. 1 Eurostat and authors' calculations

ESA2010[11] classification, consumption taxes are taxes on production and imports (D.2), and income taxes are current taxes on income and wealth (D.5). As most European local governments do not collect social contributions (D.6), these are not covered. The country sample includes all EU members as well as Norway, Iceland and Switzerland. All three are closely integrated with EU countries. Figure 1 presents European countries' split of consumption and income taxes over different levels of governments.

Across countries, the central government level collects on average about 75% of all taxes; local governments' share is around 15%. Among the five federal states in the sample, the regional share of tax revenues varies between 16% (Belgium) and 39% (Germany). Local governments' share in total taxes is highest in the Nordic countries where they are collecting up to one third of all taxes. Malta, Estonia,

[11]See Annex 2: European System of National and Regional Accounts (European Commission 2013).

Cyprus and Lithuania are positioned at the lower end. In these countries, local governments levy practically no taxes at all.[12]

In European local governments' revenues, taxes covered around 40% between 2004 and 2018 (Fig. 2). However, the tax share has been oscillating during this period, and the fluctuation pattern has been similar to the general European business cycle. There is a moderate positive correlation between GDP growth and tax revenues ($r = 0{,}476$). Overall, the linear trend throughout the period demonstrates an increasing share of taxes in local revenues.

Tax revenues were increasing during boom years 2004–2006 and dropped afterwards, induced by the economic crisis starting in 2008–2009. Due to declining tax bases, the bottom was hit in 2010 (35.8%). During the crisis, central governments assigned additional grants and subsidies to the local government level to counteract this drop. Eventually, tax revenues bounced back from 2011 onwards. In the recent years 2017 and 2018, local government tax revenues as share of total revenues have stabilised at the level of 41.5%.

At this point it is worth considering that not all of these tax revenues are autonomously self-sourced by local governments. For example, in Estonia local governments receive about 80% of all personal income tax revenues collected in the country. However, as all income taxes are collected and regulated by the central government, local governments' taxes are accounted for as transfers from the central government instead of own income tax revenues. As an outcome, Estonian local governments are statistically collecting almost no taxes at all. This shows that local tax autonomy should be considered within country-specific national regulations.

In general, the share of tax revenues received is not a sufficient indicator of local government tax autonomy. Instead, the OECD defines it via the respective local government's freedom to define its own tax bases, rates or exemptions (see Annex 1). OECD studies demonstrate that during the years between 2002 and 2014, there has only been a moderate change in the average tax autonomy of local governments in OECD federal countries (see Annex 1). For unitary governments, the change tended towards more taxing autonomy of local governments, notably in tax rate setting. This development is also linked to a decline in tax-sharing arrangements in these countries over this period (Dougherty et al. 2019).

3.2 Tax Structures

Figure 3 demonstrates the composition of European local government tax revenue in 2018 and gives cross-country information about the share of tax revenue in total

[12] The European Charter of Local Self-Government (Article 9) states that local governments should have own taxes with the right to set rates (Council of Europe 1985). Although the Charter implies some harmonization, apparently there are still huge differences.

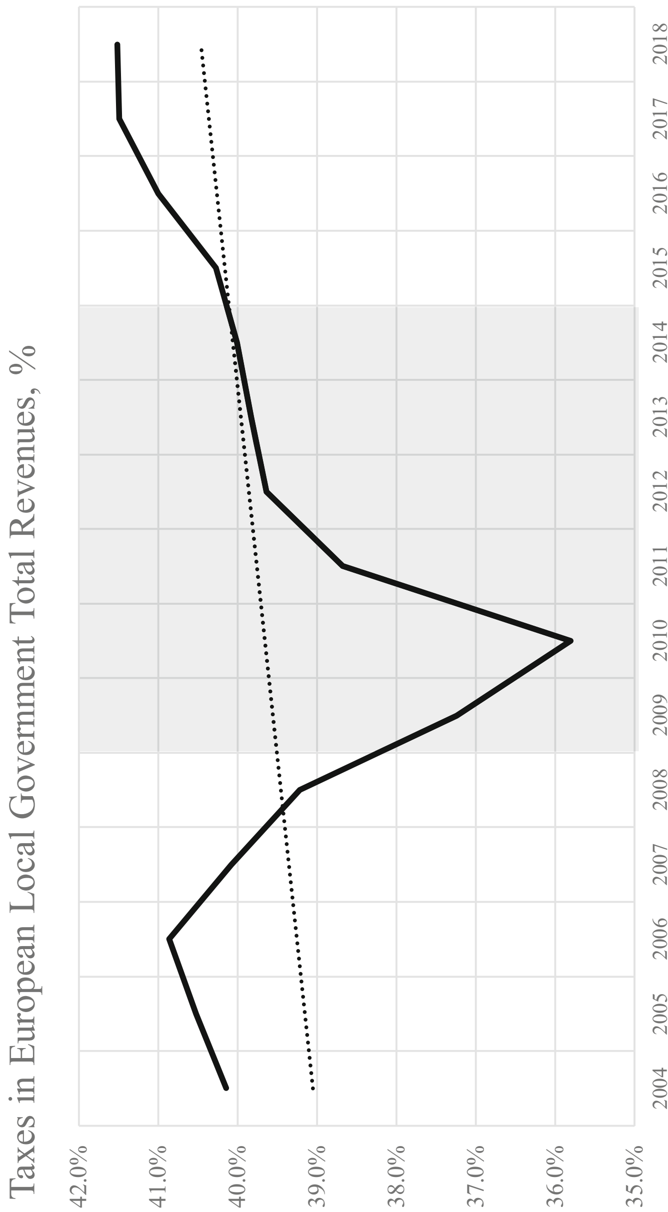


Fig. 2 The sample comprises 28 EU member states plus Switzerland, Norway and Iceland; the sample average is weighted with total revenues. In grey: the crisis-related period of low real GDP growth; see also Fig. 4 (Eurostat and authors' calculations)

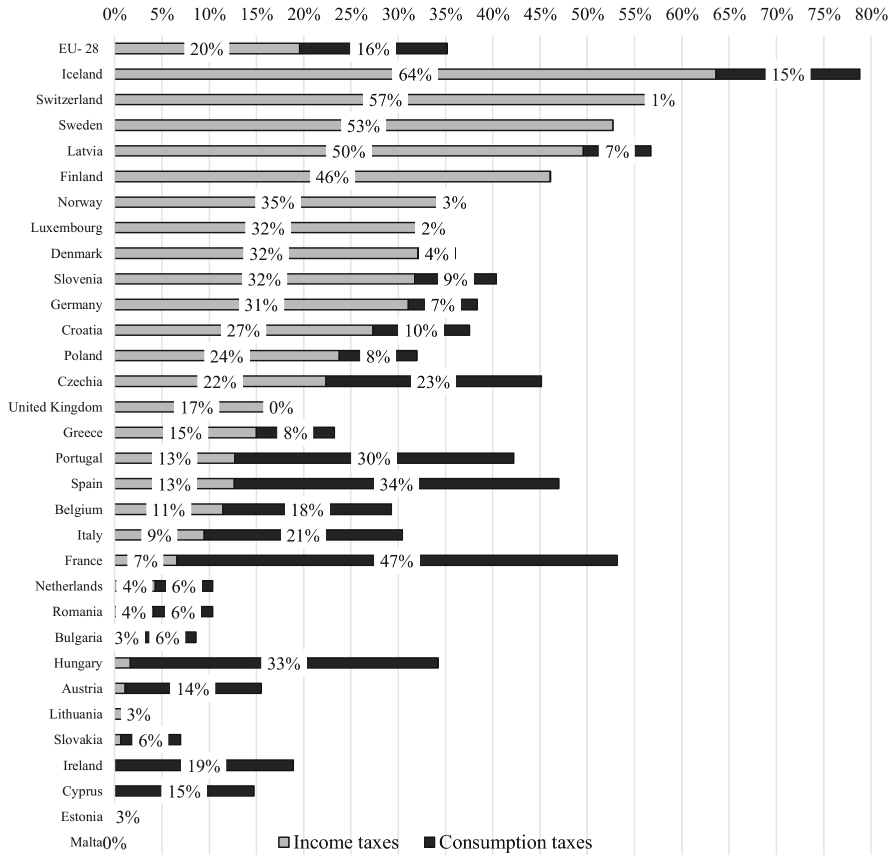


Fig. 3 Eurostat and authors' calculations

local government revenue. In the EU28 average, about 20% of all revenues at local level were collected as income and 16% as consumption taxes.[13]

There are countries in which local governments only collect one type of tax (e.g. the UK and Finland: income taxes). The variety in tax structures across countries is rather large. In some Nordic countries, local governments collect a relatively high proportion of income taxes (as well as in Switzerland and Latvia)

[13]As Fig. 2 above showed, European countries' tax revenue proportion in total revenues was at 41.5% in 2018, which is more than the 2018 EU28 average in Fig. 3. There are two reasons for this deviation. Contrary to Fig. 3, data for Fig. 2 was weighted by European local government total revenues. That means that countries with larger absolute revenues have more weight in the average indicator (Fig. 2). The second reason is related to the underlying datasets—the EU28 indicator (Fig. 3) does not include Norway, Switzerland and Iceland. These countries are, however, included in the dataset underlying Fig. 2.

where they cover more than 45% of all revenues. These countries also have a high local tax share in total revenues. Interestingly, there is a positive correlation between the Local Tax Autonomy Index estimated by the OECD and the share of income tax revenue in total revenues ($r = 0.580$) (OECD 2019a). In contrast, Ireland, Cyprus and Estonia are collecting rather limited amounts of income taxes as part of total revenues.

About one third of European countries collect more consumption taxes than income taxes at local level (e.g. France, Spain, Hungary and Portugal). At the same time, Nordic countries (also the UK, Switzerland and Luxembourg) collect only few taxes related to consumption activities. In sum, we observe rather heterogeneous structures of local government taxes across Europe without any common pattern.

3.3 Tax Structure Dynamics and Reforms

The following over-time analysis extends the focus to property taxes as additional source of local government tax revenue. Those are a combination of various taxes from different categories. Hence, a property tax can either be a consumption or an income tax, depending on the exact tax base.[14] Local government taxation of income, consumption and property has been dynamic over the period 2004 to 2018. To link changes in taxation structure with the European economic cycle, we split the 15 years of interest into three different subperiods, which broadly follow the general pattern of European Union countries' GDP dynamics. Figure 4 depicts the development of different tax shares in total local government tax revenues.

Over the entire period, the composition of local government taxes has been rather persistent in Europe. Income tax shares fluctuate around 58% and consumption taxes around 42% of all taxes. On the central government level, this relation is antagonal, and consumption taxes are relatively more important than income tax flows. The linear trends depict a slight increase in the share of income taxes and a corresponding decrease in the share of consumption taxes. Property taxes cover about one third of all tax revenues and have slightly increased over the whole period.

Despite this relative stability in terms of general proportions, there are visible changes in patterns over the three subperiods. From 2004 to 2008, European economies were growing. In these boom years, local governments shifted from income to consumption taxes. At the same time, the share of property taxes declined.

Economic crisis hit most of European economies in 2009. The second subperiod (2009–2014) depicts the global economic recession, followed by fast recovery and slow growth afterwards. The relative shares of tax types reacted to the economic

[14]Among 27 European Union member countries, there exist 56 rather heterogeneous forms of property taxes on all government levels. Most of them take the (current) market value of the property as tax base (Claus et al. 2016).

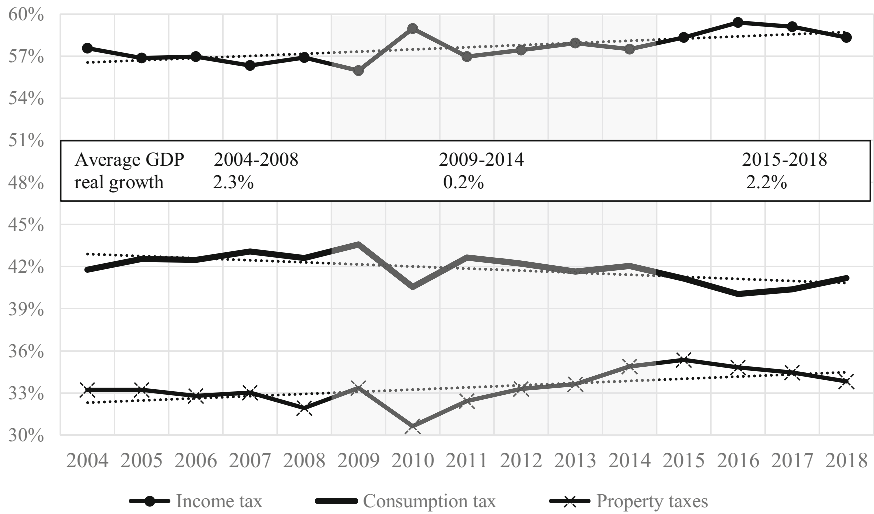


Fig. 4 Tax type shares in local government total tax revenue for EU28 plus Norway, Switzerland and Iceland. Since a property tax can be classified as income or consumption tax, the three lines do not add up to 100 percent. Dotted lines show linear trends (Eurostat and authors' calculations)

turmoil. In the recession, earlier trends were overturned. The proportion of income taxes increased from 56% (2008) to 59% in the following year and, accordingly, consumption taxes dropped from 43% to 40%. The share of property taxes declined equivalently. Although European economies bounced back soon, the earlier period trends had reversed. The share of income taxes continued to grow, and the share of consumption taxes declined further.

In the last subperiod, from 2015 to 2018, economic growth in Europe gained speed again. As the visual analysis shows, higher growth rates accompanied renewed changes in taxation structure trends. The proportion of income taxes in all local tax revenues started to decrease from 2016 onwards, consumption taxes gained more importance. Property taxes started to lose their share in total taxes already from 2015. These taxation structure dynamics are comparable with the boom years before the global recession.

To conclude, tax proportions at the European local level have remained broadly the same over the analysed 15 years period. However, related to the economic cycle, the relative share of different tax types varied. This relates to the question of how to design local taxation in a way that stabilises tax revenue over different phases of the economic cycle.

Table 2 Tax structure changes in European countries, measured by local government tax revenues

Most significant changes in consumption taxes			Most significant changes in income taxes		
Country	Consumption taxes (D.2) in total taxes, % 2018	Change 2004–2018 *percentage* points	Country	Income taxes (D.5) in total taxes, %, 2018	Change 2004–2018 *percentage* points
Hungary	94.7%	+46.3%	Lithuania	20.9%	+13.0%
Slovakia	83.3%	+31.5%	Italy	30.7%	+12.7%
Ireland	85.7%	+26.4%	Bulgaria	21.3%	+10.7%
Lithuania	75.0%	−14.9%	Hungary	4.8%	−45.4%
Italy	67.7%	−12.2%	Slovakia	8.2%	−35.7%
Poland	25.3%	−8.4%	Czech Republic	49.3%	−7.7%

Source: Eurostat and authors' calculations

3.4 Tax Structure Changes

European local governments' current tax structure is somewhat different from the European Commission recommendations for an optimal tax composition for the general government. As mentioned above, the Commission promotes a shift from labour-related (income) to consumption-based taxes. However, the mix of local government functions requires a relatable tax base, which brings about limitations to the design of an optimal tax structure as described by the EU. Some countries have changed their local governments' taxation structure from 2004 to 2018 quite fundamentally. Table 2 only includes those countries, which induced the most far-going changes in the two tax types. Clearly, such a significant change is not an outcome of natural developments but a result of deliberate political actions.

Hungary, Slovakia and Ireland have considerably increased the share of consumption taxes in total taxation. These countries practically replaced most of their income taxes with consumption taxes. Contrary to that, Lithuania, Italy and Poland brought consumption taxes down. In Lithuania, taxes cover only 3% of all revenues, and consumption taxes account for 75% of them. Conversely, an increase of consumption taxes led to sharp declines of income taxes in Hungary and Slovakia, which brought the income tax share down to less than 3% of their total budgets. The share of income taxes declined moderately in the Czech Republic. Lithuania, Italy and Bulgaria have increased the share of income taxes in local government tax revenues. However, such taxes make only a minor proportion of all revenues.

3.5 Property Taxes

As outlined in Part 2, property taxes are considered one of the most natural types of taxes for local governments. Supranational organisations like the OECD recommend a more extensive use. In the ESA2010 framework, property taxes can either be

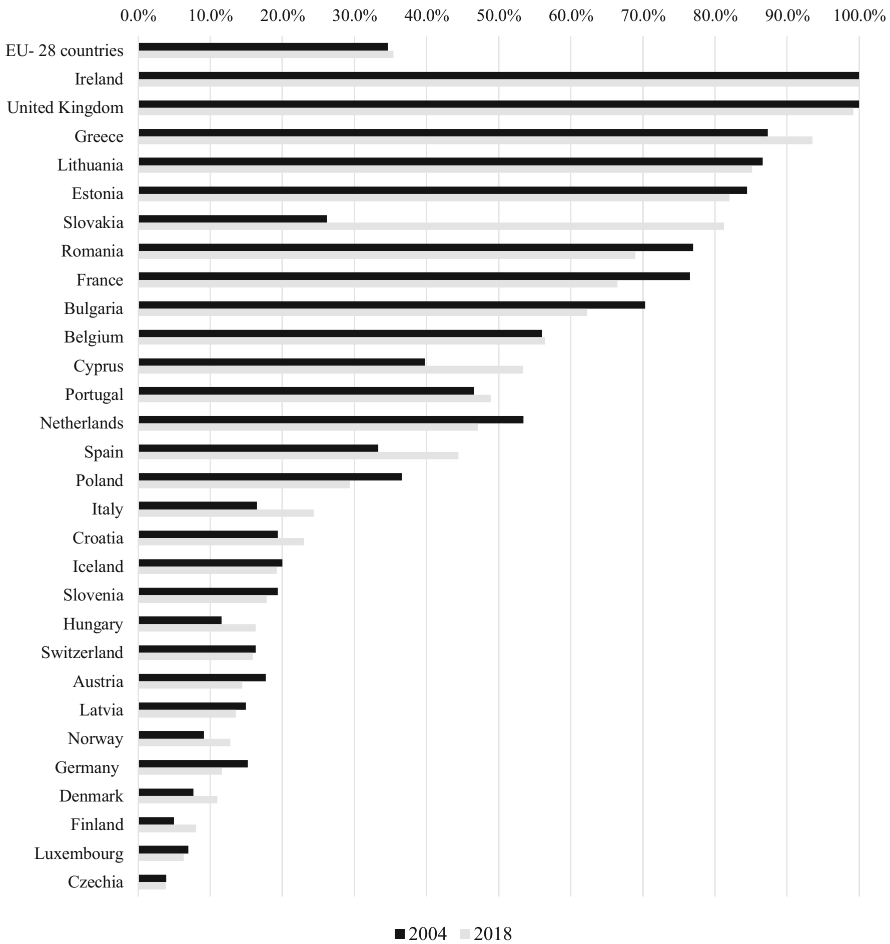


Fig. 5 Sweden and Malta do not collect property taxes on the local level (Eurostat and authors' calculations)

income or consumption taxes, e.g. taxes on land and structures, certain capital taxes and other (Annex 2, European Union 2019). Figure 5 depicts local government property tax shares in total local tax revenue over the 28 European countries in 2004 and 2018 accordingly.

With more than 90 percent, Ireland, the UK and Greece had the biggest shares of property taxes in 2018. The European average in both years has been rather stable at around 35% of all taxes. Nordic countries received minor revenue from property taxes which accounted for around 10% and less as compared to all tax revenues. An obvious exemption is Slovakia, which radically increased local government property tax income between 2004 and 2018.

3.6 Beyond Revenue Statistics: An Alternative View

The qualitative analysis of own-source municipal taxes levied in the EU28 plus Norway and Switzerland irrespective of their relevance in terms of revenue shares provides an alternative perspective. It shows that property taxes are indeed quite widespread (Table 3).

The analysis is based on case study research published by Geissler et al. (2019), as well as by OECD/UCLG (2016). It does neither consider shared taxes nor taxes of other local governments besides municipalities, like counties, provinces or regions.

Except for Malta and Sweden, municipalities in all EU member states levy taxes on land and/or property. Less common are own-source corporate income/business taxes, which municipalities in 9 out of 30 countries levy (and eight out of the EU28). These are Austria, Czech Republic, Germany, Hungary, Portugal, Spain, Cyprus, Luxembourg and Switzerland. The numbers for municipal own-source personal income taxes are similar; they are levied in Belgium, Bulgaria, Denmark, Finland, Italy, Sweden, Croatia and, again, Switzerland. In addition, in many countries local governments also levy excise taxes, tourist taxes and vehicle taxes. Besides own-source taxes, municipalities usually receive shares of centrally imposed taxes (PIT, VAT, etc.) over which they have no autonomy.

4 Discussion and Conclusion

The debate over optimal tax structures has deepened since the global economic recession starting in 2008. Empirical studies have demonstrated that some taxes are more detrimental to economic growth than others (Åsa 2016). There is a broad consensus that countries should decrease excessive tax burden on labour and incomes. International institutions recommend shifting the tax burden more towards consumption and property related taxes. However, with respect to differing sets of public services and governance objectives at the central and at the local government level within as well as across countries, differences in appropriate tax structures exist and will remain in place. From this perspective, there is no one-size-fits-all optimal tax structure for local governments.

Nevertheless, the analysis of country-specific tax structures at local level with respect to their optimality can provide important insights for future tax policy. In this study, we analysed structures and their dynamics at the European local government level in the years from 2004 to 2018. This period allows for evaluating the relevance of cyclical fluctuations related to the financial crisis of 2008 and the subsequent recession.

Our conclusions are the following. First, the biggest tax source for European local governments are income taxes (which covered about 58% of all taxes in 2018); consumption taxes are less relevant (42%). Local governments in Europe collect hardly any social security contributions. Although being levied in nearly all

Table 3 Municipal own-source taxation of property, corporate income and personal income in EU28 countries plus Norway and Switzerland

	Municipal own-sourced taxes						
	Property tax on land and/or buildings	Corp. income tax/business tax	Personal income tax		Property tax on land and/or buildings	Corp. income tax/business tax	Personal income tax
Austria	x	x		Portugal	x	x	
Belgium	x		x	Slovenia	x		
Bulgaria	x		x	Spain	x	x	
CZ	x	x		Sweden			x
Denmark	x		x	UK	x		
Estonia	x			Malta			
Finland	x		x	Cyprus	x	x	
France	x			Lithuania	x		
Germany	x	x		Romania	x		
Greece	x			Luxembourg	x	x	
Hungary	x	x		Latvia	x		
Ireland	x			Croatia	x		x
Italy	x		x	Norway	x		
Netherlands	x			Switzerland	x	x	x
Poland	x						

Source: own table

countries, local property taxes only cover about one third of all local tax revenues. Across EU countries, the local government tax structures are rather heterogeneous—a common European pattern does not exist.

Second, local government taxation structure is business cycle sensitive, particularly during a deep recession. In 2009, the severe economic decline throughout Europe was followed by the break of earlier taxation structure trends. During growth periods before 2008/2009 and after 2015, consumption tax revenues expanded relatively faster than income tax revenues. Accordingly, times of low and even negative real GDP growth rates in the European Union (2009–2014) were accompanied by an increase of income tax relative to consumption tax revenues. In theory, the variation of the savings rate during the economic cycle could explain this pattern: Households increase their savings rate in times of low growth which drives down consumption stronger than income. In times of high economic growth, especially after a crisis, households regain optimism and decrease their savings rate again, which leads to a stronger increase in consumption than income. This mechanism would explain a stronger cyclical reaction of consumption and revenue from consumption tax compared to income and revenue from income tax. However, the empirical EU28 savings rate developed in a somewhat more nuanced manner over time (Eurostat 2018). Whereas the relative increase of local consumption tax revenues from 2004 to 2008 was indeed accompanied by a decreasing savings rate, the declining relative consumption tax revenue from 2009 to 2016 was accompanied by a higher savings rate only in the years 2009/2010. The (first decreasing and then stagnant) savings rate thereafter cannot explain decreasing relative consumption tax revenues from 2010 to 2016 and their increase afterwards. Hence, we assume that the dynamics observed in relative tax revenue structures after 2010 are indeed related to changing tax rates/structures. Certain European countries in our sample, like Hungary, Slovakia and Ireland have changed their local government tax structure rather radically from 2004 to 2018. Some have increased their share of consumption taxes in local revenues; other countries relied more strongly on income taxes.

Third, cyclicality of tax revenues calls for more stable and predictable tax bases. Property taxes satisfy the criteria as efficient local taxes. From 2004 to 2018, the relative share of local property tax revenue has been slightly increasing but was comparably low overall.

Altogether, these conclusions allow for one general insight in terms of local government tax structures which are optimal in the sense that they provide stable revenues, allow local governments to autonomously adapt to cyclical fluctuations and minimise negative side effects. It appears advisable to increase the share of property taxation in the local tax basket at the expense of labour and business income taxation and to grant local governments the freedom to set tax rates, define bases, etc. Since 2015 the property tax share in the European local government tax basket declines. To reverse this trend, reforms seem necessary. The considerable cyclical variation of local government tax revenue points to unstable budgets, which in turn call for external regulation of local government finances. Regulation, however, is a rather late step in keeping local budgets sound. Reforms to the tax structure which provide more/more stable own-source tax revenue can be an approach which cures

the disease of ongoing budget deficits at an earlier point. If such reforms work out, the necessity for regulation decreases.

Annex 1: OECD Tax Autonomy Indicators: A Quick Overview

Taxing autonomy at subnational government level is often described with general fiscal indicators such as subnational government share of general government revenues. It is, however, widely accepted that true revenue powers at subnational government level are determined not only by delegated tax revenues but also with regulatory practices such as fiscal rules. While there are no readily available statistical sources of regulatory practices at subnational government taxes, the OECD has developed a method to measure tax autonomy in more detail.

OECDs Fiscal Federalism Network has developed subnational government taxing power indicators since the mid-1990s. These indicators have been based on data collected with questionnaires sent to OECD member governments and non-members who participate the Fiscal Federalism Network. In particular, the OECD has developed a "taxonomy of tax autonomy", which sets out five main categories and several subcategories of subnational government tax autonomy (Table 4). Using the data from several rounds of questionnaires and studies and combining also data obtained

Table 4 OECD tax autonomy

a.1 The recipient SCG sets the tax rate and any tax reliefs without needing to consult a higher-level government **a.2** The recipient SCG sets the rate and any reliefs after consulting a higher-level government
b.1 The recipient SCG sets the tax rate, and a higher-level government does not set upper or lower limits on the rate chosen **b.2** The recipient SCG sets the tax rate, and a higher-level government does sets upper and/or lower limits on the rate chosen
c.1 The recipient SCG sets tax reliefs – but it sets tax allowances only **c.2** The recipient SCG sets tax reliefs – but it sets tax credits only **c.3** The recipient SCG sets tax reliefs – and it sets both tax allowances and tax credits
d.1 There is a tax-sharing arrangement in which the SCGs determine the revenue split **d.2** There is a tax-sharing arrangement in which the revenue split can be changed only with the consent of SCGs **d.3** There is a tax-sharing arrangement in which the revenue split is determined in legislation, and where it may be changed unilaterally by a higher-level government, but less frequently than once a year **d.4** There is a tax-sharing arrangement in which the revenue split is determined annually by a higher-level government
e Other cases in which the central government sets the rate and base of the SCG tax
f None of the above categories a, b, c, d or e applies

Note: This is the classification that has been used in the data collection exercise but it can be subject to change. Source: Blöchliger and King (2006), OECD (2019a)

from the OECD National Accounts database and the OECD Revenue Statistics database, the Fiscal Network has developed the Fiscal Decentralisation Database (OECD 2019b). This dataset allows online access to data on fiscal tax autonomy.

Between 2002 and 2014, there has been only a moderate change in local government tax autonomy of federal countries in the set of OECD members (Fig. 6, lower panel). It is also interesting to note that in federal countries, the taxing power at the local government level is restricted compared with the overall situation. Like the local governments in the unitary countries (Fig. 6, upper panel), the local governments in federal countries are mainly allowed to set the tax rates. Nevertheless, in federal countries the local government autonomy to set both tax rates and tax reliefs is still higher than for local governments in unitary countries.

For unitary governments, the change has been towards more taxing autonomy of local governments below the central government level, notably in tax rate setting. This development is also linked with a decline in tax-sharing arrangements in these countries over this period (Dougherty et al. 2019).

Annex 2: European System of Accounts ESA 2010

Taxes on production and imports (D.2) are comprised of the following components:

(a) Taxes on products (D.21): (1) value added type taxes (VAT) (D.211); (2) taxes and duties on imports excluding VAT (D.212);—import duties (D.2121),—taxes on imports excluding VAT and duties (D.2122); (3) taxes on products, except VAT and import taxes (D.214), e.g. excise duties and consumption taxes.
(b) Other taxes on production (D.29)

Current taxes on income, wealth, etc. (D.5) are divided into:

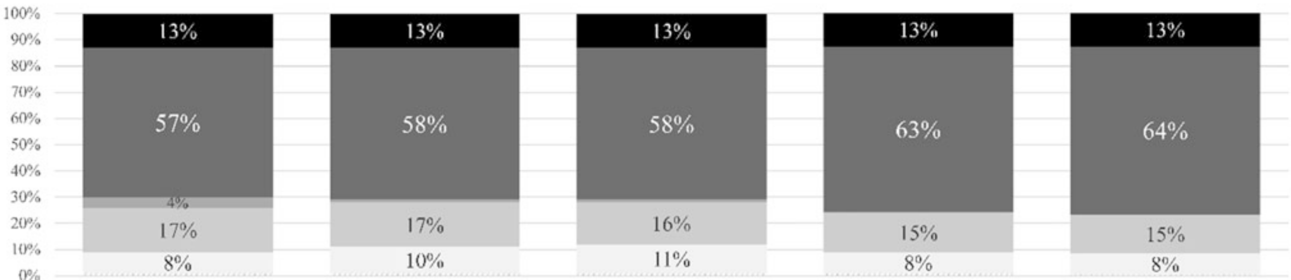
(a) Taxes on income (D.51):

    (a) Taxes on individual or household income, examples of which are income from employment, property, entrepreneurship, pensions, etc., and including taxes deducted by employers, for example pay-as-you-earn taxes. Taxes on the income of owners of unincorporated enterprises are included here; (b) taxes on the income or profits of corporations; (c) taxes on holding gains; (d) taxes on winnings from lotteries or gambling.

(b) Other current taxes (D.59)

Taxes on property (European Union 2019, p.268)—recurrent taxes on immovable property and other property taxes:

D.29A Taxes on land, buildings or other structures.
D.59A Current taxes on capital.
D.91A–B Taxes on capital transfers.



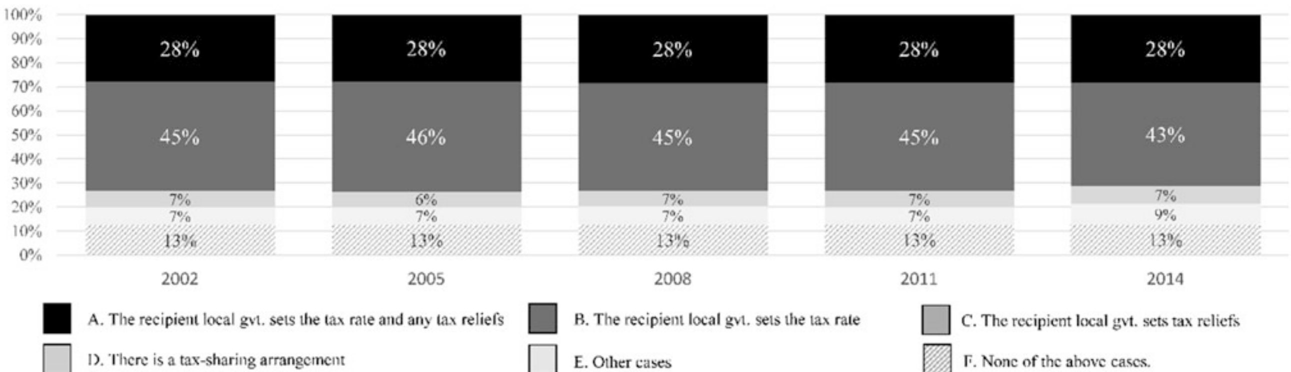


Fig. 6 Change in tax autonomy for local governments unitary and federal OECD countries, 2002–2014 (% of total subnational tax revenues) (Dougherty et al. 2019, own calculations)

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