Chapter 3

Monitoring and managing the finances of sub-national governments

In most OECD countries, the finances of sub-national governments (SNGs) form a significant component of overall national finances. SNGs have also been significantly affected by the recent economic and financial crisis. This chapter discusses recent trends in the management of SNG finances and of fiscal relations across levels of government, including the main drivers of SNG debt levels, the limitations on SNGs' capacity to improve their fiscal situation, the various types of fiscal rule and models such as "rainy day funds" that govern and stabilise SNG finances, and related issues and challenges for monitoring and managing SNG finances.

1. Introduction

Sub-national government (SNG) debts represented on average 13% of GDP and 17% of total public debt in OECD countries in 2013. This chapter analyses the main drivers of sub-national government debt, and how they have evolved since the beginning of the financial and economic crisis in 2007. It examines strategies adopted to monitor and control sub-national government debts, and raises some principal challenges and tentative recommendations.

2. Limitations on sub-national governments' capacity to improve their financial situations

SNGs enjoy less autonomy for improving their fiscal situation than central governments (CGs) (Vammalle and Hulbert, 2013). First, the revenue base of SNGs is smaller and SNGs' autonomy to increase revenues is usually limited, with little or no power over tax rates or tax bases, high reliance on transfers, etc. Therefore, for SNGs, it is more relevant to look at deficits and debt as a share of their revenues, rather than as a share of gross domestic product (GDP). On this measure, SNG deficits (as a share of revenues) increased from 1.5% in 2007 to 4.5% in 2010, while the average SNG debt-to-revenue ratio rose from 70% to 83% during the same period. In 2010, it represented more than one-and-a-half years of revenues in countries such as Canada (Provinces), Germany (*Länder*) or Japan.

Second, an important share of SNG expenditure is mandatory and/or difficult to cut, because reductions entail high social and political costs:

- A particularly large share of SNG spending is in critical sectors. On average, SNGs spend 50% of their budgets on education, health and social protection, i.e. sectors where cuts are particularly visible, unpopular, or may be costly in the long run.
- Some SNG expenditures are expected to rise due to demographic factors. Population ageing implies increases in health and elderly care expenditures in the coming decades, which in some countries represent a large share of SNG spending.
- Rules and standards of SNG expenditure are often dictated by higher levels of government. This gives SNGs very little autonomy in deciding to reduce the levels or standards of services delivered in order to reduce their deficits.

Finally, fiscal rules often constrain SNGs' room for manoeuvre, as they have less opportunity to use debt to adjust their budgets. Decreases in revenues therefore rapidly lead to expenditure cuts. The most noteworthy example is in the United States, where almost all US states have a balanced budget rule in their constitution. This led to wide-ranging expenditure cuts in 2008-09 during the global financial crisis, which further amplified the effects of the crisis (Blöchliger et al., 2010).

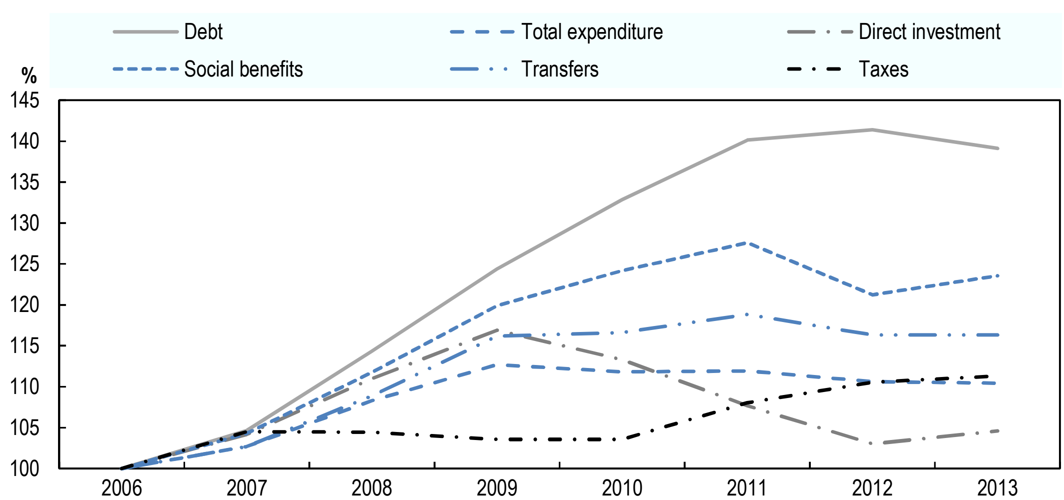
Therefore, looking at the ratio of SNG debt to SNG revenues gives a better picture of the reimbursement capacity of SNGs (Figure 3.2)

3. Recent trends in SNG finances

In most OECD countries, SNGs have been affected by the recent financial and economic crisis, and were active players both in the initial stimulus phase, and in the subsequent consolidation policies.

During the first phase of the crisis (2008-10), SNGs actively contributed to the stimulus policies, and CGs often helped SNGs cope with the crisis, in order to prevent them from running pro-cyclical policies and undermining national recovery plans (Blöchliger et al., 2010). During this period, SNG finances experienced a "scissors effect": tax revenues decreased, while transfers from CG, SNG public investment and SNG spending on social benefits increased (Figure 3.1). As a result, the ratio of SNG deficits to revenues increased from 1.5% in 2007 to 4.5% in 2010 (Vammalle and Hulbert, 2013), and the SNG debt-to-revenue ratio rose from 70% to 83% during the same period.

Figure 3.1. **Evolution of SNG finances since 2006**

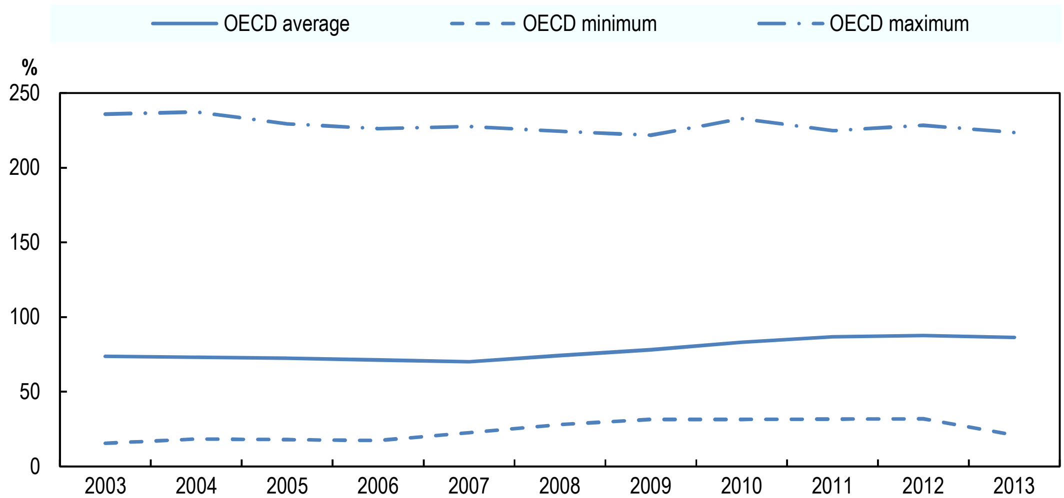


Source: Based on OECD (2015), *OECD National Accounts Statistics* (database), http://dx.doi.org/10.1787/na-data-en.

StatLink http://dx.doi.org/ 10.1787/888933288620

During the second phase of the crisis (2010-12), as most OECD countries engaged in consolidation plans, SNGs were also requested to contribute to the national consolidation effort (Vammalle and Hulbert, 2013), and SNG total expenditure stabilised. Given the flat growth of SNG revenues (both taxes and transfers) and the persistent growth of social transfer expenditures, the adjustment variable was public investment, which fell drastically. SNG debt levels continued to increase until 2012, and have started to decrease since (Figure 3.2).

Figure 3.2**. Development of SNG debt as a share of revenues from 2003 to 2013**



Note: All OECD countries except Chile, Greece, Korea, Mexico, New Zealand, Poland, Turkey. For Australia and Switzerland, data refer to 2012 instead of 2013. OECD average refers to unweighted average. Data consolidated except for Japan, Korea, the United Kingdom and the United States.

Sources: Based on OECD (2015), *OECD National Accounts Statistics* (database), http://dx.doi.org/10.1787/na-data-en and European Commission (2015), *Government Finance Statistics* (database), Eurostat, http://ec.europa.eu/Eurostat/web/government-finance-statistics/data/database.

StatLink http://dx.doi.org/ 10.1787/888933288633

4. What are the main drivers of SNG debts?

Designing an efficient monitoring and/or control mechanism requires understanding what the drivers of SNG debt are. SNG deficits and debt have three main causes:

- Structural mismatch between SNG spending obligations and allocation of revenues. SNG deficits and debts may be the result of the institutional framework created for fiscal relations across levels of government, where the revenues assigned to SNGs are not sufficient to cover their expenditure responsibilities. This would thus result in structural SNG deficits, or the under-provision of public goods provided by SNGs.
- Economic downturns can also generate temporary SNG deficits, and thus contribute to building up SNG debt. Indeed, SNG spending obligations tend to be rather stable over the economic cycle (even pro-cyclical to some extent, for instance when SNGs have social protection responsibilities), while their revenues are more likely to be more sensitive to the cycle. As growth recovers, these deficits should disappear, and SNGs should regain balanced budgets or even surpluses.
- Finally, SNGs may be subject to soft budget constraints and moral hazard, thus leading them to over-spend and issue debt in the expectation that they would receive increased transfers or be bailed out in case of financial difficulty. In this case, monitoring mechanisms and fiscal rules can be useful to prevent structural deficits and accumulation of SNG debts.

The most appropriate policy action and instruments depend on the mix of causes of SNG deficits and debts. **Rainy day funds** can be an effective tool for smoothing out revenues, thus preventing SNGs from issuing debt to compensate revenue decreases (Box 1.5). Rainy day funds are mainly used in federal countries: Canada (state and local levels), Finland, Germany (state and local levels), Mexico (state and local levels), Sweden and Switzerland (state and local levels) (Table 3.1). The formulas used for **allocating grants** are also crucial, as they can be either pro-cyclical, if they are based on current revenues and GDP growth for example, or on the contrary, they can help smooth the cycle, if they are based on the revenues of several past years (as in Denmark). The **allocation of expenditure** can also smooth the cycle, by granting SNGs the least cyclical expenditures (expenditure on education for example tends to be far less cyclical than that on social protection). Finally, **off-budget funds**, ad hoc increases of **CG transfers** or **cuts in mandated expenditures** are also used (Table 3.1).

Table 3.1. **Mechanisms to protect SNGs against cyclical fluctuations of revenues in OECD countries**

	Rainy day funds	Off-budget funds	Higher revenues from CG compensating for projected fluctuations	Higher revenues from CG compensating for actual fluctuations	Special financial support for SNGs facing budget difficulties	Cuts on mandated expenditures	Allocation of less cyclical expenditures
Australia local			x				
Australia state				x			
Austria local							x
Austria state		x					x
Belgium local							
Belgium state							x
Canada local	x						
Canada state	x	x	x				
Chile					x		
Czech Republic		x					
Denmark			x				
Estonia					x		
Finland	x	x	x			x	
Germany local	x		x	x	x	x	
Germany state	x	x				x	
Ireland			x				
Italy local						x	
Italy state						x	
Korea							
Mexico local	x			x	x		
Mexico state	x			x	x		
New Zealand							
Poland							
Slovak Republic		x					
Slovenia							
Spain local				x			
Spain state				x			
Sweden	x					x	
Switzerland local	x						
Switzerland state	x						
Turkey							x
Total answers	10	6	6	6	5	6	4

Source: OECD (2011a), *OECD Network on Fiscal Relations across Levels of Government Survey on Sub-national Fiscal Rules and Macroeconomic Management*, OECD, September 2011, updated in March 2013.

Ageing and health spending, which impact significantly upon SNG finances in many countries, are areas which have attracted a range of approaches to control costs and introduce efficiencies. Box 3.1 outlines approaches adopted across various countries.

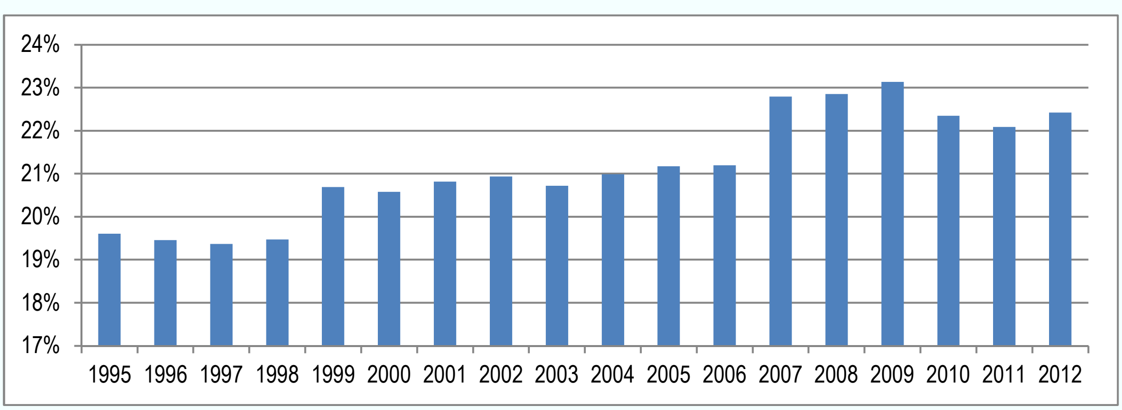
Box 3.1. **Reforms to alleviate ageing and health cost pressures on SNG finances in selected countries**

- **Austria**: The federal government, *Länder* and social security institutions came to an agreement on a healthcare reform that was approved by the National Assembly in 2013. Targets are set to align health expenditure growth with average GDP growth (+3.6% per year). Agreements with sub-national governments aim to ensure a joint planning of public healthcare spending, increase the binding force of planning at the *Länder* level, and establish joint financing. This reform aims to generate EUR 3.4 billion in savings until 2016.

- **Belgium**: Population ageing should have large repercussions on sub-national finances in Belgium, as local authorities are responsible for a large share of social measures in favour of the elderly – in particular via the *centres publics d'action sociale* (CPAS), who own retirement homes or hospitals. Large investments will need to be carried on in the years to come in order to maintain an adequate provision of public services in this sector, which will induce additional stress on sub-national finances. Recently, the sustainability of public finances regarding costs induced by ageing has become a major subject in Belgium. A long-term strategy based on a reduction of public debt was introduced. The diminution in future interest charges paid should generate extra funding to finance social protection expenditures. However, a recent reform (October 2011) of fiscal federalism in Belgium transferred additional competencies to SNGs in 2014, in particular in the health and social protection (including old age) sectors. These additional competencies granted to regions and communities should induce an increase of 4.4% of GDP in SNG expenditures. In parallel, the fiscal autonomy of SNGs should be reinforced, via an increase in autonomous revenues and the suppression of transfers from the federal government (the equalisation system will be maintained). These new competencies granted to regions in healthcare and social protection could hence generate additional fiscal pressures on sub-national budgets in the long run. Moreover, real growth in healthcare spending has been limited at 3% for 2014 for all levels of government.

- **Denmark**: The increase in sub-national local healthcare spending, together with a political will to provide healthcare services equally across regions, were main drivers of the Danish 2007 territorial reform (see below). The reform was implemented in parallel to the Health Act of 2007, and partly aimed to solve problems faced by the healthcare sector, where new medical technologies increased specialisation and called for larger regions. These problems had already led to a hospital reform in the region of Copenhagen, when several small municipalities merged their hospitals to provide a better service.

Local healthcare expenditures as a share of local revenues in Denmark (1995-2012)



Source: OECD (2015), *OECD National Accounts Statistics* (database), http://dx.doi.org/10.1787/na-data-en.

Box 3.1. **Reforms to alleviate ageing and health cost pressures on SNG finances in selected countries *(continued)***

A main argument in favour of the reform was a potential decrease in bureaucratic costs and taxation levels; decentralised public services in healthcare needed to be designed in a way that could "meet future requirements by creating sustainable structures with a clear responsibility to provide high-quality welfare service to the population" while maintaining democratic accountability. Larger local authorities were seen as a solution to this problem. Although the Danish Government expected to generate synergies and economies of scale in the long run, increased costs for municipalities in the short run were envisaged, and should be borne by municipal authorities. Regions are responsible for all hospitalisation services, while municipalities gained responsibilities in medical prevention and health promotion.

This health reform was accompanied by a reform of the financing of local governments towards less autonomy in spending (the independent taxes levied at the regional level were replaced by a health tax, redistributed as an earmarked block grant from the central government to regions and municipalities. The distribution of grants (which finance more than 80% of healthcare activities in regions) is based on a formula based on the expected need for healthcare (including the distribution of age at the local level). The reform was considered as a structural adjustment towards a sustainable provision of healthcare services by sub-national governments. A major evaluation of its impact on service provision and local finances is currently developed by the central authorities.

- **Finland:** The demographic evolution of Finland is anticipated to drastically affect sub-national finances in the years to come. Finland should experience an earlier and faster increase of its old age dependency ratio, compared to other OECD or European countries; in particular, the share of people aged over 80 will increase from less than 15% in 2000 to around 25% in 2050, when it will be high in the OECD and larger than in other Nordic countries. The financing of pensions, health and long-term care should hence become a major issue. Health and social protection account for nearly 50% of total local spending in Finland, and pressures on sub-national finances are already starting to emerge. The new territorial reform of Finland aims to amalgamate municipalities on a voluntary basis in order to create larger entities which would allow reaching an adequate size for efficient service provision, and benefit from economies of scale. Moreover, the Government and the opposition agreed in March 2014 to centralise most social and healthcare expenditure in five regions (they currently are a responsibility of municipalities); the proposal will be examined by the Parliament in late 2014. Municipalities will still be responsible for financing services. If approved, this reform will come into force in early 2017.

- **Italy**: The Government decided to cut healthcare expenditure by EUR 2.5 billion in 2013 and EUR 5.4 billion in 2014, which will affect SNG spending since most of healthcare is decentralised.

- **Japan:** Local governments in Japan are responsible for a large share of public spending in the health and old age sectors. Municipalities manage the National Health Insurance (*kokumin kenko hoken*), one of the two main health insurance schemes in the nation. Since 2000, they are also responsible for the Long-Term Care insurance (*Kaigo hoken*), which covers public spending for old-age services. The ageing population in Japan is a main challenge for local governments. The old age dependency ratio should exceed 30% in 2030 and threatens redistributive expenditures in Japan. Moreover, the elderly tend to concentrate in regions with weaker economies and tax bases, which generate high pressure on local governments in these areas. The value of long-term care services should increase dramatically, from JPY 5.6 trillion in 2004 to an estimated JPY 19.8 trillion in 2025. In response to this financial pressure, the system has already been revised several times (change in unit prices in 2003; exclusion of some costs from insurance coverage in 2005; introduction of the "long-term care prevention allowance" in 2006).

Box 3.1. **Reforms to alleviate ageing and health cost pressures on SNG finances in selected countries *(continued)***

- **Netherlands**: The Social Support and Long-Term Care Act, planning for decentralisation of responsibilities to municipalities in 2015, is under discussion.
- **Poland**: The government is considering decentralising the National Health Fund (NFZ) in 2014-15.

Sources: Vammalle, C., R. Ahrend and C. Hulbert (2014), "A sub-national perspective on financing investment for growth II - Creating fiscal space for public investment: The role of institutions", *OECD Regional Development Working Papers*, No. 2014/06, OECD Publishing, http://dx.doi.org/10.1787/5jz3zvxc53bt-en; OECD (2013a), *OECD Economic Surveys: Austria 2013*, OECD Publishing, Paris, http://dx.doi.org/10.1787/eco_surveys-aut-2013-en; OECD (2014a), *OECD Economic Surveys: Poland 2014*, OECD Publishing, Paris, http://dx.doi.org/10.1787/eco_surveys-pol-2014-en; National Reform Programme 2014 (Finland, Netherlands).

5. Fiscal rules and SNG finances

An alternative or perhaps supplementary approach to the direct monitoring of SNG debt is a rule-based approach to limit SNG borrowing. Fiscal rules aim to restrain one or more dimensions of sub-national governments' fiscal aggregates. There are three main types of fiscal rules applied in this context: budget balance rules, expenditure ceilings and borrowing limits. These usually involve numerical targets based on ratios using either the level of GDP, of tax or total SNG revenues. This section provides a general overview of the use of fiscal rules for SNG finances in OECD countries, then analyses more precisely the three types of rules mentioned above. Finally, the last section focuses on enforcement mechanisms and consequences if rules are not respected.

Fiscal rules for SNGs have been in place in many OECD countries for a long time, and the recent global financial crisis has triggered several reforms tightening sub-national fiscal rules (Vammalle and Hulbert, 2013). However, the impact of fiscal rules on SNG debt is subject to debate (Box 3.2). The effectiveness of rules depends on the ability of SNG to circumvent them, as well as on the monitoring requirements for SNGs.

Balanced budget rules

As Table 3.2 illustrates, the most common types of fiscal rules in OECD countries are budget balance rules and borrowing constraints rule. Many SNGs are subject to a golden rule, and hence are able to borrow for investment purposes only. Direct expenditure limits are less frequent.

For some EU countries (e.g. Austria, Italy), budget balance rules have been modelled to a greater or lesser extent on the EU-wide economic governance rules which curtail excessive deficits and require a "close to balance" fiscal position. It is notable that the surveillance and co-ordination mechanisms across levels of government in some cases resemble those that apply under the EU Stability and Growth Pact (Box 3.3).

Box 3.2. **Impact of fiscal rules on SNG finances: A debated topic**

Legal borrowing constraints might have opposite consequences on SNG debt levels. On the one side, tight fiscal rules are set to restrain governments from over-indebtedness. The empirical evidence on this matter, however, is inconclusive. Some studies find evidence that balanced budget rules have negative impacts on budget balance deficits. Other literature concludes that fiscal rules do not play an important role in ensuring better fiscal performance. In this case, a plausible explanation is that sub-national fiscal rules might not be sufficient to ensure good performance when spending mandates of sub-national governments are underfunded. In any case, an analysis of the impact of fiscal rules on fiscal balances risks to suffer from a severe endogeneity problem because, as highlighted by the recent economic crisis, fiscal rules are often the response to deteriorated fiscal balances rather than the cause. Other experts get around the endogeneity problem by using the fact that in 2001 Italy relaxed fiscal rules for municipalities below 5 000 inhabitants as a quasi-experimental research design. Their estimates show that, on average, this relaxation of fiscal rules triggered a shift from balanced budgets to a 2% deficit.

On the other side, borrowing restrictions may be easily eluded in a situation where the dependence on transfers is high, responsibilities are not clearly allocated, or accountability levels are low. An illustrative example can be found in Italy. Italian local public finances suffered a deep crisis during the 1970s and 1980s due to a tax reform introduced in 1972-73 that drastically reduced the fiscal autonomy of municipalities and made them extremely dependent on central government grants. In this context, some argue, expenditures kept rising and the inability of local governments to raise revenues and cover expenses led them to borrow large amounts of funds from commercial banks. The consequence was that municipalities approached bankruptcy and had to be bailed out by the central governments through an increase in transfers in 1978 (a measure introduced jointly with stricter debt limits). The unintended outcome was that over-indebted municipalities were *de facto* compensated for their bad financial performance through larger transfers. So, high reliance on transfers might generate a common pool problem as SNGs do not fully bear the cost of overspending and this can translate into high levels of debt.

Source: Ahrend, R., M. Curto-Grau and C. Vammalle (2013), "Passing the buck? Central and sub-national governments in times of fiscal stress", *OECD Regional Development Working Papers*, No. 2013/05, OECD Publishing, http://dx.doi.org/10.1787/5k49df1kr95l-en.

Table 3.2. **Types of SNG fiscal rules in OECD countries**

Sub-national government	Budget balance rule	Borrowing constraint	Expenditure limit
Australia local		x	
Australia state	x	x	
Austria local	x	x	x
Austria state	x	x	x
Belgium state	x		
Belgium local	x	x	
Canada state	x	x	
Canada local	x	x	
Chile		x	
Czech Republic	x		
Denmark	x	x	x
Estonia	x	x	
Finland	x		
Germany state	x	x	
Germany local	x	x	
Ireland	x	x	
Italy state		x	x
Italy local	x	X	
Korea	x	X	x
Mexico state		X	
Mexico local		X	
New Zealand	x	X	x
Norway	x	X	
Poland	x	X	
Slovak Republic	x	X	
Slovenia	x	X	
Spain state	x	X	x
Spain local	x	X	x
Sweden	x		
Switzerland state	x		
Switzerland local	x		
Turkey		X	x
Total	26	26	9

Sources: Fredriksen, K. (2013), *Fiscal Rules for Sub-central Governments – 2011 Update of the OECD Indicator*, March, http://www.oecd.org/eco/public-finance/Fiscalrulesforsub-centralgovernments2011updateoftheOECDindicator.pdf; OECD (2011a), *OECD Network on Fiscal Relations across Levels of Government Survey on Sub-national Fiscal Rules and Macroeconomic Management*, OECD, September 2011, updated in March 2015.

Box 3.3. **Recent reforms of SNG balanced budget rules**

- **Austria**: In spring 2012, Austria adopted new Internal Stability Pact, which came into force in December 2012. This pact sets new fiscal rules that apply to all levels of government. Concerning deficits, all levels of government must reach a balanced budget in 2016. From 2017 onwards a structural balance rule will be implemented, relating deficits to the output gap. The general government cycle will be used in order to calculate the SNG structural budget requirements (whose target will represent two-ninths of the total cyclical effect, the other seven-ninths being allocated to the CG). Asymmetric SNG shocks are not considered a problem since SNG revenues have little cyclicality: tax-sharing apportionment formulas between central authorities and the *Länder* rely mostly on population (hence are relatively non-cyclical), and local authorities are mainly financed through less cyclical taxes based on real estate. The new rules also include a debt criterion. All levels of government must reduce their level of debt by one-twentieth per year.
- **Belgium**: The Co-operation Agreement reached in December 2013 between the federal government, communities and regions for implementing the Treaty on Stability, Co-ordination and Governance requires the general government budget to be balanced; individual targets in nominal and structural terms for central and local authorities will be defined.
- **Czech Republic**: A proposal under consideration would require local and central governments to balance their budgets if total public debt exceeds 48% of GDP.
- **Denmark**: The Budget Law approved in 2012 introduces a balanced budget rule: structural deficits (on a yearly basis) should not exceed 0.5% of GDP.
- **Estonia**: The State Budget Act came into force in March 2014, and introduces a budget balance rule for the general government, and breakdown by level of government.
- **Germany:** In 2009, Germany introduced a "debt brake" in its Constitution (*Grundgesetz*) to ensure that sub-national budgets are financed without any structural deficits from 2020 onwards, with only a small structural deficit allowed for the federal budget (0.35% of GDP). In addition, a new instrument, the Stability Council, was instituted to survey all public budgets on an annual basis using common benchmarks, to monitor public borrowing and to co-ordinate medium-term financial planning in a multi-level government context.
- **Iceland**: The Parliament passed a new act on local governments in September 2011, which includes two main fiscal rules on local government finances. The first is a balancing rule for current operations of local governments, obliging them to balance revenues and expenditures over a three-year period. The second is a debt rule that limits the total debt and liabilities of local governments to 150% of total revenue. Local governments with debt and liabilities above 150% are required to bring the debt ratio under this benchmark in ten years. Local governments with total debt exceeding 250% of revenue are prohibited from raising new debt except for refinancing.
- **Italy**: The Domestic Stability Pact introduced a budget balance rule for municipalities and provinces. The Stability Law for 2014-16 ease these budget constraints for local governments to exclude capital account payments up to EUR 1 billion and another EUR 500 million to accelerate payment of past-due debts.
- **Japan**: The Fiscal Management Strategy introduced in 2010 includes numerical targets for the short, medium and long term to reduce the primary budget deficit of the central and local authorities.
- **Mexico**: The Federal Budgetary law (*Ley Federal de Presupuesto y Responsabilidad Hacendaria*) approved in late 2013, introduces a structural balance rule; a constitutional reform to limit state and municipal debt is still under consideration.

Box 3.3. **Recent reforms of SNG balanced budget rules *(continued)***

- **Netherlands**: An agreement anticipating the entry into force of the Law on the Sustainability of Public Finances was reached in January 2013 with local authorities; a multi-annual budget balance path will be introduced for local governments. In 2013, a deficit limit of 0.5% of GDP was applied to local authorities as a whole.
- **Poland**: The Public Finance Act (2011) already stipulated to balance local current budgets. In 2014 new rules came into force for local authorities: the debt servicing-to-revenues ratio must remain smaller than the average ratio of current revenues (plus asset sales and operating expenditure) to total revenue over the last three years.
- **Slovenia**: The Parliament approved in 2013 a balanced budget amendment to the constitution that will come into force in 2015.
- **Spain**: An amendment to the constitution was adopted in 2011 to underpin the fiscal consolidation targets for all Spanish administrations, following the EU framework. The main feature of the reform was that neither the central government nor the autonomous communities were allowed to have deficits which exceeded the maximum set by the European Union, and local governments were required to balance their budgets. The maximum structural deficit should be set according to law as a percentage of GDP. This limit will only be in force from 2020 onward. The Organic Law on Budgetary Stability and Financial Sustainability (2012) introduces a structural balanced budget rule for all levels of governments from 2020 onwards. Debt reduction pathways will be revised in 2015 and 2018 to ensure that this objective is met.

Sources: Vammalle, C., R. Ahrend and C. Hulbert (2014), "A sub-national perspective on financing investment for growth II - Creating fiscal space for public investment: The role of institutions", OECD Regional Development Working Papers, No. 2014/06, OECD Publishing, http://dx.doi.org/10.1787/5jz3zvxc53bt-en; OECD (2014b), *OECD Economic Surveys: Czech Republic 2014*, OECD Publishing, Paris, http://dx.doi.org/10.1787/eco_surveys-cze-2014-en; OECD (2014c), *OECD Economic Surveys: Denmark 2013*, OECD Publishing, Paris, http://dx.doi.org/10.1787/eco_surveys-dnk-2013-en; OECD (2013b), *OECD Economic Surveys: Japan 2013*, OECD Publishing, Paris, http://dx.doi.org/10.1787/eco_surveys-jpn-2013-en; Stability Programme 2014 (Belgium, Estonia, Italy, Netherlands); Convergence Programme Poland (2014); National Reform Programme Slovenia (2014).

Expenditure and expenditure-growth ceilings

Only a relatively small number of OECD countries rely on expenditure limits for sub-national governments. Expenditure ceilings aim to restrain SNGs' spending growth over the medium-to-long run, thereby indirectly limiting SNG deficits. Ceilings can be set annually (Denmark, Italy: state and local) or for a multi-year period (Austria: state and local, through calculations based on the EU mechanism). They may be set proportionally to income (Canadian states, Turkey) or linked to an objective needs criteria, such as population growth (Slovenia, Spanish local governments).

In most countries, expenditure ceilings are set for current (operating) expenditures only (Denmark, Estonia, Italian local governments and Korea). For instance, in Estonia, SNG's operating expenditures may not exceed operating revenues. Overall expenditures are limited in Italian regions only; the Internal Stability Pact (ISP) targets both current and capital expenditures (over 2011-13, regional expenditures must not exceed the expenditure average over 2007-09). In Spain, growth in local public spending must not exceed GDP growth (in nominal terms) for nine years; this limit was imposed by the central government, and additional expenditure ceiling were negotiated with Autonomous Communities.

Expenditure ceilings may restrain spending on specific budgetary lines only (Denmark, Italian local governments and provinces, Turkey). This is typically for personnel expenditure (local governments in Italy, Turkey).

Box 3.4 outlines developments in some OECD countries in the context of fiscal consolidation over recent years.

Box 3.4. **New expenditure ceilings for SNGs in selected OECD countries**

- **Austria**: The new Internal Stability Pact signed in May 2012 introduces a limit on expenditure growth of SNGs: aggregate expenditure growth of all levels of government should not be above the average potential GDP growth.
- **Denmark**: a new system of expenditure control was agreed upon in March 2012. From 2014 four-year binding expenditure ceilings for all levels of governments came into force. They cover most public spending with the exception of investments and unemployment outlays. Municipalities and regions have agreed to limit their expenditures; a breach in the ceiling for a given year will have to be compensated in the following year. Moreover, federal transfers may be reduced in case of non-compliance.
- **Finland**: The Basic Public Services Programme approved in mid-2012 introduces a target for municipal expenditure (the average municipal spending growth must be lower than 0.4% by 2020, assuming that local responsibilities remain the same). Moreover, from 2015 local responsibilities will have to match available funding; new responsibilities will have to be financed either through increased revenues or cuts in other expenditure.
- **Slovak Republic**: Since 2014 individual municipal expenditures for one given year cannot be superior to expenditures for the previous year.
- **Slovenia**: The Fiscal Balance Act introduced several measures to reduce the general governments' debt and deficit, which came into force in mid-2012. In particular limits were set in order to limit labour-related costs for public employees (including at the local level).
- **Spain**: The Organic Law on Budgetary Stability and Financial Sustainability (2012) introduces new expenditure ceilings for SNGs. Variations in expenditures should not exceed the medium-term GDP growth (calculated over three years according to EU methodology)

Sources: Vammalle, C., R. Ahrend and C. Hulbert (2014), "A sub-national perspective on financing investment for growth II - Creating fiscal space for public investment: The role of institutions", OECD Regional Development Working Papers, No. 2014/06, OECD Publishing, http://dx.doi.org/10.1787/5jz3zvxc53bt-en; *OECD Economic Surveys: Austria 2013*, OECD Publishing, Paris, http://dx.doi.org/10.1787/eco_surveys-aut-2013-en; National Reform Programme 2014 (Finland); OECD (2014c), *OECD Economic Surveys: Denmark 2013*, OECD Publishing, Paris, http://dx.doi.org/10.1787/eco_surveys-dnk-2013-en; National Reform Programme Slovenia (2014).

SNG debt and debt-service restrictions

It is also open to countries to introduce numerical limits on the debt level, new borrowing, or debt service costs of SNGs. Indeed, limits of this kind are widely used for SNGs across OECD countries. The most common restrictions are limits on the total level of debt and on the emission of new debt (Table 3.3).

Table 3.3. **Debt and debt service restrictions in OECD countries**

	Limits on debt level	Limits on the issue of new debt (caps)	Limits on debt service	No limits	Other
Australia local				X	
Australia state				X	
Austria local	X				
Austria state	X				
Belgium local	X				
Belgium state					
Canada local	X		X		
Canada state					
Chile					
Czech Republic			X		
Denmark				X	
Estonia	X				
Finland				X	
Germany local		X			
Germany state					
Ireland		X			
Italy local			X		
Italy state			X		
Korea	X	X	X		
Mexico local					
Mexico state					X
New Zealand					X
Poland	X	X	X		
Slovak Republic	X		X		
Slovenia	X				
Spain local	X	X			
Spain state	X	X			
Sweden				X	
Switzerland local				X	
Switzerland state				X	
Turkey	x	x			
Total answers	12	9	7	7	2

Source: OECD (2011a), *OECD Network on Fiscal Relations across Levels of Government Survey on Sub-national Fiscal Rules and Macroeconomic Management*, OECD, September 2011, updated in March 2015.

In most cases, limits are expressed as a share of SNG total or current revenues. They are sometimes set as a share of GDP, and in some rare cases, as a ceiling on total debt.

There is an important variation on the ceilings used across countries: ceilings on the overall level of debt vary from 60% to 150% of total revenues, and those on debt service range from 12% to 25% of current revenues (Box 3.5 provides a range of country examples).

Box 3.5. **Debt and debt service restrictions on SNGs in selected OECD countries**

Restrictions on the level of debt

- **Austria:** A debt brake was introduced for all levels of government in 2012.
- **Czech Republic**: The new Constitutional Act (approved on October 2012) introduces new principles for budgetary discipline and accountability. In particular, at the local government level SNG gross debt shall not exceed 60% of a four-year average of revenues.
- **Estonia**: Total SNG debt should not exceed 60% of total SNG revenues from 2012 onwards.
- **Greece**: Total debt should not exceed regular revenues.
- **Iceland**: The Local Government Act introduces a debt rule that limits the total debt and liabilities of local governments to 150% of total revenue. Local governments with debt and liabilities above 150% are required to bring the debt ratio under this benchmark within ten years. Local governments with total debt exceeding 250% of revenue are prohibited from raising new debt (except for refinancing).
- **Poland**: SNG debt should not exceed 60% of GDP.
- **Portugal**: Two recent laws introduced new fiscal rules for SNGs. At the regional level, the law on the Finances of the Autonomous Regions stipulates that the autonomous regions' liabilities should not exceed one-and-a-half times their three-year average net current revenue. At the municipal level, the law on Local Finances introduces similar requirements for each municipality individually (municipalities' liabilities should not exceed one-and-a-half times their three-year average net current revenue).
- **Slovak Republic**: Total SNG debt should exceed 60% of total SNG current revenues.
- **Spain:** The Organic Law on Budgetary Stability and Financial Sustainability introduces overall debt ceilings for all levels of government. Debt should not exceed 13% and 3% of GDP for autonomous communities and local governments, respectively. Moreover, SNGs should no longer be able to borrow in order to finance current expenditures after 2020.
- **Turkey**: SNG debt should not exceed 100% of SNG annual revenues. This ratio is set at 150% for metropolitan municipalities and provinces.

Restrictions on debt service

- **Czech Republic**: SNGs a debt service ratio should not exceed 30% of SNG revenues.
- **Greece**: Debt repayments should not exceed 20% of regular revenues.

Box 3.5. **Debt and debt service restrictions on SNGs in selected OECD countries *(continued)***

- **Italian local governments**: Interest payments should not exceed 12% of current revenues.
- **Italian regions**: Interest payments should not exceed 25% of revenues from taxes, transfers and property sales.
- **Poland**: The sum of loan instalments and interest payments must not exceed 15% of total debt (until December 2013). From 2014 onwards, local governments' debt service should not exceed a three-year average sum of operating surpluses and privatisation receipts.
- **Slovak Republic**: Loan instalments and interest should not exceed 25% of current revenues for the previous year.

Restrictions on debt maturity

- **Mexico**: A bill passed the Senate in April 2013 that proposes a constitutional change to impose stricter controls on SNG borrowing (it still has to pass the lower house to be ratified). If validated, debt would not be used to finance current expenditures, and should be repaid by the end of the contracting administration.

Source: OECD (2011a), *OECD Network on Fiscal Relations across Levels of Government Survey on Sub-national Fiscal Rules and Macroeconomic Management*, OECD, September 2011, updated in March 2015.

Such debt and debt service restrictions are not used by regions/states in very decentralised countries (federal and quasi-federal). However, in federal countries, states/regions often set restrictions for their local governments, thus leading to different situations across the country (e.g. Canada). These limits may also differ among SNGs when they are self-imposed (as in New Zealand).

Enforcement of SNG fiscal rules

Rules and controls are only effective if they are actually enforced, and SNGs that break the rules are in general subject to a range of consequences. In the context of the recent fiscal consolidation plans, several countries have tightened their sanction mechanisms in case SNGs break their fiscal targets (e.g. Spain, Italy). Sanctions and procedures for SNGs breaking fiscal rules must not be confused with the procedures in place for SNGs facing financial difficulties, even if they are sometimes similar.

In addition to establishing new or strengthening existing fiscal rules, some countries have also tightened their enforcement. This has been achieved either by increasing the transparency and reporting requirements, imposing financial sanctions or restructuring plans on SNGs breaking the rules. Some countries have even established new sanctions for political officials responsible for breaking the rules (Box 3.6 provides a range of country examples).

Box 3.6. **Enforcement of fiscal rules for SNGs**

- **Austria**: Austria's new fiscal rules foresee that if a government misses its target, an internal excessive deficit procedure (EDP) will be launched. It will benefit from a tolerance for one year; however, if the target is missed for two consecutive years, sanctions apply. Within the framework of this internal excessive deficit procedure, the government which missed the target is given two months to design appropriate action to restore its public finances. Sanctions are decided by vote in a co-ordination committee between levels of government, where the concerned government level is not allowed to vote (note that this holds even for the central government). Financial sanctions will represent 15% of the deviation, to be deducted from shared taxes.
- **Czech Republic**: In addition to introducing new debt and deficit ceilings, the 2012 Constitutional Act strengthened enforcement mechanisms. If the debt target is not respected, central authorities may cut revenues to a municipality or region by 5% of the difference between its amount of debt and the 60% target. These suspended revenues can only be released to repay SNG debt obligations made before the year in which the suspension occurred.
- **Germany**: The 2010 constitutional amendment included the establishment of a Stability Council to monitor the budgetary developments at the federal and *Länder* levels, and introduced a federation-wide early warning system to prevent budgetary distress. The Stability Council replaces the former Financial Planning Council, and is composed of the federal ministers of finance and economic affairs, as well as the *Länder* ministers of finance. In 2013 the Stability Council was also charged with monitoring compliance with the upper limit on the general government structural deficit under the Budgetary Principles Act twice a year. An independent advisory board was set up to support the Stability Council in monitoring compliance with the upper limit on the general government structural deficit.
- **Italy**: Enforcement of the Internal Stability Pact was strengthened in 2011 by the introduction of a wide range of possible sanctions. For example, regions breaking the fiscal rules may not be allowed in the following year: a) to commit current expenditure (net of health) beyond the minimum commitment of the last three years; b) to hire new personnel; c) to hire external managers; or d) to issue bonds and take out loans, not even for investment purposes. Regions may even experience a reduction or suspension of financial transfers from the CG. Reporting rules have also been tightened, in particular for periods before elections. The audited financial statements of the regions must be published on their websites. If the results are not consistent with the Italian Internal Stability Pact, heavy sanctions may be imposed on the political officers, such as automatic disqualification from office and a ten-year interdiction from office.
- **Slovak Republic**: The Constitutional Act No. 493/2011 on Fiscal Responsibility stipulates that from 2015 onwards, sub-national governments exceeding the debt target will pay a fine of 5% of the difference between the debt level and the target.
- **Spain**: Where the autonomous communities missed their deficit target by a wide margin in 2011, the Organic Law on Budgetary Stability and Financial Sustainability introduces sanctions for governments deviating from fiscal rules: they should submit a restructuring plan and, in the case of repeated deviations, a temporary (partial or total) re-centralisation of budgetary powers could be imposed.
- **Turkey**: The municipal law No. 5393 states that if local authorities do not comply with fiscal rules, the related provisions of the Turkish Panel Code regarding malpractice apply. Hence central authorities may impose sanctions to responsible personnel (local representatives may undergo a trial on Turkish Criminal Code).

Source: OECD (2011b), *OECD Network on Fiscal Relations across Levels of Government Survey on the Impact of National Consolidation Strategies on SNGs and the Strategy of SNGs*, OECD, September-October 2011, updated in January 2012; Stability Programme for the Slovak Republic 2014-17 (2014).

Procedures in cases where SNGs fail to meet fiscal rules range from actions from CGs, or actions taken by SNGs themselves. In many OECD countries, CGs may take action without making any changes to legislation:

- The most common procedure consists of a CG imposing non-financial sanctions on SNGs breaking the rules (either automatic or discretionary), obliging SNGs to offset the breach in future budget, or to take measures so that the rule is respected in the future.
- Financial sanctions may also be applied to SNGs. These can take the form of a fixed fine, or decreases in transfers or shared taxes from a CG. In the Slovak Republic, the Ministry of Finance may impose a fine up to EUR 16 597 to SNGs breaking fiscal rules. The new Austrian fiscal rules introduce possible deduction in shared taxes, proportional to the deviation.
- Administrative sanctions reducing the freedom of SNGs are used in a few OECD countries. Such sanctions often take the form of greater control of central authorities over sub-national finances, through the appointment of a public officer in charge of monitoring to some degree SNG revenues, spending and borrowing.
- Finally, in some countries, sanctions on SNG officials are also possible. These go from their removal (in Poland, local governments' councils or executive bodies may be dissolved) to possible penal sanctions (Italy, Turkey).

Table 3.4 provides an overview of country practices in this regard.

6. Key outstanding challenges for monitoring SNG finances

CGs face a number of challenges when monitoring SNG debts, which can be usefully and concisely summarised under the sections set out below.

Lack of information about SNG budgeting practices

In many countries (particularly in federal and quasi-federal countries), SNGs are free to set their own budgeting laws and practices, and the CG may have little information about these. Canada has recently used the "OECD Budgeting Practices and Procedures Survey" (OECD, n.d.) to gather information about provincial budgeting practices, which were until then obscure for the CG. The results of the survey show a large variety of practices across provinces, with some using more modern budgeting instruments than the CG itself (Rigaud and Arsenault, 2013).

Lack of appropriate and timely information about SNG financial and debt situation

According to OECD Budgeting Principle No. 5, budget documents and data should be open, transparent and accessible. But financial information reported by SNGs often comes with a long time lag, and is often incomplete, thus preventing CG from taking timely corrective measures. Timely information is important for SNGs and CGs to react rapidly to deteriorating fiscal situations of sub-national entities, but also to identify early deviations from fiscal rules, and hence take early correction measures. A recent experience of the OECD Secretariat illustrates this lack of information of CGs on SNG finances: a survey was recently sent out to countries to build a database of financial variables (revenues, expenditures, debt) by region, and only eight countries were in a position to provide such information.

Table 3.4. **Enforcement actions of SNG fiscal rules taken by higher levels of government (without changes in legislation)**

	Oblige SNGs to take measures (raising taxes, reducing spending, etc.)	Oblige SNGs to offset the breach in future budget	Remove, replace of punish officials	Impose financial sanction on an automatic basis	Impose financial sanction on a discretionary basis	Impose administrative sanctions that limit the freedom of SNGs	Make recommenda-tions on corrective measures
Australia local			X			x	x
Australia state							
Austria local							
Austria state							
Belgium local	x (borrowing constraints only)	x (balance budget rule only)					
Belgium state					x (balance budget rule only)		
Canada local			x	x		x	x
Canada state							
Chile							
Czech Republic					x		
Denmark				x (expenditure ceilings only)	x		
Estonia	x			x			x
Finland							x
Germany local		x (balanced budget rule only)			x (balanced budget rule only)	x	x (balanced budget rule only)
Germany state							
Ireland			x				
Italy local	x (balanced budget rule only)	x (balanced budget rule only)	x (expenditure ceilings only)	x		x (balanced budget rule only)	x
Italy state	x	x	x	x		x	x
Korea	x					x	
Mexico local							
Mexico state							
New Zealand	x (balanced budget rule only)						x
Poland			x				
Slovak Republic				x?	x		
Slovenia							x
Spain local	x						x (except expenditure ceilings)
Spain state	x (balanced budget rule only)	x (borrowing constraints only)					x (balanced budget rule only)
Sweden		x					
Switzerland local	x	x		x	x	x	x
Switzerland state							
Turkey		x	x (borrowing constraints only)			x (expenditure ceilings only)	

Source: OECD (2011a), *OECD Network on Fiscal Relations across Levels of Government Survey on Sub-national Fiscal Rules and Macroeconomic Management*, OECD, September 2011, updated in March 2015.

Ensuring reliability of financial information provided by SNGs

Financial audit is necessary to assess the quality of financial reporting and the reliability of financial information. Audits and controls may be centralised at the CG level, or decentralised (with sub-national governments directly in charge of controls). In such a decentralised framework however, the central government still has a major role to play: it should "set the standards and monitor the effectiveness of the internal control systems at the local level" (Baltaci and Yilmaz, 2006). A decentralised control approach may be more adequate in countries where SNGs enjoy a strong degree of financial autonomy, as sub-national governments are directly responsible for preparing and executing budgets. Most OECD countries have introduced some form of auditing of sub-national finances (Box 3.7 provides some country examples).

Box 3.7. **Auditing local finances in Sweden and France**

In Swedish municipalities and county councils, an assembly is granted authority for decision making, while elected representatives (regrouped in committees) are responsible for administration and execution. Following the Local Government Auditing Inquiry (1998), the assembly elects auditors to monitor the financing and executing of policies. All the audits must be carried out independently, in accordance with standards published by the Swedish Association of Local Authorities and the Swedish Federation of County Councils.

In France, the Decentralisation Law of 1982 created the regional chambers of audit. These public bodies are responsible for an *ex post* auditing of SNG accounts, and must also review the management of local governments and related entities. A recent report from the *Cour des Comptes* points out excessive spending and poor management in many French SNGs, with particularly high personal expenses, growing rapidly. Moreover, the court criticises the quality of financial data provided at the sub-national level.

Sources : Baltaci, M. and S. Yilmaz (2006), *Keeping an Eye on Subcentral Governments: Internal Control and Audit at Local Level*, The International Bank for Reconstruction and Development/The World Bank, http://siteresources.worldbank.org/ WBI/Resources/InternalControlandAuditatLocalLevel-FINAL.pdf; *Cour des Comptes* (2013), *Les Finances Publiques Locales*, https://www.ccomptes.fr/Publications/Publications/Les-finances-publiques-locales.

Lack of comparability of SNG data

Financial information provided by SNGs is often not homogeneous across SNGs, and thus, it may be difficult for CGs to compare SNGs' situations, and to assess the sustainability of their debts.

Homogeneity of sub-national accounting rules facilitates the processing of budgetary and financial information. Local governments' accounting standards tend to be more homogeneous than those of regions/states. In federal and quasi-federal countries in particular, a large share of federated entities do not abide by homogeneous accounting rules for budgets. Local governments use the same accounting standards as CGs in 11 countries, while this share is only the case in 3 states/regions.

Ensuring that SNG budgets present a true, full and fair picture of their public finances

OECD Budget Principle No. 7 requires that budgets present a true, full and fair picture of the public finances. In practice, the experience of many countries has been that – partly in response to the rigours of fiscal rules – some SNGs have resorted to “fiscal gimmicks”, the use of off-balance expenditure, and other practices that reduce fiscal transparency. Off-budget funds and local public enterprises or agencies are frequently used by SNGs, and should be closely monitored. Box 3.8 provides some relevant country examples.

Box 3.8. **Example of regulation of off-budget funds in SNGs in OECD countries**

Municipal off-budget funds in Portugal

In Portugal, most local governments maintain off-budget funds through municipalised services (*serviços municipalizados*, entities with special statute, created with the aim of increasing flexibility in the provision of public services) and local enterprises. In 2010, the amount of debt of municipalised services and local public enterprises was estimated around EUR 147 million and 1 787 million respectively.

The Local Finance Law (2013) sets new fiscal rules for local governments in Portugal, through the introduction of individual borrowing limits for sub-national entities. The definition of debt considered for the rules have been extended, and includes local governments themselves, municipalised and inter-municipalised services, inter-municipal entities, municipal associations, local enterprises, enterprises owned partly by municipalities, etc. Hence this reform should increase transparency over sub-national finances and limit the use of off-budget funds by local governments.

Reform of the Australian Loan Council

The formal legislation introducing the Australian Loan Council, passed in 1927, was amended in 1936 in order to cover a broader spectrum of sub-national debts.

The 1927 Financial Agreement granted the Commonwealth significant powers over states’ debt in terms of management, regulation, etc. However, following this initial legislation, many attempts were made by state governments to circumvent the Loan Council’s borrowing limits through the use of off-budget entities. To address this issue, the 1936 reform extended the Council’s authority to debt issued by local and semi-government bodies.

Sources: Portuguese Public Finance Council (2012), “Analysis of debt limits in the regional and local finance bills”, *Occasional Paper* No. 1/2013; von Hagen et al. (2000), “Subcentral government bailouts in OECD countries: Four case studies”, *Inter-American Development Bank Research Working Paper* R-399.

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