

FISCAL DECENTRALISATION IN THE EU AND ITS INTERACTION WITH EU'S FISCAL RULES

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The article considers the issue how fiscal federalism affects the capacity of Member State to achieve sound and sustainable finances as the Treaty and SGP obligations concern the general government as a whole, i.e. central, state and local government plus social security. Article provides a brief overview of the allocation of responsibility for public expenditure and revenues items across level of government, and examines how this interacts with the EU framework for fiscal surveillance. Consideration is given to various institutional arrangements that have been put in place by Member States to co-ordinate the budgetary positions across levels of government, in part to comply with the provisions of the Treaty and SGP.

Introduction

In recent years, the management of public finances in EU Member states has not only been affected by the process of integration, it has also been influenced by a process of decentralisation whereby the budgetary autonomy of lower levels of government has been increased.

The EU's fiscal rules impose important and challenging budgetary obligations on Member States. Countries are required by the Treaty to avoid excessive deficit positions (defined against a reference value for deficits of 3% of GDP), and under Stability and Growth Pact (SGP) they are required to achieve and maintain a budget position of "close to balance or in surplus".

A further feature of EU's fiscal rules is the fact that the budgetary commitments are given by the central government, the requirements in terms of the budget balance concern the general government: this covers central and local (state) governments and social security. The fiscal rules looks at the overall budgetary position – it does not distinguish between the allocation of fiscal unbalances across different levels of government. It is the *responsibility of Member States to organise their fiscal relations across different levels and sectors of government* so as to ensure that they can meet the budgetary requirements set down in the Treaty and SGP.

The patterns of organisation and decentralisation of expenditure and revenues

The process of transferring more budgetary authority to lower levels of government is motivated in part by political factors, namely as a way of reconciling divergence or tensions between communities with national political cohesion or has been an expression of the citizen's right to participate in the conduct of public affairs. Decentralisation may also be justified on economic grounds: in particular, lower levels of government may be able to better tailor the provisions of public services to local needs and preferences, and to establish a link with the taxes that are needed to finance them, thereby increasing accountability at the local level¹.

¹ for more details see Oates, E.,W.(1972) Persson,T., Roland, G. and Tabellini, G.(1996); Fossati, A., Panella, G. (1999)

There are large differences between EU Member States in the way budgetary responsibilities are divided between different levels of government. This is in part linked to the system of government and particular whether the country is a federal (Austria, Belgium and Germany) or unitary state. However, the distinction is not clear cut. Spain and Italy could be classified in both groups, since there are unitary states with some characteristics of federal state. The Nordic countries (Denmark, Finland and Sweden) also have some special characteristic, as they are unitary states where the principle of “self-government” is ground in the Constitution.

Table 1 Decentralised government in the EU

MS	Regional or state government	Local government	
		Upper tier (counties, provinces, departments)	Lower tier (municipalities, districts)
BE	3 ¹⁾ regions	10 provinces	589
DK	--	14 counties	275
DE	16 states (landers)	426 Kreise	16 121 ²⁾
EL	--	54 Nomoi	5 922
ES	17 autonomous communities	50 provinces	8 082
FR	22 regions	96 departments	36 559
IT	20 regions	108 provinces	8 104
LU	--	--	118
NL	--	12 provinces	8 082
AT	9 states (landers)	--	2 353
PT	--	--	275 ³⁾
FI	--	--	455
SE	--	23 counties	286
UK	--	135 counties	319 districts

Notes: ¹⁾+3 communities, ²⁾ 117 Kreisfreie Stadte ³⁾ 4 207 parishes

Source: Fossati, A., Panella, G.: *Fiscal Federalism in the European Union*

A common **indicator for assessing the degree of fiscal decentralisation** is to look at sub-national **revenue and expenditure, both as a percentage of GDP and of total public expenditures**. Table 1 report this indicator based on the data available in the European System of Accounts (ESA). These figures must be interpreted with care as they give an approximate indication of the size of lower levels of government, but do not measure budgetary autonomy.

Table in Appendix A show that in general the federal and the Nordic countries are the most decentralised according to the indicator. When measured in terms of *sub-government expenditure* (i.e. state and local) *as a percentage of total government spending*, then Denmark (57%), Germany (43%), Belgium (41%), Sweden (40%) and Spain (38%) stand out as having a highly decentralised fiscal structure². A second group consist of the Netherlands (35%), Finland (34%), Austria (33%), Italy (30%), the UK (26%) and France (19%). The most centralised Member States are Luxembourg, Portugal (both 14%) and Greece (4%). With respect to the development of lower levels of government over time, the figures generally show slow changes since 1995, the first year for which figures are available for all Member

² One should keep in mind that this figure does not measure local autonomy in deciding on expenditure

States. Nevertheless, a relative increase since 1995 is recorded in the size of government in Denmark, Sweden and Italy. A relative decrease is recorded in the size of the local government in Netherlands.

Table in Appendix B examine the *composition of public spending* by sub-central levels of government in Member States where data was available. According to the theory of fiscal federalism, public spending of sub-central authorities could be expected in policy domains where are large differences in preferences (needs) across regions, but less so in areas whereas economies of scale and spillover effects prevail.

As expected, defence is never decentralised, reflecting the presence of spillover effects, economies of scale and political considerations. A considerable percentage of the resources of sub-central authorities are devoted to items such as education, housing, recreation and culture: decentralised provision of these items may be justified on the ground of tailoring public goods and services to local needs and preferences. The largest differences between Member States can be found in the categories of health and social security and welfare, where sub-central authorities in several countries have an important role to play.

It should be noted, that the scale and composition of public spending by sub-central authorities does not coincide with the actual degree of budgetary autonomy of sub-national authorities. This is because the central government can influence to a large degree the expenditure choices of sub-central authorities for example by mandating standards of public goods and services that sub-central authorities must provide. Local or state government expenditures, for example include expenditures that are part of national programmes. In the Nordic states, central control is generally confined a high degree of independence in areas like primary education, social and health services. Their counterparts in the Netherlands, Germany, Austria and Italy have a role too in providing the major welfare services, though with more detailed steering by higher tiers of government.

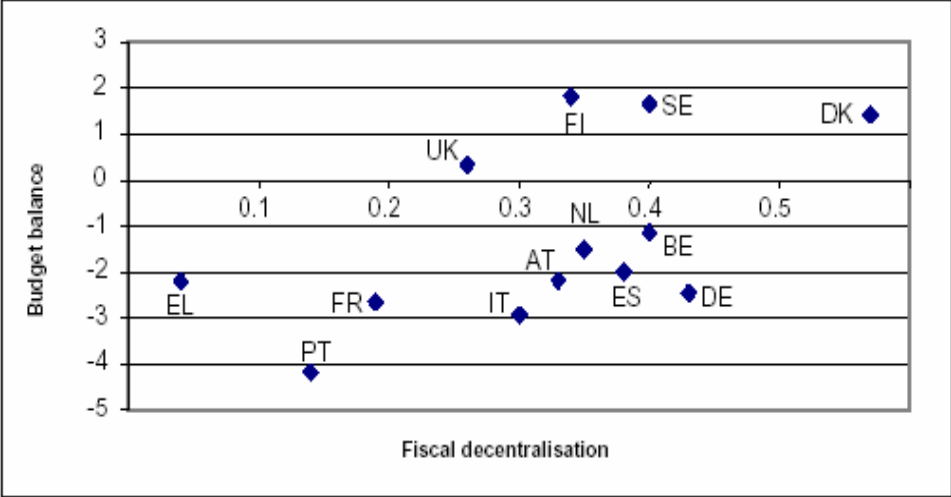
Sub-central authorities can be financed through taxes, grants, service charges and fees. Table in Appendix C show the main categories as according to the ESA95 classifications. There are large differences in the way Member States finance their expenditure at lower level of government.

In Belgium, the states rely mostly on *transfers from the central government*. For the states in Austria and Spain, transfers also account for a large part of their revenues, although to a lesser extent than in Belgium. In Austria *tax sharing* represents another important part of income, while the states in Spain have increased their tax autonomy in the second half of the 1990s. For the German states, the transfers from the central government are much smaller and tax income is the most important source of revenue. This reflects the importance of tax sharing of national taxes with the central government. Transfers to local government are relatively high in the UK and the Netherlands, which indicates their relatively centralised system of financing local governments. This contrasts with Italy and France, where the autonomy of lower levels of government in raising taxes is higher. In Italy, reforms in the 1990s have strongly decreased local government's dependence on transfers from centre and extended their autonomy in raising taxes. Finally, the data for the category of *taxes on income and wealth* show very large differences between Denmark, Finland and Sweden, where figures range from 10 to 15% of GDP, and other Member States, where these figure usually is below 2% of GDP, in line with the fact that income taxes are the most important source of income at local level for the Nordic countries.

Fiscal decentralisation and its interaction with the EU’s fiscal rules.

Previous data clearly illustrate the importance of public finances at sub-central level when considering the overall budgetary situation of a Member State. A question arises whether there is a link between the degree of fiscal decentralisation and the budgetary performance, in particular the capacity of Member State to meet the budget balance and debt requirements for general government set down in the Treaty and SGP.

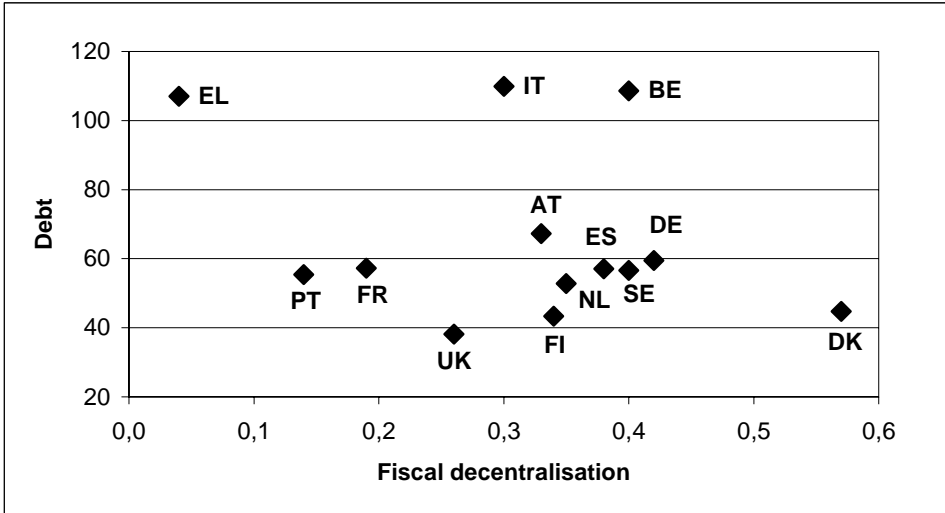
Graph 1 Fiscal decentralisation and budgetary situation



Source: Public finance in EMU-2003 [online]

Graph 1 compare an indicator for fiscal decentralisation with indicators for budget balance and graph 2 for debt. All figures for fiscal decentralisation are for 2001, except for PT (figures are for 1999). The indicator for budget balance is calculated as the average cyclically-adjusted budget balance over the period 1998-2001. Debt is measured as a gross debt as a percentage of GDP, year 2001.

Graph 2 Fiscal decentralisation and debt



Source: Public finance in EMU-2003 [online]

It show that, at first glance, there is no apparent link between the degree of fiscal decentralisation and budgetary performance. Possible link between fiscal decentralisation and budgetary performance may exist depending upon whether or not a sub-central authority faces

a hard budget constraint³. Lower level of government may not take adequate account of the spillover effects of their budget policies and may face incentives to shift the costs of their expenditure decisions to the central level of government. The extent of that depends on the institutional set-up of the system of financing of lower levels of government.

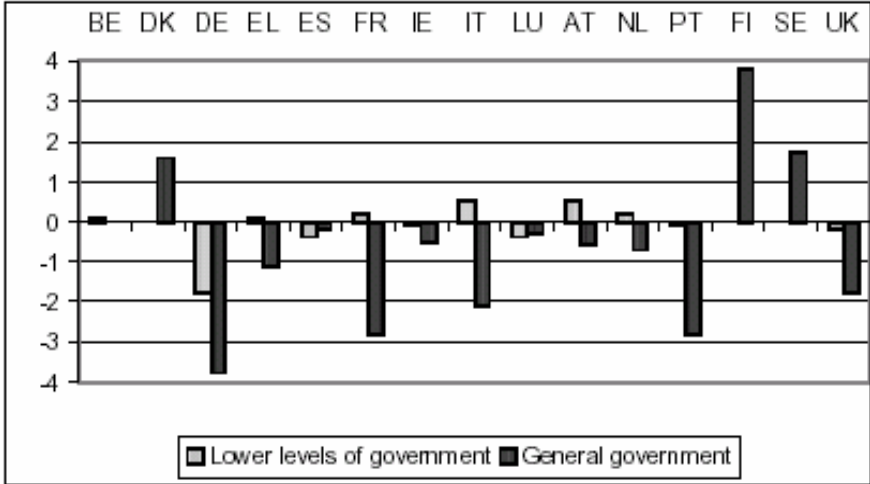
There may be a tendency for higher levels of public spending and deficits if there is a vertical fiscal imbalance, i.e. when sub-central authorities have important responsibilities for public expenditures but limited own resources and are thus reliant on transfers and grant from central authorities. These transfers may create the perception that local public spending is funded by non-residents. As a consequence, expenditure discipline and costs awareness might deteriorate. This pressure for increased transfers to sub-central authorities could translate into higher deficits and debt of the general government. Sub-central government may engage in excessive levels of borrowing if they consider that in event of default, they will be bailed out by a higher level. This pressure may rise with the degree of vertical fiscal imbalance, since at sub-national level, the smaller are the possibilities at that level to raise taxes in the event of financial problems.

Borrowing restrictions

In response to these pressures, government in recent years have paid close attention to the incentives embedded in the design grants and revenue sharing arrangements with sub-central authorities. Many countries have also introduced borrowing restrictions for lower levels of government, and empirical evidences indicate that higher degrees of vertical fiscal imbalance and sub-national borrowing restrictions are indeed associated.

Borrowing restrictions are usually found to be effective in restraining fiscal policies at lower levels of government. All EU countries apply restrictions to local government spending and borrowing, but in various form. Their impact within the EU is examined on Graph 3 which contrasts the general government budget balance (dark column) and the budget balance of local and state (where relevant) government. Local and state governments usually balance their budgets or run small deficits or surpluses. The only exception is Germany, where net lending by local and state government accounts for almost half of the general government deficit in 2002.

Graph 3 The contribution of lower levels of government to general government (net lending (-) or net borrowing (+) in 2002)



Source: Public finance in EMU-2003 [online]

³ Rodden, J.: Decentralisation on the challenge of hard budget constraints. In *The World Bank Prem-Notes*, 41.

Examples of initiatives in several Member States to co-ordinate budgetary position across levels of government

Apart from borrowing and budgeting restrictions for sub-national authorities, the federal Member States and Italy and Spain have also introduced institutional arrangements at national level, usually referred as a *national stability pacts*. These arrangements can be summarised according to the formulation and scope of their targets, the measurement of the targets, their legal status, the process of surveillance and the enforcement including possible sanctions.

In **Austria** was domestic stability pact enacted in January 1999 and amended in October 2002 by an agreement between the federal government, provinces and the local authorities that covers the period until 2004. The agreement covers the joint achievement of a balanced budget by 2002 as well as financial burden sharing arrangements. The system of monitoring and enforcement includes possible fines, subject to unanimous decision from all interested parties.

In **Belgium** the co-ordination of the budget balance position of various levels of government is ensured by the agreement concluded initially in 200, and renewed in 2002, between the federal government, the communities and regions to adhere to the budgetary targets as recommended each year by the High Council of Finance. The agreement covers the period of 2001-2005, and does not include formal sanctioning procedures in case of deviation from the permissible deficits. However, the federal government can restrict the borrowing capacity of communities and regions for a period of up to two years upon recommendations of the High Council of Finance.

In **Germany** on March 2002 the federal government and the Lander agreed on a kind of National Stability Pact for the implementation of the SGP. Federal government and the Lander (including the local governments) commit to comply with the budgetary rules of EMU. The Financial Planning Council⁴ issues recommendations on budgetary policies and regarding enforcement, will discuss the reasons of non-respect of the rules and give recommendations in order to restore budgetary discipline. Nevertheless, the lack of threat of sanctions going above recommendations could imply less compliance with mutually agreed targets.

In **Italy**, a domestic stability pact came into force through legislation adopted in connection with the budget law for 1999. It aims at improving the budget balances of local governments by fixing targets for the reduction of their deficits. Health care expenditure is subject to a separate agreement⁵. Possible fines under the budgetary rules of the Treaty and the SGP are to be levied on the local authorities that have failed to meet their targets, in proportion to the overshoot for which they are responsible.

In **Spain** the General Law of Budgetary Stability (GLBS) was enacted in 2001 has taken effect from 2003. All general government sub-sectors should show a surplus or a balanced budget. The central government monitors budgetary execution and assesses the degree of fulfilment of the objective. Possible fines under the budgetary rules of the Treaty and the SGP will be shared by those public entities responsible for the deficits.

This overview shows differences and similarities in the way Member States address the challenges of coordinating the overall budgetary position across levels of government. The

⁴ The Financial Planning Council consists of the Federal Ministry of Finance, the Federal Ministry of Commerce and Labour, the Finance Ministries of Lander, representatives of local authorities and local authority associations.

⁵ These expenditure accounts for over two third of regional expenditure.

differences reflect historical circumstances, variation in political structure and diversity in budgetary processes. Some Member States have chosen to replicate the medium term objective, while others have chosen to define specific budgetary targets on a yearly basis. In some cases, the arrangements are laid in national law while in others they are formulated as an arrangement between levels of government. Some arrangements specify of non-compliance, such imposing sanctions, while others do not.

Conclusion

The contribution of sub-central authorities to the overall budget position is changing in a number of countries in light of efforts to devote certain public functions to regional/local authorities. The challenge in meeting EU budgetary requirements is therefore affected by the way in which Member State allocate fiscal functions (both revenues and expenditures) across different levels of government. This is especially the case of federal countries and the Member States where local authorities have considerable budgetary autonomy

The direct contribution of lower levels of government to the general government deficit is generally limited since all Member States apply restrictions to local government borrowing. To help comply with the EU's fiscal rules, the federal Member States and Italy and Spain have recently introduced arrangements that aim to co-ordinating the budgetary position across levels of government. More experience with the implementation of these arrangements is needed before conclusions can be drawn on their effectiveness. In this respect, strong legal base and enforcement mechanism would be expected to contribute to the credibility and effectiveness of the arrangements.

Experiences discussed above can be an inspiration also for Czech Republic, when the central government is preparing proposals of public finance reform to achieve the EU's fiscal rules.

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Appendix A: Structure and revenues at state and local government level

MS			Total Expenditure						Total Revenues					
			% of GDP			% of Total			% of GDP			% of Total		
			1995	2000	2001	1995	2000	2001	1995	2000	2001	1995	2000	2001
BE	Federal	<i>State</i>	14	13	14	26	27	27	13	14	14	27	27	28
		<i>Local</i>	7	7	7	12	14	13	7	7	7	14	13	13
DK	Unitary; local self-government	<i>Local</i>	32	31	31	53	56	57	33	31	31	56	53	54
DE	Federal	<i>State</i>	13	14	14	27	29	28	12	13	12	26	28	27
		<i>Local</i>	8	7	7	15	15	14	8	7	7	16	15	16
EL	Unitary	<i>Local</i>	2	2	2	3	4	4	2	2	2	5	4	4
ES	Unitary; federal features	<i>State</i>	7	9	9	15	22	23	6	8	8	16	21	21
		<i>Local</i>	6	6	6	13	15	15	6	6	6	15	16	16
FR	Unitary	<i>Local</i>	10	10	10	18	19	19	10	10	10	20	19	19
IT	Unitary; federal features	<i>Local</i>	13	14	14	24	30	30	13	14	15	28	30	32
LU	Unitary	<i>Local</i>	7	6	-	15	14	-	7	6	-	15	13	-
NL	Unitary	<i>Local</i>	23	16	16	45	35	35	23	16	16	49	34	35
AT	Federal	<i>State</i>	8	10	10	14	18	18	9	10	10	16	20	19
		<i>Local</i>	9	8	8	16	15	15	8	8	8	16	16	15
PT*	Unitary	<i>Local</i>	5	7	-	12	14	-	5	5	-	14	12	-
FI	Unitary; local self-government	<i>Local</i>	19	16	17	31	33	34	20	16	16	36	29	30
SE	Unitary; local self-government	<i>Local</i>	23	22	23	34	39	40	23	23	23	37	38	38
UK	Unitary, four constituent nations	<i>Local</i>	12	10	11	26	28	26	11	10	11	29	25	26
EUR-12			16	16	-	31	33	-	16	15	-	33	32	-
EU-15			16	15	-	31	33	-	16	15	-	33	32	-

Note: *Figures for PT concern 1999.

Source: Public finance in EMU-2003 [online]

Appendix B: Sub-national government spending by function as a percentage of total local spending

MS	General public services	Defence	Public order and safety	Education	Health	Social security and welfare	Housing and community amenities	Recreational, cultural and religious affairs	Fuel and energy	Agriculture, forestry, fishing and hunting	Mining, manufacturing and construction (except fuel and energy)	Trans – portation and communication	Other economic affairs	Other functions
ES	6,9	0	4,2	18,3	20,5	5,1	10,7	5,6	0,1	3,5	1,0	7,2	2,7	14,2
DE	6,4	0	6,2	18,3	10,6	20,1	8,6	3,5	0,3	2,2	0,1	5,8	4,3	13,6
DK	3,9	0	0,3	12,3	16,1	57,5	0,9	2,8	0,0	0,0	0,1	2,8	2,5	0,8
FR	10,6	0	2,3	19,6	2,3	17,7	24,1	7,7	4,2	0,0	0,0	3,6	0,0	7,8
NL	9,4	0	3,4	17,9	2,6	22,6	20,0	5,8	0,5	0,0	0,5	6,7	0,0	10,6
UK	4,0	0	12,3	28,7	0,0	32,5	5,4	3,1	0,0	0,1	0,0	4,9	1,0	8,0
IE	2,3	0,	1,8	11,3	45,5	5,2	14,9	1,9	3,8	0,2	0,0	11,3	0,7	1,1

Source: Public finance in EMU-2003 [online]

Appendix C: The composition of total revenues at state and local level as a percentage of GDP (year 2000)

	AT		BE		ES		DE		DK	FI	SE	FI	IT	LU	NL	UK	EL	PT
	State	Local	State	Local	State	Local	State	Local										
Taxes o income and wealth	1,9	2	0	0,7	1	0,8	5,5	1,4	15,1	10,3	15,4	0,7	1,6	2,3	0,7	1,5	0,1	0,6
Taxes on production and imports	1,3	2,9	0,8	1,2	1,5	2,2	4	1,6	1,1	0	-	3,6	4,6	0,2	0,7	0	0,2	1,6
Current transfers within general government	4,8	1,5	10,5	2,7	4,2	1,9	1,5	2,1	11,9	3,7	3,8	3,3	4,8	2,2	10,9	7	1,1	1,4
Other	2	2,2	2,3	1,9	1,2	1,2	2,2	2,1	2,4	2,1	-1,4	2,3	2,8	1,4	3,8	1,5	0,7	1,3
Total Revenues	10	8,6	13,6	6,5	7,9	6,1	13,2	7,2	30,5	16,1	17,8	9,9	13,8	6,1	16,1	10	2,1	4,9

Source: Public finance in EMU-2003 [online]