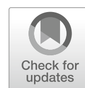
Budget Institutions for Subnational Fiscal Discipline: Local Fiscal Rules in Post-Crisis EU Countries



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.

G. Turley (✉) · S. McNena
J.E. Cairnes School of Business and Economics, National University of Ireland Galway, Galway, Ireland
e-mail: gerard.turley@nuigalway.ie

C. Raffer
German Institute of Urban Affairs, Berlin, Germany

© Springer Nature Switzerland AG 2021

R. Geissler et al. (eds.), *Local Public Finance*,
https://doi.org/10.1007/978-3-030-67466-3_2

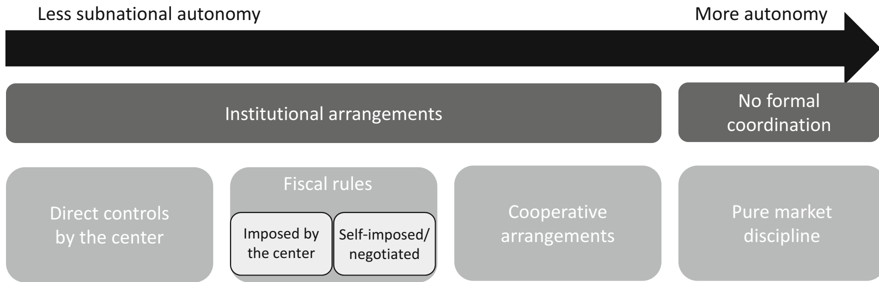


Fig. 1 Institutional framework for fiscal regulation. Source: Ter-Minassian and Craig (1997); Eyraud and Gomez Sirera (2015)

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.

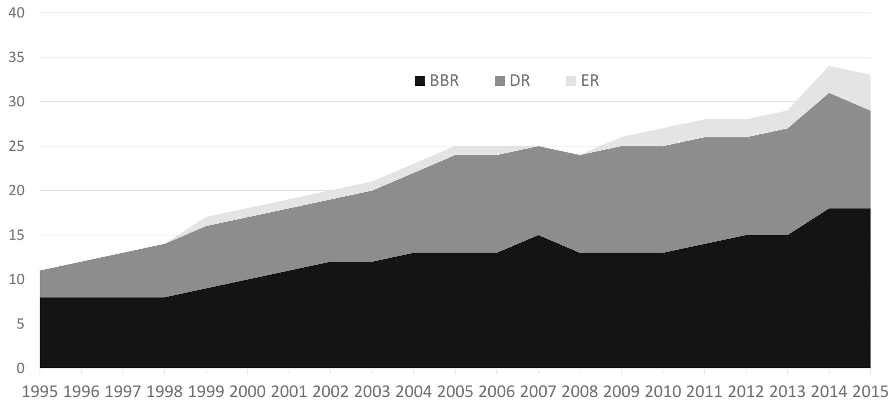


Fig. 2 Development of fiscal rules over time (1995–2015) for the EU-28 member countries, in absolute numbers (own graph, data source: European Commission Fiscal Rules Strength Index)

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]

---

[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

References

Asatryan, Z., Castellon, C., & Stratmann, T. (2018). Balanced budget rules and fiscal outcomes: Evidence from historical constitutions. *Journal of Public Economics, 167*, 105–119.

Braun, M., & Tommasi, M. (2002). *Fiscal rules for subnational governments. Some organising principles and Latin American experiences*. Paper prepared for the IMF/World Bank conference rules-based fiscal policy in emerging market economies, Oaxaca, Mexico, 14–16 February 2002.

Crivelli, E., & Shah, A. (2009). *Promoting subnational fiscal discipline: a review of budget institutions and their impact on fiscal performance*. Max Planck Institute for Research on Collective Goods (Bonn, Germany), and the World Bank, respectively.

Debrun, X., Moulin, L., Turrini, A., Ayuso-i-Casals, J., & Kumar, M. (2008). Tied to the mast? National fiscal rules in the European Union. *Economic Policy, 23*(54), 297–362.

Escolano, J., Eyraud, L., Badia, M. M., Sarnes, J., & Tuladhar, A. (2012). *Fiscal performance, institutional design and decentralization in European Union countries* (IMF working paper 12/45). Washington, DC: IMF.

European Commission. (2018). *Numerical fiscal rules in EU member countries database*. Accessed September 17, 2019, from https://ec.europa.eu/info/publications/fiscal-rules-database_en

Eyraud, L., Debrun, X., Hodge, A., Lledó, V., & Pattillo, C. (2018). *Second-generation fiscal rules: balancing simplicity, flexibility, and enforceability* (IMF staff discussion note 18/04). Washington, DC: IMF.

Eyraud, L., & Gomez Sirera, R. (2015). Constraints on subnational fiscal policy. In C. Cottarelli & M. Guerguil (Eds.), *Designing a European fiscal union. Lessons from the experience of fiscal federations* (pp. 90–132). London: Routledge.

Eyraud, L., & Lusinyan, L. (2013). Vertical fiscal imbalances and fiscal performance in advanced economies. *Journal of Monetary Economics, 60*(5), 571–587.

Foremny, D. (2014). Sub-national deficits in European countries: The impact of fiscal rules and tax autonomy. *European Journal of Political Economy, 34*, 86–110.

Geissler, R., Hammerschmid, G., & Raffer, C. (Eds.). (2019). *Local public finance in Europe - Country reports*. Berlin: Hertie School of Governance and Bertelsmann Stiftung.

Goodhart, C. (1975). *Monetary relationships: A view from Threadneedle street* (Papers in monetary economics), Vol. 1, Reserve Bank of Australia.

Grembi, V., Nannicini, T., & Troiano, U. (2016). Do fiscal rules matter? *American Economic Journal: Applied Economics, 8*(3), 1–30.

Hagemann, R. (2012). *Fiscal consolidation. Part 6. What are the best policy instruments for fiscal consolidation?* (OECD economics department working paper 937). Paris: OECD.

Heinemann, F., Moessinger, M. D., & Yeter, M. (2018). Do fiscal rules constrain fiscal policy? A meta-regression-analysis. *European Journal of Political Economy, 51*, 69–92.

Henning, C. R., & Kessler, M. (2012). *Fiscal federalism: US history for architects of Europe's fiscal union* (Peterson Institute for International Economics working paper 2012–1).

Kennedy, S., & Robbins, J. (2001). *The role of fiscal rules in determining fiscal performance* (Department of finance working paper 2001–16). Canada.

Kopits, G. (2001). *Fiscal rules: Useful policy framework or unnecessary ornament?* (IMF working paper 01/145). Washington, DC: IMF.

Kopits, G. (2014). Ireland's fiscal framework: Options for the future. *The Economic and Social Review, 45*(1), 135–158.

Kopits, G., & Symansky, S. (1998). *Fiscal policy rules* (IMF occasional paper 162). Washington, DC: IMF.

Kornai, J., Maskin, E., & Roland, G. (2003). Understanding the soft budget constraint. *Journal of Economic Literature, 41*(4), 1095–1136.

Kotia, A., & Lledó, V. D. (2016). *Do subnational fiscal rules foster fiscal discipline: new empirical evidence from Europe* (IMF working paper 16/84). Washington, DC: IMF.

Kumar, M., et al. (2009). *Fiscal rules—Anchoring expectations for sustainable public finances*. Washington, DC: IMF.

OECD. (2013). Sub-central fiscal rules: Making fiscal policy sustainable. In H. Blöchliger (Ed.), *Fiscal federalism 2014: Making decentralisation work* (pp. 37–55). Paris: OECD.

OECD/KIPF. (2016). Monitoring sub-central government debt: Trends, challenges and practices. In H. Blöchliger & J. Kim (Eds.), *Fiscal federalism 2016. Making decentralisation work* (pp. 107–136). Paris: OECD.

OECD/UCLG. (2016). *Subnational governments around the world. Structure and finance*. Paris: OECD.

Pisauro, G. (2003). *Fiscal decentralization and the budget process: A simple model of common pool and bailouts* (Italian Society for Public Economics working paper 294).

Plekhanov, A., & Singh, R. (2007). How should subnational government borrowing be regulated? Some cross-country empirical evidence. *IMF Staff Papers, 53*(3), 426–452.

Poterba, J. M. (1997). Do budget rules work? In A. J. Auerbach (Ed.), *Fiscal policy. Lessons from economic research* (pp. 53–86). Cambridge, MA: MIT Press.

Raffer, C., Geissler, R., Hammerschmid, G., & Wegrich, K. (2018). *Local government fiscal regulation in the EU: the impact of balanced budget rules*. Paper presented at EGPA conference, University of Lausanne, 5–7 September 2018.

Rodden, J. (2002). The dilemma of fiscal federalism: Grants and fiscal performance around the world. *American Journal of Political Science, 46*(3), 670–687.

Schaechter, A., Kinda, T., Budina, N., & Weber, A. (2012). *Fiscal rules in response to the crisis – Toward the "next-generation" rules. A new dataset* (IMF working paper 12/187). Washington, DC: IMF.

Schick, A. (2010). Post-crisis fiscal rules: Stabilising public finance while responding to economic aftershocks. *OECD Journal on Budgeting, 10*(2), 1–17.

Sutherland, D., Price, R., & Joumard, I. (2006). Sub-central government fiscal rules. *OECD Economic Studies, 41*(2), 141–181.

Ter-Minassian, T. (2007). Fiscal rules for subnational governments: Can they promote fiscal discipline? *OECD Journal on Budgeting, 6*(3), 1–11.

Ter-Minassian, T., & Craig, J. (1997). Control of subnational government borrowing. In T. Ter-Minassian (Ed.), *Fiscal federalism in theory and practice* (pp. 156–172). Washington, DC: IMF.

Turley, G., & McNena, S. (2018). Financing local government in the twenty-first century: Local government revenues in European Union member states, 2000–2014. In R. Kerley, J. Liddle, & P. T. Dunning (Eds.), *Routledge handbook of international local government* (pp. 496–517). London: Routledge.

von Hagen, J., & Eichengreen, B. (1996). Federalism, fiscal restraints and European monetary union. *The American Economic Review, 86*(2), 134–138.

Wyplosz, C. (2013). Fiscal rules: Theoretical issues and historical experiences. In A. Alesina & F. Giavazzi (Eds.), *Fiscal policy after the financial crisis* (pp. 495–525). Chicago, IL: University of Chicago Press.