Session 4

FISCAL RULES IN A DECENTRALISED FRAMEWORK

FISCAL FEDERALISM AND THE STABILITY AND GROWTH PACT: A DIFFICULT UNION

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1. Introduction

During the Nineties, the degree of fiscal decentralisation in EU member states increased: a process to enlarge the responsibilities of local governments in the management of public expenditure and taxation was set in motion in some countries not organised on a federal basis[1].

During the same years, budget rules aimed at guaranteeing the soundness of the public finances of EU member states and ensuring margins for counter-cyclical policies were defined and introduced at the European level. These rules are based on the consolidated budgets of general governments. The existence of different levels of government is not taken into account.

The interaction between these two developments has not yet been adequately examined. This paper proposes a first analysis of the compatibility between the degree of decentralisation decided at national level and the budget rules introduced at European level.

In highlighting the allocative advantages of local autonomy, traditional theories of fiscal federalism stress the need to guarantee both control of national public finances and the possibility of carrying out counter-cyclical policies at the national level. To that end, the introduction of limits on transfers from the central government and on recourse to market financing by local governments is necessary. These constraints must be flexible, in relation to cyclical events and to the need to spread the burden of public-sector investment over several generations.

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* Banca d'Italia. The views expressed in this paper are those of the authors and do not commit the Banca d'Italia.

1 In this paper, the term federalism has been attributed a broad meaning. With regard to the significance of the term federalism and the classification of the various institutional structures that can be defined federal, see for example Brosio (1996), Forte and Cerioni (1996) and Patrizii (1998).

These theoretical indications have been confirmed by the legislation adopted in many countries. When regulating the activities of local governments, it is unusual to rely solely on market action, i.e. penalisation in terms of higher interest rates, which would affect the most indebted governments. Variations of the so-called golden rule are often applied. Despite placing constraints on indebtedness, the possibility to compensate possible overshoots over several financial years is almost always permitted: on an annual basis the constraints apply *ex ante* but not *ex post*.

The launch of the Monetary Union posed a problem for fiscal regulation at the European level. The solutions adopted in several countries with federal structures are more flexible than the rules defined in the Maastricht Treaty and in the Stability and Growth Pact: the rules are defined in relation to numerical parameters that also have to be observed *ex post*; flexibility is envisaged only in connection with exceptional cyclical events or others beyond the control of governments; a monitoring procedure was introduced that provides for the formulation of multi-year financial programmes and the possibility formally to recommend corrective measures during the course of the year and to impose monetary sanctions in cases of default.

These rules apply to national states; there is no reference to local governments in the Union documents. Although the operations of all levels of government are relevant to compliance with the regulations, which refer to general government, in fact it is the central government that is responsible for compliance and for paying any penalties in the event of violation. Without suitable regulation, local governments that have the possibility to take on debt could free-ride on the back of central governments. More generally, a potential conflict exists between the constraints placed on national public finances and the flexibility allowed to decentralised public finances.

In those countries that are already organised on a federal basis and in those in which reforms are underway to increase the degree of decentralisation, the need to conform national rules to the new European context is strong. The level of domestic flexibility must be made compatible with the lower level envisaged in the Stability and Growth Pact; the asymmetry between the responsibilities assigned to the central government and those assigned to regional and local governments must be corrected.

The analysis conducted in this paper demonstrates the difficulty of reconciling full enjoyment of the allocative benefits of fiscal decentralisation with full utilisation of the margins for counter-cyclical policies offered by compliance with the Pact. In considering possible solutions, particular attention is addressed to the solution outlined in Italy in the Domestic Growth Pact; it is pointed out that such solution will need to be improved.

The second section of this paper briefly examines the propositions which have gained a wide consensus in the literature on fiscal federalism, comparing theoretical precepts with the practical solutions adopted in countries with federal structures. The third section first summarises the European regulations on public-sector budgets and then examines their implications for regulating the relations among the various levels of government at the national level. The fourth section analyses the solution adopted by Italy in the context of increasing decentralisation of responsibility for expenditure and revenue.

2. Fiscal federalism and budget constraints

The current structure of national states is the result of a long process of aggregation and disaggregation of different jurisdictions, which over time have yielded some fiscal prerogatives while maintaining others. In recent decades a clear tendency to decentralise responsibility for expenditure and taxation has emerged in many countries (Ter-Minassian, 1997; Wildasin, 1997).

Economic theory also offers reasons favouring decentralised forms of government. Responsibility for the management of services should be entrusted to that level of government whose jurisdiction comes closer to the area in which the services are provided. In this way, supply could be adjusted to the needs and preferences of the citizens of each region, thus allowing closer monitoring of the conduct of elected representatives and competition among local governments to the benefit of citizens[2]. The expenditure functions assigned to each level of government affect the allocation of sources of tax receipts and financial relations between central and local governments.

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2 For a critical analysis of these indications, see Fausto (1996 and 1999).

This section examines the implications, in terms of instruments for controlling indebtedness in situations of decentralised finance, of two types of federation: the first type resembles a union of sovereign states (corresponding to the institutional structure of the European Union); the second is closer to the prescriptions of economic theories on fiscal federalism[3]. The solutions adopted by the leading federally-structured countries are also analysed.

2.1 Budget constraints in a situation of radical federalism

Let us consider a situation in which local governments enjoy absolute autonomy in matters of public expenditure, taxation and recourse to debt. In this context, the stability of monetary and financial conditions represents a public good to which all local governments contribute by maintaining sustainable budget positions. There is an incentive for each local government to exploit the benefits accruing from the discipline of others without itself complying with the rules (free-riding). This creates a double cost for the other entities: the free-rider's excessive indebtedness can put pressure on interest rates to rise; it can also result in bankruptcies requiring bail-outs[4].

Before all else, we must ask if market regulations can avoid these kinds of situation. For regulations to be effective, certain conditions have to be met (Lane, 1993):

a) no government body should have privileged access to the market;
b) the market must have access to all the information necessary to evaluate the financial reliability of each body;
c) the bailing-out of troubled bodies must not be allowed;
d) mechanisms to ensure that entities react to market signals must exist.

These conditions are both very strict and unlikely to obtain simultaneously. In particular, the reaction times of decentralised fiscal authorities may be excessively long, for example when administrators work to short time horizons. It is also difficult to ensure absolute

[3] The distinction made in this paper is comparable to the more common one between confederations and federations.

[4] Somewhat similar problems arise with regard to fiscal competition, i.e. the introduction of preferential tax treatment in order to attract tax bases. On this subject, see for example Smith (1996).

credibility of the ban on bail-outs. Finally, evaluation of the financial situation of a body could be hindered by “creative accounting”.

Consequently, it may be useful to supplement market rules with the means to control the overall indebtedness of a federation’s members. Excluding administrative controls, which require local governments to obtain prior approval of their financial strategies from central governments and which by their very nature are incompatible with a federal structure, two solutions may be considered:

a) collective management of indebtedness;
b) the introduction of rules (balanced budget, pre-fixed ceiling for the total deficit, golden rule) and sanctions for non-compliance.

With co-operative solutions, all levels of government must be involved in formulating the objectives of economic policy and be responsible for their attainment. However, these solutions do not eliminate the incentive for opportunistic behaviour. Moreover, co-operation may require protracted negotiations, especially when a large number of bodies is involved, to the detriment of the effectiveness of economic policy.

The introduction of rules also raises various problems, such as the credibility of their rigorous application, in particular for the management of bail-outs, and the possibility of efficient monitoring to avoid forms of “creative accounting”.

For these reasons an eclectic approach appears useful, one that combines rules with forms of co-operation based on peer pressure. Such an approach must in any case keep account of the need to allow margins of flexibility in order to offset cyclical effects on the budget without adopting pro-cyclical policies and to deal with exceptional circumstances that impact on the recourse to debt[5].

Considerations of tax-smoothing and inter-generational equity may justify the funding of certain activities through limited recourse to debt. The problem is especially acute in the case of public-sector investment. The realisation of major projects requires a substantial temporary increase in total expenditure; without recourse to debt, this implies a peak in taxation, the intensity of which may lead to the projects being abandoned. In addition, since the benefits of the project may be spread over a long

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[5] The solution adopted by the European Union includes these features (see Section 3.1).

period of time, financing it through taxation would lead to an unfair division of the burden among generations[6].

2.2 The economic theory of fiscal federalism

The literature on fiscal federalism is very extensive. A complete survey is beyond the scope of this paper and we will therefore limit ourselves to summarising the key propositions on which there seems to be broad agreement.

The main advantage of a federal structure is increased efficiency resulting from the decentralization of allocative functions. On the other hand, a central government can perform the functions of redistribution and macroeconomic stabilisation more efficiently[7].

The crucial element in the production of public goods is the territorial range of the benefits: each public service should be produced and financed according to the preferences of the citizens residing in the area that enjoys the benefits. This area may coincide with national boundaries or it may be limited to a particular region. The fact that political processes are needed to disclose the citizens' preferences justifies the existence of several administrative jurisdictions[8].

The redistribution function could also be interpreted as a local public good (Pauly, 1973), with each community being allowed to decide its own level. However, the analogy with the allocative function no longer holds if the effects on the citizens' choice of domicile are considered: where capital and labour are highly mobile, significant differences in redistribution levels may cause "the rich to flee the poor and the poor to chase the rich" (Musgrave and Musgrave, 1984, p. 514).

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6 See Balassone and Franco (1998) and the references therein. For an analysis of the problems connected with public-sector investment within the framework of the Stability and Growth Pact, see Balassone and Franco (2000).

7 The principal bibliographical reference is Musgrave (1959). For an updated discussion of the problem of the allocation of expenditure functions, see Ter-Minassian (1997).

8 One difficulty arises from the fact that it is rare for public services to coincide with territorial divisions: theoretically, it could be necessary to provide as many jurisdictions as there are services to be produced. There are also problems in relation to free-riding and the difficulty of expressing preferences (see Olson, 1965, and Arrow, 1951). Solutions to these problems have been suggested (for example, Tiebout's "voting with the feet", 1956). The classic reference on the optimal size of jurisdictions is Buchanan (1965); for an updated analysis, see Cornes and Sandler (1995).

A centralised authority for stabilisation is justified by the risk that the impact of built-in stabilisers and expansionary or restrictive measures decided at local level may be diminished or annulled if jurisdictions are closely integrated in economic terms[9]. The co-ordination of decentralised stabilisation policies may also be hindered by incentives for local authorities to behave as free-riders.

By virtue of the functions assigned to it, the central government should have access to the tax bases that are more mobile, more sensitive to cyclical factors and less uniformly distributed.

A rigorous interpretation of this criterion would allocate the lion's share of tax bases to the central government. Income and capital transfers are adequate tax bases for redistribution policies. Moreover, income tax is particularly sensitive to the cycle, as is sales tax. Finally, corporate income tax should be allocated to the central government so as to avoid distortions in choosing where to locate productive activities[10]. Local governments would retain only property tax and public utility charges[11]: the former affect tax bases that are not very mobile; the latter permit full application of the benefit principle.

This implies that the revenue sources allocated to local governments may be insufficient to finance the expenditure relevant to the functions assigned to them. It may become necessary to make transfers to decentralised bodies or allow them a share of the central government's tax revenues. If qualitative and quantitative standards affecting the local production of public services are imposed at national level, the need for forms of financial support may increase.

Separating the responsibility for expenditure and its financing weakens the cost-benefit relationship associated with public services, reducing the allocative advantages of a decentralised system[12]. In addition, transfers not subject to pre-defined limits do not encourage efficient

9 The importance of these considerations for the allocation of stabilisation functions in the European Union tends to increase as the markets gradually become more closely integrated.

10 The assigning of mobile tax bases to decentralised governments also risks encouraging fiscal competition; (see, for example, Smith, 1996).

11 The difficulty of evading taxes on natural resources makes them suitable to decentralised levels of government. However, the fact that the central government is responsible for their allocation among the different jurisdictions argues in favour of their attribution to the latter.

12 See, for example, Buchanan (1967) and Oates (1972).

management[13]; central governments' financial support to local administrations has often been cited as one of the factors underlying the excessive growth in public expenditure[14]. In some circumstances, increases in local government spending can jeopardise macroeconomic stabilisation measures carried out by central governments.

Controls on the managerial efficiency of local authorities and limits on transfers and revenue-sharing are necessary. Just as controlling the indebtedness of local governments in conditions of "radical federalism" cannot be rigid, nor can controls on transfers. There must be margins to offset the effects of cyclical swings or exceptional events on the budget and to permit tax-smoothing measures. One possibility is to allow recourse to debt, but this raises the problems already indicated in Section 2.1.

2.3 Fiscal federalism in practice

Reference to western nations provides a wide range of arrangements for the allocation of expenditure and revenue functions and for controls on local government indebtedness.

At the end of the eighties, the share of central government outlays in total public-sector spending ranged from 41 per cent in Canada to 95 per cent in Paraguay (Ahmad *et al.*, 1997). The allocation of expenditure functions among the different levels of government partly reflects theoretical indications: in several cases the territorial range of the benefits seems to be the criterion; (most countries assign defence, foreign affairs and international trade to the central government but local transportation, firefighting and city police services to local governments.) Central governments are generally responsible for redistribution. However, responsibility for particularly important expenditure functions, such as

[13] The structuring of transfers so as to provide useful incentives is one of the most complex elements in the theory of fiscal federalism. Cullis and Jones (1992) offer a review of the budget constraints determined by different types of transfer. Garcia-Milà *et al.* (1999) stress the risks associated with heavy reliance on central government grants, especially when institutions make it difficult for the central government to avoid a regional government expectation of higher future grants in response to increased borrowing.

[14] King (1984) examines explanations of the so-called "fly-paper effect" (i.e. the fact that an increase in central government transfers causes an increase in local public-sector expenditure that is greater than that which would result from an equivalent increase in personal income); see also Oates, 1979. For the implications of programmes in which the benefits are geographically concentrated and financing is met by general taxation, see Weingast *et al* (1981).

healthcare and education, is not predominantly assigned to any given level of government.

The contribution of local governments' own revenues to total public-sector revenue also varies greatly: in the early nineties, in the industrialised countries, it ranged from 3 per cent in the Netherlands to 49 per cent in Canada (Norregaard, 1997). The solutions adopted are often based on theoretical indications: in general, property taxes are assigned to local governments, while corporate taxation is assigned to central governments (in relation to the different degree of mobility of the respective tax bases); income and sales taxes are assigned to the central government, on account of their sensitivity to the cycle and of the redistributive function of income tax.

There are three means of covering any imbalances between local governments' revenues and spending: sharing in central governments' tax revenues; transfers; and indebtedness. The importance of controlling local government spending is confirmed by widespread dissatisfaction with the utilisation of funds transferred from central governments (Ter-Minassian, 1997): varying kinds of organisational structures have been criticised, from "conditional" transfers for healthcare and transportation utilised in Italy, to unconditional transfers for Medicaid and support of large families in the United States, to transfers based on full reimbursement of expenses for healthcare and higher education in Canada.

Recourse to debt is generally permitted. The industrialised countries rarely rely on market regulation alone; Canada is the only country that does not have provisions to limit the provinces' debt or other central government controls[15]. Brazil had relied on market regulation in the past, but in 1996 it introduced controls following the rapid accumulation of debt by the local governments. The market model was also not effective in Argentina. In Australia and the Scandinavian countries, central and local governments co-operate in defining the objectives for national public finance. Pre-determined regulations are in force in the United States, Spain and Switzerland. Germany utilises a combination of rules and co-

[15] The Canadian experience seems to suggest that there are large lags in the effects of market controls: despite a significant deterioration in its rating and a subsequent increase in risk premium, the debt of the Canadian provinces consistently increased for years before corrective budget policies were introduced (Ter-Minassian and Craig, 1997). For a different view of the issue, see the comments by F. Delorme in this volume.

operation. The rules generally limit the total deficit, permit indebtedness for certain objectives only or set a ceiling on expenditure for interest payable. The constraints on indebtedness generally apply *ex ante*: possible overshoots may be compensated for in subsequent financial years[16]. Direct administrative controls are particularly widespread in non-federal states.

3. European tax regulations and their implications for national legislation

3.1 European balance sheet regulations

The model of European Union created by the Treaty of Maastricht is similar to the radical federalist system described in 2.1 above: member states have retained virtually total sovereignty in questions of expenditure and taxation.

A simple formalisation of the no-rules risk

The risk of free-riding posed by a Monetary Union without budgetary rules[17] can be represented in terms of simple games such as “prisoner’s dilemma” or “hawks and doves”.

For the sake of simplicity, let us suppose there are only two member states (I and J) and that the game is perfectly symmetrical. The tax regime of each state produces a benefit (B) and carries a cost (C) - with B>C - and the benefits are divided equally between the two states, so that the outcome for each is B-C provided both are co-operative. If one country is not co-operative it will incur no costs but will continue to receive its part of the benefits produced by the other’s co-operation (with the result B/2), while the other country will reap B/2-C only. If both countries are not co-operative, each will obtain D (Figure 1).

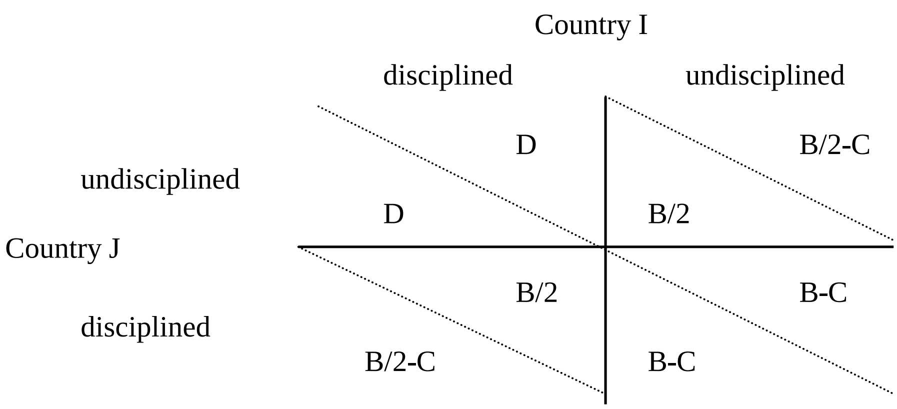
If the order of possible outcomes is B/2>B-C>D>B/2-C the game is a prisoner’s dilemma. If the order of possible outcomes is B/2>B-C>B/2-C>D the game is hawks and doves.

16 This, for example, is the case of the United States; for a detailed analysis, see McGranahan (1999).

17 For references to this risk, see among others: Canzoneri and Diba (1991), Allsopp and Vines (1996), Artis and Winkler (1998), Eichengreen and Wyplosz (1998).

Figure 1

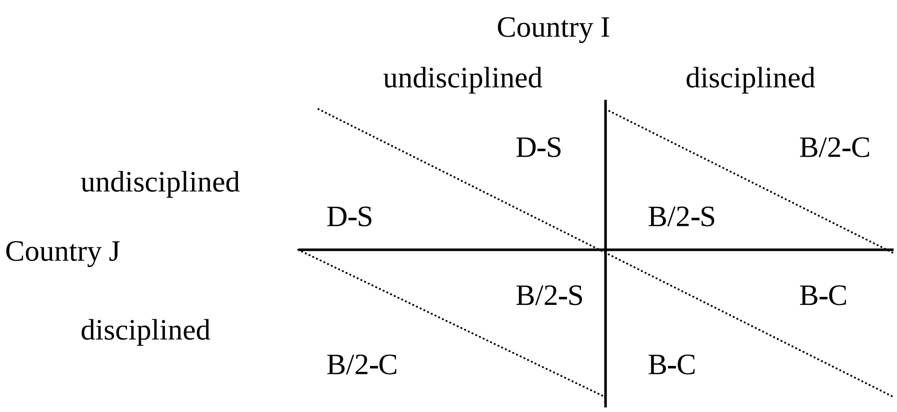
A general game at EU level (1)



(1) The outcome obtained by Country J is shown beneath the diagonal dotted lines; that obtained by Country I is shown above them.

Figure 2

A sanction is introduced



In the prisoner's dilemma the uncooperative strategy wins over the co-operative strategy (by guaranteeing a better outcome regardless of the other player's strategy) so that both countries have an incentive to adopt it. An equilibrium is thus the result of both countries adopting an uncooperative strategy. In hawks and doves there is no dominant strategy (non co-operation gives higher utility when the other player is co-operative but not when he is not); the game yields two equilibria in pure strategies; both imply the defection of one or the other players.

In this context sanctions (S) may change the result to make the co-operative strategy dominant (Figure 2). In the above example the sanction must comply with the stricter of the two restrictions: S>D-(B/2-C) and S>-(B/2-C).

The solution adopted

The problem of potential incentives for fiscal disobedience has been addressed at the European level and a series of rules, procedures and sanctions has been identified. Specifically, the Treaty of Maastricht sets quantitative ceilings for the government deficit and the public debt (of respectively 3 and 60 per cent of GDP) and envisages sanctions for wayward states; the Stability and Growth Pact approved in Amsterdam in June 1997 spelled out the objectives, control procedures and sanctions in greater detail[18].

The Pact commits member states to pursue the medium-term objective of "a budget close to balance or in surplus". The European Council later clarified that this objective should be achieved over the duration of the economic cycle[19]. The Pact may thus be considered as an attempt to reconcile counter-cyclical policies and sound public finances[20].

Each state must define a budgetary target for the neutral phase of the

18 For a review of the reasons adduced for introducing the Pact and an analysis of its potential macroeconomic implications, see European Commission (1997), Artis and Winkler (1997) and Eichengreen and Wyplosz (1998).

19 This interpretation is supported by the Resolution of the European Council of 16-17 June 1997, in Council Regulation no. 1466/97 of 7 July 1997 and in the Opinion of the Monetary Committee of 12 October 1998, later adopted by the Council.

20 Balassone and Monacelli (2000) emphasise the risk that the rules concerning the debt hinder the reconciliation proposed in the Pact.

cycle. In practical terms this means defining a cyclically-adjusted budget balance[21] around which the unadjusted balance fluctuates by virtue of built-in stabilisers and discretionary measures, if any. The further this balance lies below the 3 per cent ceiling, the greater is the margin available for counter-cyclical policies without incurring excessive deficits[22].

The choice of a medium-term target for the neutral phase of the cycle is dictated mainly by three factors: a) the depth of expected recessions; b) the elasticity of the budget in relation to the cycle[23]; the size of the discretionary measures that may be taken to enhance the impact of built-in stabilisers. Past experience suggests that in the majority of EU countries a cyclically adjusted deficit of between 0 and 1 per cent of GDP should make it possible for built-in stabilizers to become fully operative without incurring a risk of overshooting the 3 per cent ceiling (Buti et at., 1998)[24].

Any state with an excessive deficit is required to adopt corrective measures according to a fixed timetable. Failure to comply brings sanctions. Specifically, the country must pay a non-interest-bearing deposit equal to 0.2 per cent of GDP plus one tenth of the difference between the 3 per cent ceiling and the actual deficit (up to a maximum of 0.5 per cent of GDP). For each successive year that the deficit is judged to be excessive only the variable component of the sanction must be paid[25]. Should the

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21 We use the definitions given by the IMF, the OECD and the European Commission: budget corrections apply only to automatic reactions (i.e. those determined by current legislation). For a methodological review of the methods for estimating structural balances, see Banca d'Italia (1999).

22 The Treaty establishes that the deficit may not exceed 3 per cent of GDP unless (a) exceptional circumstances obtain (these may include a recession leading to a reduction in real GDP of at least 2 per cent; (b) it is close to 3 per cent; (c) the overshoot is absorbed in the short term. These three conditions render the 3 per cent ceiling particularly strict (see Buti et al., 1997).

23 The term 'elasticity' is commonly used in preference to the term 'semi-elasticity' to indicate the ratio between the absolute change in the deficit/GDP ratio and the percentage change in GDP.

24 These figures are based on European Commission estimates for the period 1960-1997 (a maximum output gap averaging 4 percentage points; average budget elasticity equal to 0.6). The choice of medium-term target should reflect the need to cover adverse circumstances other than those connected with the economic cycle (e.g. increases in interest rates), to reduce the public debt and to deflect pressures on spending generated by demographic trends. On this point, see the Opinion of the Monetary Committee of 12 October 1998, later adopted by the European Council.

25 The fixed component is intended to discourage excessive deficits, while the variable component is an incentive to limit their amount. The German Finance Minister, Theo Waigel, had initially proposed a deposit equal to 0.25 per cent of GDP for each point - or fraction thereof - between the actual deficit and the 3 per cent ceiling. This would have produced discontinuities in the

(continues)

excessive deficit persist, the deposit is converted into a fine after two years[26].

To the monetary costs of sanctions must be added their consequences in terms of loss of reputation, which could translate into the inclusion of a higher risk premium in yields on government securities.

The approach taken is therefore actually less flexible than the solutions adopted in some federally structured countries:

a) the rules are defined on the basis of established numerical parameters;

b) *ex post* compliance with the parameters is required each year;

c) margins of flexibility are envisaged only in connection with exceptional cyclical events (established *ex ante* as a decline in GDP) or in any case events beyond the governments' control;

d) no margin of deficit is specifically reserved for investment expenditure[27];

e) monitoring procedures are envisaged, starting with an announcement of targets in special multi-year programmes (whose consistency with the rules is evaluated) and continuing with a mid-year examination of public finances and *ex post* verification of results;

f) peer pressure is strengthened by the European Council's power to make formal representations to governments of the need to adopt corrective measures during the year;

g) non-compliance triggers the application of pre-established monetary sanctions;

h) overshoots must be rapidly dealt with; sanctions increase as situations of excessive deficit persist.

The public nature of the whole procedure can contribute to the efficacy of the control exerted by the market on governments' budgetary policies.

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application of sanctions and could, furthermore, have pushed the latter to politically unacceptable heights.

[26] If no corrective measures are adopted, the sanctions can be applied in the same year in which the deficit is judged to be excessive.

[27] No distinction is made in the Treaty between current and and capital expenditure for the purposes of determining the deficit. The volume of capital expenditure is included only among the relevant factors to be borne in mind when deciding whether there is excessive debt.

3.2 Implications of national legislative frameworks

The above rules apply to national governments. More specifically, compliance with budgetary rules is evaluated in respect of general government as defined in the European System of Accounts (ESA), i.e. including central government, local governments and social security funds[28]. EU documents do not assign specific responsibilities to local governments.

While compliance with the rules involves the behaviour of all levels of government, it is effectively the central government that is held responsible and that bears the costs of non-compliance. It is, in fact, the European Council that ensures co-ordination of the general economic policies of the Member States and it is a representative of each Member State at ministerial level, authorised to commit the government of that Member State to sit in the Council[29]. Obviously, each Member State is free to define the necessary procedures and regulations to ensure co-ordination between different levels of government.

To understand the consequences of this asymmetry in a scenario in which decentralised levels of government enjoy some measure of independence in their budgetary policies, another example based on games may be helpful. Let us suppose that there is only one local government agency (LG) and that fiscal compliance by both local (LG) and central (CG) governments produces a benefit B at cost C, which is split equally between the two levels of government. Let us then suppose that the same benefit can be produced by CG's fiscal compliance alone, in which case, while the benefit is split equally between CG and LG, the cost C is borne wholly by CG. Lastly, let us suppose that LG's compliance does not produce any benefit by itself (the cost C of this fruitless effort is borne entirely by LG) and that the outcome when CG is non-compliant is D.

The table of outcomes for this game is shown in Figure 3. LG's dominant strategy is undisciplined (as D>D-C and B/2>B/2-C/2). This situation can be interpreted as an extreme example of the incentive problem encountered in a federation in which the responsibilities for expenditure and taxation are separated. According to the arrangement of

28 See Article 2 of the Protocol on procedures for excessive debt.

29 See Articles 145 and 146 of the Treaty establishing the European Community, as amended by the Treaty on European Union of 7 February 1992.

Figure 3

The federal game at national level

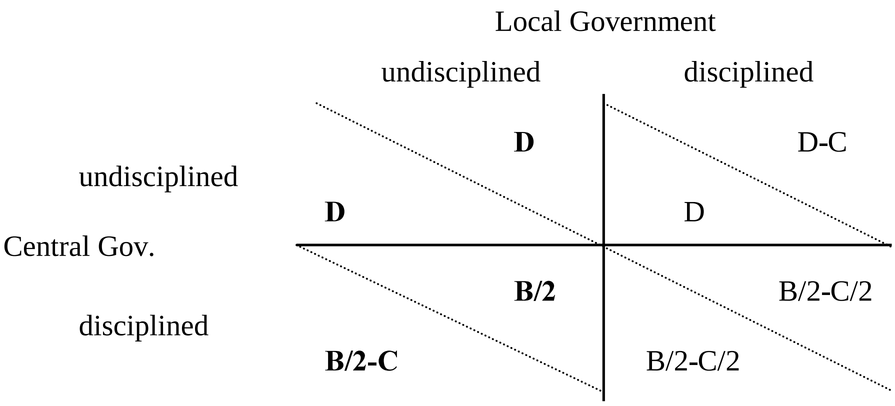
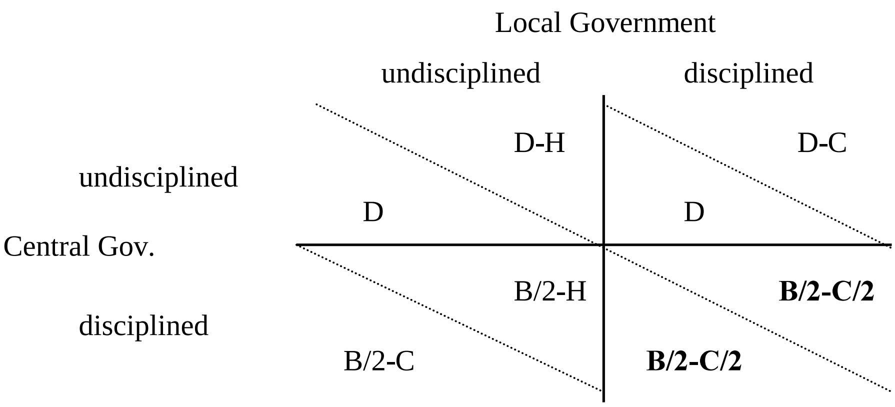


Figure 4

The effects of control over local deficits



outcomes, CG may find it expedient either to comply or not to comply (the outcomes of the two equilibria resulting from CG's choice are indicated in bold type): the general government may turn out undisciplined, or CG may ensure compliance while LG plays the free-rider. If $D<[(B/2)-(C/2)]$, in other words if CG achieves a better outcome when both governments are disciplined than it would by being uncooperative, the situation is one in which some form of control over local government deficits could usefully be introduced. The introduction of a sanction H ($H>C$) in the event of LG being undisciplined would alter the matrix, as shown in Figure 4, making LG's dominant strategy to co-operate (as $D-H<D-C$ and $B/2-H<B/2-C/2$) and shifting the equilibrium to one of full co-operation (in bold type).

Monetary Union introduces two modifications with respect to the matrices in Figures 3 and 4:

a) the cost of fiscal co-operation increases because the definition of co-operation is narrower than that used at the national level (in terms of both sanctions and the reference period for defining co-operation);
b) the pay-off of strategies change, on account of the externality generated by the choices of other Member States.

Let us suppose that the new cost level is K ($K>C$) and that the externality is such as to determine an expected increase in the outcome achieved by CG in the event of non co-operation (from D to D+E) while leaving unchanged the outcome achieved by CG in the event of co-operation[30]. The new game table is shown in Figure 5.

In this environment the effect of national controls (the sanction H) may be cancelled by the higher cost of discipline (if $K>2H$, LG's dominant strategy becomes "undisciplined"). Moreover, the combined effect of the higher cost of co-operation and of the changed outcome determined by externalities may render undisciplined the dominant strategy for CG too (if $D+E>B/2-K/2$). Again there are two possible equilibria (in bold type in Figure 5): general government may turn out to be undisciplined (a situation consistent with that described in Figure 1 in Section 3.1 above), or CG may ensure overall discipline while LG free-rides.

[30] In other words it is assumed that an uncooperative state will benefit from other states' co-operation while not being penalised by their defection, whereas a co-operative state will not only benefit from other states' co-operation but also bear the cost of other states' defection.

Figure 5

The federal game at national level after EMU (without “European” sanctions)

		Local Government	
		undisciplined	disciplined
Central Gov.	undisciplined	**D-H+E** **D+E**	D-K+E D+E
	disciplined	**B/2-H** **B/2-K**	B/2-K/2 B/2-K/2

Figure 6

The federal game at national level after EMU (with “European” sanctions)

		Local Government	
		undisciplined	disciplined
Central Gov.	undisciplined	D-H+E D+E-S	D-K+E D+E-S
	disciplined	**B/2-H** **B/2-K**	B/2-K/2 B/2-K/2

The sanctions envisaged in the Pact can be explained as a means of preventing some states (those where the equilibrium of the federal game at national level implies non co-operation) from free-riding at the expense of others. If sanctions are borne only by CG, the prevention of free-riding at EU level will not solve the problem at national level: a review of national controls is also needed (sanction H). This outcome is shown in Figure 6, in which the sanction introduced in the Pact (S, S>D+E+K-B/2) affects only the outcome that can be achieved by CG, which is obliged to allow LG to free-ride in order to ensure overall co-operation.

To conclude, the Pact increases the need for mechanisms to control decentralised governments. Two considerations, in particular, could render national rules inadequate:

a) European regulations are generally speaking more restrictive than those adopted at national level; the resulting higher costs of co-operation could lead to national penalty systems becoming inadequate and to a conflict between the constraints on national public finances at the European level and the flexibility allowed to decentralised institutions at the national level. For example, the level of local government investment prior to the Pact in countries applying the *golden rule* may determine excessive deficits;

b) the allocation of responsibility for compliance with EMU fiscal rules among central and local governments and of the possible costs incurred because of non compliance is asymmetrical; in the absence of adequate national rules, local governments that are able to contract debts could act as free-riders on the back of the central government.

3.3 Possible solutions

In principle three strategies appear possible: the duplication of European rules at the national level; the amendment of existing legislative frameworks; the introduction of a market for “deficit permits”.

Extending the Stability and Growth Pact to the national level

This solution poses several problems:

a) if the bodies to be disciplined are too small in economic terms, it could be difficult to measure GDP and in any case the meaningfulness of available data (in regard to mobility of factors of production, for example) would be affected;

b) the high number of bodies involved could make monitoring particularly costly. The evaluations needed for the cyclical adjustment of budgetary data could be especially problematic, as could those necessary for a case-by-case examination of "exceptional" circumstances to justify excessive deficits;

c) the financing of local investment expenditure through local taxation could pose particular problems, especially where unusually costly projects could lead to expenditure peaks.

The extension of European rules to the larger decentralised governments only (i.e. in Italy, the Regions) could be a solution provided smaller decentralised governments have only limited autonomy; otherwise the cost of adjustment would merely be shifted from the central government to the larger local governments.

Adapting existing regulations at the national level

This approach cannot take the form of an introduction of administrative controls on the indebtedness of decentralised governments. As stated earlier, this solution would be in clear conflict with the spirit of a federal set-up.

Amendments would have to be aimed at allowing recourse to debt financing for both structural reasons (e.g. public-sector investment) and cyclical reasons (e.g. the absorption of cyclical effects on the budget).

Control systems in place in some states address these two aspects by setting flexible ceilings to the deficit: on the one hand the ceilings exclude capital expenditure (the golden rule); on the other hand they are applied only on an *ex ante* basis and if the deficit overshoots the ceiling the overshoot can be compensated in subsequent financial years: in some cases (e.g. some American states) the deficit overshoot must be financed through recourse to specially constituted 'rainy day funds', without recourse to the market[31].

In the new scenario created by European regulations, these solutions appear most easily adaptable to structural aspects, in other words the financing of investment, while the cyclical aspect appears more complex. In both cases credible sanctions would have to be established to deal with non-compliance.

With regard to the structural aspect, adoption of the golden rule would have to be flanked by an overall ceiling on investment expenditure by local governments. When setting this limit, the need for the overall cyclically adjusted general government budget to be in balance or close to it would have to be taken into account: any deficits allowed to decentralised units would have to be compensated by a general government surplus with a generous enough margin to allow for the counter-cyclical measures.

Moreover, rules would have to be drawn up to define the criteria for allocating among decentralised bodies the overall deficit allowed for investment programmes. To this end, given the difficulties of defining an adequate reference parameter (population, amount of infrastructure, overall receipts, etc.) a co-operative approach could be contemplated. By involving decentralised governments in the process of defining overall budgetary targets, they would acquire greater responsibility for behaving consistently with the pursuit of the targets set and reaching agreement on the allocation of resources. The peer-pressure incentive for compliance generated in a co-operative framework could be strengthened by allocating any sanctions handed down by the EU among those agencies responsible for overshooting.

With regard to the absorption of cyclical effects on the budget, the application of ceilings that are valid only *ex ante* is clearly in contrast with European legislation, which as we have seen is based on *ex post* limits. On the other hand, the introduction of strict budgetary constraints that are valid *ex post* is problematic, since it would distort the allocation of resources (to the detriment of the more flexible expenses) and force decentralised units to adopt pro-cyclical policies.

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[31] See McGranahan (1999) for the US experience.

The establishment of rainy day funds could be a solution, though it would imply a review of the ESA accounting rules for calculating budgetary indicators. Under current rules transfers of resources to such funds are not included among the disbursements that comprise net indebtedness, nor is the use of such resources included among receipts; in neither case do movements of money through these funds alter the size of the deficit. The accumulation and use of these funds would have to be entered respectively under expenditure and receipts in the General government account; only in this way would their use avoid overshooting the 3 per cent threshold[32].

A market in deficit permits

The thesis that the problems of externalities might be solved by creating appropriate ownership rights and allowing free trade in them was first put forward by Coase (1960). Casella (1999) suggested taking this approach to the question of fiscal discipline within the EMU. Comparing the negative externality produced by members running excessive deficits to that of pollution, this article suggested using the machinery developed in environmental economics[33]. With reference to the Italian domestic stability pact (Section 4), the Commissione Tecnica per la Spesa Pubblica (an experts' committee on public expenditure) raised the possibility of introducing a system of deficit permits for local and regional governments in its 1998 paper.

Once the overall ceiling[34] on permits and their initial allotment is set, market incentives would produce, through free trade, the most efficient allocation in relation to the financial needs of the various governments in any given year. The total volume of permits issued could be related to the national economic cycle, so as to allow both a "structural" margin for investment and a variable margin to absorb the cyclical impact on the budget. Deficits above the amount fundable by the permits would result in

[32] These operations would nevertheless have to be excluded when evaluating cyclically adjusted budgetary positions.

[33] An early suggestion of a market in pollution permits is Dales (1968); later a vast literature has developed; for a discussion of the benefits and limitations of the approach see Baumol and Oates (1988).

[34] The ceiling is needed to prevent the sort of problems cited in Sections 2.1 and 2.3 in relation to the possibility that financial markets can prevent excessive build-up of debt.

a cut in the permits assigned the following year. The financial market could also be involved in the discipline by prohibiting borrowing or bond issues lacking debt permit coverage.

The system described is subject to three main difficulties. First, efficacy requires that the deficits of the various governments generate the same externality and are thus perfect substitutes. But the risk of triggering a financial crisis is not uniform across governments. If this risk were the function of a single variable, e.g. the level of debt, then one would merely have to make the value of the deficit permits of the governments inversely proportional to their stock of debt. However, the risk depends on a number of factors[35], and determining the value of the permits held by each government is complicated.

Second, the efficiency of the market in permits depends on how competitive it is. This makes the mechanism ill-suited to situations in which the number of governments is small (within the EMU there would be just eleven players, and vastly different in size at that)[36].

Finally, there is no easy solution to the problem of determining the initial allotment of permits. The possible criteria (GDP, population, etc.) would produce greatly differing allocations. If the demand for permits exceeded the supply, then the countries with an allotment greater than their requirement would enjoy positional rents.

The first two objections appear more cogent for a permit market among Member States at EMU level than for one among local governments within each country. Presumably the risk connected with each entity’s deficit is more uniform within than between countries: the size of the governments is smaller, and in many cases they have only recently acquired the power to issue their own debt. The number of market operators would be vastly greater. Of course, so extensive a market could entail higher administrative costs.

The third difficulty, which is strictly political, would be encountered at the national level as well. It would be compounded, at least initially, by

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35 For instance, the risk may depend on the degree of exposure of the banking system, the degree of international openness, and so on. See among others Eichengreen and Portes (1986), Kharas (1984) and Hernandez-Trillo (1995).

36 The problem could be attenuated by a continuous double auction market (a system used in many financial markets); see Friedman and Rust (1993).

local governments' problems in adapting to the new machinery for the allotment of resources.

Apart from these difficulties, the permit system seems better suited to financing investments than to buffering the budgetary effects of the business cycle. In the investment area, trading in permits could certainly contribute to greater efficiency in resource allocation. The financial needs connected with investment projects could be planned, and the realisation of works modulated, as a function of available resources. As to the cyclical effects, however, the initial allotment would necessarily be based on forecasts of national economic developments; the emergence of a discrepancy in the course of the year could result in over demand for permits, which would penalise the governments of areas where cyclical performance was especially poor.

An overview

Each of the three solutions has drawbacks. Replicating the Stability Pact at national level is impeded by lack of the necessary data. Leaving room to buffer cyclical effects on local government budgets without compensating action by the central government (which would give local governments an incentive for opportunistic behaviour) requires solutions that are inconsistent with the ESA95 accounting rules. The formation of a deficit permit market faces the difficulty of finding an equitable criterion for the initial allotment of permits and that of the dubious ability of local governments to adapt to the new context.

In light of these problems, a combination of actions could usefully be evaluated.

a) A domestic stability pact would appear to be feasible for the larger local government bodies (in Italy, the Regions), for which the problem of lack of data is solvable.
b) The need to spread investment costs over a number of years could be addressed (albeit with the difficulties recalled above) by recourse to either market mechanisms or the application of rules.
c) To buffer cyclical effects, the best solution appears to be the institution of reserve funds. As noted, however, this would require the revision of the European rules for national accounts.

4. Italy: the domestic stability pact

Some EU countries are faced with the necessity of adjusting relations between central and local government to the new European framework. Measures for budgetary co-ordination between the various levels of government are under study in Austria, Belgium and Germany.

Italy has taken a first step in this direction with the domestic stability pact introduced with the 1999 budget. This action was all the more necessary as a result of the decentralisation begun in the early nineties. Decentralisation has brought a gradual transition from “derived” regional finances, in which virtually the entire regional budget consisted of rigidly earmarked central government transfers, to fundamentally “autonomous” financing, with revenues derived from regional taxes and percentage shares in certain central government taxes and their allocation increasingly left to regional decision.

Decentralisation

The main steps in regional decentralisation have been: the attribution to the Regions of health service contributions and automobile taxes in 1992; the abolition of state transfers (except for those for the health fund, for natural disasters and for purposes of major national interest), offset by the assignment to the Regions of a share of the excise tax on petrol and the institution of an equalisation fund (1995); the attribution to the regions of a new tax (the regional tax on productive activities, IRAP) and of a personal income tax surcharge (1997); the assignment of additional responsibilities under the “Bassanini” Law (1997-98). Finally, Law 133/1999 envisages the abolition of health fund transfers, the assignment to the Regions of new shares and surcharges in central government taxes (petrol excises, VAT, personal income tax) and the redefinition of the financing and utilisation of the equalisation fund[37].

[37] The resources should come from shares in central taxes and be distributed, after a transitional period in which allotments are to be based on past spending, according to fiscal capacity. The system of earmarking is to be phased out after a transitional period in which the Regions will be required to allocate to health an amount consistent with their per capita share in the financing of the health service established at national level.

Local government autonomy has also been enhanced. The main changes have been: the institution of the municipal real estate tax (1992); the reorganisation of minor local taxes (1993); the abolition of the municipal tax on professional activities and those on municipal concessions, offset by a share in IRAP (1997); the reorganisation of the system of central government transfers (enacted in 1996, with implementation however postponed to 2000); and the institution of a municipal surcharge on personal income tax (1998).

The transition to more pronounced forms of decentralisation has become a major political issue. The possibility of a federal reform of the Constitution has been broached by a number of observers[38].

Within this general framework, before the domestic stability pact, the limits on local authorities' borrowing were set by a "golden rule" (borrowing to finance current expenditure was prohibited) with an indirect ceiling (debt service could not exceed 25 per cent of own revenues). Frequently, however, there was unlimited year-end coverage of deficits (in the health and transport sectors, for instance) by the central government.

The emerging trend in institutional arrangements implied:

a) a comparatively high degree of decentralisation;

b) high sensitivity of local government revenues to the economic cycle;

c) relatively lax constraints on indebtedness.

The analysis set forth earlier shows the risks that such arrangements entail for the observance of European budget rules.

The domestic stability pact

The domestic stability pact is designed to involve the Regions and other local authorities in the effort to attain the objectives for general government budget under the European Stability and Growth Pact[39]. The domestic pact requires local bodies to reduce deficits and their stock of

[38] See for example Buglione (1998), Fausto (1996), Forte and Cerioni (1996), Giarda (1996), Forum CEIS (1995).

[39] See Ferro and Salvemini (1999).

debt[40]. The deficit referred to (DI) is the difference between total revenues (E) net of state transfers (T) and total expenditure (S) net of investment (K) and interest payments (I)[41]:

$$DI = (E - T) - (S - K - I)$$

The definition differs widely from the European definition (DE), which is simply the difference between total revenue and total expenditure:

$$DE = E - S$$

The two definitions also differ in accounting rules. The domestic stability pact adopts a cash basis, while European rules, based on ESA95, refer to the accruals principle.

The target for the first three years of the domestic pact, beginning in 1999, is an annual reduction in the total deficit of local governments equal to at least 0.1 per cent of GDP. In the absence of data on local GDP, the contribution of each district is proportional to the level of primary current expenditure (S - K - I)[42].

The local governments' accounts will be monitored in the course of the year for consistency with the annual target. However, no sanctions for non-compliance are provided. The State-Region and State-Commune conferences will decide on any corrective measures. In 1999 the only consequence of detection of a potential overshoot was the proposal to increase the size of the reduction planned for 2000.

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40 Pica (1999) notes "the anomalous use of the word 'pact': the word assumes the existence of a forum in which local governments can agree (have the power to agree) on their conduct, bargaining with the central government. [Actually, however] ... state law ... constitutes [a] concrete means of coercion in the desired direction, not consent freely decided" (pp. 1-2; our translation).

41 Revenues are net of the proceeds of sales of financial assets and gross of the proceeds of sales of real estate assets. The same standard is used to calculate the deficit for European purposes.

42 The total correction, estimated at about 2.2 trillion lire, was divided among levels of government in proportion to total expenditure (S). The resulting targets for the individual categories of government were translated into specific objectives for each entity. For the Regions, the reduction was set at 1 per cent of primary current expenditure in 1998. For municipalities and provinces it was put at the larger between 1.1 per cent of primary current expenditure in 1998 and 3 per cent of the current-programmes deficit for the year. The latter was calculated by each government body by augmenting the 1998 deficit by 80 per cent of the nominal GDP growth forecast for 1999.

If Italy is sanctioned under the excessive deficit procedure, the fines will be levied on the entities that failed to meet their targets, in proportion to the part of the overshoot for which they are responsible.

An evaluation

The domestic stability pact is essentially a rule imposing deficit reduction on local authorities. It is based on an extended version of the "golden rule" (interest payments too are excluded from the deficit[43]) with an indirect ceiling (the previous law limited the deficit to a level that would produce debt service payments not exceeding 25 per cent of own revenue[44]). In practice, carrying annual deficits forward appears possible. The eventual correction of yearly budget overshoots is entrusted to a co-operative mechanism (the conferences).

This set of rules is marked by a series of inconsistencies and lacunae:

a) while the objective is deficit reduction, each government's contribution is correlated not with the deficit but with primary current expenditure. Thus if one region's budget is balanced or in surplus while another's is in deficit but the primary expenditure of the former is greater than the latter's, it would paradoxically have to make a larger contribution to the adjustment;

b) ultimately, the aim of the pact is to contain the relevant deficit for European purposes (DE). Taking a different budget variable (DI) as an intermediate objective makes it impossible to estimate the implications of local government targets for observance of the European rules. Specifically, it could be that the difference between the two balances (K + I - T) records an increase that more than offsets the reduction in the pact's reference balance (DI);

c) usually the golden rule excludes only investment spending from the reference deficit. Interest expenditure always forms part of the balance, the aim being to amortise the cost of public works over a number of

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43 However, the rule restricting market borrowing to cover only investment spending remains; consistency between the two rules would have to be ensured by state transfers.

44 Another limit is implied by the need to reduce the stock of debt. But no sanctions are provided if the debt increases. Moreover, the relevant definition of debt is not sufficiently well defined, increasing the scope for "creative accounting".

years and thus share the burden among the generations that enjoy the benefits;

d) though the pact sets the objective of reducing local government debt, it introduces no machinery to assure its attainment. Reduction of the pact's reference deficit (which excludes major budget items, including interest expenditure) does not actually guarantee that net new borrowing will diminish. Furthermore, the debt ceiling imposed by the previous legislation based on the ratio between debt service and own revenue seems a weak instrument given increasing local taxation powers and relatively low interest rates;

e) the pact divides a possible European sanction among the various government authorities in proportion to the share of the overshoot for which each is responsible. This formulation does strengthen the incentive for deficit reduction, but it also has certain undesirable characteristics. It would be better to impose sanctions for failure to achieve the deficit objective even if Italy is not fined at the European level. Apart from the fact that such conduct constitutes free-riding, failure to punish it could narrow the scope for national counter-cyclical measures within the 3 per cent ceiling. Moreover, if the overshoot is confined to a small number of governments, the size of the fine could be too large for credibility.

Certain features of the pact, moreover, appear ill-suited to strengthen Italian discipline consistently with the observance of European rules:

a) even if recouped in the years following, any local government budget overshoots must be made good immediately by the central government;

b) the problem of cyclical effects on local budgets is not dealt with (at a time when the devolution of tax base makes local government budgets more sensitive to macroeconomic conditions).

5. Conclusion

Our analysis underscores the problems inherent in the combination of increasing fiscal decentralisation within the EU Member States with rules set at European level to guarantee sound public finances at national level and leave scope for counter-cyclical policy measures.

Specifically, we highlight the difficulty of reconciling full achievement of the allocative advantages of fiscal decentralisation with full exploitation of the scope for counter-cyclical policy action offered by compliance with the Stability and Growth Pact.

We have noted: a) the reduced flexibility of the European approach compared with solutions adopted in federally structured states; b) the asymmetry between the responsibilities laid on national and local governments by European rules (compliance with the rules depends on the conduct of all levels of government, but *de facto* it is the central government that is answerable to the EU and that must pay the price of non-compliance); c) the consequent need for stricter controls over local governments to prevent free-riding; d) the difficulty of finding fully satisfactory solutions.

Devising appropriate solutions is hard for a number of reasons: a) the mechanical extension of the Stability and Growth Pact is feasible only for the larger local bodies; b) allowing local bodies to amortise investment expenditure over a number of years entails significant problems, whether market mechanisms or predetermined rules are used; c) the best way of buffering the effect of the economic cycle on local government budgets, i.e. the use of a reserve fund, requires revision of the EU's rules for national accounts.

In the course of the nineties, Italian institutional arrangements moved to a relatively high degree of decentralisation, marked cyclical sensitivity of local government revenues and lax constraints on indebtedness. This set of arrangements could impede compliance with European budgetary rules.

The domestic stability pact is a first step towards a solution. Essentially, it is a rule requiring local governments to reduce their deficits. Our examination has revealed a number of problems that require some fine-tuning of the mechanism:

a) while the objective is deficit reduction, individual contributions are not correlated with that variable but with primary current expenditure;

b) the adoption of a different budget variable as an intermediate objective precludes prior estimation of the implications of local government targets for the observance of European rules;

c) the pact has an anomalous golden rule that excludes interest spending from the reference deficit;

d) while setting the objective of reducing local government debt, the pact introduces no machinery to assure its attainment;

e) a local authority's failure to achieve its objective is punished only if Italy is subjected to a European sanction, which could narrow the scope for counter-cyclical measures within the 3 per cent ceiling;

f) local government budget overshoots, even if recouped in subsequent years, must be made good by the central government in the year they are incurred;

g) the problem of cyclical effects on local budgets is not addressed.

At the time of its introduction the EU Stability and Growth Pact gave rise to a wide debate. Many participants stressed that it provides no "reward" for countries that are "virtuous" during cyclical expansions, achieving budget balance or surplus. Bean (1998) observes that "The problem with the pact as presently framed is that it is <u>all stick and no carrot</u>; rewarding good fiscal behaviour in booms rather than, or in addition to, punishing bad behaviour in slumps would surely make better sense" (p. 106). Paraphrasing this critique, one might say that Italy's domestic pact as it presently stands is "neither stick nor carrot".

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THE FINANCING ARRANGEMENTS FOR THE REGIONAL (AUTONOMOUS) GOVERNMENTS FOR THE PERIOD 1997-2001

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1. Introduction

Fiscal decentralisation has been one of the key features of developments in the Spanish public sector in recent decades. This phenomenon is rooted in the 1978 Spanish Constitution, which changed the territorial organisation of the State by enabling the regional (autonomous) governments (RGs) to be created. Since then, there has been a gradual shift of responsibilities for the management of certain services from the State to the RGs along with development of the arrangements for financing these responsibilities. To give an idea of their importance, in 1988 the RGs were responsible for almost 18% of general government expenditure and obtained 11.6% of general government tax revenue.

It is worth analysing this process of fiscal decentralisation in Spain, not only due to its own importance but also because the achievement of the objectives set for the public sector depends largely on spending responsibilities and financing instruments being suitably distributed between central and regional government.

Studying decentralisation in Spain is not, however, a straightforward matter. The transfer of responsibilities and the development of the financing arrangements have not progressed at the same pace or had the same scope in all the RGs, with substantial differences persisting up to the present. These differences stem from the different constitutional provisions under which the regions were granted their autonomy[1].

In terms of powers assumed and their financing arrangements the RGs can be classified into several groups. As far as the assumption of powers is concerned the most important criterion for classification is whether the responsibility for managing health services has been assumed.

[*] Banco de España. We wish to thank Rafael Álvarez, Colin Anderton, José María Bonilla, Philip Hill, Eloísa Ortega, Asunción Rubio and Beatriz Sanz for most helpful comments and suggestions. In addition, this document has benefited from the work done by the Statistical and Central Balance Sheet Office of the Banco de España on the regional (autonomous) governments.

[1] Tables 1 and 2 detail the RGs and the differences in their respective powers.

The RGs granted autonomy under article 143 of the Spanish Constitution have not assumed the responsibility for managing health services. In contrast, Andalusia, the Canary Islands, Catalonia, Galicia and Valencia, along with the Basque Country and Navarre, that is to say, the regions which gained autonomy under article 151 of the Spanish Constitution, those assimilated and those with their own specific status due to their historical jurisdiction, have assumed this responsibility. Nonetheless, the RGs in the first group will progressively move onto an equal footing with those in the second[2]. With regard to the financing arrangements applied, the RGs can be grouped into "ordinary-regime" RGs (all except the Basque Country and Navarre), which have limited fiscal autonomy, albeit with certain differences between them, and the "specific-status" RGs (Comunidades Autónomas de régimen foral) (the Basque Country and Navarre) which, besides having health responsibilities integrated into their overall financing arrangements, have extensive fiscal autonomy. The figure below shows the various groups of RGs that result from applying the above classification criteria.

Figure 1

Classification of the RGs according to their financing arrangements and the responsibilities they have assumed (*)

GROUPS OF RGs / CLASSIFICATION CRITERIA		FISCAL AUTONOMY	RESPONSIBILITIES ASSUMED (1)
ORDINARY-REGIME	ARTICLE 143	LIMITED	ALL THOSE TRANSFERRED EXCEPT HEALTH
	ARTICLE 151	LIMITED	ALL THOSE TRANSFERRED
SPECIFIC-STATUS		FULL	ALL THOSE TRANSFERRED

(*) Table 1 indicates for each region which of the categories shown in the figure it falls into.
(1) The only powers which cannot be transferred by the State (or assumed by the RGs) are those specified by article 149 of the Spanish Constitution, which provides that the State has exclusive powers in certain areas, including defence and the armed forces, justice, international relations, etc.

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2 In recent years these regions have assumed responsibility for education although, in some cases, the actual transfer of services, which the regions in the first group had previously assumed, has still not occurred.

The basic legal framework for the financing arrangements for the ordinary-regime regions is made up of the Spanish Constitution and Organic Law 8/1980 of 22 September 1980 on the financing of the RGs (LOFCA). The financing arrangements for the specific-status regions are also regulated by the respective Accords (Conciertos) and Agreements (Convenios) with the State. Further to this legislation, the Fiscal and Financial Policy Council (Consejo de Política Fiscal y Financiera, hereafter, CPFF) was set up. It is composed of the State ministers of Economy and Finance and of General Government and of the RG ministers of Finance, and acts as a consultative and discussion body with wide-ranging tasks relating to the co-ordination of the RGs’ financial activity. The agreements reached within the CPFF form the basis for developing the RGs’ financing arrangements.

This paper focuses on analysing the financing arrangements for the RGs. The following section describes the arrangements currently in force for the ordinary-regime RGs, following the 1996 CPFF Agreement, after first summarising the previous system. The third section analyses the financing arrangements for the specific-status RGs. Finally, the fourth section concludes by discussing the information available on the RGs’ resources, within the framework of the National Accounts and the respective State and RG budgets.

2. Financing arrangements for the ordinary-regime regional (autonomous) governments

On 23 September 1996 the CPFF approved the RG financing arrangements for the period 1997-2001. The Agreement was embodied in Organic Law 3/1996 of 27 December 1996 on partial amendment of the LOFCA (see above) and Law 14/1996 of 30 December 1996 on the assignment of taxes from the State to the RGs and complementary fiscal measures. The new arrangements are only applied to those RGs that accepted them, i.e. all except Andalusia, Castile-La Mancha and Extremadura, which remain subject to the previous system.

A brief summary of the financing arrangements in place before the 1996 Agreement came into force is given below. Thereafter, the main channels of financing for the ordinary-regime RGs under the current system are explained.

2.1 Financing arrangements in force until 1996

The development of regional government, in the case of the ordinary-regime RGs, commenced with the appearance of pre-autonomous entities (entes preautonómicos) and continued with the approval of the LOFCA, of the respective autonomy charters (estatutos de autonomía) and of the agreements on the financing arrangements signed within the CPFF. The various stages of this process up to 1996 are described below, indicating the main changes to the financing arrangements in each of them.

Pre-autonomous entities

The RGs did not emerge until the approval of the autonomy charters. Previously, certain administrative structures (pre-autonomous entities) intended as a basis for subsequent actual autonomy had been set up. These structures were financed by State transfers, not equivalent to a share of tax revenues.

Transitional period

This period ran from the approval of the respective autonomy charters to the CPFF agreement of 7 November 1986. During these years many responsibilities were transferred. As a result, new requirements for funds arose, which were met through the emergence of most of the current financing instruments. In addition, the RGs' share in State revenue (participación en los ingresos del Estado, hereafter, PIE) was defined, in terms of the actual cost of the responsibilities assumed, and in February 1982 the method of calculating this actual cost was approved in the CPFF. Until 1984, the calculation was carried out by means of negotiations on committees in which the State and RGs were represented on an equal footing. Between 1984 and 1987, the percentage shares were fixed annually by law for the RGs as a whole. Finally, Law 30/1983 on the assignment of taxes was passed in this period and the Inter-Territorial Compensation Fund (Fondo de Compensación Interterritorial, hereafter, FCI) was created in 1982[3].

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[3] The law regulating the FCI is Law 7/1984 of 31 March 1984.

Agreement on regional financing for the period 1987-1991

The method for applying the regional financing arrangements for the period 1987-1991 (CPFF of 7 November 1986) came into force in this period. This radically changed the method for calculating the share in State revenue. It was now defined as a transfer of resources from the State to finance that part of the general responsibilities assumed, excluding health care and social services responsibilities[4], not financed through assigned taxes. The distribution system and the rules governing its future evolution were established, most of which are still in force today. This system represented a significant advance in that it was objective and automatic, and the above-mentioned negotiations between the State and the RGs and the ad hoc calculations disappeared. As regards tax revenue, the assignment of taxes was extended to registration duties (Impuesto sobre Actos Jurídicos Documentados) and the Canary Islands' Economic-Fiscal Regime (Régimen Económico Fiscal) was reformed with the creation of the Canary Islands' General Indirect Tax (Impuesto General Indirecto Canario). Finally, the criteria for distributing the FCI were modified in 1990 (Law 29/1990 of 16 December 1990), and this fund was adapted to the new EU legislation on structural funds.

Agreement on regional financing for the period 1992-1996

On 20 January 1992 the regional financing arrangements for the five-year period 1992-1996 were agreed in the CPFF, with the creation of the specific tranche of the share in State revenue, corresponding to the share of 15% of "territorial" personal income tax payments (those arising within each region). The financing of the RGs under the new agreement continued to be based essentially on the share in State revenue (PIE), with its amount being calculated as follows:

The PIE for the initial year was obtained starting from a total volume of resources for the RGs as a whole. This volume was determined principally by the resources transferred in 1990 under the previous system and was assumed to be sufficient to finance all the areas of responsibilities assumed and assumable. This overall volume of financing was divided into two blocks, one for the article 143 RGs and the other for the article 151 RGs, these being the two main groups of RGs, referred to by the articles of

[4] These responsibilities are financed independently of the PIE with specific transfers from the Social security Treasury Department, as will be analysed below.

the Spanish constitution under which they gained autonomy. The aim was to treat regions with the same level of assumable powers equally when distributing the resources among the RGs. The volume included in each of the two blocks was distributed among the RGs in accordance with certain weighted socio-economic variables defined in article 13 of the LOFCA (population, insularity, area, administrative units, relative wealth, fiscal effort and geographical dispersion)[5], following a number of adjustments[6]. The amount for each RG resulting from this distribution was reduced by an estimate of the revenue from assigned taxes and from the charges for services for which responsibility had been transferred[7]. The resulting amount represented the initial financing obtained by each RG from the share in State revenue.

Finally, to determine the PIE in the subsequent years of the five-year period, the percentage share in State revenue was obtained for each RG for the base year. This percentage share was defined as the RG's initial financing from the share in State revenue expressed as a percentage of the so-called "structurally adjusted tax revenue" (ITAE), namely State revenue from unassignable direct and indirect taxes, excluding resources from the EU, plus social security and unemployment insurance contributions. In subsequent years, the RGs received a State transfer calculated by applying the aforementioned percentages to the ITAE. In this way, the shares in State revenue in respect of the general tranche grew at the same rate as the ITAE, subject to a ceiling determined by the growth rate of GDP and a floor determined by the growth of Equivalent State Expenditure[8] (the latter prevailing over the ceiling). These percentages were only revised in the event of transfers of new services or the assignment of new taxes.

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5 The weights of each of these variables differed depending on whether the RGs had or had not assumed responsibility for education. Among the variables, population had the highest weight (64% in RGs that had not taken over education responsibilities and 94% in those that had), followed by area (16.6% and 3.5%, respectively).

6 Among other adjustments, a redistribution of 2.7% of the outcome was made on the basis of the relative poverty of the RGs as a whole.

7 Moreover, the portion relating to responsibilities not taken over and included as assumable in the calculation of the amount to be financed was deducted from each RG, and the cost of the services not included in the distribution was added due to their being under the exclusive remit of certain RGs.

8 Equivalent State Expenditure encompasses the proportion of the expenditure of certain ministerial departments and independent agencies relating to the common responsibilities assumed and to education, and which are included in chapters I, II and IV of the Budget.

Under this general system of transfers, as from 1994 the State transferred 15% of the estimated “territorial” personal income tax receipts (those arising within each region) to the RGs, in such a way that the previously calculated share in State revenue was split into two tranches: a) a general tranche, corresponding to the previous share in State revenue, less an annual estimate of 15% of territorial personal income tax receipts; b) a specific tranche, corresponding to the aforementioned annual estimate of 15% of territorial personal income tax receipts. As this channel of financing was based on estimated as opposed to actual amounts, it permitted, subject to certain limits (between 0.5% and 2%), the generation of additional personal income tax revenue, insofar as the net tax actually raised in each region was higher than initially estimated.

In addition to these unconditional transfers, the RGs received other conditional transfers. These were resources earmarked for a specific purpose, including most notably transfers from the Social security Treasury Department, from the Inter-Territorial Compensation Fund (FCI) and from the EU, those received under programme contracts and under joint investment agreements, and the resources arising from the share of local governments in State revenue, which seven RGs currently administer, and the subsidies managed by the RGs.

Finally, the RGs supplemented and completed their revenue through various taxes (taxes assigned by the State, own taxes and surcharges on State taxes) and borrowing[9].

2.2 Financing arrangements for the period 1997-2001

On 23 September 1996, the Fiscal and Financial Policy Council (CPFF) approved the content of the regional financing arrangements for the period 1997-20001. This agreement was embodied in Organic Law 3/1996 of 27 December 1996 on partial amendment of the LOFCA and Law 14/1996 of 30 December 1996 on the assignment of taxes from the State to the RGs and complementary fiscal measures. The core of the reform is as follows.

Initially, 15% of personal income tax receipts are assigned, along with regulatory responsibilities for the tax rate schedule (including the

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9 The conditional transfers, tax resources and borrowing are analysed in detail in the following section, when the new financing arrangements are studied.

tax-free allowance) and deductions. Once educational responsibilities have been fully transferred, at the end of the five-year period, 30% will be assigned to the RGs. In the meantime, the 15% tranche of territorial tax revenue under the previous arrangements remains in place.

Regulatory powers are granted in respect of the taxes assigned and of the tranche corresponding to the shared personal income tax.

Consequently, under the new arrangements the resources of the RGs that accepted the Agreement[10] are as follows:

2.2.1 Tax resources

The ordinary-regime RGs' tax revenue may be of two types: assigned taxes and own taxes and surcharges on assigned or assignable taxes. Assigned taxes are transferred from the State to the RGs, under certain legal conditions. As regards own taxes and surcharges, the RGs enjoy greater regulatory autonomy.

Assigned taxes

Before the 1997 reform, the taxes assigned were the wealth tax, the inheritance and gift tax, the tax on property transfers and documented legal acts and the tax on gaming. The RGs were empowered to administer and levy these taxes, but did not have regulatory powers.

Law 14/1996 made radical changes to the assignment of taxes. First, personal income tax was partially assigned. Second, certain regulatory powers were granted over these taxes. Finally, specific consumption taxes at the retail stage and VAT at the retail stage became assignable, although they were not actually assigned.

As regards personal income tax, initially 15% of the revenue raised was assigned to those RGs that accepted the agreement. This percentage, as mentioned above, will rise to 30% once the transfer of educational responsibilities has been completed. Until then, the difference between the final target of 30% and the initially set figure of 15% will, as seen below,

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[10] Table 3 gives an outline of the overall resources of the ordinary-regime RGs, distinguishing between the regions that accepted the new arrangements and those that have retained the previous financing arrangements.

be handed over to the RGs in the form of a share in the territorial revenue from the tax, as under the previous arrangements.

The assignment of personal income tax has been implemented by dividing the tax rate schedule into two tranches: the first, equal to 85%, corresponds to the State, and the second, or regional schedule, is equal to the remaining 15%[11]. The RGs have the power to regulate the regional tax rate schedule, subject to the constraint that the amount payable as a result of applying the individual or joint regional tax rate schedule to the ordinary final tax base may be neither 20% higher nor 20% lower than the amount payable when the State tax rate schedule is applied to the same tax base. 15% of the State tax deductions are applied to the regional tax rate schedule to obtain the regional net tax payable. Further, the RGs may create their own deductions for individuals and households, non-corporate investment and the application of income, provided that they should not directly or indirectly entail a reduction in the actual tax levied on any category of income[12]. These deductions, if applied, are subtracted from the regional net tax payable.

In any event, and in contrast to the other assigned taxes, the management of personal income tax remains within the remit of the State.

Secondly, the 1997 reform introduced restricted regulatory powers over the rest of the assigned taxes. In particular, regulatory responsibilities were established: over the tax-free allowance and the tax rate schedule of the wealth tax (which must be progressive and have the same number of brackets as that of the State, with the amount of the first bracket of the final tax base and the marginal rate also being the same); over the rate structure (necessarily progressive) and, in the case of mortis causa acquisition, over reductions from the tax base for the inheritance and gift tax. In the case of the tax on property transfers and documented legal acts, the RGs may regulate the rate charged on property transactions, and on the establishment and assignment of real rights relating thereto, as well as the rate payable on notarial documents. Lastly, in relation to gaming tax, their powers extend

11 The CPFF agreement of April 1998 established that the reduction in income tax (Law 40/1999 of 9 December 1999) would only be applied to the State schedule and, consequently, the weight of the regional tranche is higher than 15% (between 17% and 18%).

12 In 1998, many RGs used their regulatory powers, both in relation to personal income tax and to the other taxes transferred to them. As regards personal income tax, nine RGs introduced new deductions relating to promoting childbirth, making access to housing or the purchase of a second dwelling easier, encouraging specific donations and compensating certain family expenditure (on the disabled, custody, education).

to tax exemptions, applicable rates, fixed charges, allowances and accrual, and to management, settlement, tax-collection and inspection matters.

The RGs that did not accept the Agreement remain subject to the previous arrangements, i.e. personal income tax has not been assigned to them and nor do they have regulatory powers over the other assigned taxes.

Finally, the Canary Islands Regional Government has a special economic-fiscal regime based on free trade and on duty- and tax-free arrangements for consumption, as the EU harmonised indirect tax system is not applied in this region[13]. This special regime was provided for under Law 20/1991 of 7 June 1991, and amended by Law 19/1994 of 6 July 1994, and consists of a differentiated and lesser indirect tax burden than in the rest of the state[14].

Own taxes

The RGs are able to create taxes, levies and special contributions based on a series of conditions set in the LOFCA (organic law on RG financing). These conditions are of a technical nature and aimed, for example, at avoiding double taxation. In this case, the creation, regulation, management and administration of the taxes are the responsibility of the RGs.

Own taxes are highly diverse, and include the following: tax on bingo, tax on under-exploited agricultural estates, water infrastructure fees, tax on air pollution, dumping and water treatment fees, Canary Islands tax on oil-derived fuels, etc.

Tax surcharges

The LOFCA allows RGs to set surcharges on various taxes. Prior to the 1997 reform, it was established that the possibility of setting surcharges

13 Prior to the constitutional arrangements for the RGs being set in place, the Canary Islands government took over an "autonomousl" entity, the JIAI (the Inter-Provincial Island Tax Board). This body used to raise and distribute among local governments entry and luxury taxes, which originate in the free-port status of the Canary Islands.

14 The taxes involved are the following: the Canary Islands indirect general tax, with a similar structure to that of VAT, albeit with fewer rates and without taxing the retail trade stage; the Canary Islands production and imports levy; and the special rate structure of the Islands levy on incoming goods.

related to the assigned taxes. In any event, the State rate acted as a floor. In addition, the single-province RGs[15] were authorised to set surcharges on the municipal tax on business activities. Generally, the RGs set surcharges on the tax on gaming and also on the business activity tax in the case of the single-province RGs.

Following the 1997 reform, the possibility of setting surcharges on taxes that were assignable but not actually assigned was extended, provided that this did not entail a reduction in State revenue or distort the nature of the tax.

2.2.2 Transfers from the State and from the EU

Share in State revenue (a + b):

a) *Share in the net payable amount of personal income tax raised in the regional territory in question (the specific tranche).*

As earlier indicated, the Fiscal and Financial Policy Council (CPFF) agreed in 1993 to split the share in State revenue (PIE) into two blocks. The first corresponded to the PIE in the strict sense (general tranche), and the second was set at 15% of the net amount payable in respect of personal income tax collected in each region, the so-called share in territorial personal income tax receipts (specific tranche). The latter was deducted from the previous PIE.

Following the 1997 reform, this share in 15% of personal income tax receipts remains in place, but only temporarily until the transfer of educational responsibilities has been completed. At that moment it will disappear and the assigned portion of personal income tax will rise from 15% to 30%.

In fact, as explained in detail in the Box, the 15% share in the net payable amount of personal income tax does not apply to those RGs for which the volume of financing calculated for the base year (1996) under the previous system (the sum of the receipts from assigned taxes and charges for services plus the share in State revenue), after deducting the receipts from assigned taxes and charges for services and the receipts from

[15] The regions comprising a single province have taken over the financial resources of the now-defunct provincial authorities (except in the case of the Balearic Islands which, although a single-province region, has not taken over the resources of the Islands Authority Boards, which continue to exist).

the regional tax rate schedule of the assigned personal income tax, is either negative or, if positive, is less than the amount of the 15% share in the net payable amount of personal income tax.

b) The general tranche of the share in State revenue.

Following the 1997 reform, the general tranche of the share in State revenue acts as the element that balances the financing arrangements. This is because, for the base year (1996), it is calculated for each RG from the volume of total financing obtained for that year under the previous system, having deducted the receipts from assigned taxes and charges for services, the receipts from the regional tax rate schedule of the (assigned) personal income tax and the share of 15% in territorial personal income tax receipts (when established). Neutrality is thus ensured in the base year, in the sense that the financing by assigned taxes and charges for services and by the share in State revenue, calculated under the previous arrangements, must be equal to the financing by assigned taxes and charges for services plus the receipts from the regional tax rate schedule of the assigned personal income tax and plus the share in State revenue, calculated under the new arrangements (see Box). The value of the general tranche of the share in State revenue may be positive or negative. In the latter case, the negative value represents the compensation that the RG must pay the State as a consequence of the excess financing received through the mechanisms of the arrangements.

Once the value of the general tranche of the share in State revenue is known for each RG in the base year, the percentage share in State revenue is calculated for the same year in order to determine the PIE in the following years of the five-year period. This percentage share is defined as the aforesaid value of the general tranche of the PIE expressed as a percentage of the value of the structurally adjusted State tax revenue in the same base year (ITAE[16]). In each subsequent year, the annual revenue under the general tranche of the PIE of each RG is such that, as a percentage of the ITAE[17], it is the same as in the base year. For the RGs that accepted the new agreement, the percentages for the year 2000 are as follows:

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16 The ITAE is defined as the sum of State revenue from direct and indirect taxes (excluding those that are assignable), plus social security and unemployment insurance contributions.

17 During the five-year period, the PIE shall be revised in the case of transfer to the RG of new services (e.g. transfer to the Madrid RG of certain areas of responsibility for education), of assignment of taxes or fixing of the tranche of the share in the territorialised revenues of personal income tax, in the latter case in accordance with the previous rules.

Figure 2

Percentage shares in state taxes

REGIONAL (AUTONOMOUS) GOVERNMENT	PERCENTAGE SHARE IN STATE TAXES
ASTURIAS	0.0051549
BALEARIC ISLANDS	0.0900466
CANTABRIA	0.1764212
MADRID	0.2855747
MURCIA	0.3126853
LA RIOJA	0.0707610
ARAGÓN	0.2357855
CASTILE-LEON	0.8476505
CANARY ISLANDS	0.5328196
CATALONIA	0.6018842
GALICIA	0.9659995
VALENCIA	0.6236465

Inter-Territorial Compensation Fund

The aim of the Inter-Territorial Compensation Fund is to correct regional imbalances It is endowed annually with a total amount of not less than 35% of the new civil investment approved in the central government budget. This annual endowment shall be at least PTA 128,845 million, the minimum endowment established in 1992. The recipient RGs of these funds are those whose per capita income is lower than 75% of the EU average. These RGs must earmark the resources from the funds to financing investment projects "which, directly or indirectly, promote the creation of income and wealth in the region". The share-out among the RGs is made in accordance with a series of variables and applying distributive weights.

BOX
DETERMINATION OF THE FINANCING IN THE BASE AND SUBSEQUENT YEARS OF THE ORDINARY-REGIME RGs WHICH ACCEPTED THE 1996 CPFF AGREEMENT

The amounts in the base and subsequent years are determined as follows:

The financing for each RG calculated under the previous arrangements (FT1) must be equal to the financing under the new arrangements (FT2), in the base year.

FT1 = FT2

FT1 includes the receipts from assigned taxes and the charges for the services transferred (TC1+TA1) and the share in State revenue (PIE1).

FT1 = (TC1+TA1)+PIE1

FT2 includes the receipts from assigned taxes and charges for services (TC2+TA2), the “receipts from the regional tax rate schedule of the assigned personal income tax (TIR2) and the share in State revenue (PIE2). The latter is in turn made up of the share in the territorial personal income tax revenue (PIR2) and of the share in general State revenue, strictly speaking (PIE2´).

FT2 = (TC2+TA2) + TIR2 + PIE2

PIE2 = PIR2 + PIE2´

To establish the equivalence between the two types of financing in the base year, first FT1 is calculated for that year applying the criteria of the financing arrangements prior to the reform. Subsequently, TC2 and TA2 are subtracted from FT1, leaving FT´, and TIR2(1) is subtracted from the latter, leaving a positive or negative value (FT´´).

FT´ = FT – (TC2 + TA2)

FT´´ = FT´ - TIR2

In the event that FT´´ is negative or else positive but less than PIR2(2), the latter shall not be set for the RG concerned(3); otherwise, PIR2 (which shall be equal to TIR2 in the base year) shall be set and subtracted from FT´´, to give PIE2´.

PIE2´ = FT´´ - PIR2

PIE2´ (the share in general State revenue, strictly speaking) thus becomes the mechanism for balancing the system since, as has just been shown: a) in the case of the RGs for which PIR2 is set, PIE2´ will be equal to FT´´ - PIR2; b) in the case of the RGs which do not have a PIR2 set, PIE2´ shall be equal to FT´´ (positive or negative).

In order to determine PIE2´ in subsequent years, once the value of PIE2´ is known, the definitive percentage share for the five-year period in general State revenue (PPI) is calculated, this being defined as the value of PIE2´ expressed as a percentage of the structurally adjusted State tax revenue (ITAE) in the same base year. The definitive value of the PIE2´ tranche each year is equal to PPI (calculated in the base year) multiplied by the ITAE of each year.

During the five-year period, the ITAE shall be revised in the event that new services are transferred to the RG, that taxes are assigned or that the tranche of the share in the territorial personal income tax revenue is set, in accordance with the above rules (PIR2).

(1) TIR2 in the base year is calculated as the sum of: a) the net amounts payable, attributable to the residents of the RG (presented in 1997 and relating to 1996), under the regional tax rate schedule of the tax; b) 15% of the receipts from personal income tax obtained in 1996 through settlement or self-assessment, as well as the attributable part of the discretionary assessment. That part of the deduction for international double taxation made by taxpayers resident in the territory which is attributable to that territory (15% of the total deduction) is deducted from this sum.
Subsequently, in the rest of the five-year period, the revenue to be paid to each RG shall include: a) the net amounts payable under the regional tax rate schedule of the tax which the residents in the territory of the RG have reported in the return presented in year t+1, corresponding to year t (if negative its value shall be zero); b) the personal-income-tax revenue raised in t through settlement or self-assessment which corresponds to the RG, with the same tax-rate-schedule criteria and deductions as indicated for a), as well as the attributable part of discretionary rebates of the same year. As the final amount of the receipts from the regional tax rate schedule of the personal income tax is only known the following year, the RGs shall share in the net receipts obtained each year through payments on account. These payments shall be determined as the amount of the budget forecast of personal-income-tax revenue for year t from withholdings, payments on account and partial payments, multiplied by the updating index for the RG's tax rate schedule of the tax and also by 0.98. One twelfth of this amount shall be handed over each month.

(2) The amount of the tranche of the share in territorial personal income tax revenue (PIR2) is determined, in the base year, as 15% of the net receipts from the personal income tax paid by the residents of the RG (which must be equivalent to PIR2). When FT`` <= PIR2, provided that the resulting value is not negative, reducing coefficients shall be applied to this 15%. The amount of the PIR2 in subsequent years is determined as the PIR2 of the base year multiplied by the modulation index or correcting coefficient (in the case mentioned above) and by the index updating the tranche between the base year and year t. This index is calculated by dividing the State personal income tax revenue raised from the residents of the RG in year t by that of the base year, and multiplying this by 0.85. Again, as the final settlement of the tranche of the share in territorial personal income tax revenue corresponding to each year can only be made for each year as a whole, the RGs shall receive from the State budget, payments on account of the final settlement equal to one twelfth of the estimated amount, which shall be handed over monthly.

(3) In the event that FT´´ is positive but less than PIR2, a reducing coefficient shall be applied to PIR2 of 2/3 or 1/3, provided that the value of PIE2´ calculated as the difference between FT´´ and PIR2, calculated with such reducing coefficients, is not negative. In the event that the value of PIE2´ obtained by applying the reducing coefficient 1/3 to PIR2 is negative, it shall not be set.

Funds from the EU

The resources from the EU arise above all in connection with the EAGGF-Guarantee Fund and the Structural Funds, especially the FEDER (Regional Development Fund)[18] and, to a lesser extent, the European Social Fund, the EAGGF-Guidance fund and other agricultural resources. Further, the RGs have been receiving resources from the Cohesion Fund since 1995.

Other channels of conditional financing

These include resources relating to programme contracts[19], transfers in respect of joint investment agreements[20] and resources arising from the share of local governments in State revenue, which seven RGs currently administer[21], and the subsidies managed by the RGs[22].

2.2.3 The financing of social security responsibilities

The European System of National and Regional Accounts (ESA 95) defines social security funds as all central, state and local institutional units whose principal activity is to provide social benefits and whose basic resources consist of the obligatory social security contributions paid by other units. The social benefits referred to in this definition may be classified in Spain's case and according to social security terminology as:

- Financial benefits. These basically comprise benefits and subsidies in respect of unemployment, pensions, temporary disablement, maternity,

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[18] As the aim of the FEDER coincides with that of the Inter-Territorial Compensation Fund, the two are co-ordinated.

[19] Programme contracts are a means of financing certain public services, by supplementing the financing of the firms that provide such services. Such services are mainly related to passenger transport, as this is subject to political pricing.

[20] What are involved here are investment projects undertaken on a RG's territory and financed jointly by the State and the RG in question.

[21] These resources are only received by the RGs which have assumed financial stewardship of the local governments in their territory and which, therefore, act as intermediaries between the State and these local governments for their share in State taxes (Castile-La Mancha, Andalusia, Catalonia, Galicia, Valencia, Cantabria and Navarre).

[22] The source of these lies in the relationship between certain subsidies and social benefits and the management of the services that have been transferred. The State agrees with the RG or RGs affected by the transfer to devolve the management of such subsidies and benefits and to provide the resources needed to finance them.

assistance to the elderly and disabled and others. If preceded by payment by those receiving them of an obligatory social contribution, these benefits are contributory; otherwise they are non-contributory.

- Social benefits. These comprise social security fund benefits relating to care of the handicapped, care of the elderly and other social services. All these benefits are non-contributory.
- Health benefits. These comprise medical and drugs-related assistance and are financed via taxes raised by the State and transferred to social security funds.

As indicated, the financing of these benefits is by means of the social contributions received by the Social security Treasury Department and the taxes raised by the State and transferred to this Department. Thus, the single-centre principle operates in the financing of social security funds, with the Treasury Department being the recipient and distributive centre for all resources.

The devolution process in Spain has entailed the transfer to certain RGs of the management of health benefits and of certain other non-contributory financial benefits, which in no case include unemployment benefits and contributory pensions. Until 1994, only those RGs subject to article 151 of the Spanish Constitution and those assimilated thereto (Andalusia, the Canary Islands, Catalonia, Galicia and the Valencian region) had had these powers transferred to them. That year, the regions subject to article 143 of the Spanish Constitution (i.e. all the others) assumed responsibility for social but not for health services. Before this transfer, responsibility for health and social services was in the hands of centralised social security funds, specifically INSALUD and IMSERSO, respectively. These two institutes are financed via the Social security Treasury Department, the body responsible for receiving all the resources with which social security funds are financed.

Following the transfer of social services and health to certain RGs, the Social security Treasury Department continues to receive all the resources earmarked for financing these services (social security contributions and transfers from the State). It transfers to the RGs concerned the portion of these resources corresponding to them in order to finance the transferred social security services. Some RGs allocate additional resources to these functions, out of their own funds or by increasing their indebtedness.

The health system is thus financed separately outside the financing arrangements for the RGs. As a result, when the transfer of this responsibility takes place, the associated financing will be determined in parallel via the annual transfer to the RG of a portion of the INSALUD budget. The criterion applied when setting the percentage of the INSALUD budget to be transferred is that of resident covered population in the region in question, thus obtaining equality of per capita financing among the RGs. Nonetheless, certain health services are usually maintained in State centres, and therefore the cost of such centres is deducted from the INSALUD budget before calculating the portion to be transferred (the same is the case with the Health Research Fund, own revenue and the health programmes of the Ministry of Health and Consumption).

Further, at the time of transferring responsibilities to the RG in question, the actual spending of INSALUD in the region does not usually match that established under the covered population criterion. Accordingly, a transitory period is set (normally 10 years) for switching from one criterion to another, eliminating each year one-tenth of the difference.

Lastly, as deviations arise between the outturn and the initially budgeted amount, the RGs that have assumed responsibilities receive the final balance subsequently (with a lag of one or two years).

Given the significant financial problems with the arrangements in place, which meant that the RGs had to supplement the financing from the Social security Treasury Department with contributions of resources from their own budgets, the CPFF agreed in September 1994 on a new financing model for health assistance for the period 1994-97. This took real spending on health for the year 1994 as its basis and determined the growth of this spending in accordance with the nominal GDP for each year. Subsequently, in 1997, a new agreement for the period 1998-2001 was reached, meaning the arrangements are now defined as follows:

- The resources earmarked for health financing shall grow over the period in accordance with the growth rate of nominal GDP.
- Health financing shall be drawn from two funds: a general fund, equivalent to that existing previously, and another, specific fund, aimed at ensuring minimum financing to the RGs whose population shrinks, at covering needs relating to medical training and research, and at compensating RGs for the assistance provided to non-residents.

The share-out to the RGs that have assumed these responsibilities is made, in the case of the general fund, following the covered-population criterion, with updated data. And in the case of the specific fund, it is conducted ensuring that no RG whose population has shrunk should see the volume of its health financing fall by more than 0.25%, and financing extraordinary expenses relating to training and research and those arising from assistance provided to non-residents.

2.2.4 Borrowing

The RGs may incur debt, albeit subject to certain limits which are defined principally in article 14 of the LOFCA (organic law on RG financing), in the legal regulations common to all public-sector issuers and in the legislation governing RGs, in particular:

- Credit transactions maturing at less than one year should be used for covering transitory treasury requirements.
- Credit transactions at over one year, whatever the form in which they are documented, should meet the following requirements: a) the total amount of the loan should be used to finance investment expenses; b) the annual amount of repayments plus interest should not exceed 25% of RGs' current revenue.

To arrange credit transactions abroad and for the issuance of debt or any other resort to public credit, RGs require State authorisation. RGs' credit transactions should be co-ordinated with each other and with the State's debt policy in the CPFF (Fiscal and Financial Policy Council). RGs' public debt and the securities of an equivalent nature issued by them are subject, when not otherwise specified under the LOFCA, to the same regulations and enjoy the same benefits and conditions as State debt.

As a result of the foregoing, the RGs are obliged to submit to the Government (through the CPFF) an annual debt schedule which, once agreed on by both parties (Government and RG), entails automatic authorisation by the State of all the operations contained therein[23]. This schedule may be amended by the RG in the course of its execution, by means of a new proposal to the Government. Further, the State itself may provisionally suspend this schedule under exceptional circumstances if it

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23 As from 1992, following the publication of the March 1992 Convergence Programme for Spain, the so-called Budget Consolidation Scenarios (ECP) were signed by the central State and each RG, based on bilateral negotiations. These specified the maximum deficit and debt permitted in each RG. In March 1995, following the revision of the Convergence Programme in July 1994, the ECP commitments were also revised, specifying the limits for the period 1995-1997. Finally, they were again modified with the approval of the first Stability and Growth Programme in December 1998.

were to hamper the Treasury's financial policy or involve imbalance in the foreign/domestic debt ratio.

2.2.5 The system of guarantees under the new regional government financing arrangements

As the basis for determining the resources initially allocated to each region, the new system takes the amount calculated under the prior procedure for fiscal year 1996. This means that "financial neutrality" is ensured for this base year, in the sense that the financing from the receipts from assigned taxes and charges for services, plus the share in State revenue, calculated under the previous system, is exactly equal to that obtained as the sum of receipts from assigned taxes and charges for services plus receipts from the regional tax rate schedule of the assigned personal income tax, and plus the share in State revenue, calculated under the new arrangements (see Box).

The new system also sets the criteria for determining the minimum amounts to be received by each RG over time. As earlier stated, the benchmark index for the financing arising from the share in State revenue will be that of the ITAE, which was also used as a standard in the previous period. However, to avoid the risk of the behaviour of personal income tax in each region causing a loss of resources, a number of financial guarantees have been given.

The first guarantee sets a floor to the growth of personal income tax resources, ensuring that the growth during the five-year period of the resources provided by the personal income tax rate schedule (including both the receipts under the regional tax rate schedule of the assigned personal income tax and, where appropriate, the share in the territorial revenue from this tax) should be equal to the growth of nominal State GDP if this is lower than the growth of the State personal income tax revenue. Consequently, it is the State that assumes the risk of losing personal income tax revenue.

Although this guarantee refers to the overall results of each RG in the five-year period, it shall be applied each year, taking into account the cumulative financing to that year.

The second guarantee ensures for each RG that the growth of the resources obtained from personal income tax (the regional tranche assigned in the absence of changes in the regulatory powers and the share in territorial receipts) and from the share in State revenue during the five-year period shall be not less than 90% of that obtained by the RGs as a whole. The latest Council Resolution dated April 1998 adds a further guarantee whereby the minimum guaranteed increase in the share in State revenue is also set in line with the index resulting from the increase in nominal GDP. Consequently, the minimum increase in personal income tax and the share in State revenue guaranteed to each RG that has accepted the new arrangements is that of the growth rate of nominal GDP.

As in the previous case, although the guarantee covers a five-year period, annual assessments shall be made.

The third guarantee ensures the capacity to cover public services assumed (non-university education). In the last year of the five-year period, in the event of education services having been transferred, the financing per inhabitant of each region shall be not less than 90% of average per capita financing. To this end, only resources arising from receipts from taxes and charges for services, those obtained from personal income tax without the use of the regulatory power (including the share in territorial receipts) and those derived from the share in State revenue shall be considered included in this financing.

In addition, certain rules of priority are established between these guarantees: the first guarantee comes into operation first, and the amounts for each region are computed with deduction of any additional revenue they may be entitled to under the second and third guarantees. These are in turn mutually exclusive, only the largest amount being received. These guarantee funds shall not be consolidated in the financing mechanisms of the system.

In consequence, under all these guarantees, the minimum increase in the financing received by each RG that has signed the agreement is the growth in GDP, unless by changing their tax rate schedules for personal income tax or by introducing new personal income tax deductions they cause a loss of receipts in the regional tranche. Note that this system of guarantees entails a significant change with respect to the system in force prior to the reform. Under the previous financing arrangements, as indicated in section II, the GDP growth rate was the ceiling not the floor for the growth in the general tranche of the share in State revenue.

3. Financing arrangements for the specific-status regional (autonomous) governments

The financing arrangements for the specific-status RGs are based on the old municipal charters (fueros) and accords (convenios) of the historical territories of the Basque Country and Navarre that are recognised in the Constitution[24] and developed in subsequent legislation. Law 12/1981 approved the Economic Accord (Concierto Ecónomico) between the State and the Basque Country RG and Law 38/1997 of 4 August 1997, adapted, modified and extended regulatory responsibilities under the Accord. Meanwhile, Organic Law 13/1982 on reintegration and improvement of the Navarre specific-status RG recognises the power of this RG to maintain, establish and regulate its own tax regime within the general system. The Agreement (Convenio) between the State and the Navarre RG was amended on 31 December 1997.

The general characteristics of the financing arrangements for these RGs are as follows:

The Basque Country provincial authorities (Álava, Guipúzcoa and Vizcaya) and the Navarre (specific-status) RG have the power to maintain, establish and regulate, inside their territory, the tax regime, taking into account the general structure of taxes of the State and the co-ordinating provisions established. Accordingly, they are responsible for the levying, management, settlement, collection and inspection of all the taxes known as “concerted taxes” (tributos concertados), except those included in Customs Revenue and those raised through Fiscal Monopolies. The regulatory power over the aforesaid concerted taxes of the administrations which raise them is limited in the Accord or Agreement by the rules and principles of tax harmonisation and collaboration with the State which are established generally and for each tax. In general, although there are differences in this area between the Basque Country Accord and the Navarre Agreement, the General Tax Law is applied in relation to terminology and concepts, the effective overall tax burden arising from this regulatory power must not be lower than that existing in the rest of the State, the international tax treaties and conventions must not be

24 The Álava municipal charter was the only one not repealed following the civil war (1936-1939) and was still in force in 1978.

contravened and free movement and establishment of capital and persons within Spanish territory must be respected and guaranteed[25].

The 1997 Basque Country Economic Accord simplifies the fiscal harmonisation provisions, makes manufacturing excise duties concerted taxes and extends regulatory responsibilities over certain taxes, including personal income tax and corporate income tax.

Since the Basque Country RG has no power to levy the concerted taxes -the provincial authorities having this power[26]- it is financed principally by means of a transfer of resources from the provincial authorities corresponding to its territory. These transfers are called contributions to the Basque Country Finance Department.

As a consequence of the fact that the concerted taxes include almost all those existing and that the State provides services, mainly of a general nature (for example, defence, diplomatic representation, etc), but has no tax-raising capacity in this territory, the Basque Country and Navarre specific-status RGs transfer some of their resources, by means of the so-called "Cupo", to the State in order to contribute to the financing of these services.

In the case of the Basque Country provincial authorities, the “Cupo” is currently determined using the methodology approved in law 37/1997 of 4 August 1997, and is calculated in accordance with the Basque Country relative capacity index (índice de capacidad relativa). The “Cupo” for the base year 1997 corresponds to a percentage of the value of the responsibilities not assumed reduced by unconcerted revenue:

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25 In this respect, the Basque Country provincial authorities have used their regulatory power to establish, for example, tax concessions for businesses setting up within their territory (e.g. deductions from corporate income tax payable, or reductions in the corporate income tax base of 99%, 75% and 25% in the four years following the first in which the business earns a profit). Such measures have in some cases been challenged by the State and/or by neighbouring RGs in the courts on the grounds that they undermine free competition. This question has even been referred to the European Court of Justice for a preliminary ruling by the Supreme Court of the Basque Country, and to the European Commission, which after various decisions (declaring illegal, for example, a large part of the aids granted to the Korean multinational Daewoo), opened general infringement proceedings in respect of these aids in 1999. Subsequently, in January 2000, the State government and the Basque Country executive and provincial authorities reached an agreement under which the State administration undertook to withdraw the actions filed and the provincial authorities to adapt their legislation, with the removal of some of these aids. This agreement shall remain in force until 31 December 2001, when the current Basque Economic Accord expires.

26 The provincial authorities are considered local governments, not RGs, in the National Accounts sectorisation framework.

$$C = iCNA - INC$$

Where i is the attribution index (índice de imputación), CNA is the cost, in the State budget, of the responsibilities not assumed, INC is the sum of the attributable part of the unconcerted taxes and of non-tax revenue, including the budget deficit, of certain withholdings on income from capital and of the corporate income tax levied by the State.

The attribution index, fixed at 6.24%, is obtained from the formula:

$$i = \sqrt{\frac{Y_{PV}}{Y_E} \times \frac{P_{PV}}{P_E}}$$

where YPV is the income of the Basque Country, PPV is the population of the Basque Country, and YE and PE are the same variables for the Spanish State as a whole.

The “Cupo” for the subsequent years of the current five-year period is determined by applying an updating index (índice de actualización) to the base year. This index is calculated by expressing the revenue from concerted taxes belonging to revenue chapters I and II of the State budget, excluding those assignable, for the year in question as a percentage of the revenue from the same tax items in the base year, having deducted the true cost of the regional police and having adjusted the services transferred by the Social security System.

The methodology followed to determine the contribution of Navarre to general State expenditure is similar to that established for the Basque Country and is based on two fundamental rules: a) Navarre’s contribution to the State is fixed every five years, in accordance with the amount, in that base year, of State expenditure on general services and an attribution index of 1.6%, which reflects the capacity of the RG to bear the same, based on its income relative to that of Spain as a whole; b) for the other years of the five-year period the contribution is determined by that set for the base year updated by an index reflecting the increase in State revenues from agreed taxes.

The responsibility for social security affairs is considered assumed by the Basque Country and Navarre when their respective “cupos” are calculated. However, the Social security Treasury Department, following the single-centre principle, receives the amount of the contributions and of the State transfers (the proportional part established in the State budget) to finance social security. Subsequently, the Social security Treasury Department transfers directly to the Basque Country and Navarre the amount of the spending on social security in their respective territories financed by means of contributions. As regards that part of the social security spending of these territories financed by State transfers, this is not transferred directly to the Basque Country and Navarre but is deducted from the "Cupo".

Both the Basque Country RG and the Navarre RG receive other resources, in addition to the share in State revenue and the assigned taxes, which the ordinary-regime RGs also receive. These include resources received under investment agreements and programme contracts, subsidies managed by the RGs, the share of the local governments in State taxes and resources from the European Union.

As regards their capacity to borrow, the same rules apply as for ordinary-regime RGs.

4. The revenue of the regional (autonomous) governments according to national accounts and budget accounting information

The structure of the regional (autonomous) governments revenue is analysed below, on the basis of Table 4, containing information supplied by the National Accounts and by budget accounts[27]. This information has been compiled basically from the data provided by the income, use of income and capital account of the RGs. Two further sources were used: (i) the State budget, for the information on the transfers from the Social security Treasury Department to the RGs, since this information is not broken down in the social security funds account of the National Accounts, and (ii) the financial accounts, for the RGs' borrowing.

The following conclusions may be drawn from an analysis of Table 4:

The transfers from the Social security Treasury Department to finance the transferred health care and social services were the primary source of revenue of the RGs in 1998, accounting for 28.3% of their total

[27] Annex 1 explains how the various items of revenue of the RGs are recorded in the National Accounts and budget accounting frameworks.

resources. Moreover, it is foreseeable that the importance of these transfers will continue to grow in future, since the majority of the RGs have still not assumed responsibilities in relation to health.

State transfers represented 28% of the RGs' revenue in 1998, despite a sharp drop of more than 5 percentage points following the 1997 reform. Within State transfers, the share in State revenue (22.3% in 1998) is notable. This includes the share in the territorial personal income tax receipts and the share in State revenue strictly speaking. The funds from the Inter-Territorial Compensation Fund, in contrast, only represented 1.9% of the RGs' revenue. Other State transfers include, inter alia, the revenue received under programme contracts and joint investment agreements.

Tax resources were the third most important source of revenue for the RGs (26.5% in 1998), having risen sharply in weight since the 1997 reform, especially as a consequence of the incorporation of the regional tranche of the personal income tax for the ordinary-regime RGs which accepted the agreement. In fact, personal income tax revenue has become the third most important item of revenue (8.4% in 1998), behind the transfers to finance the transferred social security responsibilities and the share in State revenue. Notable among other tax resources is the revenue from the tax on property transfers and documented legal acts, which accounted for 7.5% of the total resources of the RGs in 1998.

It should be noted that the total tax resources include tax revenues raised by the Navarre RG, but not those of the Basque Country RG. As mentioned above, the provincial authorities of the latter region are responsible for raising taxes and then transferring the relevant portion to the RG. In fact, revenue from VAT, excise duties and luxury taxes (on the consumption of domestic goods) and corporate income tax, included in Table 4, are only received by the Navarre RG. Likewise, revenue from Canary Islands taxes on domestic and imported goods is only received by the Canary Islands RG.

The other transfers item includes funds from the EU, with a weight of 4.3% in total resources in 1998, and transfers from local government, which basically include the funds transferred by the Basque Country provincial authorities to the RG.

Finally, in 1998, the change in the financial liabilities of the RGs (borrowing) represented 2.6% of their total resources, following a sharp fall of more than 10 percentage points since 1992, when the Budget Consolidation Scenarios were signed by the central State and each RG.

A memorandum item in Table 4 gives a breakdown of the resources by their origin, distinguishing between those raised directly from taxpayers and those obtained from other general government bodies. This shows that only about 30% of resources are obtained directly from taxpayers and, therefore, help to increase the degree of fiscal co-responsibility of the RGs, while the majority, the other 70%, come from other general government bodies. With the new agreement for the period 1997-2000, the relative weight of tax resources rose by almost 10 percentage points of GDP, but this did not result in a corresponding increase in the resources obtained directly from taxpayers owing to the reduction in the relative weight of borrowing.

Table 5 gives a breakdown of the revenue of the RGs in 1996 and 1998, distinguishing between the ordinary-regime and specific-status RGs and, among the former, between the RGs of article 143 and of article 151 of the Spanish Constitution. Unlike in Table 4, only the revenue of chapters I to VII of the budgets is included here. Social security transfers which, as mentioned above, come outside the general financing arrangements, and borrowing, which will be analysed later, are not included.

The following conclusions may be drawn from an analysis of Table 5:

The main means of financing the ordinary-regime RGs in 1998 is through current and capital transfers, mostly from the State, which represent more than 75% of all their revenue, while tax resources account for somewhat less than 25%. However, a comparison with the situation in 1996 shows that the reform of the financing arrangements has involved a reduction in the percentage of transfers and an increase in that of tax revenue (from 83.6% and 11.2% in 1996, respectively).

The relationship between transfers and tax resources is the reverse in the Navarre RG, where transfers represent little more than 5%, and in the Basque Country, where it must be taken into account that the percentage figure for transfers (98.5%) basically includes those from the provincial authorities which are responsible for raising tax resources and then transferring the established percentage thereof to the Basque Country RG.

As in the case of the ordinary-regime RGs, comparing 1998 and 1997 shows an increase in tax resources at the expense of transfers.

Similarly important in the case of the ordinary-regime RGs is the difference between of the article 143 and of the article 151 RGs. In the former, the percentage of total revenue provided by tax resources in 1998 is much higher than in the case of the article 151 RGs (32.9% against 15.6%). This means that the RGs which have assumed greater responsibilities (the article 151 RGs) depend to a greater extent on transfers. Moreover, although the new financing arrangements have led, as mentioned above, to a reduction in the weight of transfers in both the article 143 and the article 151 RGs, this reduction has been greater in the case of the article 143 RGs.

Table 6 shows the debt (excluding trade credit) of each RG as a percentage of its regional GDP and the total debt of the RGs as a percentage of national GDP. First, the absolute importance of the debt of the RGs should be noted. It was equal to 6.3% of GDP in 1998, although in recent years there has been a fall in its rate of growth and, in 1998, the rate was even negative. Second, the most indebted RGs are those which have assumed greater responsibilities (specific-status and article 151 RGs).

Finally, Table 7 shows the relative importance of the RGs in terms of the revenue, expenditure and debt of general government as a whole. On 1998 data, the RGs obtained almost 18% of total general government resources, and 11.6% of the taxes raised by general government. Moreover, the RGs' debt represented 9.6% of total public-sector debt.

Table 1

Classification of the regional (autonomous) governments type according to financing arrangements

	TYPE ACCORDING TO THE CONSTITUTION	TERRITORIAL SCOPE		GDP at market prices, 1996 (1)		Population 1996 (2)	
		SINGLE-PROVINCE	MULTI-PROVINCE				
ORDINARY-REGIME REGIONAL (AUTONOMUS) GOVERNMENTS	ARTICLE 143 OF THE CONSTITUTION	ASTURIAS		1841,8	2,5%	1071,3	2,7%
		BALEARIC ISLANDS		1823,9	2,5%	729,5	1,9%
		CANTABRIA		952,6	1,3%	526,6	1,3%
		MADRID		11835,1	16,1%	5016,0	12,8%
		MURCIA		1755,2	2,4%	1084,4	2,8%
		LA RIOJA		549,0	0,7%	260,5	0,7%
			ARAGÓN	2468,0	3,4%	1180,2	3,0%
			CASTILE-LA MANCHA	2644,1	3,6%	1694,0	4,3%
			CASTILE-LEÓN	4455,7	6,1%	2509,8	6,4%
			EXTREMADURA	1373,8	1,9%	1075,3	2,7%
	TOTAL ARTICLE 143			29699,2	40,5%	15147,6	38,7%
	ARTICLE 151 OF THE CONSTITUTION		ANDALUSIA	9811,6	13,4%	7128,2	18,2%
			CANARY ISLANDS	2723,9	3,7%	1563,2	4,0%
			CATALONIA	14254,2	19,5%	6065,5	15,5%
			GALICIA	4070,1	5,6%	2723,8	7,0%
			VALENCIA	7038,8	9,6%	3913,2	10,0%
	TOTAL ARTICLE 151			37898,6	51,7%	21393,9	54,7%
	TOTAL ORDINARY REGIME			67597,8	92,2%	36541,5	93,4%
SPECIFIC-STATUS REGIONAL (AUTONOMOUS) GOVERNMENTS	Recognition of old municipal charters and accords or agreements with the State (additional provision one of the Constitution)	NAVARRE		1200,4	1,6%	526,6	1,3%
			BASQUE COUNTRY	4485,9	6,1%	2069,2	5,3%
	TOTAL SPECIFIC-STATUS			5686,3	7,8%	2595,8	6,6%
TOTAL				73284,1	100%	39137,3	100%

(1) PTA billions and % of total. Preliminary INE (National Statistics Office) data.
(2) Thousands and % of total. Population as at July 1st. Preliminary INE data.

Table 2

Social security and educational responsibilities assumed by the regional (autonomous) governments

TYPE ACCORDING TO FINANCING ARRANGE-MENTS	TYPE ACCORDING TO THE CONSTITUTION	REGIONAL (AUTONOMOUS) GOVERNMENTS	RESPONSIBILITIES ASSUMED				
			SOCIAL SECURITY				EDUCATION (2)
			HEALTH CARE	FINANCIAL BENEFITS		SOCIAL BENEFITS	
			INSALUD (3)	IMSERSO (4)	INEM AND OTHERS (5)	OTHERS	
ORDINARY-REGIME REGIONAL (AUTONOMOUS) GOVERNMENTS	ARTICLE 143 OF THE CONSTITUTION	ASTURIAS		X			X
		BALEARIC ISLANDS		X			X
		CANTABRIA (1)		X			X
		MADRID		X			X
		MURCIA		X			X
		RIOJA		X			X
		ARAGÓN		X			X
		CASTILE-LA MANCHA (1)		X			X
		CASTILE- LEÓN		X			X
		EXTREMADURA		X			X
	ARTICLE 151 OF THE CONSTITUTION	ANDALUSÍA (1)	X	X			X
		CANARIAS	X	X			X
		CATALONIA (1)	X	X			X
		GALICIA (1)	X	X			X
		VALENCIA (1)	X	X			X
SPECIFIC-STATUS REGIONAL (AUTONOMOUS) GOVERNMENTS	Recognition of old municipal charters and accords or agreements with the State (additional provision one of the Constitution)	NAVARRE (1)	X	X			X
		BASQUE COUNTRY	X	X			X

(1) These RGs have been transferred the responsibility for distribution of the share of the local governments (provincial governments, local councils and minor local authorities) in State taxes. In practice, this responsibility means that the RGs receive from the State, and distribute among the local government within their territory, the shares of the latter in State taxes, i.e. they act as intermediaries for these transfers.
(2) In some cases educational responsibilities have not actually been transferred, even though the autonomy charters have been amended to enable them to assume these responsibilities. - (3) National health service. - (4) Migration and social services institute. - (5) National employment office.

Table 3

Financing of the ordinary-regime regional (autonomous) governments

RESOURCES	ORDINARY-REGIME RGs	
	That have accepted the CPFF agreement of 23 September 1999 (All except Andalusia, Castile-La Mancha and Extremadura)	That have not accepted the agreement (Andalusia, Castile-La Mancha and Extremadura)
ASSIGNED TAXES	Previous arrangements + assignment of 15% of personal income tax + regulatory power	Previous arrangements
OWN TAXES	Previous arrangements	Previous arrangements
TAX SURCHARGES	Previous arrangements + possibility of establishing surcharges on taxes that are assignable but have not actually been assigned	Previous arrangements
SHARE IN STATE REVENUE	Previous arrangements + calculation changed due to the assignment of 15% of personal income tax	Previous arrangements
INTER-TERRITORIAL COMPENSATION FUND	Previous arrangements	Previous arrangements
FUNDS FROM THE EU	Previous arrangements	Previous arrangements
FINANCING OF SOCIAL SECURITY RESPONSIBILITIES	CPFF agreement for the period 1998-2001	Previous arrangements
BORROWING	Previous arrangements	Previous arrangements
OTHER RESOURCES	Previous arrangements	Previous arrangements

Table 4

Structure of the resources of the regional (autonomous) governments

%

	1992	1993	1994	1995	1996	1997	1998
1. TAX RESOURCES	15.5	15.7	16.5	16.7	15.9	24.7	26.5
VAT (Navarre)	0.9	1.1	1.3	1.5	1.4	1.5	1.8
Taxes on imports, excluding VAT	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Canary Islands taxes on imported goods (Canary Islands)	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Taxes on production, excluding VAT	10.1	9.7	10.1	10.0	9.2	10.5	11.7
On the consumption of domestic goods (excise duties and luxury taxes) (Navarre)	0.5	0.5	0.6	0.6	0.6	0.6	0.6
Tax on property transfers and documented legal acts	6.4	6.1	6.6	6.6	6.1	6.8	7.5
Taxes on gaming	3.1	2.8	2.7	2.7	2.5	3.1	3.5
Business activities tax	0.1	0.2	0.1	0.1	0.1	0.1	0.1
Canary Islands taxes on domestic goods (Canary Islands)	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Taxes on income, net worth and capital	3.7	4.1	4.4	4.4	4.3	11.8	12.2
Corporate income tax (Navarre)	0.3	0.3	0.2	0.3	0.3	0.4	0.4
Personal income tax (Navarre and the assigned 15% of personal income tax)	1.0	1.0	1.0	1.1	1.0	8.2	8.4
Wealth tax	1.0	1.0	1.1	1.0	1.0	1.0	1.0
Inheritance and gift tax	1.5	1.9	2.1	2.0	2.0	2.2	2.4
Miscellaneous and penalties	0.8	0.7	0.7	0.9	0.9	0.9	0.9
2. STATE TRANSFERS	33.4	33.8	32.7	32.7	33.1	28.4	28.0
RG's share in State revenue (includes 15% share in personal income tax)	24.0	27.2	27.5	27.6	27.5	23.9	22.3
Inter-territorial Compensation Fund	3.7	2.1	2.2	1.7	1.5	1.7	1.5
Others	5.6	4.5	3.0	3.5	4.1	2.8	4.1
3. TRANSFERS TO FINANCE THE TRANSFERRED SOCIAL SECURITY RESPONSIBILITIES	26.3	27.3	28.9	29.6	28.8	28.1	28.3
Health care	25.3	26.1	27.8	28.3	27.2	26.5	26.6
Social services	1.0	1.2	1.2	1.3	1.6	1.7	1.7
4. OTHER TRANSFERS	10.0	9.8	10.1	12.6	12.6	12.1	12.8
EU funds	3.2	2.7	2.2	4.7	4.7	4.8	4.3
Local governments (b)	5.5	5.4	5.6	5.4	5.7	5.4	5.7
Social security funds (except INSALUD and IMSERSO)	0.5	0.9	1.4	1.6	1.3	1.4	1.4
Autonomous central government agencies	0.1	0.1	0.1	0.1	0.1	0.2	0.3
Other	0.7	0.8	0.8	0.7	0.9	0.2	1.0
5. OTHER REVENUE	2.0	2.2	2.1	2.1	2.8	1.9	1.9
6. BORROWING	12.7	11.2	9.7	6.4	6.7	4.7	2.6
TOTAL RESOURCES (=100)	100.0	100.0	100.0	100.0	100.0	100.0	100.0
(% GDP at market prices)	(10.2)	(10.4)	(10.4)	(9.9)	(10.4)	(10.4)	(10.5)
MEMORANDUM ITEM: STRUCTURE OF THE RESOURCES ACCORDING TO THEIR ORIGIN							
TOTAL RESOURCES (=100)	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Resources obtained directly from taxpayers	28.3	26.9	26.2	23.1	22.6	29.4	29.0
Resources originating in the budgets of other general government bodies	71.7	73.1	73.8	76.9	77.4	70.6	70.9
MEMORANDUM ITEM: GDP at market prices (ESP billions)	60746	62643	66666	71763	75823	80008	84902

(a) Including the resources received by the RGs to finance the transferred social security responsibilities, which appear in the National Accounts as resources of the social security funds, not the RGs.
(b) Basically includes the transfers received by the Basque Country RG from the Basque Country provincial authorities.
Source: Spanish National Accounts (INE), National Audit Office, Social Security System budgets and Banco de España

Table 5

Structure of the resources (excluding borrowing) of the ordinary-regime and specific-status regional (autonomous) governments

%

	TOTAL	ORDINARY-REGIME			SPECIFIC-STATUS		
		TOTAL	ARTICLE 143	ARTICLE 151	TOTAL	NAVARRE	BASQUE COUNTRY
	(1)=(2)+(5)	(2)=(3)+(4)	(3)	(4)	(5)=(6)+(7)	(6)	(7)
1998							
STRUCTURE: TOTAL RGs=100							
1. REVENUE	100.0	89.4	24.2	65.2	10.6	3.3	7.4
1.1. Taxes (a)	100.0	85.8	37.6	48.2	14.2	14.1	0.1
1.2. Transfers (a)	100.0	90.0	19.5	70.6	10.0	0.2	9.8
1.3. Property income, fees and charges and other income	100.0	95.4	39.4	56.0	4.6	2.4	2.2
STRUCTURE: TOTAL REVENUE=100							
1. REVENUE	100.0	100.0	100.0	100.0	100.0	100.0	100.0
1.1. Taxes (a)	21.1	20.3	32.9	15.6	28.2	91.5	0.2
1.2. Transfers(a)	74.5	75.1	60.0	80.6	69.9	5.3	98.5
1.3. Property income, fees and charges and other income	4.4	4.7	7.2	3.8	1.9	3.2	1.3
1996							
STRUCTURE: TOTAL RGs=100							
1. REVENUE	100.0	88.6	21.9	66.7	11.4	3.1	8.3
1.1. Taxes (a)	100.0	79.4	28.4	51.0	20.6	20.5	0.1
1.2. Transfers (a)	100.0	89.8	20.3	69.5	10.2	0.5	9.8
1.3. Property income, fees and charges and other income	100.0	92.8	32.7	60.1	7.2	3.5	3.8
STRUCTURE: TOTAL REVENUE=100							
1. REVENUE	100.0	100.0	100.0	100.0	100.0	100.0	100.0
1.1. Taxes (a)	12.5	11.2	16.2	9.6	22.7	82.4	0.2
1.2. Transfers(a)	82.6	83.6	76.4	86.0	74.2	12.1	97.6
1.3. Property income, fees and charges and other income	4.9	5.2	7.3	4.4	3.1	5.5	2.2

(a) The Basque Country RG receives a transfer from the Basque Country provincial authorities in respect of the "concerted" taxes raised by the latter
Source: Ministry of Economy and Finance, Directorate General of Co-ordination with territorial finance departments, the budgets of the RGs and administrative agencies reporting to the RGs.

Table 6

Debt of the regional (autonomous) governments

%

	1992	1993	1994	1995	1996	1997	1998
TOTAL	3.6	4.5	5.3	5.8	6.2	6.5	6.3
ORDINARY-REGIME	3.6	4.6	5.3	5.8	6.3	6.6	6.5
ARTICLE 143	2.7	3.3	3.8	3.8	3.9	3.9	3.8
Aragon	2.2	3.5	4.3	4.6	4.9	5.6	5.4
Asturias	3.0	2.9	3.5	3.8	3.7	3.9	4.2
Balearic Islands	2.2	2.7	2.7	2.6	2.4	2.7	2.6
Cantabria	5.7	5.7	4.9	4.0	2.7	2.9	2.6
Castile-La Mancha	1.7	2.1	2.8	2.8	3.0	3.0	3.3
Castile-Leon	1.6	2.2	3.0	3.1	3.2	3.4	3.2
Extremadura	3.4	4.8	5.6	5.9	6.4	6.0	6.1
Rioja	3.8	4.1	3.9	4.2	3.7	3.4	3.4
Madrid	2.6	3.3	3.8	3.9	4.0	4.0	3.7
Murcia	5.1	5.6	5.6	5.4	5.2	5.0	4.9
ARTICLE 151	4.4	5.6	6.6	7.4	8.3	8.7	8.6
Andalusia	5.3	6.6	7.2	7.7	8.8	9.5	9.4
Canary Islands	2.9	4.1	4.8	4.7	6.1	4.9	5.0
Catalonia	3.9	4.9	6.2	7.7	8.5	9.2	8.9
Galicia	5.6	7.4	8.5	9.0	9.5	9.6	9.4
Valencia	4.1	5.2	6.1	6.5	7.2	7.7	7.8
SPECIFIC-STATUS	4.1	5.8	7.2	7.8	8.0	8.0	7.3
Navarre	4.2	7.8	10.4	11.5	10.8	9.9	8.6
Basque Country	4.1	5.3	6.3	6.8	7.3	7.5	6.9
MEMORANDUM ITEM: GDP at market prices used for the total (ESP billions)	60746	62643	66666	71763	75823	80008	84902

(a) Only debt in the form of securities and credit other than trade credit is included.

Sources: debt, Banco de España; GDP at market prices (used for the TOTAL), European Commission; regional GDP at market prices (used for the RGs), INE, *Spanish Regional Accounts* (series 1986-1996). For 1997 and 1998 national GDP at market prices has been used, distributed in accordance with the latest available Spanish Regional Accounts.

Table 7

Importance of the regional (autonomous) governments relative to general government as a whole

%

	1992	1993	1994	1995	1996	1997	1998
RESOURCES OF THE RGs AS A PERCENTAGE OF TOTAL GENERAL GOVERNMENT RESOURCES	15.0	15.3	15.6	16.1	16.5	17.1	17.9
TAX REVENUE RAISED BY THE RGs AS A PERCENTAGE OF TOTAL GENERAL GOVERNMENT TAX REVENUE	6.4	6.8	7.1	7.0	6.8	10.7	11.6
USES OF RGs AS A PERCENTAGE OF TOTAL GENERAL GOVERNMENT USES	15.8	15.4	15.4	15.0	16.3	16.7	17.7
DEBT OF THE RGs AS PER THE EXCESSIVE DEFICIT PROTOCOL AS A PERCENTAGE OF TOTAL GENERAL GOVERNMENT DEBT	7.6	7.7	8.7	9.0	9.1	9.7	9.6

Source: resources, taxes and uses, Ministry of Economy and Finance (National Audit Office); debt as per Excessive Deficit Protocol, Banco de España

ANNEX 1

The Revenue of the Regional (Autonomous) Governments in the National and Budget Accounts

ITEM	NATIONAL ACCOUNTS	BUDGET ACCOUNTS
■ Share in State revenue (including the share in territorial personal income tax receipts)	■ Current transfers from the State to the RGs	■ Current transfers under expenditure in the State budget and under revenue in the RGs' budgets
■ Inter-territorial Compensation Fund	■ Capital transfers from the State to the RGs	■ Capital transfers under expenditure in the State budget and under revenue in the RGs' budgets
■ EU funds	■ Capital transfers (revenue) of the RGs	■ Capital transfers originating in the EU budget, and recorded as revenue in the RGs' budgets
■ Joint investment agreements	■ Capital transfers from the State to the RGs	■ Transfers under expenditure in the State budget and transfers received in the RGs' budgets
■ Programme contracts	■ Current or capital transfers from the State to the RGs	■ Current or capital transfers under expenditure in the State budget and under revenue in the RGs' budgets

(continues)

ITEM	NATIONAL ACCOUNTS	BUDGET ACCOUNTS
■ Managed subsidies	■ Current transfers from the State to the RGs	■ Current transfers under expenditure in the State budget and under revenue in the RGs’ budgets
■ Assigned taxes, charges for services, own taxes and surcharges on State taxes	■ Revenue received by the RGs	■ Revenue in the RGs’ budgets (chapters I, II and III)
■ Resources to finance health care and social services	■ Resources of the social security and employment funds, only in the case of transfers from the State and RGs to social security	■ Revenue in the budget of the Social security System and expenditure, in the case of the transfers, in the State budget
■ Share of local governments in State revenue	■ Current transfers paid by the State to the local governments	■ Expenditure in the State budget, revenue and expenditure in the RGs’ budget and revenue in the local governments’ budget
■ Concerted taxes (specific-status RGs)	■ Taxes of the Navarre RG and the Basque Country provincial authorities	■ Revenue in the budgets of the Navarre RG and of the Basque Country provincial authorities

(continues)

ITEM	NATIONAL ACCOUNTS	BUDGET ACCOUNTS
■ "Cupo" (specific-status RGs)	■ Current transfers received by the State and paid by the Basque Country provincial authorities and the Navarre RG	■ Current transfers under expenditure in the budgets of the Basque Country provincial authorities and of the Navarre RG and revenue in the State budget
■ Contributions from the Basque Country provincial authorities to the Basque Country Finance Department	■ Current transfers paid by the provincial authorities of Álava, Guipúzcoa and Vizcaya to the Basque Country RG	■ Expenditure in the Basque Country provincial authorities' budgets and revenue in the RG's budgets
■ Transfers to finance health care and social services (specific-status RGs)	■ Resources corresponding to the percentage represented by the contributions of the State to the Social security Treasury Department to finance these services: reduction of the "Cupo" ■ Resources corresponding to the percentage financed with contributions: transfers from the social security funds to the Basque Country and Navarre RGs	■ Expenditure (transfers) and revenue (lower "cupo") in the State budget and revenue (contributions and transfers) and expenditure (part of contributions) in the budget of the Social security System, and expenditure (lower "cupo") and revenue (part of contributions) in the specific-status RGs' budgets
■ Borrowing	■ Change in financial liabilities (Financial Accounts)	■ Revenue in the RGs' budgets (chapter VIII)

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THE DISCUSSION ON A NATIONAL STABILITY PACT IN GERMANY

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1. Introduction

As the name suggests, the Federal Republic of Germany is characterised by a strongly pronounced federal structure. Each level of government has its own important state-related tasks to fulfil. However, the most important areas of legislation are characterised by uniformity, and, when taking major political decisions, it often proves necessary to establish a consensus among the central (Bund) and regional (Länder) authorities. In taking their budgetary decisions the different levels of government enjoy, in principle, a broad degree of autonomy. But, when it comes to the provision of public goods, the German constitution emphasises the uniformity of living conditions throughout the country, and, therefore, the system of public finances is characterised by strong links between different government levels. In addition, the "confederate principle", derived from the German Constitution, means that the central, regional and local authorities all vouch for one another so that in the event of a budgetary emergency a bail-out is ultimately required.

This system of "cooperative federalism" finds itself challenged by the requirements of the Maastricht Treaty and of the European Stability and Growth Pact, which accentuates those "Maastricht requirements" that relate to public finance criteria. Thus, on the one hand, decisions affecting new borrowing at the individual levels of government are taken in a decentralised manner. The statutory restrictions on borrowing are usually tied to the amount of government investment and are not very restrictive, when viewed as a whole. On the other hand, Germany's pan-European obligations require that the general government budget be close to balance or in surplus over the medium term. In addition, failure to comply with the

Maastricht criteria applying to the general government may result in the imposition of considerable financial sanctions.

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[*] Deutsche Bundesbank. The ideas expressed below represent the author's personal opinions and do not necessarily reflect the views of the Deutsche Bundesbank.

Approval of the European Stability and Growth Pact, coupled with the likelihood that Germany's government deficit ratio in 1997 would, at best, just narrowly fall below the prescribed 3%-ceiling, which was required for entry into European monetary union, gave rise to a fairly intense debate in Germany on the benefits of a so-called "national stability pact". By this means, compliance with the Maastricht criteria was to be anchored in the federal system itself and a breakdown given of the financial sanctions to be imposed, if any. Corresponding proposals were made and discussed by the Bund, the Länder and relevant third parties. In the Länder, in particular, it proved difficult to reach a consensus on major issues, with the result that no national stability pact has so far been adopted.

The present paper begins with a brief survey of the federalist structure in Germany and of the statutory regulations limiting public borrowing. This will be followed by a discussion of the debate surrounding a "national stability pact". In the final chapter, conclusions will be drawn and elaborated on.

2. The public finance system in Germany

"Cooperative federalism"

In Germany most important areas of legislation, including the tax system, exhibit a relatively strong degree of uniformity and in the past, the Federal Government has increasingly assumed greater legislative responsibility. However, the performance and provision of public services are largely relegated to the lower levels of government. Since the Länder (and the respective municipalities) are involved in carrying out most of these tasks and Federal legislation often impinges on Länder matters, the Länder exercise, through the upper house of Parliament (the *Bundesrat*[1]), extensive decision-making powers and a right of veto in the legislative process. This makes the wide-ranging coordination and reconciliation of policies between the Federal Government and the Länder necessary[2].

[1] The Länder Governments directly appoint their representatives to the Bundesrat. These representatives are bound in their decisions by the opinions of their government.

[2] The Financial Planning Council plays a key role with respect to coordinating public finance planning This body, which usually meets twice a year and which is composed of Federal and Länder finance ministers and of local authority officials (Deutsche Bundesbank acting in an (continues)

The public finance system is an outgrowth of the "cooperative federalism" practised in Germany[3]. Although, theoretically, the different levels of government manage their budgets independently of one another[4], a close financial relationship exists at the same time between the central, regional and local authorities. The "confederate" principle guarantees that the central, regional and local authorities ultimately have a claim to financial support in budgetary emergencies[5]. The negative sides of the "cooperative federalism" practiced in Germany are the virtually never-ending dispute over the allocation of government (tax) revenue at the different levels and between these levels and the - for the most part - rather rigid public finance system characterised by its relatively "heavy" reform-processes.

Significant role played by the regional and local government levels in the performance and provision of public goods and services

Public finance in Germany may be divided into central, regional and local authorities, on the one hand, and social security services, on the other. The central, regional and local authorities comprise the Federal Government, the 16 Länder and some 15,000 municipalities. Social security funds consist of the statutory pension insurance scheme, the unemployment insurance fund, the statutory health insurance system, the social security scheme to finance nursing care for the aged and handicapped and the statutory accident insurance scheme; in particular, the statutory health insurance system encompasses a variety of funds (350).

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advisory capacity) analyses the current state of public finance and discusses future developments at different government levels. The most important function of this body is to enunciate proposals for coordinating financial planning at the different budgetary levels based on a consistent set of economic and fiscal assumptions. Its original purpose was to coordinate a "Keynesian" fiscal policy. However, this aspect is no longer of great relevance today.

3 For a more comprehensive (English) description see: Spahn/Föttinger (1997).

4 Article 109 (1) of the Constitution.

5 For example, in 1992, the Federal Constitutional Court declared budgetary emergencies in the Länder Bremen and Saarland owing to their very high level of indebtedness and large interest burden. The other levels of government were required to assist. As a result, the Federal Government offered what are known as supplementary Federal grants. At the same time the beneficiary Länder were obliged to present consolidation plans in which they were to lay down their own consolidation efforts.

Table 1

Expenditure and personnel of different levels of government in 1999

	Expenditure		Expenditure excl. payments to other level of government		Personnel	
	bn DM	in %[3]	bn DM	in %[3]	in 1000	in %[3]
Bund[1]	543	41%	338	34%	510	12%
Länder	482	37%	375	38%	2314	52%
Local authorities	284	22%	271	27%	1610	36%
Social security funds	830					
of which						
pension insurance	*404*					
health insurance	*256*					
unemployment insurance	*101*					
nursing care insurance	*32*					

1) Incl. federal special funds.
2) Excl. payments to social security funds.
3) Excl. social security funds.

Table 1 shows that public expenditure is broadly distributed across the central, regional and local authorities. The data, once adjusted for transfers to other government levels, indicate that the Länder and municipalities are much more strongly represented than the Federal Government, the reason being that, in keeping with German federalism, public services should be provided in a decentralised manner[6]. Whereas defence and unemployment expenditure[7] account for much of the costs at the Federal government level (apart from interest payments), the Länder bear the costs of education (schools and universities) and of internal security (police and legal system), in particular. The expenses of municipalities centre around the local infrastructure and administrations and the various forms of subsidiary welfare (social assistance). The large role played by the Länder and municipalities in performing government tasks is evidenced in their respective staffing levels (Table 1). Thus the Federal Government accounts for no more than just under 12% of all

6 Article 83 of the Constitution.

7 The risk of employees' becoming temporarily unemployed is basically covered by the statutory pay-as-you-go unemployment insurance fund. By contrast, the Federal Government defrays a large portion of the costs of long-term unemployment through unemployment assistance; the municipalities are called upon as well to contribute through social assistance. In the nineties, contribution receipts from unemployment insurance did not suffice to cover their expenditure, although the contribution rates had been raised significantly; the shortfall was made up with grants from the Federal budget. The unemployment insurance is not expected to show a balanced budget again until 2002.

personnel employed by the central, regional and local authorities. The statutory pension insurance scheme and the statutory health insurance system are the most important social security services.

Shared taxes dominant – Exclusive taxes of limited importance

The cooperative aspect is emphasised in the vertical tax distribution (see Chart 1). Thus “shared taxes”, whose revenue is allocated among several levels, comprise the largest percentage of taxes (1999: 71%)[8]. “Exclusive” tax revenue sources, which may be individually controlled by varying the tax rate or assessment basis, are of less importance[9]. The allocation of turnover tax receipts is intended to achieve the “fine-tuning” necessary for an “appropriate” distribution of tax revenue between the Federal Government and the Länder[10], and changes in borrowing needs at the individual levels of government are supposed to be offset through a reallocation of turnover tax shares. The result, however, has been that the distribution of turnover tax revenue regularly becomes a bone of contention[11]. In principle, the horizontal tax distribution between regions follows the residence principle. However, in the case of VAT – derived from the principle of uniform living conditions – the goal of equalising different Länder governments revenue dominates. Thus, 75% of VAT is distributed on a per capita basis; the remaining 25% is used for the express purpose of smoothing regional disparities in Länder tax revenue.

8 Wage and assessed income tax (32% of tax revenue in 1999), corporation tax (5%) and turnover tax (30%) are distributed virtually equally between the Federal Government and the Länder, the local authorities receiving 15% of income tax revenue from the very outset. The distribution of income tax and corporation tax revenue are determined by the Constitution (Art. 106). The distribution of turnover tax revenue is subject to Federal law with the approval of the Länder.

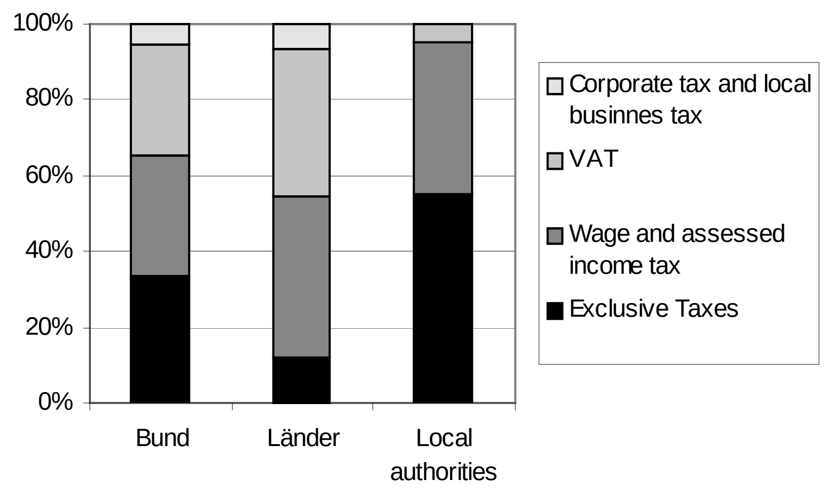
9 Especially important in this connection is the revenue which the local authorities receive: local business tax which is based on the profits of the local enterprises and property tax revenue. Major sources of revenue at the Federal level include the ”solidarity surcharge” (on wage and assessed income tax, corporation tax) and excises (especially the energy taxes). The Länder receive the proceeds from the inheritance tax and motor vehicle tax, *inter alia*, but have no means of shaping the tax rate or the assessment basis on their own.

10 See Article 106 of the Constitution, where it says that the Federal Government and the Länder have an equal claim to cover their necessary expenditure from current receipts and that the financing needs of the Federal Government and the Länder are to be reconciled with one another in such a way that an equitable distribution is reached, an excessive burdening of the taxpayer is avoided, and the uniformity of living conditions in the Federal territory is preserved.

11 In the Nineties, the distribution of turnover tax revenue among the Federal Government and the Länder was changed 5 times.

Chart 1

Vertical distribution of taxes in 1999

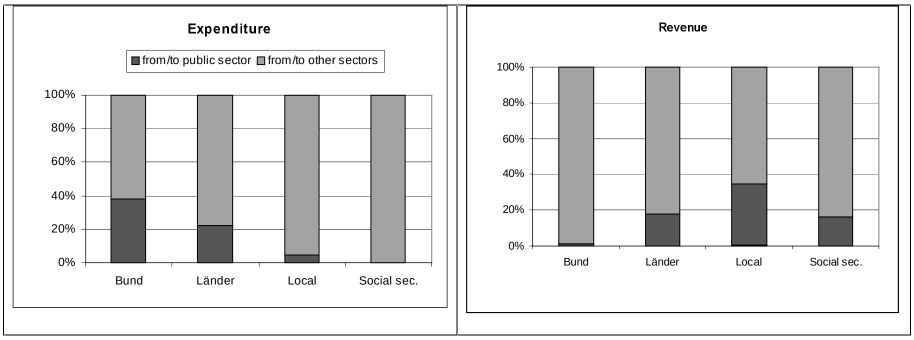


Important intergovernmental transfers

The budgets of individual levels of government are closely interlinked owing to intergovernmental transfers (see Chart 2). Thus the Federal Government makes substantial payments to the social security services (especially to the pension insurance scheme) and to the Länder – transfers to eastern Germany accounting for a large portion of these payments. Moreover, important funds flow between the Länder within the framework of the “inter-Länder equalisation scheme” and from the Länder to the local authorities in the form of current transfers - typically connected to the development of the Länder tax receipts - and investment grants. The vast majority of intergovernmental transfers are executed on the basis of fixed statutory regulations. Sometimes - as is the case with investment grants from the Länder to the local authorities - they are left more or less to the payer’s discretion.

Chart 2

The weight of intergovernmental transfers in 1999



The principle of uniform living conditions also has a major impact on how the system of intergovernmental transfers is organised. Thus, payments within the framework of the "inter-Länder equalisation scheme" further reduce differences in the financial strengths of Länder Governments (after VAT had already levelled the initial differences significantly). Moreover, the Bund provides important general Federal grants (to all "weak" Länder) and specific Federal grants (to individual Länder with "exceptional needs". The system of intergovernmental transfers greatly affects the relative financial strength of the individual Länder (see Table 2).

In addition, the Bund contributes within a comprehensive framework of cofinancing to expenditure programmes of individual Länder. The justification for these Federal payments is also derived from the principle of meeting the additional financing needs of relatively "weak" regions (i.e. "weak" as compared with the rest of the country).

Intergovernmental equalisation schemes criticised – Increase of individual governments responsibilities warranted

For years the German public finance system has been criticised on several points[12]. The key criticisms of the existing public finance system are:

[12] See *inter alia*: Baretti et al (2000), Homburg (1994), Peffekoven (1998, 1994, 1987), Sachverständigenrat (2000,1997), Wissenschaftlicher Beirat beim Bundesfinanzministerium (1997, 1992).

Table 2

Changes in the fiscal strengt indicators of the Länder via inter-Länder revenue equalisation and federal supplementary grants in 1999 [1)]

	before distribu-tion of VAT[2)]	before inter-Länder equalisation[3)]	after inter-Länder equalisation[4)]	after general federal supplemen-tary equalisation grants[5)]	after special federal supplemen-tary grants[6)]
North Rhine-Westphalia	113,1	103,6	100,5	98,8	94,1
Bavaria	117,5	106,5	100,8	99,1	94,4
Baden-Württemberg	119,5	108,3	101,2	99,5	94,8
Lower Saxony	89,9	90,2	93,0	95,7	91,9
Hesse	138,5	120,2	103,2	101,5	96,7
Rhineland-Palatinate	97,4	92,2	94,3	95,7	93,6
Schleswig-Holstein	97,4	93,8	95,1	95,5	93,2
Saarland	76,2	86,9	92,8	95,6	117,5
Hamburg	173,3	142,7	134,3	132,0	125,7
Bremen	112,2	101,7	123,3	125,6	179,6
Western Länder	113,8	104,4	100,4	98,7	96,3
Saxony	39,5	82,3	92,7	95,4	107,4
Saxony-Anhalt	34,0	81,9	92,5	95,2	108,7
Thuringia	35,9	81,7	92,4	95,2	108,5
Brandenburg	41,0	82,8	92,4	95,1	107,4
Mecklenburg-West Pomerania	36,8	81,3	92,4	95,1	109,1
Eastern Länder	37,8	82,1	92,5	90,9	108,0
Berlin	92,9	89,7	123,6	127,2	138,3
Altogether	100,0	100,0	100,0	100,0	100,0

1) Fiscal capacity per inhabitant as a percentage of German average.
2) Shares of the Länder in shared taxes (except VAT) plus Länder taxes according to their local origin. Sum of these revenues nearly DM 202 bn.
3) After distribution of VAT revenues, figures include parts of local authority taxes, before inter-Länder revenue equalisation. Sum of revenues DM 380 bn.
4) Inter-Länder equalisation (DM 14.6 bn) aims at bringing fiscal capacity relatively close to the "equalisation standard", which gives a higher weight to inhabitants of "citystates" as Berlin, Hamburg and Bremen.
5) General federal supplementary equalisation grants (DM 6.5 bn) are paid by the federal government and aim at reducing remaining deficiencies in fiscal capacitiy nearly completely.
6) Special federal supplementary equalisation grants (DM 19.3 bn) are paid by the federal government for specia needs of individual Länder (e.g. to the Eastern Länder, to small Länder in order to compensate their higher costs of government per inhabitant, to Western Länder rated "weak" before unification, to Bremen and Saarland for amortisation of their excessive debt.)

- The Länder whose tax revenue derives almost entirely from “shared taxes” (without them having the ability to levy an individual surcharge) possess almost no exclusive taxes and have no means of shaping their tax revenue on an individual basis. The result has largely been to prevent them from achieving greater autonomy, which would be desirable from the standpoint of a more efficient provision of public goods and which would mean greater fiscal equivalence for citizens.

- The current federal equalisation scheme is complicated and opaque. The effect of the intergovernment compensatory mechanisms has largely been to level out regional differences in financial strength and has even changed the “Länder league table” for financial strength (see Table 2). As a result, incentives for the regions to cultivate their own tax revenue sources are virtually non-existent from a financial perspective. The “inter-Länder equalisation scheme” should be simplified and the compensatory rates reduced. Federal equalisation grants, which the Federal Government pays to the Länder, should represent a clearly defined exception and should, to the extent possible, be provided in a “degressive” manner over time. At a more fundamental level, it is worth considering whether the Länder should be restructured, a solution which might defuse some of the conflicts currently arising within the revenue-sharing scheme.

- The result of “cofinancing” several public tasks is that responsibility for function and expenditure no longer coincide in full and the principle of “connexity” is violated. Consequently, competences overlap and the respective priorities of the central, regional and local authorities become blurred. Thus the Federal Government is involved in various Länder expenditure programmes. To ensure a more efficient use of resources, cofinancing should be curtailed.

Essentially, the critique points to the fact that the cooperative and reallocative aspects are given too much weight in the current system of public finances in Germany and hinder the more efficient performance of government activities. Future reforms should place greater emphasis on competitiveness and on the individual responsibility of the central, regional and local authorities.

After the opportunity for more wide-ranging reform afforded by the integration of the new Länder in the public finance system had gone unexploited, the Federal Constitutional Court issued a ruling in 1999, which stated that the existing federal equalisation scheme would have to be revised by the end of 2004 or, at the very least, that the existing regulations would have to be reconsidered and justified more clearly[13]. The new regulations would have to arise out of a consensus between the Federal Government and the Länder. However, the current discussion, in which the different parties (the Federal Government, fiscally strong Länder, and fiscally weak Länder) are exhibiting their typical interests, makes it seem likely that, again, at best minor changes will be made in the current system. Precisely because the Federal Constitutional Court has offered no guidelines for determining where the "golden mean" between individual responsibility and support from the Federal system as a community of solidarity lies, no legal impetus exists for a "massive" reform.

3. Current regulations limiting the size of government deficits in Germany

The budgetary autonomy of the individual levels of government, as enshrined in the German constitution, means that the Länder are fundamentally entitled to finance their expenditure through borrowing (without violating their respective constitutions). Generally speaking, a "vague" restriction on new borrowing may be derived from the "confederate" principle insofar as a public authority is called upon, in the exercise of its function, to take into account the "well-being" of other government adjuncts; in the end, however, this fails to pose an effective constraint on general government indebtedness[14]. Moreover, the German system of public finance contains statutory provisions, which are based, in principle, on the "golden rule". According to this rule, the amount of new borrowing should generally be less than investment expenditure.

[13] Or, more in keeping with the actual wording of the Constitutional Court's decision, given a justification by means of which the legislature provides itself and the general public with an account, ensures the transparency of fund distribution in accordance with the rule of law, and makes possible the budgetary planning and predictability needed to secure the basis of the Federal Government's and each Land's financial autonomy. Bundesverfassungsgericht (1999).

[14] On the contrary, the "confederate" principle and the associated "bailout" probably may provide an incentive to increase borrowing, as long as a public authority is entitled to assume that other Länder or the Federal Government will be involved in financing the debt-related burden as well.

Only weak legal restrictions on new borrowing by the Bund

At the Federal level, the new borrowing provided for in the budgetary plan is limited by Article 115 (1) of the Constitution to the planned amount of investment. Changes in the business cycle are accommodated to the extent that it is permissible to disregard this limit if the Federal Government determines that the national economic equilibrium has been disrupted[15]. However, the current interpretation of this regulation by the Bund does not effectively limit its borrowing ability. For example, the provision applies only to the planning stage, with the result that the actual execution of the budget may deviate from the initial plan. But, even more importantly the definition of investment is extraordinarily broad[16]. It includes not only fixed capital expenditure but also the acquisition of financial assets (participating interests, loan awards) and capital transfers to other levels of government and to third parties (for example, to foreign countries). At the same time, investment grants received are deducted. By contrast, loan repayments, disposals of participating interests and sales of fixed assets are not set off but nevertheless reduce new borrowing in the budget, which is the category restricted by the constitution. Depreciations are not included either when calculating the upper limit of new borrowing[17]. Finally, the regulation applies only to the Federal budget and may therefore be circumvented by borrowing via a special funds or via an off-budget vehicle[18].

[15] The notion of national economic equilibrium is not explained at greater length in the Constitution. Section 1 of the Stability and Growth Act adopted in 1967 cites a stable price level, a high level of employment and an external economic equilibrium accompanied by continuous and appropriate economic growth as overall economic objectives This enumeration, however, does not really help, if the actual overall economic situation is to be assessed. Thus the government has considerable leeway in its interpretation of the overall economic situation.

[16] In a 1989 decision, the Federal Constitutional Court called on the legislature to specify and delimit what is meant by the term "investment". This request, however, was fulfilled only to the extent that individual budgetary categories were enumerated. This measure does not seem to reflect adequately the Constitutional Court's intentions. See also: Karl-Bräuer-Institut (1997) p.21.

[17] For a critical discussion, see *inter alia* : Deutsche Bundesbank (1999) pp. 42-45, Bundesrechnungshof (1999) p. 12; Wissenschaftlicher Beirat beim Bundesfinanzministerium (1980) p. 42ff.

[18] Thus German reunification was largely financed through federal special funds such as the "German Unity" Fund, the Debt-Processing Fund and the Treuhand agency.

Only weak legal restrictions on Länder borrowing but a strong ruling at local level

The Länder are largely subject to provisions modelled on Federal Government regulations and involving investment expenditure; these provisions are to be found in the respective Länder constitutions or in the Länder budget statutes[19]. The existing statutory provisions generally place only weak constraints on the borrowing options of the Länder, as is also the case with the Federal Government[20]. By contrast, the regulations governing the local authorities are comparatively "hard". As a matter of principle, borrowing is envisaged as a secondary instrument to be used by municipal budgets, which are subject to authorisation by the Länder, only if another means of financing is not possible or appropriate. The "golden rule" which is present here as well in nuce appeals to a notion of investment which is more narrowly defined than that used in connection with the Federal Government and the Länder. Moreover, the legal framework limits the ability of the local authorities to refinance maturing debt via new borrowing[21].

The social security services have, in principle, no access to borrowing facilities. Deficits in the unemployment insurance fund, if they arise, are covered annually by transfers from the Federal budget. The statutory pension insurance scheme and the statutory health insurance scheme are pay-as-you-go systems, which, in principle, reconcile receipts with expenditure through corresponding adjustments in the contribution rates. They also have certain reserves with which they may cushion fluctuations in their financial position – especially ones occurring during the year. Given the existence of these reserves it is also possible in isolated years to build temporary deficits, however they must be compensated in the following year[22].

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19 Some Länder constitutions explicitly sanction borrowing in cases of "exceptional need". This regulation has been interpreted by some of the Länder concerned as an even more generous form of borrowing authorisation rather than as a regulation based on investment.

20 See Schemmel (1997) p. 20, Fürst (1997) p. 230.

21 See Fürst (1997) p.230, Deutsche Bundesbank (2000a) p. 47.

22 In the early nineties, the asset reserves of the statutory pension insurance and health insurance schemes were still so abundant that considerable deficits were sometimes incurred during the decade, without this leading to further debt. Now, however, these reserves have diminished to such an extent that fairly large shortfalls can no longer be tolerated and must necessarily be compensated in the following year.

Table 3

Public Debt

Year	Debt at the end of the year				
	General Government		Bund and Special Funds	Länder	Local authorities
	bn DM	as a % of GDP			
1970	125,9	18,6	8,6	4,1	6,0
1975	256,4	25,0	11,2	6,5	7,2
1980	468,6	31,8	16,0	9,4	6,5
1985	760,2	41,7	21,9	13,6	6,2
1990	1.053,5	43,4	24,7	13,6	5,2
1991	1.171,0	39,9	23,2	12,0	4,7
1992	1.342,5	42,5	25,4	12,3	4,8
1993	1.506,4	46,6	27,9	13,4	5,3
1994	1.659,6	48,9	29,6	13,9	5,5
1995	1.993,5	56,6	36,6	14,5	5,5
1996	2.126,3	59,3	38,2	15,6	5,5
1997	2.215,9	60,4	38,8	16,2	5,4
1998	2.280,2	60,3	38,5	16,5	5,3
1999	2.346,9	60,5	38,9	16,5	5,2

Marked increase in public debt in the past

The trend in general government debt makes it evident that existing regulations are unable to curtail government borrowing. As Table 3 illustrates, public debt (and the debt to GDP ratio) in Germany has grown almost without interruption since the early seventies. The trend was especially dramatic in the nineties, although it was decisively influenced by an unusual event in the guise of German reunification. The burdens associated with reunification were reflected, above all, in the debt recorded by the Federal Government and its special funds[23]. Even so, the level of debt also rose significantly at the Länder and local levels. However, the indebtedness of individual regions differs considerably. The per capita debt of the east German Länder and municipalities, which were still debt-free at the time of reunification, now stands largely at the level of the west German Länder (see Table 4).

23 See Deutsche Bundesbank (1997).

Table 4

Per-capita indebtedness of the Länder (incl. local authorities)

DM, per-capita									
Year	1991	1992	1993	1994	1995	1996	1997	1998	1999
Baden-Württemberg	5.435	5.675	5.860	6.018	6.202	6.469	6.570	6.699	6.711
Bavaria	3.899	4.057	4.155	4.066	4.128	4.601	4.885	4.980	4.942
Brandenburg	815	2.636	4.769	6.572	7.658	8.877	9.638	10.169	10.406
Hesse	7.591	7.862	8.264	8.674	9.004	9.115	9.569	9.693	9.459
Mecklenburg-West Pomerania	684	1.562	3.133	4.377	6.072	7.319	8.459	9.371	9.961
Lower Saxony	7.780	8.136	8.708	9.168	9.546	9.904	10.224	10.389	10.350
North Rhine-Westphalia	8.282	8.465	8.841	9.030	9.606	9.977	10.451	10.741	10.858
Rhineland-Palatinate	7.615	7.923	8.174	8.554	8.901	9.465	9.998	10.391	10.707
Saarland	13.745	14.736	15.675	15.138	14.788	14.510	13.995	13.601	13.550
Saxony	748	1.904	3.310	4.204	5.211	5.833	6.329	6.669	7.149
Saxony-Anhalt	733	2.683	4.556	5.796	7.061	8.804	9.842	10.864	11.754
Schleswig-Holstein	8.707	9.086	9.766	10.106	10.721	11.192	11.670	11.947	12.224
Thuringia	861	2.180	3.803	5.695	6.828	7.875	8.801	9.677	10.454
Berlin	4.543	5.896	7.637	9.059	12.144	14.043	15.390	16.839	18.161
Bremen	22.334	23.988	25.086	24.760	24.798	24.547	25.068	24.769	23.740
Ham-burg	11.425	12.036	13.426	14.667	15.305	16.385	16.763	17.168	18.002
All Länder	5.906	6.453	7.123	7.590	8.193	8.750	9.212	9.533	9.689
West Länder	7.198	7.466	7.831	8.041	8.379	8.739	9.079	9.265	9.300
East Länder	765	2.189	3.869	5.218	6.394	7.505	8.317	8.989	9.433
Berlin	4.543	5.896	7.637	9.059	12.144	14.043	15.390	16.839	18.161

"Golden rule" almost always violated in last 20 years

The inadequacy of the legal restrictions on governmental borrowing also becomes evident if compliance with the "golden rule" is used as a criterion for evaluating the existing legal framework - at least if the golden rule is understood in a narrower sense rather than the very "lax" interpretation given to it by the Federal Government and the Länder[24].

[24] In its recent publication "Guiding principles of fiscal policies" (Bundesministerium der Finanzen (2000a)), the Federal Ministry of Finance announced that it intends to apply more stringent criteria in future to the financing of investment through new borrowing. Loans to finance investment should be redeemed during the lifetime of the relevant asset. In this way, depreciations would be taken into account.

Table 5

Public deficit, investment and the golden rule

as a % of GDP	Deficit	Gross Investment	Depreciation	Net-Investment	Fulfilment of Golden Rule
1980	-2,9%	3,6%	1,7%	1,9%	-1,0%
1981	-3,7%	3,3%	1,8%	1,4%	-2,3%
1982	-3,3%	2,9%	1,9%	0,9%	-2,4%
1983	-2,6%	2,5%	1,9%	0,6%	-1,9%
1984	-1,9%	2,4%	1,9%	0,5%	-1,4%
1985	-1,2%	2,4%	1,9%	0,5%	-0,7%
1986	-1,3%	2,5%	1,9%	0,6%	-0,7%
1987	-1,9%	2,4%	1,9%	0,5%	-1,4%
1988	-2,2%	2,3%	1,8%	0,5%	-1,7%
1989	0,1%	2,4%	1,8%	0,5%	0,6%
1990	-2,1%	2,3%	1,8%	0,5%	-1,6%
1991	-3,0%	2,8%	1,9%	0,9%	-2,1%
1992	-2,6%	2,9%	1,9%	1,1%	-1,5%
1993	-3,2%	2,8%	1,9%	0,9%	-2,3%
1994	-2,5%	2,6%	1,9%	0,8%	-1,7%
1995	-3,2%	2,3%	1,9%	0,4%	-2,8%
1996	-3,5%	2,1%	1,8%	0,3%	-3,2%
1997	-2,7%	1,8%	1,8%	0,1%	-2,7%
1998	-2,1%	1,7%	1,7%	0,0%	-2,0%
1999	-1,4%	1,8%	1,7%	0,1%	-1,3%
Avrg. 1980-1999	-2,4%	2,5%	1,8%	0,6%	-1,7%
Avrg. 1991-1999	-2,7%	2,3%	1,8%	0,5%	-2,2%

1980-1990: ESA 79. Depreciation according to ESA 95 methodology - own estimates.
1991-1999: ESA 95.

In Table 5 investment, as derived from the national accounts and adjusted for depreciation, is contrasted with the actual national accounts deficit[25]. On the one hand, this includes depreciations; on the other hand, it ignores financial transactions – such as the sale or acquisition of participating interests, loan awards or repayments. As it turns out, the golden rule, so constructed, has been followed in only one year since the

[25] This does not include actual investment grants (capital transfers) made. If investment grants are paid to state-owned enterprises, it may be the case that, through this omission, asset accumulation on the part of the state has been undervalued. On the other hand, the depreciations on these investments would also have to be taken into account, with the result that the net effect would likely not be all that pronounced.

beginning of the eighties, namely in 1989. As a result, the state's loss of net wealth amounted to more than 1½% of GDP as an annual average over the past 20 years and more than 2% as an annual average during the nineties. The trend is still greatly underrecorded since the off-budget activities of the Treuhand agency, which was heavily involved in funding the financial burden resulting from unification, have not been included here. Treuhand agency debt assumed by the Federal Government came to 6.8% of GDP in 1995, but, in keeping with an Eurostat decision, this was not treated as a transaction which would increase the "Maastricht deficit".

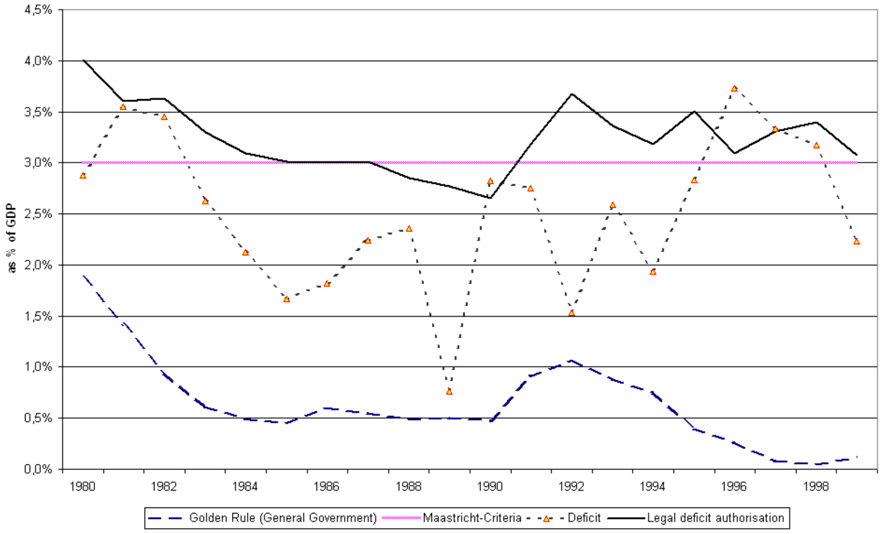
Legal restrictions on public deficits not strong enough by far

A rough impression of the difference between the previously defined and rather strict "golden rule" and the existing statutory deficit-restricting regulations may be gained by examining Chart 3. Here the Federal Government's interpretation of the corresponding provision in constitutional law is applied to the Federal Government and the Länder, and this legal authorisation – which centres on new borrowing – is transformed into the national accounts methodology. This means that investment, investment grants (capital transfers) and the room to manoeuvre gained from the sale of participating interests and loan repayments as well are regarded as setting a deficit ceiling[26]. This legal upper limit for deficits is compared with general government net investments derived from the national accounts. As it turns out, statutory authorisations are, as an annual average over the last 20 years, 3% of GDP larger than the level allowed by the strict "golden rule". As already mentioned, it is also possible to exceed this limit during the actual implementation of the budget or to justify an excess amount by declaring a disruption in the national economy or to take up loans via special funds. In short, the legal restrictions on governmental borrowing in Germany are not strong enough by far.

[26] Acquisition of participating interests and loan awards, by contrast, are not taken into account because these financial transactions do not affect the deficit in the national accounts methodology. The general government's actual ability, as prescribed by law, to take up loans is understated here, because local authorities have a certain legal ability to run deficits as well. Moreover, special funds, whose borrowing is not subject to legal constraints, may also incur deficits.

Chart 3

Bund and Länder: Legal deficit authorisation, Maastricht-criteria, actual deficit and Golden Rule (National accounts methodology)



4. Debate on a national stability pact in Germany

Pending monetary union initiated discussion on a national stability pact

Given the Maastricht Treaty requirements and the European Stability and Growth Pact, which defines these requirements more precisely, Germany's distinct federalistic structure and the considerable regional and local authority deficits incurred in the past made the notion of a national stability pact appear especially appropriate to the German situation[27]. Thus, in the nineties, the aggregate (national accounts) deficits of the regional and local authorities amounted, on average, to slightly over 1.0% of GDP (see table 6); these regional deficits were therefore greater than comparable deficits in every other country of the European Union.

27 Article 3 of the protocol on the excessive deficit procedure states that, ultimately, the central governments of the individual countries are responsible for compliance with the Maastricht criteria. The member states are required to establish intergovernmental procedures which ensure that the Maastricht Treaty requirements are fulfilled and which enforce the consequences of non-compliance.

Table 6

Public deficit ratios[1)]

as a % of GDP					
	General government	Bund	Länder	Local authorities	social security funds
1980	-2,9%	-1,7%	-1,2%	-0,3%	0,3%
1981	-3,7%	-2,1%	-1,4%	-0,5%	0,4%
1982	-3,3%	-2,1%	-1,4%	-0,3%	0,5%
1983	-2,6%	-1,6%	-1,1%	0,1%	0,0%
1984	-1,9%	-1,3%	-0,8%	0,2%	0,0%
1985	-1,2%	-0,9%	-0,7%	0,2%	0,3%
1986	-1,3%	-1,0%	-0,8%	0,0%	0,5%
1987	-1,9%	-1,4%	-0,8%	0,0%	0,3%
1988	-2,2%	-1,6%	-0,7%	0,1%	0,1%
1989	0,1%	-0,5%	-0,2%	0,1%	0,8%
1990	-2,1%	-2,2%	-0,6%	-0,1%	0,8%
1991	-3,0%	-3,3%	-0,6%	0,1%	0,7%
1992	-2,6%	-1,6%	-0,7%	-0,2%	-0,1%
1993	-3,2%	-2,2%	-1,0%	-0,1%	0,2%
1994	-2,5%	-1,1%	-1,3%	-0,2%	0,1%
1995	-3,2%	-8,3%	-1,2%	-0,2%	-0,4%
1996	-3,5%	-1,9%	-1,2%	0,0%	-0,4%
1997	-2,7%	-1,6%	-1,2%	0,0%	0,1%
1998	-2,1%	-1,7%	-0,8%	0,3%	0,1%
1999	-1,4%	-1,6%	-0,5%	0,3%	0,3%
1) 1980-1990: ESA 79. 1991-1999: ESA 95.					

The "Act on the Treaty on European Union of February 7, 1992", which was passed by the Bundestag and Bundesrat on December 28, 1992, states that *obligations arising for the Federal Republic of Germany from the legal instruments of the European Union in compliance with Article 104c of the EU Treaty are to be fulfilled on the basis of an agreement between the Federal Government and the Länder.* However, the existing deficit-dampening regulations in Germany are not sufficient in themselves to guarantee that the 3% reference value for the deficit ratio is not exceeded. Thus Chart 3 shows that most of the peak values for legal deficit allowances by the Federal Government and by the Länder (these values being based on investments in the budget) lay significantly above the

Maastricht criterion of 3% of GDP in most of the years. In addition, the prerequisites for an exceptional violation of this limit based on “disruptions in national economic activity ”, as laid down in the German public finance system, are significantly less restrictive than those specified in the Maastricht treaty and the European Stability and Growth Pact. Finally, not only the Bund and the Länder but also the local authorities and the special funds may incur deficits.

In the course of 1996, it became clear that the deficit ratio in Germany would amount to more than 3% and that “narrow” compliance was to be expected in 1997, the crucial year for entry into European monetary union. After informal negotiations between the Federal Government and the Länder failed to yield any result, the Federal Government presented its own proposal for a national stability pact[28]. The Länder, too, recognised, in principle, the necessity of an intergovernmental implementation of pan-European obligations[29]. Controversy arose, however, among the various Länder as to possible formats and finally in 1997 various Länder launched different proposals. In addition, a national stability pact was discussed by third parties in several publications[30].

Most of the proposals concerning a national stability pact for Germany have adopted the Maastricht Treaty’s 3% criterion as a ceiling for new public borrowing. The primary goal of the national pact was to “allocate” this “deficit authorisation” across individual levels of government. There are basically four major problem areas to be clarified:

- legal implementation,
- criteria for a vertical distribution of deficit authorisations across individual levels of government,
- criteria for a horizontal distribution of deficit authorisations within a single government level,
- imposition of possible sanctions against the respective authorities.

[28] See the Federal Ministry of Finance (*Bundesministerium der Finanzen*, 1996a). As early as 1994, the Economic Advisory Council of the Federal Minister of Finance had presented a study, many aspects of which found their way into the subsequent proposal from the Bund. Beirat beim Bundesministerium der Finanzen (1994).

[29] See *Frankfurter Allgemeine Zeitung (FAZ)* (1997).

[30] See *inter alia*: Fürst (1997), Sachverständigenrat (1996), Schemmel (1997), Snelting (1997), Söllner (2000), Sturm (1998), Vesper (1997 and 1999), Windels (1997).

Legal implementation

One important question to be addressed is that of the *legal form* of a national stability pact, although that will be treated only briefly in this paper. Here it is especially important to determine whether this pact should take the form of constitutional amendments or supplements, Federal or Länder acts or decrees not yet promulgated, a "Federal treaty" between the Federal Government and the Länder, or a more informal type of cooperation conducted in the absence of statutory regulations. In view of the complexity of the procedure, the Federal Government's proposal[31] envisages no constitutional amendment. Instead, the pact should be implemented by means of a Federal act and decrees, which are to be passed jointly by the Federal Government and the Länder. The Financial Planning Council as the coordinating body would have an important function here[32]. By contrast, some Länder and many authors consider a constitutional amendment[33] or "Federal treaty[34]" to be reasonable and even necessary. However, other Länder[35] reject precisely this type of firm commitment and support instead a "looser" (case by case) arrangement between the central, regional and local authorities. In general, the constitutional approach appears to be appropriate, especially if the intergovernmental imposition of sanctions based on the "excessive deficit procedure" is to be treated as binding. Otherwise, the danger exists that the national stability pact, which would necessarily restrict the budgetary autonomy of the Länder, would be constitutionally unsound and, if worst came to worst, would entail long, drawn-out proceedings before the Federal Constitutional Court. More informal ad hoc agreements, to be implemented when the 3% limit is expected to be surpassed, should be regarded sceptically. Given the discord in the public finance system during the past few years, not only between the Federal Government and the Länder but also between the Länder themselves, it is to be feared that distribution battles would be a permanent

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31 See Bundesministerium der Finanzen (1996a) and especially Bundesministerium der Finanzen (1996b).

32 The Federal Government argues that the constitution is not at odds with such a limitation on the budgetary autonomy of the Länder (with respect to borrowing). This position is shared, for example, by Hartmann (1996).

33 See *inter alia*: Fürst (1997), Schemmel (1997) p. 74ff, Wissenschaftlicher Beirat beim Bundesfinanzministerium (1994) p. 48, Hellermann (2000) p. 41 sowie tendenziell Thuringia und North Rhine-Westfalia.

34 *Inter alia*: Bavaria and Sachverständigenrat (1996) p. 191.

35 *Inter alia*: Bremen, Lower Saxony, Schleswig-Holstein.

occurrence. The Länder would have more leverage initially since the Federal Government would vouch directly for pan-European obligations.

Vertical distribution of deficit authorisations

When fixing the *vertical distribution* of new borrowing ceilings in the national stability pact, it would first be necessary to determine how much deficit financing is to be authorised for each level of government. In most proposals, the Federal Government and social security funds are grouped together on the one side and the Länder and municipalities, on the other. This is appropriate. Thus the financial position of social security services is decisively influenced by the Federal legislature and by Federal Government transfers, although – as mentioned above – social security services, under normal circumstances, show a balanced budget. The local authorities' budgets are subject to direct financial surveillance by the Länder. Moreover, since Länder transfers are critical to municipal finances, the Länder as a whole exert a direct and marked influence on the development of the local authorities' financial position.

Since most authors favour a fifty-fifty distribution of the "deficit authorisation" between the Federal Government/social security funds, on the one hand, and the Länder/municipalities, on the other[36], each of the two blocks would have 1.5% of GDP available as latitude for new debt. According to the Advisory Council at the Federal Ministry of Finance, such a distribution results - according to one rough assessment - from "the combination of several indicators" *(inter alia* the volume of the budget and the deficit in preceding years), with the pragmatic charm of a 1:1 solution playing also an important role[37]. Over and above that, however, the Federal Government, which also advocates a fifty-fifty distribution for "normal situations", exacts an "advance charge" in the event of an unfavourable

[36] See *inter alia*: Bundesministerium der Finanzen (1996a), Beirat beim Bundesministerium der Finanzen (1994) p. 33, Söllner (2000), Karl-Bräuer-Institut (1997), p. 66, Snelting (1997), p. 4.

[37] A fifty-fifty approach also roughly results if "self-financed" investments (gross fixed capital investment+capital transfers paid to the public sector – capital transfers received from the public sector) is taken into account. In the second half of the nineties, the Bund's share was 46%, the Länder's 23% and the municipalities 31%.

economic situation[38]. The Federal budget's greater sensitivity to economic upturns and downturns is given as a reason[39]. Not only do tax revenue losses resulting from changes in the business cycle place a strain on the Federal budget; the increase in expenditure which is caused by rising unemployment and losses in unemployment insurance contribution receipts which is to be financed through the federal budget does so, too. By contrast, the Länder, which were at least unanimous on *this* point, demanded a distribution of 60:40 in their "favour". The argument was put forward that the Federal budget would show significantly greater flexibility than would the rather rigid Länder budgets, which are characterised, above all, by a large share of personnel expenditure[40]. On this view, the Federal Government can absorb unexpected shocks considerably better than the Länder, for which short-term borrowing plays a major role as buffer. In addition, the local authorities have in the local business tax, which is based on enterprises' profits, one of the most economically sensitive tax revenue sources in the entire German tax system. The Länder also argued that the Federal Government is endowed with more wide-ranging powers than the Länder are to vary their tax receipts by modifying tax law or tax rates[41]. Although the positions of the Federal Government and of the Länder differed on the question of a vertical distribution, it would probably have been possible, theoretically, to have reached a consensus on this point. Such a consensus might, finally, have been possible with a fifty-fifty distribution. However, such a solution would have placed no strong constraint on borrowing by the Länder and municipalities on average. Thus, their national accounts deficits in the preceding 20 years have exceeded 1.5% of GDP only twice (in 1981 and in 1982). A 60% share for the Länder would have been tantamount to issuing them a blank cheque.

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38 In 1996, the Federal Finance Ministry set as its primary overall public sector goal a deficit ratio of 1%. This was in keeping with the then current "Waigel proposal" for a European Stability Pact. The Bund has suggested that the decission on deficit ceilings for individual governments should only been taken if the danger exists that the Maastricht criterion of 3% might be exceeded. According to the Bunds proposal, the increase in the Bund's borrowing authorisation due to cyclical reasons would have to be approved by agreement between the Federal Government and the Länder on a case-by-case basis.

39 A reason also accepted by Wissenschaftlichen Beirat beim Bundesfinanzministerium (1994), Snelting (1997) p. 5, Sturm (1997) p. 108, DIW (2000) p. 619, Vesper (1999) p. 197.

40 See Senator für Finanzen der Hansestadt Bremen (1997).

41 Thus, by modifying excises (especially the mineral oil tax) or supplementary surcharge on income tax and on corporation tax, the Federal Government has the means to adjust its tax revenue without the prior approval of the Länder.

Horizontal distribution within the Länder

It is considerably more difficult to reach a consensus on the issue of a *horizontal distribution* of deficit authorisations among the Länder (including the corresponding municipalities in each case). The Federal Government[42], some Länder and many of the other commentators[43] have argued, in principle, in favour of a distribution based on population size. This would have been a convincing solution. Thus, the Länder Government revenue-sharing scheme ensures that per capita tax receipts do not vary strongly from one Land to another (apart from the "city-states", and east german Länder, which have higher revenues due to federal supplementary grants). As a result, a Land's ability to repay, or at least carry, its debt (in other words, its potential tax receipts) would be measured not in terms of its actual tax base but in terms of its population size. This is in marked contrast to the situation within the EU. Whereas the Maastricht criteria are rightly tied to national gross domestic product, which, in the final analysis, constitutes the assessment basis for national tax receipts, the "inter-Länder equalisation scheme" results, to a great extent, in a decoupling of tax receipts from regional gross domestic product. For this reason, the arguments advanced by some commentators that those Maastricht Treaty regulations which refer to GDP in this connection be applied to a horizontal distribution as part of a national stability pact[44] carry little conviction. A distribution based in population size has another, crucial advantage in that it may be justified relatively easily and in a non-controversial manner. A regionalisation of GDP is not attempted in the "official national accounts" and entails considerable statistical difficulties[45]. If it should ever come that far, major political confrontations may be expected as to the precise method of calculation to be used.

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42 The Federal Government position as regards the horizontal distribution of revenue among the Länder was not very rigid. As an alternative to the above-mentioned principle, it proposed a distribution in line with deficits incurred in the preceding years. Moreover, the Federal Government thought it possible to take into account the special burdens of individual Länder.

43 *Inter alia* : Sturm (1997) p. 109, Fürst (1997), Wissenschaftlicher Beirat beim Bundesfinanzministerium (1994), Karl-Bräuer-Institut (1997), p. 68, Schemmel (1997) p. 50, Sachverständigenrat (1996) p. 193.

44 See Beirat beim Bundesministerium der Finanzen (1994) p. 36.

45 Although the Working Group "Regionalisation of the national accounts" attempts to break gross domestic product down by region, these figures do not form part of the official national accounts issued by the Federal Statistical Office. The figures should be regarded as providing only a rough guideline. At the present time, they have no major political impact.

Many Länder, however, have rejected a distribution based on population size[46]. Especially financially weak Länder with relatively large deficits stated that they were incapable of consolidating their budgets to the required extent over the short term[47]. Table 7 makes it clear that, with a fifty-fifty distribution between the Federal Government and the Länder, the east German Länder, in particular, showed considerably larger deficits in 1996 than would have been permitted by the national stability pact in the case of a per-capita distribution of the deficit allowance[48]. As a result, these Länder have insisted that the initial situation, and especially those deficits incurred in the preceding years, be included when determining "deficit authorisations". The argument, however, seems implausible, at least if considered over the middle and longer term. It might be viewed almost as a "reward" for deficits previously incurred, and it would encourage individual Länder to engage in strategic manoeuvring. At the same time, allowing some parts of the country to roll forward their currently large deficits would show up unfavourably differences in the long-term sustainability of public finance systems in different regions (similar problems attach to the attempt to build on past Länder expenditure). Using investment expenditure as a criterion would appear, at first glance, to offer an incomparably more attractive prospect[49]. This would make it possible – so the argument runs – to attach due weight to catching up on investment, especially in the east German Länder. This may be countered, however, with an appeal to past experience which shows reliance on public investment to be extremely problematic, especially with regard to the definitional difficulties it raises[50]. In the case of the new Länder, whose per capita debt has already reached west German levels (see Table 5), an increase in deficit-financed investment does not seem well-suited to improving their locational advantages[51].

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46 See Finanzsenator der Stadt Bremen (1997).

47 See Finanzsenator der Stadt Bremen (1997).

48 For a comprehensive comparison of the numeric outcomes for different criteria for the horizontal distribution of deficit allowances for the year 1995, see Windels (1997).

49 See *inter alia* DIW (2000), Snelting (1997), Vesper (1999).

50 See *inter alia* Wrede (1999) p. 217.

51 The auction of "debt certificates" was also discussed by some authors (Fürst (1997) p. 237, Beirat beim Bundesministerium der Finanzen (1994), Söllner (2000)). However, this option was ultimately considered impractical by most of them (with the exception of Söllner, who was willing to allocate deficit allowances by way of an auction while distributing the substance of them in a mechanical manner).

Table 7

Horizontal distribution of deficit ceilings[1)]

in bn DM

	Deficit			Upper deficit limit according to:				Deficit (national accounts) - upper deficit limit[2)]			
	National ac.[2)]	Budget. stat.	National ac.[2)]								
	1996	1999	1999	Per Capita	Avrg. deficit last 2 years	Avrg. deficit last 5 years	0,5* (Per-Capita+Def5)	Per Capita	Avrg. deficit last 2 years	Avrg. deficit last 5 years	0,5* (Per-Capita+Def5)
Baden-Württemberg	-3608	2299	2658	-7356	-1026	-2633	-4995	10014	3684	5291	7653
Bavaria	-3078	948	1603	-8529	-2111	-1709	-5119	10132	3714	3312	6722
Brandenburg	-2637	-1546	-1655	-1825	-3085	-3457	-2641	170	1430	1802	986
Hesse	-2418	632	98	-4254	-2802	-3069	-3661	4352	2900	3167	3759
Mecklenburg-West Pom	-1999	-1120	-755	-1263	-1796	-2095	-1679	508	1041	1340	924
Lower Saxony	-4306	-1768	-1907	-5545	-4316	-5046	-5296	3638	2409	3139	3389
North Rhine-Westphalia	-8528	-3989	-4174	-12658	-13131	-10851	-11754	8484	8957	6677	7580
Rhineland-Palatinate	-2101	-1413	-1607	-2835	-3621	-2502	-2669	1228	2014	895	1062
Saarland	295	92	28	-755	553	381	-187	783	-525	-353	215
Saxony	-2868	-18	360	-3151	-1442	-3119	-3135	3511	1802	3479	3495
Saxony-Anhalt	-2607	-1667	-1650	-1875	-4571	-3888	-2881	225	2921	2238	1231
Schleswig-Holstein	-1952	-769	-987	-1950	-1715	-1895	-1922	963	728	908	935
Thuringia	-2426	-1930	-1727	-1729	-2886	-3030	-2379	2	1159	1303	652
Flächenländer	-38233	-10249	-9715	-53725	-41947	-42911	-48318	44010	32232	33196	38603
Berlin	-9721	-3627	-5555	-2388	-10901	-11178	-6783	-3167	5346	5623	1228
Bremen	75	562	126	-469	-475	-60	-264	595	601	186	390
Hamburg	-3353	-1172	-1451	-1198	-4458	-3632	-2415	-253	3007	2181	964
"City states"	-12999	-4237	-6880	-4055	-15834	-14870	-9463	-2825	8954	7990	2583
Länder as a whole	-51232	-14486	-16595	-57781	-57781	-57781	-57781	41186	41186	41186	41186
West Länder	-28974	-4578	-5613	-45549	-33101	-31014	-38282	39936	27488	25401	32669
East Länder	-12537	-6281	-5427	-9843	-13778	-15588	-12715	4416	8351	10161	7288
Berlin	-9721	-3627	-5555	-2388	-10901	-11178	-6783	-3167	5346	5623	1228

1) Länder (incl. local authorities). Assumption of a fifty-fifty distribution between Bund/Social security funds and Länder/local authorities.
2) Budgetary statistics without taking into account acquisition and sale of participating interest and loan awards and repayments.

Given the differences in the fiscal histories of individual Länder, a mixed system might have been acceptable (as an interim solution), as was, in fact, proposed by the Bund and some of the Länder[52]. Thus debt authorisation based on population size might have been left as an objective to be attained over the medium term while, over the short term, during an adjustment period, the deficits incurred in preceding years might also have been taken into account. In the meantime the financial position of the Länder has improved as well. In both 1999 and 2000 the deficits run by most Länder would appear to have remained below what a deficit ceiling based on population size would have indicated (see Table 7). In 2001, however, the financial position of the Länder will again deteriorate considerably, in view of the large falls in tax revenue associated with the recent tax reform.

Distribution of sanctions

The Länder were equally unable to reach a consensus concerning the imposition of *sanctions* in connection with the excessive deficit procedure.

52 See Vesper (1999) p. 202, Sturm (1998), North Rhine Westphalia und Lower Saxony. The proposals differ considerably, however, in their formulation.

The initial Federal Government's proposal envisaged a strict "perpetrator principle". However, the Federal Government proposed later on a diluted form[53]. Sanctions amounting to 0.2% of GDP would be carried by the overall public sector (fifty-fifty between the Federal Government and the Länder). Länder which exceeded the deficit-financing ceilings (established by decree according to the prescribed criteria) would be subject to a penalty equivalent to the variable portion of the sanction and would have to allocate this among their municipalities in accordance with their own criteria. In the eventuality that each level of government were to remain below its appointed deficit ceiling but a pecuniary punishment were still exacted[54], the Federal Government's model provided for an allocation of the penalty in keeping with the formula for distributing "deficit authorisations". The Länder differed widely in their views on how possible sanctions might be allocated. Whereas financially stronger Länder such as Bavaria and Baden-Württemberg espoused a diluted form of the "perpetrator principle", other Länder (for example, Lower Saxony) rejected any attempt to regulate the distribution of sanctions on the grounds that they did not consider it to be practically feasible. A fundamental argument put forward against the strict "perpetrator principle" was that a Land or, even worse, a municipality could by no means afford to pay a penalty based on national GDP and that the German constitution, at least in its present form, which includes the "confederate" principle, would not permit the imposition of such a heavy and unusual financing burden[55]. Moreover, since regionalised national accounts deficits were not available, the intergovernmental implementation of a stability pact would have to be based, in the final analysis, on budgetary figures. Although the national accounts results might be approximated by summing up specific budgetary categories, it would at the same time be necessary to tolerate a considerable degree of ambiguity, which could be expected to give rise to political in-fighting. Finally, the question would have to be addressed as to which government the actual perpetrator of the punishable offence was. The European Stability and Growth Pact envisages payment of a non-interest-bearing deposit on the initial violation of the deficit limit. A non-recoverable penalty fee is imposed only later if the excessive deficit has not been reduced. Now, how should a situation be handled in which different

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53 See Sturm (1997).

54 This could happen, for example, if GDP is lower than expected and the deficit ratio increases as a result. The national accounts deficit could also deviate from the budgetary deficits.

55 A penalty amounting to 0.2% of Germany's GDP would, for example, be almost equivalent to the total budget volume of Saarland and its municipalities.

public authorities were responsible in different years for exceeding the deficit ceiling? Those Länder critical of the perpetrator principle suggested that the hypothetical penalty be paid by the Federal Government initially. The latter would then have the opportunity to refinance itself through a corresponding change in the allocation of turnover tax revenue in its favour. The problem with this proposal, however, is that such a reallocation also requires the approval of the Länder, which in individual cases might not be forthcoming.

In the end no consensus on a national stability pact

In the end, no consensus was finally reached on a national stability pact in Germany because the line between the constitutionally guaranteed autonomy of the Länder and the fixing of workable criteria impinging on that autonomy was too thin to secure consensus. Since the Federal Government is dependent on the approval of the Länder to implement a national stability pact, and the latter could not agree on crucial points, no national pact was adopted. This shows that the Länder have, in certain respects, a very limited interest in legally binding solutions since they do not offer any advantages for them. This is all the more true given the fact that, in the absence of a national stability pact, the Federal Government remains primarily responsible for compliance with the criteria and for the payment of any penalties incurred. Since, at the present time, the public deficit ratio appears to offer a comfortable safety margin with regard to the 3% reference value, the national stability pact is not considered an urgent fiscal policy matter.

5. Concluding remarks

Maastricht treaty and European Stability and Growth Pact

The purpose of the Maastricht Treaty was to ensure the long-term sustainability of public finances in the European Union and to defuse, from the outset, a potential conflict between monetary and fiscal policy within European monetary union. A public deficit ratio of 3% and a debt ratio of 60% were fixed as ceilings, which could only be exceeded in exceptional cases. The European Stability and Growth Pact specified, in particular, the sanctions which would follow on violation of Maastricht Treaty criteria and the criteria applicable to exceptional cases which would justify a violation of the 3% limit. In addition, participants in monetary union committed themselves to pursuing a budgetary position which was in a medium perspective almost balanced or in surplus. Public finances were to be so conducted as to allow for safety margins that would ensure compliance with Maastricht criteria in the face of unfavourable economic conditions or possible unexpected shocks[56]. Moreover, the fundamental goal of achieving at least an almost balanced budgetary position over the medium term was to be pursued.

The "Federal implementation" of European agreements: "Balanced budget rules" for the Bund and Länder

Germany's failure to implement a national stability pact is, in the end, attributed to the varied and specific interests of the central and regional authorities. The conflict between budgetary autonomy and Länder and municipality identity, on the one hand, and joint responsibility for complying with general government obligations, on the other, was not resolved. However, the author feels that the usual approach to drafting a nation-wide agreement was, by virtue of its very conception, ill-suited to accommodate Maastricht Treaty requirements and the European Stability and Growth Pact. The guiding principle was to cement the status of Maastricht's 3% deficit ratio ceiling as a fiscal reference point at the national level by distributing the deficit allowed by the Treaty to different levels of government. At the same time, the impression was often given that the larger the deficit authorisations assigned to different regions, the greater the advantages accruing to them. In point of fact, it was the politicians who were more likely to have profited from this privilege – namely, the postponement of a fiscal burden – rather than the actual inhabitants of a region. In the end the procedures proposed were relatively complicated, more or less transparent, but always extremely controversial.

It would have been more straightforward and adequate if the European Stability and Growth Pact, which had been approved in mid-1997 had been taken literally. Federal implementation of the Pact's intentions would result in the Federal Government and the Länder committing themselves to achieving at least a balanced budget over the

[56] Moreover, Länder with large debt ratios should show more ambitious budgetary items which ensure a rapid decline in the debt ratio.

medium term[57]. A balanced budget rule could be implemented without recourse to complicated intergovernmental rules for the assignment of deficit ceilings and would simultaneously - i.e. automatically - guarantee an adequate safety margin in view of the overall public sector deficit ratio of 3%. While the existing budgetary regulations for the Federal Government and the Länder which are based on investment would be replaced by the stipulation of a balanced budgetary position, the statutory constraints already in place for the local authorities could be retained. Indeed, on an annual average over the past 20 years, the deficits of the local authorities were, in the budgetary definition, 0.2% of GDP and, in the ESA, 0.1% of GDP. Supplementary regulations would also prove unnecessary for social security services since the existing regulations prescribe that they be, for the most part, structurally balanced[58].

"Balanced budget rules" not contradicted by the "Golden Rule"

The current statutory framework restricting government borrowing proved incapable of effectively halting the rise in government debt. However attractive a regulation based on the "golden rule" may appear, in theory, its practical implementation has turned out to be problematic. In the process, the definition of investment has revealed itself to be an enduringly controversial and, ultimately, malleable quantity. The problem of depreciations, in particular, was not taken into account (and might, in general, prove difficult to take into account adequately). Beyond that, it may be assumed that in the future the volume of government investment will be less than it has been in the past since many types of investment that had previously been the province of the public sector are now being assumed by the private sector[59]. Moreover, most public sector investment seems to consist of capital expenditure on replacement, which – even if the golden rule is followed – is not intended to justify borrowing anyway. Thus, in the second half of the nineties, government investment adjusted for depreciations in Germany was on average only 0.2% of GDP, and in the past 20 years it amounted, on average, to roughly ½% of GDP (see

[57] This was also proposed by Schemmel (1997), who advocates a structurally balanced general government budget (p. 27ff), and Fürst (1997) p. 234.

[58] Under current legislation, any deficits are only temporary and must be offset by adjusting the contribution rates in subsequent years.

[59] Most of the investment in telecommunications and postal services, utilities and waste disposal has been assumed by the private sector. In future, large segments of the remaining public sector investment in construction are likely to be hived off from government budgets.

Table 5)[60]. Finally, given the demographic trend and the burdens arising for future generations, it again appears appropriate to have recourse to regulations which would have the effect of imposing rather strong limits on the government's ability to borrow.

Cyclical effects to be taken into account but automatic stabilisers rather weak in Germany

As for how a "balanced budget rule" might be formulated, the Federal Government and the Länder should be placed under a strong obligation to indicate their reasons for planning or incurring deficits; the deficits should be offset by surpluses in other years. As a matter of policy, the sole justification that should be given at first are cyclical reasons. This rationale should – in the case of the Länder as well - concentrate on the overall economic situation in Germany since the system of tax revenue allocation in Germany strongly dilutes (indeed at the present time almost completely annuls) different cyclical developments in specific regions[61]. It should be evident from the individual public authorities' financial plans that cyclical deficits and surpluses will cancel out over time.

On the whole, cyclical government deficits and surpluses will probably be rather restrained in Germany given that the effect of automatic stabilisers is rather limited[62]. The cyclical impact, especially on the Länder budgets, is not expected to be strong. Although these budgets will be subject to cyclical fluctuations in tax revenue, they will be partly offset on the expenditure side since expenditure on personnel, which makes up a significant part of Länder budgets, and transfers to the local authorities,

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60 According to ESA 95. The corresponding data, especially the depreciations, are, of course, subject to a high degree of uncertainty. Still, they may be used to provide a rough basis of comparison.

61 The Financial Planning Council could assume a role in this context. Here the overall economic situation could be discussed and its effect on public finance be evaluated.The Working Group on Tax Estimates might also be consulted when assessing economic or other important temporary influences on tax revenue, which have played a major role in past years. The Working Group on Tax Estimates consists of representatives from the Federal Government, the Länder, the municipalities, the Deutsche Bundesbank, the National statistical institute, the council of economic advisers and the economic research institutes. It convenes twice a year as a rule and forecasts the trend in tax receipts on the basis of current taxation law. The budget plan and the medium-term financial planning of the Federal Government is based on Working Group estimates and these estimates are basically the ones adopted by the Länder as well, albeit in a derivative form owing to their regional adaptation.

62 See Deutsche Bundesbank (2000a).

which are based on tax revenue of the Länder, tend to respond procyclically.

The public authority concerned should explain in full other short-term – non-cyclical – shocks, which might justify deficits at that level of government over the short term, and the medium-term compensation for the deficits incurred by the public authority budgets should be specified. In this context, the granting of degressive provisional transfers from other government authorities may be worth considering. However, exceptional shocks which affect the budgets of individual Länder are likely to be rare. These are more likely to pose a problem for local authority budgets, whose receipts (in the form of local business tax) and expenditure (in the form of subsidiary welfare) are both very susceptible to special trends at the regional level[63].

The Federal Government and some Länder Governments intend to achieve balanced budgets in future

At the present time, the fundamental objective of achieving balanced budgets over the medium term has also become increasingly important in the political discussion. Thus, at the close of its last meeting in November, the Financial Planning Council observed that balanced budgets over the medium term were necessary, not least if the pan-European requirements were to be met[64]. In its guidelines for a fiscal policy for the future, published in November 2000, the Federal Government affirmed its commitment to the objective of a balanced budget. It is intended to reach surpluses for the Federal Government and for general government as a whole and to redeem public debt. A surplus of 1% of GDP is to be attained for the overall public sector. Although the Federal Government is, accordingly, no longer interested in pursuing a formal national stability pact, in the Financial Planning Council it intends to convince the Länder of the sense of its fiscal policy guidelines[65]. Some Länder recently published their plans for the future in which they envisage balanced budgets. One of the Länder, Bavaria, has committed itself through its budget statutes to achieving a fundamentally balanced budget starting from 2006.

[63] See Fürst (1997) p. 234.

[64] See Bundesministerium der Finanzen (2000b).

[65] See Bundesministerium der Finanzen (2000a) p. 19.

Amendment of the constitution necessary – incorporation in a structural reform of the public finance system

The implementation of a balanced budget rule should, in the end, be part of a more fundamental reform of the German public finance system. This presupposes an amendment to the German constitution insofar as the existing regulations concerning Federal Government and Länder borrowing would have to be replaced and the budgetary autonomy associated with them curtailed. In order to guarantee sufficient flexibility of the Länder budgets, these balanced budget rules should be included in a more comprehensive reform of the system of public finances. The main aim of such a reform should be to achieve a more concerted disentangling of the fiscal relationships between levels of government and to grant individual public authorities greater responsibility in determining the form their own activities and revenue take.

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NATIONAL AND STATE FISCAL RULES IN AUSTRALIA: AN OUTLINE AND CRITICAL ANALYSIS

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Introduction

Since the late 1980s, deficits and public debt have been the major preoccupations of Australian fiscal policy. There was a widespread public perception that a number of the States, and then subsequently the national government, were experiencing debt 'crises' or, at the very least, serious debt blow-outs. The net debt of consolidated (ie national, state and local) Australian general government reached a peak of approximately 25 percent of GDP in 1995, up from a previous trough in 1990 of a little below 10 percent. The problem here was the trend rather than the level of public debt, which remained moderate by international standards (even at the 1995 peak, consolidated *gross* general government net debt was approximately 34 percent of GDP, well below the Maastericht benchmark of 60 percent[1]).

The change in the Commonwealth (national government) debt position was particularly marked. The previous trough in Commonwealth general government net debt was about 4 percent, in 1990. This rose more than four-fold, to a 1996 peak of 19 percent. State/local government experienced a less marked, but nevertheless significant, increase, approximately doubling to a peak of 10 percent in 1992-93. Within certain individual States, both the level and growth rate of debt was considerably greater than this average. A number of States experienced downgrading of their credit ratings (by up to two rungs below their previous triple-A gradings). It is therefore unsurprising that the perception of a 'debt crisis' arose firstly at the State level. There were in the

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[1] Gross debt is, of course, not a terribly meaningful measure, and is used in Europe largely because of measurement problems (Balassone and Franco, 2000a: 8). A more meaningful 'broad' measure of the Australian general government debt position (at least in the then cash accounting environment) is given by adding net debt plus unfunded employee liabilities, yielding of figure of approximately 51 percent of GDP.

early 1990s a number of State elections in which debt was a central issue, and in which incumbent (Labor) governments which were perceived to have failed the fiscal responsibility test lost office.

The greater increase in Commonwealth net debt arose partly from the impact of recession in the early 1990s, reflecting the greater cyclical sensitivity of Commonwealth finances. From 1992-93, however, the economy had recovered, but significant deficits continued to be recorded. In 1992-93, the underlying cash deficit was 4 percent of GDP. Three years later, even though year-on-year GDP growth had reached 4.5 percent, the deficit had only been reduced to 2 percent. Unsurprisingly, public finances were a significant issue in the Commonwealth election of 1996, when the Labor government was defeated and replaced by a Coalition (conservative) government headed Prime Minister John Howard.

It was as a reaction to this perceived debt crisis that through the 1990s almost all Australian Governments moved to adopt explicit fiscal rules requiring structurally balanced 'cash' budgets. This required the national government and a number of the States to embark on significant fiscal adjustment programs. Many Governments combined these deficit-elimination policies with explicit debt-reduction programs, to which asset sales programs have made a considerable contribution.

At the end of the 1990s, Australian governments adopted accrual accounting in their general government sectors, a step which to date has been taken by a relatively small number of governments world-wide. This led the Australian national government and a number of the States to re-cast their fiscal rules in accrual accounting terms. A key focus of this paper is upon the implications of the move to accrual accounting for fiscal rules.

1. Australian Fiscal Rules under Cash Accounting

As mentioned above, prior to the adoption of accrual accounting, most Australian governments had during the 1990s adopted explicit rules requiring balanced cash budgets. Upon coming to office in 1996, for example, the present Commonwealth government asserted as its primary fiscal policy rule a requirement to 'achieve underlying[2] [cash] budget balance on average over the business cycle'. This was accompanied by a strong medium-term emphasis upon debt reduction or elimination. Many of the States had earlier adopted similar fiscal rules. For example, in New South Wales the rule adopted in 1995 is that 'the Budget should be at least balanced (on a Government Finance Statistics cash basis) over the course of a full business cycle', and there was an accompanying explicit medium-term objective of achieving zero net debt by 2020.

Although not made explicit, these governments have in practice, consistent with the focus upon debt reduction/elimination objectives, targeted structural cash surpluses rather than merely balanced cash budgets. This is true notwithstanding that the largest contribution to the reduction of debt levels has come from privatisation and other asset sales.

Why the fiscal objectives of cash surpluses and debt reduction/elimination? Simplistic anti-debt views have been enormously influential. Rising quantums of public debt, arising from cash deficits, are routinely characterised in official fiscal policy statements as a threat to fiscal sustainability. This, of course, constitutes an argument for stabilising the *quantum* of debt (albeit an erroneous one, given that fiscal sustainability may be quite consistent with rising debt as long as the debt/GDP ratio remains contained). The reduction or elimination of public debt has been justified by three further propositions, namely that:

- public debt is an inherently unfair imposition on future generations,
- continuing debt reduction is essential if Australia is to retain the confidence of international capital markets, so as to be able to fund its large external current account deficit (CAD)
- it was essential that triple-A government credit ratings be restored through debt reduction.

2 The 'underlying' budget balance was an adjusted version of the cash budget result in which privatisation receipts and other 'net advances' are treated as equivalent to borrowing (ie as 'financing transactions') rather than as equivalent to revenue. The practice of adjusting the cash budget balance for the impact of privatisation receipts was also adopted in most States by the mid-1990s.

These rather traditional arguments were joined in the early 1990s by a new theme. The elimination of cash deficits was increasingly presented as a key means by which national savings could be increased, thus reducing the requirement for external funding of private sector investment and thereby reducing the CAD. Initially at least, this argument was based upon the (false) assumption that the cash deficit was a measure of government dissaving.

2. Accrual Accounting and Fiscal Rules

As will be obvious, recent Australian fiscal policy has been characterised by a pervasive failure, particularly at the political level but also at the bureaucratic level, to distinguish between deficits/debt arising from public consumption and deficits/debt arising from public investment. A key advantage of accrual accounting is that it clearly distinguishes between consumption and investment. The accrual *operating balance* measures the gap between revenue and consumption (operating expenses), whereas the cash balance measures the gap between revenue and outlays (capital as well as current).

I have argued elsewhere that the "golden rule" of public finance is best expressed as a rule requiring that the operating balance average zero over the business cycle (Robinson, 1998). The golden rule is, of course, primarily concerned with intergenerational equity. From a golden rule perspective, to require balanced *cash* budgets is inequitable because it requires that all general government capital expenditure be contemporaneously tax-financed, even though the benefits generated by such capital expenditure will accrue over potentially considerable periods into the future. It is more appropriate that the costs of such capital should be met by taxpayers over time in accordance with the inter-temporal distribution of the benefits which public capital generates for the community. The principle of a balanced accrual budget (a zero *operating* balance) implies precisely this, because taxpayers in each time period are paying the costs (measured by depreciation and interest payments on borrowing used to fund capital expenditure) of the existing public capital from they derive benefits.

To formulate the golden rule as a requirement that the accrual operating balance average zero over the business cycle is approximately equivalent to a stipulation that there be a structural cash deficit equal to general government *net* investment. This in essence is the British version of the golden rule (Robinson, 1998). It may be contrasted with another traditional version of the golden rule, enshrined for example in the German constitution (Balassone and Franco, 2000b: 15), which permits cash deficits equal to *gross* general government investment. Such a version of the golden rule would mean that current taxpayers make no fiscal contribution to the costs of the capital assets from which they are deriving benefits: a situation which does not appear consistent with the principle of intergenerational equity.

As Balassone and Franco note (2000b: 13), an important issue concerns the types of public sector investment to which one should apply the golden rule approach to the intertemporal allocation of the cost of capital assets. Simplifying a little, one can distinguish between *commercial* public sector investment and *social* public sector investment. Commercial investment refers to public enterprise investment aimed at producing outputs to be sold in market transactions, in the expectation that price at which those outputs are sold will at least cover their costs of production. Social investment, on the other hand, refers to investment in assets such as (non-toll) roads, school buildings and infrastructure, parks and museums, which generate benefits of a non-financial nature for the community. Social investment is focused in the general government sector, and commercial investment in the public enterprise sector. So the question is, does the golden rule apply to both types of investment, or only to one or the other?

Some economists regard the golden rule as a rule applicable to all public investment (Buiter, 1999). Others take it to certainly apply to commercial public sector investment, but as of uncertain relevance to social investment (eg Verbon and van Winden, 1993: 5-6). My view is that, at least as an approximation, the golden rule should apply to social investment but not to commercial investment. The intertemporal allocation of the costs of commercial capital investment is determined by pricing policy rather than by taxation principles. If one believes that allocative efficiency ought to be the principle criterion for setting prices, the application of the golden rule to commercial public sector investment becomes inappropriate. Equity (including the principle of intergenerational equity) is, by contrast, a taxation policy criterion of central importance. Hence the view that the golden rule should apply only to social investment and, therefore, that it should be interpreted as relevant to the *general government* operating balance, and not to the operating balance of the consolidated public sector.

To assert that the golden rule guarantees intergenerational equity in fiscal policy would be to absurdly oversimplify the complex issue of intergenerational equity. Nevertheless, it can be argued that the golden rule, if supplemented by other policies, may represent the best practicable approximation of the intergenerational equity principle, and that the golden rule is certainly much superior in this respect to a balanced cash budget rule.

The golden rule version of intergenerational equity is that each time-period (financial year) should pay for itself, without fiscal transfers from other time periods. The golden rule thus represents, in a sense, a *time-period* version of the benefit principle. The key problem here is that time-periods are not, of course, 'generations'. The question therefore arises: if one were to define intergenerational equity as a state in which each *generation* (as opposed to each time period) pays for itself, without fiscal transfers from other generations, what relationship would a medium-term fiscal rule designed to assure intergenerational equity bear to the golden rule?

A threshold problem in answering this question is, of course, the inherently ambiguity of the concept of a 'generation'. However, whether one defines generations as birth-cohorts (a la generational accounting) or in some other related manner, it can be shown that there is a clear relationship between the golden rule and intergenerational equity in this sense of a ban on intergenerational fiscal transfers (Robinson, 1999). In summary, this is that:

- If each 'generation' pays for itself in each financial year, the golden rule will be complied with,
- Intergenerational transfers are not the only reason why generations may not pay for themselves in each time period. The other reason is, of course, inter-temporal transfers (life-cycle) within generations,
- In the presence of such inter-temporal transfers within generations, the outcome of a ban on intergenerational transfers would be the golden rule

modified by the fiscal consequences of these inter-temporal transfers within generations.

The conclusion that the golden rule is a superior approximation to the intergenerational equity principle than is a cash balance rule follows directly from this. If it were possible to operationalise fiscal policy rules couched in terms of the lifetime treatment of generations (in the broad spirit of generational accounting), then this would be better still. However, as experience with the application of generational accounting has demonstrated, this is not a practicable matter. It is arguably more practical to combine the golden rule approach with specific policies designed to deal with fiscal problems arising from intertemporal transfers within generations, and more particularly from the impact of demographic discontinuities in areas such as social security and health expenditure (eg increased contributory, as opposed to pay-as-you-go, funding of pension/superannuation schemes).

The Australian emphasis upon fiscal policy as a tool of national savings policy endows accrual accounting with further relevance because it is the accrual operating balance—and not the cash budget balance—which measures government savings. This means that, insofar as fiscal policy aims to ensure that government makes a non-negative contribution to national savings, what is required is that the government achieve a structurally balanced operating balance, or even that it target a structural operating *surplus* of a certain magnitude. This point is further discussed below.

The adoption of accrual accounting therefore can be seen as presenting an opportunity to significantly recast medium-term fiscal policy rules. This is not, of course, to suggest that the cash budget balance measure has become irrelevant—it is perfectly possible to accept the continued relevance of cash accounting to fiscal demand management, while endorsing accrual accounting as the appropriate language for the expression of medium-term fiscal rules.

Two State governments (Queensland and Victoria) have responded to the opportunity presented by the arrival of accrual accounting by adopting fiscal rules broadly consistent with the golden rule approach (see below). The national government and a majority of the State governments, however, have retained essentially the same approach to fiscal policy. Why then have these governments bothered to adopt accrual accounting? The explanation of this apparent paradox is that the adoption of accrual accounting within the Australian general government sector has been driven not by fiscal policy considerations, but by perceived managerial benefits (associated particularly with product costing and asset management).

The fact that the fiscal policy framework has for the majority of Australian governments remained essentially the same following the introduction of accrual accounting does not, however, mean that the move to accrual accounting has been inconsequential for fiscal policy. At the Commonwealth level, the basic fiscal rule has since the introduction of accrual accounting been reformulated in terms of a new deficits/surplus measure, the so-called *fiscal balance*. The fiscal rule is now 'fiscal balance, on average, over the course of the business cycle' (Treasury, 1999a: 2).

3. Fiscal Balance

Fiscal balance is defined in flow terms, as the general government operating balance[3] minus general government net acquisition of non-financial assets (net investment for short). The concept is nevertheless most readily understood in stock terms.

It helps here to remind ourselves of the distinction between financial assets/liabilities and non-financial assets. Non-financial assets are assets held by general government agencies which yield non-financial benefits (e.g. non-toll roads and school buildings). Financial assets and liabilities are those which entail flows of money, such as bonds, superannuation and leave liabilities to government employees, certain lease commitments, revenue accruals, government holdings of traded shares and (in the case of the general government balance sheet) the government's equity in commercial public enterprises. Net financial worth is the market value of all financial assets minus the market value of all financial liabilities. It follows that:

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3 Defined in terms of the Australian Government Finance Statistics system. The measurement of the operating balance is discussed further below.

Assets - Liabilities = Net Worth = Non-Financial Assets + Net Financial Worth

If we were then to define net financial liabilities as financial liabilities minus financial assets (and thus as a measure equal in absolute value, but opposite in sign, to net financial worth), this could be expressed as:

Net Worth = Non-Financial Assets - Net Financial Liabilities

It is useful to clarify the relationship between net financial liabilities and net debt. Net Debt is the market value of a *sub-set* of financial liabilities (bonds issued to the public) minus the market value of a *sub-set* of financial assets (principally debt owed to government and government cash holdings). Net financial liabilities, by contrast, is the value of *all* financial liabilities minus *all* financial assets. The difference is non-debt financial assets (such as public enterprise equity) and non-debt liabilities (such as employee liabilities). In a sense, net financial liabilities might be considered to constitute a type of *broad (net) debt* measure. Any changes in net debt will also affect net financial liabilities, but net financial liabilities is also affected by any movements in non-debt financial assets and liabilities.

If we ignore, for simplicity, breaks in the "articulation" of flow in stock concepts which arise principally from so-called "revaluations" (many of which are attributable to what economists term valuation effects), it can be said that:

Operating Balance = ΔNet Worth

and:

Net Acquisition of Non-Financial Assets = ΔNon-Financial Assets

and therefore that:

Fiscal Balance = ΔNet Financial Worth = - ΔNet Financial Liabilities

This makes it clear why the fiscal balance is regarded by the Commonwealth Treasury as 'the accrual counterpart of the underlying cash balance' (Treasury, 1999b: 1.14). Whereas the stock counterpart of the cash budget balance is conventional net debt, the stock counterpart of the fiscal balance is broad (net) debt. These two stock concepts are, as noted above, closely related. Also of importance here is the fact that the earlier version of the government's fiscal rule focussed upon the *underlying* cash budget balance. The underlying cash balance excludes privatisation receipts[4] from the conventional cash balance measure. The stock counterpart of the underlying cash balance is therefore net debt plus public enterprise equity. Thus the difference between fiscal balance and the underlying cash balance is, approximately speaking, the change in net financial liabilities *other than* net debt and public enterprise equity. Over time movements in the sum of conventional net debt plus public enterprise liabilities will tend to correlate reasonably highly with movements in net financial liabilities.

Nevertheless, movements in the sum of conventional net debt plus public enterprise liabilities can in any particular year diverge quite substantially from the movement in net financial liabilities. Thus, even though the re-formulation of the Commonwealth government's medium-term fiscal rule in terms of the fiscal balance rather than the cash budget balance has occurred within the context of fiscal policy continuity, this re-formulation does have non-trivial implications for the government's fiscal stance.

4. Fiscal Sustainability, Net Financial Worth and the Fiscal Balance Rule

The inter-temporal budget constraint (ITBC) is, of course, the usual starting point for any analysis of fiscal sustainability, and is also the foundation stone for generational accounting. The ITBC requires that the present value of future primary (cash) deficits equals (and here formulations differ) either initial the public sector net wealth or the negative of initial net (or even gross) debt. As Balassone and Franco remind us (2000a: 8), the stock and flow variables

4 And certain intra-public sector loan repayments which had been previously treated as income flows. The concept of the underlying cash balance was introduced into the official Australian Bureau of Statistics government accounting framework in the first half of the 1990s as a response to the widespread use by governments of receipts from privatisations and certain other transactions in order to "improve" their cash budget outcomes.

employed in the ITBC must be congruent. If one expresses the ITBC in terms of net debt, it is obviously necessary that both capital payments/receipts *and income flows* associated with non-debt financial assets and liabilities be treated as revenue or expenditure relevant to the calculation of the primary deficit. This means, for example, the inclusion of income derived from public enterprises, income from government holdings of shares in private-sector companies[5], and superannuation payments to retired public servants. The primary deficit is in this case defined as all payments and receipts other than those associated with debt.

If, by contrast, one chooses to express the ITBC in terms of net wealth, then (approximately speaking) all payments and receipts associated with *all* assets and liabilities will need to be excluded in the measurement of the primary deficit. If one defines the concepts of assets and liabilities conventionally in terms of formally contracted entitlements and legal ownership, the concept of 'net wealth' clearly corresponds closely to that of general government net financial worth as defined in the preceding section. It is relevant here that the fundamental valuation principle employed by the Australian Bureau of Statistics in estimating net financial worth is that all financial assets and liabilities should be valued according to their *economic* value[6].

There are considerable advantages to be gained from the use of general government net financial worth rather than general government net debt as the key fiscal sustainability indicator. Perhaps the most important advantage is that net financial worth cannot be manipulated via transactions which transform debt into non-debt financial assets/liabilities. Asset sales are not the only form such transactions may take. Another example of a transaction which reduces general government net debt without (necessarily or commensurately) increasing general government net financial worth is what might termed the 'capital restructuring' strategy. This technique, of which extensive use was made in Australia in the 1990s, involves governments requiring public enterprises to borrowing additional funds in order, supposedly, to raise their

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5 Which might, for example, be held by public employee superannuation funds.

6 This means, approximately speaking, the present value of associated future financial flows or, if the asset is to be sold, its market value.

gearing ratio to more commercial levels. The public enterprise then transfers the borrowed funds to the general government sector as a 'repatriation of equity capital'. The result is an entirely illusory reduction of general government net debt (and of the cash deficit). Once the focus is upon net financial worth rather than net debt, such strategies become useless as a means of window-dressing the budget.

Whatever the choice of stock variable used in the ITBC, it is not appropriate to include assets which do not yield (direct) monetary income. The economic value of 'social' assets is the present value of the non-financial benefits which these assets generate for the community. If one were to include such assets in the ITBC 'net wealth' measure, it would be necessary also to treat these non-financial benefits as imputed expenditure when measuring the deficit. Not only would this be a rather impractical business, but it would arguably be an exercise with little relevance to the issue of fiscal sustainability, which is fundamentally concerned with government's capacity to meet its financial obligations.

As noted above, under the new Australian government balance sheet conventions, net worth equals the sum of net financial worth and non-financial assets. General government non-financial assets overwhelmingly comprise 'social' assets which yield no financial returns. In terms of fiscal sustainability, it is therefore net financial worth rather than net worth which is relevant. The balance sheet 'valuation' of non-financial assets has, moreover, little to do with the economic value of the assets concerned. It is, broadly speaking, an accounting valuation based upon depreciated cost[7]. This yields a concept of net worth which is consistent with the traditional golden rule view that the intergenerational equity in relation to capital expenditure, which requires that the *cost* of *social* assets be distributed over time in accordance with the inter-temporal in terms of the non-financial benefits generated by those assets. This cost-allocation approach to intergenerational equity has considerable practical merit.

7 Albeit unnecessarily complicated through the application of what accountants term 'deprival value' methodology — see Robinson, 1998.

Net financial worth is, as noted above, the stock counterpart of the new fiscal balance measure. The fiscal rule requiring a zero structural fiscal balance therefore implies that (volatility related to revaluations aside) net financial worth remain constant in dollar terms. Clearly this is not necessary from a fiscal sustainability point of view. It is, of course, sufficient that the net financial worth/GDP ratio have moderate upper and lower bounds. Just as a small continuing structural cash budget deficit is perfectly consistent with fiscal sustainability, so also is a small continuing deficit on the fiscal balance.

5. Zero Fiscal Balance versus the Golden Rule

Because the zero fiscal balance rule is so closely related to the zero cash balance rule, a comparison with the golden rule approach is straightforward. We first contrast their net worth implications, and then their implications for net financial liabilities (broad debt).

Revaluations aside, the golden principal of a balanced accrual operating statement implies that general government net worth remain constant. By contrast a zero fiscal balance rule implies that there is an operating surplus equal to net investment. This means that if general government net investment is positive, net worth will be rising. This perhaps helps to explain why the Commonwealth has with the arrival of accrual accounting articulated a new ancillary fiscal policy objective: that of ‘improving the Commonwealth’s net assets [ie net worth] position over the medium to long term’ (Treasury, 1999a: 1.15, 1.19). It is, however, one of the problems of accrual accounting that there is a tendency for the uninformed to assume that to increase net worth is a self-evidently desirable thing. From the golden rule perspective, however, the pursuit of *increasing* net worth implies undue imposts upon current generations, and reflects what Treasury itself correctly identified in 1995 as a misconceived ‘presumption that increases in net worth are good’ (Treasury, 1995: 5).

Although if general government net investment is positive this rule implies rising net worth, it is possible for net investment to be negative, in which case such a rule is consistent with an operating deficit and reduced net worth. "Net investment" (more formally, net acquisition of non-financial assets) will be negative if the sum of depreciation and sales of assets such as excess land exceeds new capital expenditure. Negative net investment is not merely a hypothetical possibility. In 2000-2001 Commonwealth general government net investment is projected to be *minus* $3.6 billion. Significant sales of general government assets made an important contribution to this outcome. This means that the Commonwealth could, if it wished, run an operating deficit of up to $3.6 billion during 2000-01 while still achieving a zero fiscal balance. Thus it can be said that the zero fiscal balance rule unintentionally opens the door to short-run manipulation by fiscally-irresponsible governments.

What about the debt implications of the two approaches? Valuation effects aside, the zero fiscal balance rule naturally implies constant general government net financial liabilities (broad debt). This is, of course, merely an accrual version of the constant net debt consequences of a cash balanced budget. The consistent observation of a zero fiscal balance rule over time would (cyclical issues to one aside) be that general government net financial liabilities would be zero. By contrast, the golden rule (in the balanced accrual budget form) implies that increases in net financial liabilities equal increases in the general government capital stock. And if the golden rule were observed consistently throughout time, net financial liabilities would equal the balance sheet value of the general government capital stock (and net worth would therefore be zero) (Robinson, 1998, 1999).

Thus the golden rule only implies rising (broad) debt if the general government capital stock is increasing. Over the long run, the public capital stock should rise, and in this sense the golden rule certainly does imply rising net financial liabilities. Nevertheless, given irregularities and discontinuities which tend to affect public capital expenditure, it is perfectly possible that even governments committed to maintaining the level of services provided by the public capital stock will at times preside over periods during which new investment will be less than depreciation. (This is true even if the government is not conducting significant sales of general government assets, of the type referred to above in relation to Commonwealth negative net investment during 2000-01). During such periods, the golden rule would actually imply reductions in broad debt (see Robinson, 1996b).

This result incidentally stands in contrast to the alternative version of the golden rule referred to above, which would permit cash deficit equal to *gross* general government investment. Such a version of the golden rule would imply that the general government net debt could only move in one direction: upwards. It would also imply, approximately, that a reduction in net worth each year equal to the magnitude of depreciation.

It hardly requires mention here that the golden rule does not claim to guarantee fiscal sustainability as well as intergenerational equity. It needs to be accompanied by an explicit 'debt' ceiling, along the lines of what the British call their "sustainable investment" rule. Following the discussion in the previous section, a case can be made that the most appropriate way of formulating such a ceiling is in terms of a *maximum* ratio of general government net financial liabilities/GDP. This should, naturally, be accompanied by rigorous capital budgeting procedures designed to ensure that all social capital expenditure passes a social cost/benefit test. It should also be noted that, as pointed out by Buiter (1999: 18), the golden rule should not be taken to imply a *stable* debt/GDP ratio.

6. National Savings Policy

As noted above, boosting national savings is a fundamental element of current Commonwealth fiscal policy. Originally, this policy was based upon the presumption that budget surpluses (in cash terms, or in fiscal balance terms) measure government savings (Fitzgerald, 1993). This was, of course, an incorrect view, because it failed to distinguish between consumption spending and investment spending. Saving, by definition, is income (revenue) minus consumption (operating expenses). The proper measure of government savings is therefore not the fiscal balance (or, for that matter, the cash balance), but the operating balance. Thus a zero fiscal balance implies, not that government savings are zero, but rather that savings equal net investment.

Policy-makers no longer suffer from this illusion. They now clearly recognise that what the fiscal balance measures is not government savings, but rather government net lending to/from the private sector. The zero fiscal balance rule is defended by the Commonwealth Treasury on the grounds that it is appropriate that government should not draw on private sector savings to funds its own investment. This policy approach raises issues which are very familiar to all economists from debates in past decades about fiscal crowding out. The basic problem is that a policy requiring that savings equal investment is that it can be achieved not only by increasing savings but also by reducing investment. Such a policy also makes it difficult to deal with inherent irregularities in capital expenditure requirements.

As in the US, there has been debate amongst Australian economists both about whether increasing public sector savings is an appropriate means of increasing national savings and, more fundamentally, about whether a low savings ratio is a problem at all (see, eg Pitchford, 1990; Jonson, 1989). Even if one accepts that it is appropriate in the medium-term for fiscal policy to target a positive level of government savings, there are policy alternatives to the current approach. Governments could set defined savings targets which are not linked to the magnitude of public investment. An operating surplus equal to a specific percentage of GDP might, for example, be targeted. Like the zero fiscal balance policy, this would, of course, imply rising general government net worth—but as a matter of temporary policy expedience to address the CAD problem rather than as a matter of basic fiscal principle.

7. Further Remarks on Fiscal Measurement Issues

Notwithstanding the advantages of accrual accounting, it has to be frankly acknowledged that the introduction of accrual accounting has created some fiscal transparency problems in Australia. The new accrual-based Budget Papers are very confusing even to many trained economists, let alone to Ministers, parliamentarians and other lay uses.

There are a number of reasons why this confusion is much greater than it ought, by rights, to have been. One key problem is that the Australian public sector has adopted not one accrual accounting system, but two. There is the system based upon Australian Accounting Standard (AAS) 31. And there is the Government Finance Statistics (GFS) system developed by the Australian Bureau of Statistics (in conformity with international standards developed by the International Monetary Fund and United Nations). The numbers generated by these two systems tend to differ quite significantly. For example, the 1999-2000 Commonwealth general government operating balance was $13.5 billion on a GFS basis. By contrast, the AAS 31 general government operating balance before abnormals was $9.5 billion (and, just to confuse things even more, there was a $22.9 billion AAS 31 operating balance *after* abnormals). GFS general government net worth was minus $11.6 billion, while AAS 31 net worth was minus $52.9 billion (Treasury, 2000).

Merely having two accounting systems is a serious retrograde step in Australia. Prior to the introduction of accrual accounting in Australia, there was great progress towards the standardisation of government budget accounting, based upon the cash accounting version of GFS. This progress has now been reversed.

Why two systems? AAS 31 is driven by the idea that government accounting should operate just like private sector accounting, whereas GFS is tailor-made for public sector policy purposes. This means that AAS 31 incorporates accounting policies which do not necessarily make a great deal of sense in a government context. Perhaps the most important concrete difference between the two systems relates to the treatment of 'revaluations'. AAS 31 treats a range of 'revaluations' as if they were ordinary revenue or expenses, whereas GFS excludes revaluations from the operating statement.

The ABS defines revaluations as "changes in stocks that arise from price movements" (ABS, 2000: 9), although it might be more complete to add that they may also arise from changes in expectations even where there is no market price which changes. An example of a revaluation which AAS 31 recognises in the operating statement is a change in the market value of debt which arises from altered expectations about forward interest rates and which does not reflect any underlying lending transaction. Another example is gains/losses on any government external debt arising as a consequence of exchange rate movements.

The problem with factoring in valuations effects of this type into fiscal policy variables such as the operating balance or the fiscal balance is obvious. It would mean that any such revaluations would need to be offset fully and immediately by adjustments to public sector consumption. For example, if a change in forward interest rate expectations led to a significant fall in the market value of public debt, it would then be permissible to immediately increase current expenditure by the full amount of the capital gain. Conversely, if there were a capital loss, it might be necessary to cut current expenditure forthwith so as to fully offset the loss. I have argued elsewhere that such a policy would make very little sense indeed (Robinson, 2000), and I would imagine that most economists would take a similar position. Of particular concern here is the volatility (and even rapid reversibility) of valuation changes.

This is also the view of the Commonwealth Treasury in Australia. The new fiscal balance measure was defined earlier in this paper as equal to the operating balance (in GFS terms) minus net investment. However, the Treasury's definition of the fiscal balance is in fact specified in terms of the AAS31 operating balance, and is the AAS 31 operating balance *excluding* revaluations minus net investment. Treasury argues that the exclusion of revaluations is appropriate because revaluations 'do not reflect changes in the Government's resource position' (Treasury, 1999b: 13; 1999a: 1.30).

This is relevant to the issue of the valuation of public debt. Some economists who argue that public debt should be valued at face value rather than market value, because fluctuations in market value are of little or no relevance when debt positions are relatively stable over long periods of time. Underlying this argument is the valid concern that fiscal policy should not be destabilized by an inappropriate requirement that immediate fiscal adjustments be made in response to volatile valuation effects. The problem, however, is that any measure of debt based upon face value is of dubious meaning. To add together the face value bonds of different yields is essentially to add incommensurable quantities. The only valid principle according to which a meaningful debt aggregate can be obtained is, arguably, economic value, which naturally changes with changes in expected forward interest rates. Market valuation is a proxy for economic value. As Chalk and Hemming (2000: 17) remind us, where the secondary market for public debt is thin, market valuation may not be a very good proxy for economic value. This is, however, not a problem in Australia or in OECD countries generally.

In a cash accounting environment, fiscal policy destabilisation arising from valuation effects does not arise if the primary fiscal policy targets are formulated in terms of the fiscal flows rather than stocks, because the cash balance (and variant thereof) are not impacted upon by valuation effects. In an accrual accounting environment it is also possible to exclude such destabilizing influences by focusing upon flow rather than stock variables, if one defines the key flow variable (whether it is the operating balance or the fiscal balance) in the GFS manner so as to exclude valuation effects.

8. Fiscal Policy at State Level

The Australian States have historically played a pre-eminent role in the provision of public infrastructure, and have as a consequence undertaken more general government capital expenditure that has the Commonwealth government. In the context of significant economic and population growth, the greater the level of capital expenditure undertaken by a government, the more difficult it becomes to insist that all general government capital expenditure be funded without the use of debt. Thus the adoption during the 1990s of balanced cash budget rules was necessarily more difficult for most States then it was for the Commonwealth. Traditionally, and indeed right into the 1980s, most States did not in fact aim to achieve balanced cash budgets. Rather, most sought to achieve balanced cash *current accounts* (ie, a position where ordinary revenue covers current, but not capital, expenditure)[8]. This approach is equivalent to the version of the golden rule which permits cash deficits equal to *gross* (as opposed to net) investment. As mentioned above, this means that current taxpayers make no fiscal contribution to the costs of the capital assets from which they are deriving benefits, and amounts to an unduly lax fiscal position.

For most States, it was the debt scare of the 1990s which led to a fiscal policy shift. Hence, for example, the New South Wales move in 1995 to a policy of balanced cash budgets and debt elimination, alluded to earlier. Queensland had adopted very similar policies a couple of years earlier, and other States such as Victoria and South Australia adopted the policy of balanced cash budgets while seeking to reduce rather than eliminate debt (Robinson, 1994, 1995, 1996c).

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8 In earlier times, this principle was expressed differently, with the use of separate capital funds.

In more recent times, there has been a major shift in fiscal policy in Victoria and Queensland. Taking advantage of the move to accrual accounting, both States have adopted fiscal rules broadly consistent with the golden rule approach. In late 1999, the Queensland Government indicated that henceforth its principal fiscal rule would be to achieve ‘an overall General Government operating surplus’. In practice, this has meant a very small operating surplus. The following year, the Victorian Government indicated that in also would pursue a fiscal policy designed to ‘maintain a substantial budget sector operating surplus’. The aim for a *substantial* operating surplus has been rationalised as a means of building in a shock-absorber to prevent the emergence of an operating deficit during recession (this itself raises interesting issues which cannot, unfortunately, be explored here). So as to guarantee fiscal sustainability as well as inter-generational equity, Victoria also committed itself to ‘maintain state government net financial liabilities at prudent levels’, with a short-term goal to maintain the State’s triple-A credit rating.

9. Fiscal Responsibility Legislation

This paper has explained and analysed the recent Australian approach to medium-term fiscal rules. As in many other parts of the developed capitalist world, there has in Australia been a further response recent fiscal challenges: the development of legislative fiscal responsibility frameworks. Prior to concluding this paper, it may be useful to provide a little background on these developments.

There is no balanced budget or similar requirement in either the Commonwealth Constitution nor in any of the constitutions of the Australian States. Nor had there historically been any serious attempt to legislate fiscal responsibility rules in Australia. This statement needs to be qualified marginally, in that a number of States in the past had legislation requiring that their budgets be balanced on a so-called "consolidated fund" accounting basis. However, given that borrowings were counted as a form of revenue for consolidated fund purposes, this requirement was worthless in policy terms.

In the first half of the 1990s, there were demands from some quarters, including Australia's principal business organisation (the Business Council of

Australia), for legislation to stipulate and enforce medium-term fiscal policy rules. Public debate ensued, with the ultimate consequence that the Commonwealth and many of the States have adopted fiscal responsibility legislation. Most of this legislation has been heavily influenced by the New Zealand fiscal Responsibility Act of 1994. With the partial exception of New South Wales, this body of legislation does not stipulate specific and concrete fiscal rules. For example, the Commonwealth's 1996 Charter of Budget Honesty articulates a number of quite elastic "principles of sound fiscal management" including "prudent" debt levels, and a "reasonable" degree of tax stability and predictability. The Charter legislation purports to "require" governments to stipulate specific fiscal rules and targets consistent with these broad principles, but provides no sanctions which would enforce this requirement.

The main significance of the Charter and similar State fiscal responsibility legislation arguably lies in provisions which significantly and hence fiscal transparency. These include New Zealand-style requirements that, prior to elections, governments should release fiscal projections which are certified by key Treasury officials (Robinson, 1996a).

Conclusion

The fiscal challenges faced by Australian government during the 1990s may not have been very serious by international standards, but they were taken very seriously in Australia. They led directly to a strong emphasis upon fiscal responsibility, the centrepiece of which has been the adoption of clear medium-term fiscal policy rules. For most Australian governments, the rule has been balanced cash budgets, and even after the shift to accrual accounting, essentially the same rule has continued to apply. For two State governments, however, the shift to accrual accounting has been accompanied by a more fundamental fiscal policy shift, towards versions of the golden rule. Even where there has been no such fiscal policy shift, the introduction of accrual accounting has had non-trivial implications for Australian fiscal policy.

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DEVOLUTION IN THE UNITED STATES: THEORY AND PRACTICE

Robert Tannenwald[*]

The United States has a long tradition of state autonomy from the central government. The nation's first constitution, the Articles of Confederation, gave the federal government little authority, vesting most of it in the 13 states that comprised the country during its first few years. In 1787, when the current United States Constitution was ratified, states ceded some of their authority reluctantly to the central government, only after it had demonstrated its inability to curb destructive interstate economic competition, to implement coherent foreign policy, and to deter sporadic insurrections. The states sought assurances against further federal encroachment of their prerogatives in the Constitution's tenth amendment, which provides that "the powers not delegated to the United States by the Constitution, nor prohibited by it to the states, are reserved to the states, respectively, or to the people".

The trend of the last 70 years--a dramatic expansion of the size, scope, and authority of the federal government--has been an historical aberration. As recently as 1930, federal spending accounted for only 31 percent of total governmental outlays by all levels of government. Today that percentage stands at 61 percent.

During the past decade, a number of policymakers and scholars have asserted that more fiscal responsibilities should be "devolved" or returned to the states. The most famous--or notorious--advocate of such devolution was Newt Gingrich, the former discredited Speaker of the United States House of Representatives. When the Republicans gained control of the U.S. House of Representatives in 1994, commentators predicted an imminent "devolution revolution", which would bring about a major "rebalancing" of the nation's intergovernmental relations[1]. Actually, the extent of devolution over the past

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[*] Federal Reserve Bank of Boston. The author's views do not necessarily represent those of the Federal Reserve Bank of Boston or the Board of Governors of the Federal Reserve System.

[1] The term "devolution revolution" was coined by Richard P. Nathan (1996). For an assessment of the progress of devolution during the past several years in federal legislation, Supreme Court rulings, and (continues)

seven years has been modest. While the states have been given more discretion in the implementation of some programs, Washington still "calls the shots" to a significant degree.

The devolution revolution has fizzled because its most powerful proponents have had higher priorities. For them, the devolutionary cause has been an intermediate goal, to be bargained away, if necessary, to achieve other ends. Whatever the theoretical merits of devolution, in practice U.S. policymakers have had "other fish to fry". Perhaps devolution will be assigned a higher priority under the Bush Administration, since its cabinet members include many former state officials who have been enthusiastic supporters of a larger role for the states in the nation's governance. Further weakening of the U.S. economy, with concomitant reductions in projected federal surpluses, could also "re-energize" the devolutionist movement. However, initial policy proposals introduced by the new president, such as one for education reform, include considerable federal controls on state behavior.

This paper, an updated version of an earlier piece written by the author (Tannenwald 1998), explains the theoretical justification for devolution from an economist's perspective and identifies the political forces that have thwarted progress towards the devolutionary ideal. It illustrates these forces by analyzing how they have shaped U.S. policies concerning health care for children, health care for low-income households (the U.S. Medicaid program), and federal assistance for primary and secondary education. Most of the supporting evidence comes from policies adopted by Congress under the U.S. Balanced Budget Act of 1997 (BBA).

Presidential recommendations and orders, see Kincaid (1998). Kincaid is also the creator of the term "rebalancing" of the federal system to describe devolution.

1. Devolution from an Economist's Perspective

Other things equal, economists tend to be attracted to policies that promote the efficient allocation of resources between the public and private sector, among competing uses within each sector, and across geographic space. They also tend to favor policies that promote efficient production, whether by encouraging the adoption or invention of more efficient technologies, the implementation of a given technology in an operationally efficient manner, or the adjustment of producers' size to realize economies (or to reduce diseconomies) of scale. Economists supporting devolution in the United States believe that one or more of these various aspects of efficiency would be enhanced if more responsibilities currently assigned to the federal government were shifted to the states[2]. In 1996, Steven Gold identified three intergovernmental fiscal policies that, according to devolutionists, promote efficiency: a reduction in federal aid to the state and local governments, the substitution of block grants for matching entitlements, and greater flexibility for states in implementing grants (Gold, 1996). I would add two more policies to this list: the curtailment of "underfunded" federal mandates and a reduction in the degree to which federal intergovernmental assistance redistributes resources from wealthy to poor states.

When a nation government expands intergovernmental aid, in effect it tells subnational governmental units, "You are spending too little; there are certain public needs and wants that you are not satisfying." Many devolutionists believe that U.S. federal spending has bloated government beyond what citizens in many areas of the country want. In their view, the federal government should give the states more fiscal independence and responsibility, so that they will be freer to respond to the preferences of their citizens.

Matching requirements enhance the budgetary efficiency of grants, that is, the level of state spending for a desired purpose induced per dollar of federal subsidy. States presumably vary in their preferences for the targeted

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2 For normative economic analyses of federalism and devolution, see Oates (1972); Gramlich (1987); and Inman (1985). For more general analyses of devolution, see Gingrich (1995); Donahue (1997); Nathan (1996); Rivlin (1992); Rich and White (1996); Peterson (1995); Osborne and Gaebler (1992); and Kincaid (1998).

service. Some would be willing to spend more of their own funds on this service if the cost of providing it were lower. Matching requirements achieve such a cost reduction, inducing some states to contribute more of their own funds. Federal grants imposing no matching requirements lack such leverage, in effect giving some states more money than necessary to achieve a given amount of increased spending[3].

However, matching requirements irk many devolutionists because, even though they may give federal aid programs more "bang" for the federal "buck", they distort states' decisions concerning how to allocate their own tax dollars. In order to obtain federal money for a matching grant, states must substitute outlays on the targeted public service for funds that, in the absence of the matching requirement, would be spent for other purposes. In economic terms, matching grants distort the relative per unit costs to states of providing alternative public goods and services. In this manner the federal government imposes its preferences on states. To devolutionists this imposition is different from the coercion of mandates only in degree, not in kind.

A "devolutionary" economist believes that federally imposed requirements dictating how states should administer grant programs diminishes the technical efficiency of government. The most efficient administrative means of attacking a given problem vary from state to state. By giving states more flexibility in implementing grants, the federal government, according to this view, would reduce the "diseconomies of scale" that plague many intergovernmental programs. Such decentralization also promotes policy experimentation and innovation and, therefore, further improvements in technical efficiency, both present and future.

The economic logic of devolution also implies that federal aid should not be allocated among the states according to fiscally equalizing formulas. Such formulas rely on allocative criteria other than interstate differences in preferences for the level of public goods, the key criterion for maximizing economic welfare and, therefore, for achieving an efficient geographical allocation of resources. In effect, fiscally equalizing formulas coerce relatively

3 For a theoretical analysis of the fiscal incentives provided by open-ended matching grants, as opposed to block grants, as well as a review of the empirical evidence concerning the relative cost-effectiveness of the alternative approaches, see Chernick (1996).

prosperous states to give some of their resources to relatively poor states. According to the goal of geographic allocative efficiency, transfers among states should be voluntary, not coerced.

2. Priorities Overshadowing Devolution

Whatever the theoretical justification for these devolutionary policies, economic and political forces have weakened support for them during the past seven years. Many Congressional advocates of devolution, most of them Republicans, have viewed these policies primarily as means to reduce the deficit, to dismantle the welfare state, to build support among Republican governors, or to free up money for tax cuts favoring traditional Republican constituencies. The dramatic turnaround in the federal government's fiscal condition, from one of substantial deficit to trillions of dollars of projected aggregate surpluses over the next decade, has undercut one of devolution's most widely embraced rationales. Furthermore, after attempts to confront former President Clinton on budgetary issues backfired in 1995, the Republican Congressional leadership has been more predisposed to compromise with centrist Congressional Democrats[4]. That the Republicans have now captured the White House will not necessarily make them bolder. Given the closeness of the 2000 presidential election and a 50-50 split in the U.S. Senate, they may still find it expedient to sacrifice devolution to achieve other priorities. Indeed, President Bush has suggested that federal programs for improving education should entail a considerable amount of federal control.

3. Federal Policy Toward Children's Health Care-the Children's Health Insurance Program (CHIP)

The large number of Americans without health insurance, especially children, has been an acute concern of federal and state policymakers for many years. According to the General Accounting Office (GAO), in 1994 approximately 10 million American children, or about 14 percent of them, had

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4 See Weaver (1996), Pierson (1998), and Swope (1997).

no health insurance ("Health Insurance for Children: Private Insurance Coverage Continues to Deteriorate", 1996). By 1999, despite considerable publicity about the problem and extensive efforts to remedy it (such as CHIP), the percentage had fallen only to 12.5 percent (Broaddus and Ku, 2000).

The problem is attributable more to a failure to enroll children in publicly funded programs rather than the unavailability of such coverage. An estimated 40 percent of all uninsured children were eligible for some type of publicly funded coverage in 1996 (Seldin et al., 1998). The percentage of uninsured children in low-income families eligible for such coverage is much higher--estimated at 95 percent at the beginning of the year 2000 (Broaddus and Ku, 2000). Nevertheless, the problem of uninsured children has been exacerbated by a rise in self-employment and, given the escalating cost of health care and increasing competitiveness of the economy, a decreasing willingness of employers to insure employees' dependents.

During 1993-1995, the percentage of children lacking coverage varied dramatically among the states, ranging from a high of 24.9 percent in New Mexico to a low of 6.6 percent in Minnesota and Wisconsin (Table 1, column 1). These young Americans accounted for more than one-quarter of all the nation's uninsured residents. Lack of health insurance was even more widespread among children in families with incomes below 200 percent of the federal poverty level. Approximately 22 percent of these children were not covered; state percentages ranged from a high of 35 percent in New Mexico and Texas to a low of 11.1 percent in Vermont (Table 1, column 2).

Prior to the enactment of CHIP, state efforts to expand children's health-insurance coverage were a textbook example of "laboratories of democracy" at work[5]. As of May 1997, 36 states had voluntarily expanded minimum federal Medicaid requirements for children's coverage, had initiated their own coverage programs for children or families, or were subsidizing privately implemented children's coverage. Of the other 14 states, eight had privately

[5] Justice Louis Brandeis coined this phrase to stress the advantages of innovative diversity among the states. See *New State Ice Company v. Liebman*, 285 U.S. 262, 311 (1932).

Table 1
Children under Age 19 Uninsured, by State, 1993-1995 and the Estimated Federal Allocation Under Child Health Block Grant

State	umber of Children Uninsured (in thousands)		Percent of Children Uninsured		
	% of US total	% of US total	Total	<200 % FPL	% of US total
Alabama	1,9	2,2	15,9	25,8	2,0
Alaska	0,2	0,1	10	15	0,1
Arizona	2,4	2,6	20,3	29,6	2,5
Arkansas	1,2	1,3	18,9	25,2	1,1
California	17,0	17,9	18,4	26,7	19,5
Colorado	1,2	1,0	11,9	20,9	1,0
Connecticut	0,8	0,7	9,6	18,7	0,9
Delaware	0,2	0,2	12,4	18,8	0,2
District of Columbia	0,2	0,2	16,1	18	0,3
Florida	6,2	6,2	17,1	24,4	6,4
Georgia	3,0	3,0	15,5	24,3	2,9
Hawaii	0,2	0,2	7,8	12,5	0,3
Idaho	0,5	0,4	13,7	17,9	0,4
Illinois	3,3	3,0	10,3	15,8	3,2
Indiana	1,8	1,8	10,9	18,2	1,8
Iowa	0,9	0,9	10,9	21,5	0,8
Kansas	0,8	0,8	10,8	18,4	0,8
Kentucky	1,3	1,3	13,1	18,1	1,2
Lousiana	2,5	2,7	20,1	26	2,3
Maine	0,4	0,3	12,2	18,8	0,3
Maryland	1,5	1,4	12	20,5	1,5
Massachusetts	1,3	1,0	9	14,6	1,1
Michigan	2,3	2,2	8,5	14,3	2,3
Minnesota	0,8	0,7	6,6	12,3	0,7
Mississippi	1,4	1,5	18,5	24	1,3
Missouri	1,5	1,4	11,3	16,8	1,4
Montana	0,3	0,3	11,7	19,2	0,2
Nebraska	0,4	0,4	9,1	16,1	0,4
Nevada	0,7	0,6	18,4	27,9	0,7
New Hampshire	0,3	0,3	10,2	23,3	0,3
New Jersey	2,3	1,9	11,4	22,2	2,1
New Mexico	1,3	1,5	24,9	35	1,2
New York	5,9	5,6	12,5	18	6,4
North Carolina	2,1	1,9	13,1	19,2	1,9
North Dakota	0,1	0,1	8,1	14,9	0,1
Ohio	3,1	2,9	9,7	16	2,9
Oklahoma	2,1	2,3	22,7	33,5	1,8
Oregon	1,0	0,9	12,2	18,5	1,0
Pennsylvania	3,1	2,8	10,1	16,7	3,0
Rhode Island	0,3	0,3	11,4	20,4	0,3
South Carolina	1,5	1,5	14,7	19,3	1,6
South Dakota	0,2	0,2	9,3	14,7	0,2
Tennessee	1,7	1,6	12,2	16,5	1,7
Texas	12,9	14,4	23,2	34,9	12,3
Utah	0,7	0,6	9,9	16	0,6
Vermont	0,1	0,1	7,2	11,1	0,1
Virginia	1,9	1,7	11,7	18,8	1,7
Washington	1,3	1,2	9,7	18,5	1,2
West Virginia	0,6	0,6	14,1	19,9	0,6
Wisconsin	0,9	1,0	6,6	14,2	1,0
Wyoming	0,2	0,2	14,4	26,8	0,2
United States	100,0	100,0			100,0

Sources: Alan Weil, The New Children's Health Insurance Program: Should States Expand Medicaid? (Washington D.C.: The Urban Institute, October 1997), page 2.
Weil's model was based on data from the Bureau of Cenus, Current Population Survey data, Cindy Mann and Jocelyn Guyer, Overview of the New Child Health Block Grant. (Washington D.C.: Center on Budget and Policy Priorities, August 28, 1997).
Mann and Guyer used data from General Accounting Office, August 12, 1997.
Note: The Current Population Survey (CPS) most likely overstates the number of uninsured children because it does not adjust for the underreporting of children who have Medicaid coverage. The number of children reported to have Medicaid coverage on the CPS is substantially below the number of enrollees that states themselves report to HCFA (16.5 million versus 21.4 million in 1995). The Urban Institute's TRIM2 microsimulation model attempts to adjust for this undercount by imputing Medicaid enrollment to individuals to align to HCFA enrollment counts. The result is to increase the number of children on Medicaid and reduce the number of unisured children. The Urban Institute estimates that 4.6 million children below 200 percent of poverty are uninsured as opposed to 7.2 million on the CPS. However, since the S-CHIP statute allocates funds to states on the basis of CPS estimates, those estimates are used in the brief cited above.

financed Blue Cross or Blue Shield Caring-affiliated Programs for Children (Gauthier and Schrodel, 1997). In the federal arena, the defeat of the Clinton Administration's national health insurance plan in 1994 initially discouraged further efforts to expand children's coverage. However, state leadership and compelling empirical evidence of the extent of the problem inspired a variety of fresh proposals for federal involvement, which ultimately led to inclusion of a major initiative in the BBA.

BBA appropriated $46.2 billion from federal fiscal years 1998 through 2007 "to enable [States] to initiate and expand the provision of child health assistance to uninsured low-income children." To put these amounts in perspective, according to the Congressional Budget Office (CBO), they were roughly equal to projected federal outlays over this period on student loans, about three-fourths of spending on farm-price supports, and about one-seventh of outlays for Food Stamps (Congressional Budget Office, 1998)[6]. CBO estimated that by the year 2002, the program, formally known as the State Children's Health Insurance Plan (CHIP), will have extended health care insurance to approximately 2 million children who would not be covered otherwise (Congressional Budget Office, 1997).

To the consternation of devolutionists, the amount ultimately allocated to CHIP was considerably higher than that recommended by the President in his budget for fiscal year 1998 (FY 1998), thanks largely to the efforts of Senators Edward Kennedy (D-Massachusetts) and Orrin Hatch (R-Utah). In early 1997, Kennedy and Hatch unveiled a five-year $20 billion child health-insurance bill to be financed by an increase in the federal excise tax on cigarettes from 24 cents to 67 cents per pack (Hosansky, 1997)[7]. The President's budget proposed no increase in the cigarette tax (U.S. Office of Management and Budget, 1997).

With the support of these two powerful senators from opposite ends of the political spectrum, the Clinton administration was able to insert $17 billion for the extension of children's health-coverage into the budget agreement hammered out with Republican Congressional leaders in early May. The

6 The $23.1 billion figure includes approximately $2.8 billion in extended coverage for children achieved through Medicaid.

7 The Kennedy Hatch Plan was submitted on April 8 as S. 525 and S. 526.

inclusion of this program helped to appease the Democratic left, uneasy with the magnitude of tax and spending cuts that the President conceded in striking the deal. While legislators from tobacco states kept a cigarette tax increase off the table, subsequent efforts by Hatch in reconciliation moved the Senate Finance Committee to approve an increase of 20 cents per pack, enough to generated an estimated $15 billion through FY 2002. Roughly half was earmarked for an expansion of the child insurance program, bringing its proposed total five-year funding to approximately $24 billion, close to the final amount actually appropriated. The tobacco tax increase was eventually scaled back to 10 cents per pack for FY 1998 through FY 2000, rising to 15 cents a pack in the year 2001 (Carey, 1997; Congressional Budget Office, 1997).

3.1 A Block Grant-Matching Grant Hybrid

Keen on balancing the budget, neither Congress nor the administration had any interest in structuring CHIP as an open-ended entitlement. However, neither did they warm to initial suggestions by Majority Leader Trent Lott (R-Mississippi), Senator Arlen Specter (R-Pennsylvania), and Representative Tom Daschle (R-South Dakota) to subsidize the cost of children's health coverage by providing vouchers or tax credits to parents. Such proposals in part reflected a concern that instituting a large public program would induce private employers to curtail coverage for children, leading to a substitution of public for private insurance and consequent increase in CHIP's cost (Hosansky, 1997). Concern about such substitution waned as deficit forecasts became more sanguine.

Ultimately, Congress designed CHIP as a block grant program, stipulating a total appropriation for each of the subsequent ten federal fiscal years as well as a formula governing the allocation of funding among the states. From FY 1998 through FY 2000, allocations were based on each state's number of uninsured low-income children, adjusted for the state's average cost of health care (*Balanced Budget Act of 1997*, 1997, p. 905). This allocation rule penalized states that in the past had most aggressively attacked the problem of uninsured children. Moreover, if extended indefinitely into the future, this rule would have created an incentive for states to postpone extending coverage in the short run in order to augment their allotment in subsequent years. Partially for this reason, Congress stipulated that, in FY 2001 and beyond, the formula will also take into account the number of all low-income children, covered or not, residing in the state (*Balanced Budget Act of 1997,* 1997, p. 905; Weil, 1997). Each state's estimated percentage of the nationwide CHIP allocation for FY 1998 through FY 2002 is presented in Table 1, column 5.

Contrary to devolutionist philosophy, the program imposes matching requirements on the states. They are more lenient than those required by Medicaid; that is, states will have to spend less to elicit a federal CHIP dollar than a regular federal Medicaid dollar. In effect, a state's CHIP matching rate (the ratio of state to federal funds in total program spending) will equal 70 percent of its Medicaid matching rate (*Balanced Budget Act of 1997*, pp. 908-9; Mann and Guyer, 1997). For example, Massachusetts' Medicaid matching rate is 50 percent; that is, it must spend an additional dollar of its own funds to obtain an additional dollar of federal assistance. Under CHIP, its matching rate is 0.7 x 50, or 35 percent. As a result, it has to spend only an additional 53.8 cents to elicit another federal dollar ((1.00/.538) = (65/35)).

The CHIP matching formula also conflicts with devolutionary principles in that a state's matching requirement increases with its per capita income. As an illustration, currently Mississippi's Medicaid matching requirement is 23 percent. Thus, it must spend 29.9 cents to obtain an additional federal Medicaid dollar ((1.00/.299) = (77/23)). Its CHIP matching rate is .7 x 23, or 16.1 percent; it has to spend only 19.1 cents to obtain an additional federal CHIP dollar ((1.00/.191) = (83.9/16.1)). In this manner, the matching formula favors low-income Mississippi over high-income Massachusetts, effectively leading to the reallocation of resources from the latter to the former, regardless of the relative strength of each state's preference for coverage extension[8].

8 However, the CHIP matching formula is less fiscally equalizing than Medicaid's. Thus, while Mississippi's CHIP matching requirement is less than Massachusetts' in both programs, Mississippi's advantage is less under CHIP.

3.2 States' Flexibility in Designing and Implementing CHIP

In addition to the matching requirement, Congress included other stipulations that constrain states' use of federal funds. In general, a state may spend no more than 10 percent of its funds for purposes other than the extension of children's health care coverage (e.g., outreach and overhead). With certain exceptions, extension of coverage is limited to children with family income below 200 percent of the federal poverty line, which in 1997 was $16, 276[9]. The program sets forth standards governing minimum health-care benefits and scope of coverage, limits premiums and the use of deductibles and co-payments, and includes maintenance-of-effort provisions designed to prevent states from substituting CHIP funds for current children's health-coverage programs, whether independent or under Medicaid.

Yet, within these regulatory constraints, and partly because of the variety of children's health-care programs already operating, Congress decided to give states considerable administrative leeway. States have the option of extending children's coverage by expanding Medicaid, augmenting existing state-financed programs, or establishing new ones. Should a state opt to establish or to expand its own programs, it will have the freedom to decide whether to administer its programs through state agencies, to contract with private organizations, or to subsidize the provision of insurance through private markets. Subject to the broad federal regulations alluded to above, it will be able to determine which children to cover. For example, it could elect to limit expansion of coverage to children under the age of six or between the ages of six and 18. As Cindy Mann and Jocelyn Guyer point out, it could limit eligibility to children residing only in certain geographical areas of the state; cap enrollment, putting children in excess of the cap on waiting lists; and even vary waiting lists from county to county. The state would also have the authority to determine which providers will participate in the program, how care will be delivered, and what quality standards must be met by providers (Mann and Guyer, 1997).

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9 This was the official poverty threshold as of 5 June 1998 for a family of four with two related children, as reported in June 1998 by the U.S. Bureau of the Census.
Internet Citation: http://www.census.gov/hhes/poverty/threshold.html.

4. Medicaid

4.1 A Little Background

For at least three reasons, reforming Medicaid has been one of this decade's most salient and controversial issues in U.S. federalism. First, the program has mushroomed in recent years, growing much faster than outlays for other purposes. Between 1988 and 1992, combined federal and state spending on this program increased by 124 percent, compared to 50 percent for all federal, state, and local outlays. While growth in Medicaid spending has slowed dramatically over the past five years, it still grew by 31 percent between 1992 and 1995, compared to only 12 percent for spending by all levels of government[10].

Second, as discussed in more detail below, the explosive growth in Medicaid spending between 1988 and 1992 was attributable in part to states' exploitation of regulatory loopholes that permitted them to channel federal dollars into programs other than the provision of health care for the poor and uninsured. Although the federal government has since greatly narrowed these loopholes, the measures Congress enacted to accomplish this purpose have been attacked as arbitrary and inequitable in their varying stringency across states. Since the loophole tightening included restrictions on state taxation of health care providers, it also raised constitutional concerns centered around the Tenth Amendment.

Third, access to health care, especially to the poor, is widely considered to be what Musgrave and Musgrave would call a nationwide "merit" good, that is, a service that the nation should provide as a matter of moral necessity and enlightened, long-run self interest (Musgrave and Musgrave, 1976). According to this view, it is one thing to deny low-income individuals an entitlement to cash. It is another thing to deny them an entitlement to medical treatment when they are sick or injured, even when it is expensive to do so.

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[10] Figures for growth in Medicaid spending come from Holahan and Liska (1997), p. 1. Estimates of growth in spending at all levels of government are based on annual calendar-year data from author's calculations using machine readable National Income and Products Accounts data provided by the U.S. Bureau of Economic Analysis.

While Medicaid has been center-stage in many Congressional debates since 1990, lawmakers have failed to enact a comprehensive package of reforms. Apart from legislation curbing the exploitation of loopholes enacted in 1991 and 1993, the most significant Medicaid reforms were spearheaded by states acting under Section 1115 and Section 1915(b) waivers under the Social Security Act[11]. The Medicaid provisions of BBA constitute the most significant reforms of the program since 1991.

The issues raised by these provisions were also broached in debate over the BBA of 1996: Should Medicaid be an entitlement? Should state matching requirements be reduced? Should states have more flexibility in specifying eligibility criteria and the scope and duration of benefits? Should they have more flexibility in negotiating reimbursement rates with providers? Should loopholes exploited by states in recent years be further narrowed?

While the changes introduced by BBA were significant, they were far milder than those under serious consideration as recently as 1996. Medicaid is still an open-ended matching grant entitlement program with mandatory eligibility categories and guaranteed minimum benefits. BBA did not incorporate proposals supported by the Republican Congressional leadership to convert Medicaid into a block grant. Nor did it impose a per capita cap on federal Medicaid matching payments to the states, as proposed by the National Governors Association in 1996 and the Clinton Administration early in 1997[12].

4.2 More Flexibility for the States in Implementing Medicaid

Several of BBA's provisions gave states more flexibility in negotiating reimbursement rates for health providers. For example, the Act repealed the "Boren Amendment" to the Omnibus Budget Reconciliation Act of 1980. The Amendment required states to reimburse hospitals and nursing homes at rates

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[11] Section 1115 "Research and Demonstration" waivers give the states more flexibility. Section 1915(b) "Freedom of Choice" waivers are restricted to programs designed to increase the availability of managed care options and are usually limited to one geographic area within a state. See Holahan and Liska (1997), p. 3; Holahan et al. (1995), and Holahan and Nichols (1996), pp. 48-54.

[12] Swope (1997), p. 1004; Pierson (1998), pp. 153-71; and Holahan and Nichols (1996), pp. 42-7. For an in-depth analysis of the Medigrant proposal, see Holahan and Liska (1995).

that are reasonable and adequate to meet the costs which must be incurred by efficiently and economically operated facilities in order to provide care and services in conformity with applicable state and federal laws, regulations, and quality and safety standards[13]. Opponents of the amendment, including in their ranks many state health officials, argued that health care providers filed law suits (or threatened to file suits) based on the amendment to extract unreasonably high Medicaid reimbursement rates. As another example of enhanced state discretion, BBA in effect relieves states of the cost of compensating providers for the Medicare copayments and deductibles of individuals eligible for both Medicare and Medicaid[14].

BBA significantly increased states' authority to use managed care in the delivery of services to Medicaid patients. Virtually every state program developed under a Section 1115 or Section 1915 (b) waiver as well as all Medicaid reform proposals floated at the national level, incorporate this feature (Holahan and Nichols, 1996, pp. 50-3). BBA gave states the authority, without first obtaining such waivers, to require most Medicaid recipients to enroll in managed care organizations (MCOs) that do business only with Medicaid. Furthermore states can force recipients to choose among only two MCOs and lock them into their choice for 12 months unless a recipient can demonstrate that he or she has been unjustly denied access to covered services. Under prior law, absent a waiver from the federal government, a recipient had the option of "disenrolling" without cause after one month's membership (*Balanced Budget Act of 1997,* 1997, pp. 848-9).

The right to mandate managed care gives states a tool for enhancing the access of Medicaid patients to adequate health care. With fee-for-service reimbursement rates so low, providers have been reluctant to take on Medicaid patients. While in theory states could improve access by reimbursing providers more generously, many have assumed that few providers would respond to such incentives. If this assumption were correct, most of the increased state outlays would simply reward existing Medicaid providers for doing what they would do anyway. By permitting all states to contract with MCOs with an exclusively Medicaid clientele, architects of the BBA hoped to develop

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13 42 U.S.C. 1396a(a)(13).

14 P.L. 105-33, sec. 4714.

institutions with a contractual responsibility to provide care to the poor and uninsured[15].

In addition to giving states greater discretion to introduce potentially cost-saving reforms, BBA gave states two options for expanding coverage for children. (These options are separate from the S-CHIP program and are available to states regardless of whether they choose to implement that program through an expansion of Medicaid). First, they can offer children continuous coverage for a 12-month period after their eligibility has been initially verified. Under prior law, states were required to reevaluate the eligibility of all Medicaid beneficiaries with each change in their financial condition. As a result, monthly or even weekly fluctuations in income, occurring often in low-income families, caused frequent interruptions in children's coverage. Second, states can presume that a child is eligible for coverage on the basis of a cursory screening until their Medicaid agency makes a final determination based on a thorough investigation.

4.3 New Underfunded Mandates

BBA imposed two new underfunded Medicaid mandates on the states: restoration of Medicaid coverage for certain immigrants rendered ineligible by the Personal Responsibility and Work Opportunity Reconciliation Act of 1996 (PRWORA) and increased costs resulting indirectly from increases in Medicare premiums.

4.3.1 Restored Medicaid Coverage for Immigrants

PWRORA significantly reduced the eligibility of legal immigrants for several means-tested welfare benefits. Those residing in the U.S. at the time of the law's enactment were not spared cuts. They were declared ineligible for Supplemental Security Income (SSI) and Food Stamps; even those receiving

[15] Medicare and the American Health Care System: Report to Congress (1995). Cited in Holahan and Nichols (1996), p. 45. See also Norton (1995) and Zuckerman and Verrilli (1995). For discussions of the advantages and disadvantages of greater utilization of managed care for Medicaid patients, see Zuckerman et al. (1997), and Schneider (1997).

benefits at the time of enactment were to lose them after a grace period of approximately one year. As a result, some of these legal resident aliens (about one-quarter of them, according to CBO estimates) lost their entitlement to Medicaid benefits, too, because eligibility for SSI is a sufficient condition for Medicaid eligibility. The authority to determine whether they were eligible for Medicaid, Temporary Assistance to Needy Families (TANF), and other federal means-tested programs was vested in the states. These provisions of PWRORA were among the most devolutionary in that they significantly reduced federal spending on welfare and delegated implementation to the states[16].

Proponents of these restrictions on the eligibility of legal immigrants argued that many were bringing relatives to the United States to avail themselves of SSI, Medicaid, and Food Stamp benefits. The resulting increase in the cost of these programs was substantial. Imposing these restrictions would therefore both curtail abuse of these programs and realize substantial savings for the Treasury. However, opponents, President Clinton among them, maintained that these limitations unreasonably discriminated against a group of residents "in the United States legally and making every effort to become productive members of society". Upon signing PWRORA into law in the summer of 1996, the President vowed that, if reelected, he would fight for the restoration of some lost benefits (Carney, 1997, pp. 1134-5). Making good on his promise, the President proposed in his FY1998 budget that immigrants legally residing in the United States as of August 22, 1996 and receiving SSI benefits because they are disabled should continue to receive them. Such immigrants receiving SSI because of their elderly status would lose their benefits, but if they could requalify on the basis of disability, they would be allowed to do so. Any legal immigrants in residence before the August 22, 1996 deadline not receiving SSI disability benefits would be eligible for them if they subsequently become disabled (U.S. Office of Management and Budget, 1998, p. 109).

The Clinton Administration's willingness to fight for these recommendations was bolstered by the increasing political clout of immigrants and the strong support they lent the President during his successful reelection campaign. Under the terms of PWRORA, some 500 thousand immigrants

[16] See Irene Lurie, (1997), pp. 73-89, and Guyer et al., (1996).

stood to lose benefits, 80,000 in New York State alone. As a result, Asian-Americans and Hispanic-Americans increased their rate of voter registration and lobbied aggressively to have benefits restored. A significantly larger percentage of Asian-American and Hispanic-American voters registered as Democrats and supported Clinton in 1996 than in 1992 (Carney, 1997, pp. 1132-3). The bipartisan budget accord negotiated between the President and Congressional leadership adopted the President's recommendation (Rubin, 1997, p. 995). In the reconciliation phase of negotiations, the House Ways and Means Committee and Senate Finance Committee adopted versions less generous than the President was seeking. The Ways and Means proposal would have grandfathered benefits for all legal immigrants in residence and on SSI rolls on or before the deadline, whether qualifying on the basis of disability or elderly status. However, immigrants subsequently becoming disabled could not qualify. The Senate Finance Committee version differed from that of Ways and Means in that it allowed immigrants in residence before the deadline to receive benefits if they had since become disabled before September 30, 1997 (Katz, 1997a, pp. 1450-1). However, under the explicit threat of a Presidential veto, the full Senate, as well as the Conference Committee negotiating the final budget bill, both supported the Clinton Administration's original proposal (Katz 1997a, p. 1530; 1997b, p. 1848).

This provision not only reversed to a modest degree the previous widening of state discretion in setting immigrant policy but, according to CBO estimates, has increased federal spending by approximately $11.5 billion between FY 1998 and FY 2002. BBA did not restore these immigrants' eligibility for Food Stamps or rescind provisions of PWRORA restricting the access to several federal means-tested programs of immigrants arriving after PWRORA's date of enactment[17].

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[17] *Balanced Budget Act of 1997* (1997), pp. 944-9, and Congressional Budget Office (1997), pp. 62-4. For an analysis of the implications of the provisions of PWRORA and BBA governing aliens' access to welfare benefits for the respective roles of the federal government and the states in crafting the nation's immigration policies, see Fix and Tumlin (1997). For a more general discussion of intergovernmental relations and immigration policy, see Skerry (1995), pp. 71-85.

4.3.2 Increases in Medicare Premiums.

The increases in Medicare Part B premiums included in BBA indirectly impose additional costs on the states because Medicaid pays these premiums, as well as deductibles and copayments, for low-income beneficiaries. Currently the income ceiling determining a Medicare patient's eligibility for this assistance is 120 percent of the federal poverty line. BBA increased this ceiling to 135 percent and, with respect to payments for certain home health services, 175 percent. It established a block grant to the states, with no matching requirement, to finance coverage for this newly eligible group. However, funds for this purpose were appropriated only for five years, from FY1998 through FY2002 (*Balanced Budget Act of 1997*, 1997, p. 880; and Schneider, 1997, pp. 8-9). Moreover, Congress explicitly recognized that the appropriated amount, $1.5 billion over the five-year period, might be insufficient to cover all costs. BBA instructed states to offer the benefit on a first-come first-serve basis and to limit the number of recipients so that the state's allocation will not be exceeded (*Balanced Budget Act of 1997*, 1997, pp. 881-2).

4.4 New Constraints on Disproportionate Share Hospital Payments

Of all the BBA's provisions, those imposing the most severe restrictions on states' flexibility in using federal Medicaid dollars concern payments to Disproportionate Share Hospitals (DSHs)--the costly Medicaid "loophole" alluded to above. The DSH program is a arguably the nation's most graphic example of intergovernmental fiscal pathology. Its history demonstrates the difficulty of targeting categorical grants, containing their costs when they are provided on a matching open-ended basis, and capping them once a large number of states have become financially dependent on them[18].

DSHs are hospitals whose patient mix includes a large portion of Medicaid recipients and people with no health insurance. In recognition of the severe financial difficulties that these institutions face, Medicaid gives states the option of providing special assistance to them through either lump-sum payments or unusually high reimbursement rates for services rendered to

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[18] This section, which discusses the DSH program, draws heavily from Coughlin and Liska (1997); Schneider et al. (1997); and Gold, (1996a).

Medicaid clients. States initially proved reluctant to avail themselves of this option, in part because they still had to put up some of their own money to trigger federal matching payments. To overcome this reticence, the federal government loosened the program's restrictions on states. For example, in 1985 the Health Care Financing Administration (HCFA) allowed states to accept donations from private health care providers to help finance Medicaid services. Using their considerable flexibility in implementing their DSH programs, states were able to pay the donated money right back to the providers, precipitating federal matching funds in the process. In this manner, states were given the capacity to elicit federal assistance while evading their matching obligations. In a similar arrangement, some states imposed a tax on their health care providers and gave them DSH payments in proportion to their tax payments, thereby triggering federal payments.

By the beginning of the decade, states figured out that they could legally use these financial arrangements to channel federal Medicaid money into their general fund, to be used for purposes that have nothing to do with health care for the poor and uninsured. As an illustration, consider the following hypothetical example of a state with only one hospital. The state imposes a tax on the hospital's gross receipts, generating $1,000 in tax revenue. It puts $400 of this revenue into its general fund and $600 into its DSH program. The federal government matches these DSH dollars with $600 of its own. The state makes a $1,200 DSH payment to the hospital. The hospital comes out $200 ahead and the state has generated an additional $400 for its general fund.

As states' fiscal distress deepened during the 1991-1992 recession, the temptation to exploit these "arrangements" became too great for most states to resist. Between 1990 and 1992, federal DSH outlays grew from $1.4 billion to $17.5 billion. The number of states taking advantage of the DSH program grew from 6 to 39. According to a 1993 survey, approximately one-third of all DSH funds were channeled into other programs (Ku and Coughlin, 1995). However, there was considerable variation in the degree to which states exploited DSH financing schemes. In 1992 DSH spending comprised 35 percent of all Medicaid spending in New Hampshire and 43 percent in Louisiana. In several states, by contrast, it accounted for less than 1 percent.

Many state officials defended the use of DSH financial arrangements to extract federal assistance, even though they acknowledged that they diverted

Medicaid dollars from their intended purpose. Some officials saw exploitation of this loophole as just compensation for the costs of such underfunded federal Medicaid mandates as the Boren Amendment and required extension of coverage to pregnant women and new categories of children. Others criticized proposed limits on provider tax schemes on the grounds that they would violate the "reserved powers" clause of the Tenth Amendment of the Constitution. Finally, it was alleged that, given how dependent many states had become on Medicaid funds, sharply curtailing their availability would seriously undermine their financial condition, creating more problems than it would solve.

Despite this opposition, the federal government enacted laws in both 1991 and 1993 intended to curtail "abuses" of the DSH program. The 1991 law 1) generally banned provider donations, 2) stipulated that provider tax revenues could not exceed 25 percent of a state's outlays for Medicaid (net of federal assistance), 3) stipulated that provider taxes had to be broad-based and that Medicaid reimbursements to a particular provider could not be linked to the provider's tax liability (i.e., providers could not be "held harmless"), and 4) capped each state's DSH outlays. Specifically, nationwide DSH payments were limited to 12 percent of total Medicaid costs. If a state's ratio of DSH payments to total Medicaid outlays equaled to or exceeded 12 percent in 1992, the state could not exceed this amount in subsequent years. If a state's ratio was less than 12 percent, it could increase DSH payments at the same rate as increases in total Medicaid outlays[19].

While the 1991 and 1993 limitations cut DSH spending substantially, concerns about the program continued to fester. Attempts to cap spending had created an interstate allocation of funds that tended to favor states who had exploited the DSH loophole most extensively in the early part of the decade. DSH payments per low-income resident varied dramatically among states. These inequities were exacerbated by legislated exemptions from constraints for New Hampshire and Louisiana, the two states with the highest ratio of Medicaid revenues to total spending. In addition the various loophole-narrowing provisions enacted in 1991 and 1993 still left opportunities for

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[19] Medicaid Voluntary Contribution and Provider-Specific Tax Amendments of 1991 (P.L. 102-234) and Omnibus Budget Reconciliation Act of 1993 (P.L. 103-66), sec. 13621.

channeling Medicaid funds into state general fund coffers through interagency transfers. Policy makers found arrangements involving transfers from public mental health facilities to be especially objectionable since provision of mental health services are mandated by Medicaid. Finally, the various constraints imposed on DSH payments in some instances worked at cross purposes. For example, these constraints were making it difficult for some states to spend their total DSH allotment granted them in the 1991 legislation (Coughlin and Liska, 1997, p. 5). With these lingering concerns, and the need to cut federal spending to eliminate the federal deficit, the BBA of 1997 scrapped the 1991 allotment rules and substituted new state-specific allotments from 1998 through 2002. After 2002, each state's DSH spending will be allowed to grow at the rate of increase of the U.S. Consumer Price Index and will be capped at 12 percent of the state's total Medicaid outlays. In addition, the Act gradually introduces limits on DSH spending for mental health. By 2003, when these limits are fully phased in, a state's DSH outlay for this purpose will be limited to 33 percent of its 1995 level (*Balanced Budget Act of 1997*, 1997, pp. 873-6.)

According to simulations conducted by the Urban Institute, the new allotments and caps will narrow interstate dispersion in reliance on federal DSH dollars as well as DSH spending per low-income resident. Yet, the allotments partially reflect the outcome of what Kincaid has termed "mediated competition" among states for Congressional favor (Kincaid, 1991). Thus, while New Hampshire and Louisiana have experienced disproportionately large percentage reductions in DSH funding (relative to their 1995 levels), South Carolina, another state relying heavily on DSH financial arrangements, will enjoy relatively small proportionate cuts (Coughlin and Liska, 1997, p. 4)[20]. In addition, opportunities for exploiting such financial arrangements still exist. In fact, CBO assumes that states will respond to BBA's DSH limits by intensifying their exploitation of such opportunities, reducing by 25 percent the gross the federal cost savings that these limits would otherwise achieve (Congressional Budget Office, 1997, pp. 49-50).

While many states have converted the DSH program to something akin to a general revenue program, others have used the program for its intended purpose. Moreover, even in states that have “abused” the program, some of its

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20 For another state-by-state analysis of the new cap’s implications, see Schneider et al. (1997).

outlays have hit its target. Therefore, the DSH limits imposed by BBA have diminished the ability of DSH to serve its low-income, uninsured clientele. The new limits are not the only source of additional financial pressure faced by DSHs. The potentially averse consequences for DSHs have generated pressure on states to shore up these institutions.

5. Whither Devolution under the Bush Administration? Early Evidence from the President's Proposal for Education Reform

Some might surmise that the election of a Republican president will get the "devolution revolution" moving again in the United States. Some of the President's nominations for U.S. cabinet posts suggest that this may be the case. For example, "Tommy" Thompson, former Governor of the State of Wisconsin and the President's choice for Secretary of Health and Human Services, is an ardent believer in the capacity of state's to solve public policy problems if given the necessary autonomy and flexibility. He has put his beliefs into action; Thompson's pioneering efforts at welfare reform in Wisconsin inspired and shaped comparable reforms at the national level enacted by Congress in 1995.

However, President Bush's recent proposals for reforming U.S. education aid demonstrate the same ambivalence toward devolution that has characterized CHIP and reform of Medicaid. On the one hand, the President has proposed that states be given more flexibility in allocating federal grants among competing uses, especially those targeted for low-income school districts. On the other hand, he wants to impose accountability standards on local school districts, varying the amount of federal aid each receives depending on the academic performance of its students on federally mandated tests. His rhetoric reflects his ambivalence. He has lamented the fact that "today, nearly 70 percent of [U.S.] inner city fourth graders are unable to read at a basic level on national reading tests" and that [U.S.] "high school seniors trail students in Cyprus and South America on international math tests." On the one hand, he has asserted that "although education is primarily a state and local responsibility, the federal government is partly at fault for tolerating these abysmal results." On the other hand, he has stated that his program is "based on the fundamental notion that an enterprise works best when responsibility is placed closest to the most important activity of the enterprise, when those responsible are given greatest latitude and support...." (The White House, 2001).

The political roots of President Bush's education initiative can be traced back at least as far back as 1995. In that year, Congressional Republicans engaged in an ill-fated attempt to dismantle the U.S. Department of Education. Former President Clinton's opposition, backed by that of the majority of the American people, insured that the attempt was unsuccessful. Since then, the American public has consistently characterized the Democrats as more committed to improving education than Republicans. The spectacle that Republican lawmakers made of former President Clinton's impeachment did not help their image. In an attempt to change this perception, Republicans, often with moderate Democratic co-sponsors, have periodically submitted legislation loosening the strings attached to federal aid while simultaneously calling for the federal imposition of standards for education achievement, enforced by financial rewards and punishments. Former President Clinton, with his allies in Congress, fought to maintain federal rules governing how aid should be spent. In particular, he wanted to appropriate over $11 billion to help school district's hire 100,000 new teachers in an effort to reduce average class size (Kirchhoff, 1998).

“Devolutionists" scored a moderate victory in April 1999 with the expansion of the "Ed-Flex" Program (P.L. 106-25). Ed-Flex (short for "education flexibility"), enacted in 1994, gave a dozen states authority to waive a limited number of federal regulations governing the allocation of a limited number of federal education grant programs. In return, the states had to develop a comprehensive plan, subject to federal approval, showing how the waiving of federal regulations would enable them to enhance student achievement. They also had to submit a plan for monitoring student progress and making their evaluations available to parents. P.L.106-25 in affect gave all 50 states the option of applying for the right to wave the regulations covered by Ed-Flex. Republicans and moderate Democrats successfully fought attempts by the Clinton Administration to tack on to the legislation appropriations targeted on teaching hiring (Kirchhoff, 1999a).

In June of 1999, Republicans, buoyed by their initial success, introduced two new expanded "ed-flex" programs that would have consolidated several other programs into block grants and introduced more lenient waivers of federal regulations. One bill would have allowed school districts to divert much of the money targeted for additional hiring of teachers to training existing teachers, to hire special education instructors, or to increase merit pay. Another broader measure would have given all states the option of converting the bulk of federal education programs into block grant programs, including money targeted for low-income school districts, vocational education, and technology assistance. The first plan passed the House of Representatives. The second, however, was watered down into a 10-state pilot program. Since the Senate deadlocked over both bills, the whole issue has postponed for the Bush Administration to address (Kirchhoff, 1999b; Koszczuk, 1999).

President Bush's education proposals are similar to those introduced by Congressional Republicans during the second half of 1999. The most "devolutionary" component of the Bush Administration's plan would give states or individual school districts the option of entering into a charter agreement with the U.S. Secretary of Education. The charter would spell out a five-year performance agreement between the Secretary and the state or school district spelling out targets for improvement in student achievement. In return for meeting its targets, the state or school district would gain freedom from a wide variety of regulatory requirements constraining the allocation of federal school aid. All schools, even those not subject to charter agreements, would enjoy at least some reduction in regulatory requirements.

However, as in earlier Republican proposals, the price of greater flexibility would be greater accountability. Charter states or school districts would have to meet the objectives stipulated in the terms of their charter or lose their exemption from federal regulations. As a condition of receiving federal aid, all states would have to establish standards of competence in reading, math, history, and science. They would have to implement annual standardized tests for every child in grades three though eight and report student assessment results to parents and to the public at large, disaggregated by race, gender, English language proficiency, disability, and socio-economic status. Schools and states whose disadvantaged students fail to make adequate progress (as judged by national assessment tests) would eventually lose some of their federal assistance for administrative purposes. Under these conditions, disadvantaged students could use federal assistance to transfer to a higher performing public or private school or to receive supplemental educational services from a provider of their choice (The White House, 2001).

6. Conclusion

BBA and President Bush's education reform proposal reveal the federal government's ambiguous feelings about relinquishing its role as the "dominant senior partner" in U.S. federalism[21]. BBA included new grant programs, including one that inserts the federal government into a policy arena where the states have taken the initiative. However, the Act gave the states flexibility in determining how the major new program, extension of children's health insurance coverage, should be implemented. Moreover, the new grant programs are capped, although most impose matching requirements. The Act left Medicaid as an open-ended matching entitlement, despite numerous previous proposals to transform it into a block grant. The Act restored some previously rescinded mandates, appropriated funds to assist compliance with others, and imposed some new ones. President Bush's proposed school reforms give states and school districts more flexibility in using federal education grants but impose new mandates designed to ensure accountability. All in all, neither BBA nor the President's school reform plan push the nation very far along the devolutionary path. It appears that, while the "devolution evolution" is proceeding gradually, the devolution revolution is on hold.

[21] In Martha Derthick's "strong senior/weak junior" model of U.S. federalism, the federal government is the dominant partner and the states the junior partner. See Derthick (1989), pp. 34-8.

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CONSOLIDATION OF PUBLIC FINANCES IN BELGIUM: AN EXAMPLE OF APPLICATION OF EUROPEAN NORMS IN A STATE WITH A FEDERAL STRUCTURE

Henri Bogaert and Thérèse Père[*]

I. The institutional reform of 1988 to 1993

The last institutional reforms which took place at the beginning of the 1990s[1] constituted a decisive step in the process of the federalisation of Belgium which has continued to evolve since its beginnings in 1970 right up to the present day[2]. These took place in a context of consolidation of public finances: cutting the public deficit and fighting the snowball effect were the central issue in Belgian budgetary policy at that time, even before the commitments that were undertaken by European countries in the context of the Maastricht treaty.

1. Aims of institutional reform

The fundamental purpose of State reform is to respond to the increased demands for autonomy from the federated bodies. The process of federalisation, as in many federal States, tends to transfer the allocation functions of public authorities to the federated bodies and to keep at the central level those matters which are linked to public sovereignty (justice, the army, law enforcement etc.) and redistribution (social security, including health care).

Three specific objectives can be attributed to the laws passed from 1988 to 1993: the finalisation of the process of Belgian federalisation which had been initiated in 1970, the extension of the scope of competencies of the federated authorities, the gradual adaptation of the

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1 Special Laws of 8 August 1988 concerning institutional reforms intended to augment the competence of the federated bodies; on 12 January 1989 on the Brussels institutions; on 16 January 1989 concerning the financing of the Regions and Communities, supplemented by the Special Act of 16 July 1993 setting up the federal structure of the State.

2 New stipulations concerning the redistribution of competencies and funds between the various levels of power were covered by a Special Law which should be put to the vote in 2001.

ratios for the distribution of financial resources between the federated bodies.

- *Finalisation of the process of federalisation in Belgium which had been initiated in 1970*

The creation of the Brussels Capital Region and the other Community institutions for the Brussels Region (Law of 1989) and then the subdivision of the province of Brabant between the three Regions (Law of 1993) have defined the current federal structure of Belgium. The country comprises three Communities (Flemish, French and German) on the one hand and three Regions (Flanders, Wallonia and Brussels Capital) on the other. The Communities assume responsibility for cultural matters and everything that can be personalised and/or share these areas with the Federal government, and the Regions assume and/or share responsibility for matters linked to the occupation of the land and supervision of local authorities. Each body has its own parliament (called a Council) and a government. From the beginning, however, the Flemish Community and the Flemish Region merged and therefore only have one Council and one Government.

- *The extension of the scope of the powers of the federated authorities*

The new powers transferred to the Communities in 1989 essentially relate to education. For the Regions, it was infrastructure policy and transport (except the railways), management of the Funds of the municipalities and provinces, unemployment alleviation programmes and restructuring of national sectors (iron and steel, textiles, shipbuilding). The personnel and buildings needed to exercise these powers were also transferred to the federated bodies. Overall the reform has virtually quadrupled the total budget managed by the Communities and the Regions. In 1993 the sharing of competence between the federal authority and the federated bodies was further extended to include the following areas: international relations (in their areas of competence) and foreign trade, the environment, agriculture and scientific policy.

- *The adaptation of the distribution ratios for financial resources between federated bodies*

The law provides for a period of 10 to 11 years for a gradual transition from the situation as it was in[3] to the new distribution ratios. Eventually the Regions will share the funds allocated to them in proportion with their contribution to the national personal income tax (P.I.T.) revenues[4]. The same criterion will be used for the distribution of funds attributed to the Communities (apart from the German Community, which is separately financed by a grant) for areas of competence other than education. In the case of education, the distribution ratio observed at the outset (56.5% for the Flemish Community and 43.5% for the French Community) will gradually reach the respective levels of 57.55% and 42.45% which is the estimate made at the time of the proportions of the population aged less than 18. From 2000 onwards they will be distributed in proportion with the recorded school population.

2. *Method of financing for federated bodies as stipulated in the laws of 1989 and 1993*

2.1 *The sources of financing*

The sources of financing for the federated bodies may be divided into five categories.

- Shares of the tax revenue levied by the federal authority account for almost 90% of the funds of the Regions and Communities identified in the law in 1989 (cf. point 2.2). The Regions may levy supplements (additional centimes) or grant discounts (from 1994) on these taxes[5], but the Communities have not been given the right to do this.
- Regional taxes (registration duties and inheritance tax, real estate withholding tax, taxes on gaming and betting, leisure equipment or drinks) and, from 1993, Community taxes (radio and television licence

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3 Before 1989 the distribution took into account the relative contribution to the personal income tax and also the number of inhabitants and the size of the territory.

4 A supplement, the national solidarity intervention, is nevertheless provided for those Regions in which the personal income tax per inhabitant is lower than the national average.

5 After consultation between the Federal Government and the executives of the Regions and without prejudice to the rights of the municipalities to levy additional centimes.

fees)[6], which amount to 8% of the funds identified. The federated authorities have more autonomy in this area. The law provides for the possibility, on a case by case basis, of altering the levels of duty, the exemptions or even the taxable basis.

- The grants from the federal government, which amount to less than 3% of the funds provided by the Law, while this was the essential means of financing before 1989[7].
- The other revenues specific to the Regions and Communities, such as, for example the taxes on water and the environment or revenue from property tax. These funds increased from 0.4% of GDP in 1989 to 0.9% in 1999 (figures from the national accounts for 2000).
- The loans, which are not only envisaged by the Law as a source of financing for the Regions and Communities but are actually required from the beginning of the 1990s, by the transitional mechanisms put in place by the law (see below).

2.2 The shares of tax revenue allocated

The Special Financing Act of 1989 stipulates that the funds transferred will be taken from VAT and personal income tax (P.I.T.). The shares of VAT are destined solely for the Communities and correspond to the financing of their new powers in the area of education. The proportions of P.I.T. which are allocated finance the other powers of the Communities and all the powers of the Regions. The law not only defines the total amount of funds to be attributed to the Regions as a whole on the one hand and the Communities on the other, but also the distribution of these funds between them individually. The method of calculation, which is used, has changed over time, particularly in the case of the funds taken from P.I.T. During the first 10 years, i.e. during the transitional period, these were covered by five different calculation rules, depending on the type of powers with which they are linked. From the year 2000 onwards, i.e. in the definitive regime, only two types of mechanisms will exist, one of them for funds levied from VAT, and the other for all funds levied from P.I.T.

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6 Initially in the law of 1989, the radio-TV license fee was defined as shared non-fiscal revenue.

7 These relate to financing of programmes to get unemployed people back into work (Regions), university education provided to foreign students (Communities), the “main morte” (Brussels Region) and also the financing of the German Community and the Joint Community Committee.

We should make it clear at the outset that the shares of taxation which are allocated, both from P.I.T. and from VAT, are independent of the overall amount of these revenues. Only the distribution of P.I.T. between the Regions or between the Communities is important, since this constitutes the criterion for the sharing of funds between each of them and, combined with the distribution of the population by region, it determines which region(s) will be the beneficiary or beneficiaries of the solidarity intervention.

The calculation of the shares of tax to be allocated as stipulated in the law takes into account the amount of change in the consumer price index and the growth in real terms of the gross national product for the budgetary year in question. The law stipulates, however, that "while awaiting the definitive setting of these parameters, the adaptation takes place on the basis of the parameters for the previous year", with the understanding that a rectification process will take place in the following year. This stipulation gives rise to differences, which are sometimes considerable, between the funds which are payable or "transferable" in a given year and the funds actually granted, since these parameters fluctuate considerably from one year to another. The retrospective analysis carried out in this section considers the revenue due to each body and is based on the parameters for the current year.

2.2.1 The definitive regime

From 2000 onwards the total of the shares of revenue from personal income tax allocated to the Regions on the one hand and the Communities on the other corresponds to the funds transferred during the previous year[8] - except the solidarity intervention - adjusted in accordance with the change in the average consumer price index, and real growth in the gross national product for the year.[9] The distribution between the three Regions or the two Communities of the total obtained in this way is in proportion with their contribution in relation to the total revenue from personal income tax. The Region or Regions in which the amount of tax per inhabitant is lower than the national average also receive(s) the solidarity intervention, which is the product of 468 BEF at 1990 prices - indexed on

[8] I.e., in 2000, the funds granted to each of the federated bodies at the end of the transitional period.

[9] According to the Law of 16 July 1993; initially the Law of 1989 linked the adaptation to the level of *nominal GNP growth*.

the basis of the average consumer price index - multiplied by the number of inhabitants.

The total of the share of VAT revenue to be transferred to the Communities is calculated in the same way as during the transitional period (see below). Its distribution has, however, been adapted "since the 1999 budgetary year, in accordance with the number of pupils, based on the objective criteria determined by law" (art. 39 §2 of the Law of 1989)[10].

2.2.2 The transitional period

The essential aim of these 10 “intermediate” years from 1989 to 1999 was to organise *in a progressive way* the redistribution of funds between each of the entities to arrive at the application of the definitive rules defined above. The Law of 1989, however, also aimed to reconcile the extension of the powers of the federated bodies with the desire to preserve the consolidation of all the country’s public finances.

Though, the mechanisms that were put in place gave rise to an increase in the funds available to the Communities and Regions of 0.8% of GDP between 1989 and 1999, which was actually due to a significantly larger increase in the shares of P.I.T., 1.5% of GDP, and a fall in the share of VAT, by 0.7% of GDP (cf. figure 1). In other words, the real average annual rate of growth in terms of the amount of funds transferred was 2.9% for 10 years or, taking into account the fall in 1990, 3.4% for 9 years, of which 6.5% for the share of P.I.T. and 0% for the share of VAT. Without going into detail on the technical aspects of the financing laws, which are extremely complex, we will try to ascertain the origins of this considerable growth.

Shares of VAT allocated to the Communities

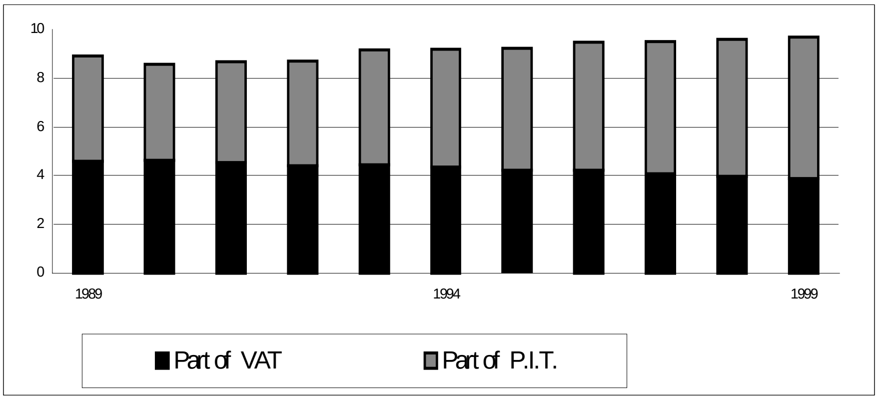
The Law of 1989 states the value of the amounts to be transferred to each Community in 1989 and then stipulates that their development will be adjusted in line with the retail price index from 1990 onwards. These theoretical amounts, however (which are also called base amounts) were first reduced by 3.6% in 1989 and then, subsequently and for an indefinite

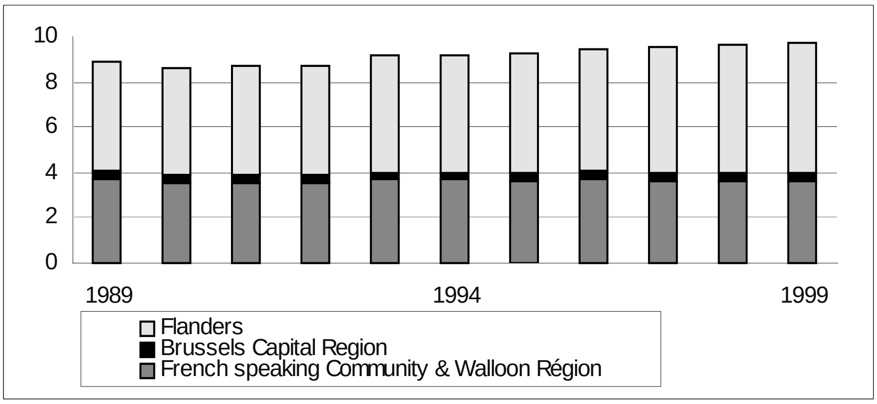
[10] The precise modalities governing the definition of this new distribution ratio were defined in the Law of 23 May 2000 and were only applied from the 2000 budgetary year.

Figure 1

Transitional period: shares of tax due to the Communities and the Regions

(percentage of GDP)





period (even beyond the transitional period), they are corrected by an adjustment factor which reflects the assumed change in the school population. This corrective factor has always been slightly lower than one. The change in the shares of VAT transferred, which we should remember are intended to finance the powers transferred in the area of education, have therefore tended to be limited to the growth in inflation, which accounts for their significant fall as a percentage of GDP. *The law therefore initially obliged the Communities to take drastic consolidation measures or to resort to borrowing*, even if only to finance recurring expenditure on wages and teachers' salaries.

Shares of personal income tax allocated to the Regions and the Communities

As in the case of shares of VAT, the value of the amounts to be transferred to each Region and each Community in 1989 are stated explicitly in the law, which also stipulates that their development, from 1990 onwards, is in line with the retail price index. For 20% of these basic amounts, however, the payment is transferred to the following years in the form of perpetual annuities (including capital and interest) spread over a period of 9 to 10 years. In this way the law therefore also imposed an *obligation to borrow* on the federated bodies, but this was essentially a situation of *preliminary financing* to the extent that the swelling of annuities over the years quickly reduced the theoretical level of “forced” borrowing (from 20% in 1990 to 11% in 1994 and 0% in 1998). This mechanism, like the one put in place for shares of VAT, expresses the Government’s desire to make the federated bodies take part in the consolidation of public finances in the country. The application of this mechanism alone would have reduced the share of P.I.T. in 1999 virtually to their 1989 level as a percentage of GDP, after the fall at the beginning of the period.

However, the progressive distribution of funds between the bodies in order to reach the new distribution ratios in 1999, gave rise to an increase in the total amount of tax transferred of 1.0% of GDP over 10 years. Indeed, for the regional or Community powers that already existed before the Law of 1989[11], the legislature wanted to prevent the situation where another body (the one whose funds were previously proportionally higher than its contribution to national P.I.T.) would have less funds than before the law came into force. Reconciliation of this concern with the progressive application of the new distribution ratios required a progressive increase in the total amount of funds financing the existing powers.

Finally, in view of the financial difficulties encountered by the federated bodies (particularly the Communities) during the first few years, the Law of 16 July 1993 increased the funds to be transferred[12]. The shares of P.I.T. allocated to the Communities were increased by 4.5 billion in 1993. Then, from 1994 onwards, the rate of growth in all the funds coming

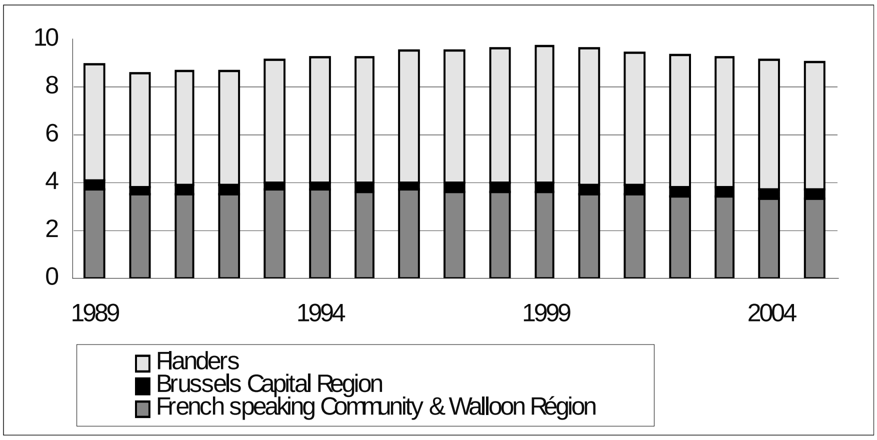
[11] And for the funds of the municipalities, but excluding other new powers (e.g. teaching).

[12] Beyond the cost of the new powers transferred (agriculture and missions for the Province of Brabant).

from P.I.T., both in favour of the Regions and the Communities, was progressively adapted in line with the growth in GNP at constant prices. Following this, the shares of P.I.T. transferred increased by a further 0.4% of GDP between 1993 and 1999.

Figure 2

Share of taxes to be transferred until 2005
(percentage of GDP)



Differentiated development for each body

These overall developments do, of course, cover different situations in each body.

The increase of 0.8% of GDP in the share of tax allocated to the Communities and the Regions as referred to above is located solely in Flanders (Community and Region), with the funds allocated to the French Community and the Walloon Region falling by 0.1% of GDP and those of the Brussels Capital Region remaining virtually unchanged[13]. Between 1989 and 1999 the average annual rate of growth in resources due was 3.7% for Flanders, 1.8% for the bodies in the South of the country and 3.0% for the Brussels Capital Region.

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[13] Rise of 0.76% in GDP in total, of which 0.83 for Flanders, 0.03 for Brussels and a fall of 0.10 for the bodies in the South of the country.

2.2.3 Contrast between the transitional period and the definitive period

The mechanisms set out in the Financing Act indicate a change in 2000. The rate of real growth in funds to be transferred to the federated bodies actually becomes significantly lower in the definitive regime than it was during the transitional period. As an illustration, assuming an average GNP growth rate of 2.6% per year at constant prices[14], they would fall by 0.6% of GDP between 1999 and 2005 following an average real growth rate of 1.5% per year, which is clearly lower than the rate during the previous 10 years (2.9%). The reduction would be even greater for Flanders: 1.6% instead of 3.7% previously.

3. Control mechanisms set out in the Laws of 1989 and 1993

Although the law gives financial autonomy to the Communities and Regions, while extending the resources and powers delegated to the federated bodies it has at the same time imposed a number of stipulations intended to safeguard the economic and monetary union of the country, price stability and the consolidation of public finances as a whole. These are mainly compulsory co-ordination mechanisms between levels of power and the creation of a body for the “monitoring” of financing needs.

3.1 Controls in relation to fiscal flexibility

The Regions can levy additional centimes or grant reductions on personal income tax. The law does, however, state that prior consultation is required between the Federal Government and the Executives of the Regions. Furthermore, a maximum percentage can be fixed if necessary by Royal Decree (Art. 9 of the Law of 1989). None of the Regions have made use of this opportunity during the transitional period, but this aspect of financing legislation is being highlighted at present because the extension of the fiscal autonomy of the Regions is an important focus of the new special draft law for 2001².

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14 Cf. “Perspectives Economiques 2000-2005”, Federal Planning Bureau, April 2000.

3.2 Controls in relation to borrowing arrangements

Both the Regions and the Communities are able to issue debt on their own account or for the public interest bodies that depend on them. They must, however, submit the conditions and the calendar for possible public debt in Belgian Francs for approval by the Minister of Finance. This approval is also necessary for debt issued outside Belgium. In the case of private loans, on the other hand, the federated authorities are only obliged to inform the Minister of Finance.

3.3 Controls in relation to the amount of debt

We have seen that the mechanisms of the Financing Act already required the federated bodies to borrow funds, particularly during the first few years, even in the event of zero growth in their expenditure in real terms. On the other hand, the law does not impose any direct constraints on the growth and actual nature of their expenditure. Taking into account the revenue allocated by the law, the actual level of the deficit and the debt owed by each body is the result of its own budgetary policy, and each one assumes its own financial responsibility.

In order to remove any excess, however, the legislature has nevertheless decided to set up a Council of "the wise" to carry out a monitoring role and to make recommendations. It has created a *"Financing needs of public authorities" section* within the Higher Finance Council (C.S.F.). This section issues a report each year on the financing requirement of the public authorities; it can issue an opinion on the opportunity of limiting the borrowing capacity of a public authority, at the initiative or at the request of the Minister of Finance. Where applicable, such a limitation may be imposed by a Royal Decree for a maximum of two years (Art. 49 art. 6 and 7 of the Law of 1989).

In order to fulfil its mission, the section has made efforts to define, for each year since 1989, "intermediate" norms for the rate of growth in spending and deficits for each public authority, not only for each of the Communities and Regions, but also for the Federal government and Social Security authorities. These norms were dictated from the beginning by the fundamental aim of reducing the levels of indebtedness in the long term for all public administrations and eliminating any snowball effect. This aim was supplemented over the years by the need for Belgium to meet the budgetary criteria of the Maastricht Treaty, and then the Stability and

Growth Programme of the European Union. Clearly they have been adapted each year in accordance with the economic context and the budgetary achievements of the previous year.

4. The norms defined by the Higher Finance Council for each of the Communities and Regions

4.1 During the transitional period

The Higher Finance Council (C.S.F.) has been aware of the different ways in which the funding of the federated bodies was developing before and after the year 2000 as a result of the Financing Act (more or less pronounced depending on the case, see above), and has wished to preserve their long-term budgetary autonomy. It has therefore taken as its objective the stabilisation of the level of indebtedness15 of each federated body at the beginning of the definitive phase, i.e. in 2000. It then worked out, for each body, the real growth rate in primary expenditure which, when applied every year, allows each of these bodies to reach this target without any major leaps. This norm, used in accordance with a criterion of "neutrality between periods" was intended to avoid the series of possible budgetary slippages followed by drastic restrictions and the appearance of the snowball effect. This growth rate is clearly different for each body in accordance with its initial level of indebtedness and the growth in its revenue during the transitional period, and it is updated each year in accordance with the real results from the previous years. The deficit recommended by the section for each federated body, year after year, therefore follows on from these parameters. Following the reform of 1993, which further accentuated the difference between the growth of revenue before and after 2000, particularly in Flanders, the section, with the agreement of this Community, has extended the horizon established for stabilising its level of indebtedness to 2010 instead of 2000. This has the effect, as compared with the other solution, of reducing the recommended average rate of growth in expenditure but it avoids a sudden drop in 2000.

We should point out that the recommendations of the CSF relate to parameters which are close to the budgetary data (corrected primary expenditure and maximum admissible deficits) and do not refer to concepts from the national accounts. In fact these do not exist analysed by

[15] Defined with reference to revenue, in the absence of precise regional and community GDP figures.

Community or by Region. The national accounts only (since 1995) provide a consolidated account of the operations of all the Communities and Regions.

4.2 From 2001…until 2010

In its annual report in June 1999, the Higher Finance Council updated the norms in relation to the Communities and the Regions, taking into account on the one hand the new context of national budgetary policy following Belgium's participation in European Economic and Monetary Union and, on the other hand, the respective financial situation of the federated bodies in 2000. At the end of the transitional period the discounted budgetary balance for all the Communities and Regions is zero, but it actually covers contrasting situations; the maximum admissible balances recommended by the CSF for 2000 are negative for the Walloon Region (-6.2 billion), the French Community (-4.6 billion) and the Brussels Capital Region (-2.7 billion) but there is a large surplus for Flanders (+14.4 billion).

For each of the Bodies with a deficit, the Higher Finance Council is maintaining the budgetary objective of achieving budgetary equilibrium in 2010 at the latest, along with a constant reduction in their level of indebtedness. As in the past, it works from this target to obtain a "constant" growth rate for primary expenditure between 2001 and 2010 and then a recommended development for the deficit.

For Flanders, whose budgetary equilibrium has been exceeded by a wide margin since 2000, the Higher Finance Council considers it desirable that it should keep its budget at least structurally in balance. Nevertheless it stresses that, continuing to draw inspiration from the scenario seen during the transitional period (which implies a stabilisation in levels of indebtedness in 2010, albeit at a lower level than in 2000), Flanders should reduce its surplus more gradually to reach equilibrium in 2010 and would therefore make a greater contribution towards reducing the national level of public indebtedness.

In parallel with this, in the context of the political demands for national budgetary stability, the Higher Finance Council recommends that each federated body should work out an internal multiannual Stability Programme, for a period at least covering the period of Belgium's Stability Programme, and considers it desirable that the National Accounts Institute

(Institut des Comptes Nationaux) should draw up individual public accounts for each Region and Community.

II. The European fiscal rules and their application in Belgium

1. Fiscal criteria in the Maastricht Treaty (7 February 1992)

The budgetary convergence criteria set out in the Treaty on European Union cover, on the one hand, the level of the deficit as a percentage of GDP (defined in the terms used by the ESA, the European System of Integrated Accounts, i.e. excluding loans granted and participating interests) and on the other, the level of indebtedness. These two criteria apply to all public administrations. In order for a country to be able to become a member of Economic and Monetary Union (E.M.U.), its deficit must be equal to or less than 3% of GDP or must in any case be approaching this reference value, having fallen substantially and consistently. Its level of indebtedness must be less than or equal to 60 percent or must have been reduced sufficiently and must be approaching the reference value at a satisfactory rate. The cut-off date was originally scheduled for the end of 1996, but it was postponed to the end of 1997, while the Ecofin Council decided that the third phase of construction of Monetary Union would begin on 1 January 1999.

2. Budgetary targets of the Pact for Stability and Growth (Amsterdam, 17 June 1997)

The (future) Member States of E.M.U. undertake, from 1999 and for the whole duration of their membership, to avoid excessive deficits (higher than 3% of GDP) and to respect the medium-term objective of maintaining a healthy budgetary position, close to equilibrium or with a surplus, which allows them to face normal fluctuations in the economic climate while keeping the deficit within the limits of the reference value. They have set out their medium-term objectives and their interim annual objectives in a programme of convergence and undertake to take corrective action whenever they have information indicating significant slippage, either actual or forecast, against these targets. Apart from the preventative measures issuing warnings where there is a risk of slippage, financial sanctions are also stipulated (deposit to the Commission without interest, not reimbursed if no correction takes place after 2 years).

Both the Maastricht Treaty and the Stability Pact recognise only one interlocutor for each country, namely the central government, even if the objectives apply to the whole of the public finances, and hence all the public authorities in a country. They therefore impose an obligation on each Member State to organise the efforts between its various levels of authority.

3. *Application of European budgetary norms in Belgium*

The budgetary criteria imposed by Europe for access to Monetary Union have only reinforced the policy of consolidation of public finances which Belgium has imposed upon itself since 1982. The Belgian Government has therefore subscribed to the target of a 3% deficit in 1996, since this criterion also prevented the risk of restarting the snowball effect even in unfavourable economic circumstances, made it possible to create room for manoeuvre in the medium term and, in the long term, to ensure financing for the expenditure caused by demographic ageing by accelerating the process of reducing indebtedness.

a. *The first Belgian convergence plan*, submitted in *June 1992*, describes the way in which the Government was expecting to achieve this objective. First of all it decided to set up a major emergency programme that same year (measures amounting to 135 billion) to achieve an overall deficit of 5.7% of GNP in 1992, i.e. a primary surplus of 5.1% of GNP, since the interest burden amounted to 10.8% of GNP. Starting from here, the convergence plan defined a normative linear path to reach a deficit of 3% in 1996, consisting of a primary surplus of 7%, with interest charges reduced to 10% of GDP. Sharing of the consolidation effort between different levels of authority is also mentioned, but the plan does not impose any additional effort on the federated bodies beyond compliance with the norms recommended to them by the C.S.F. (see section I.4. above) which should improve their primary balance by 0.6% of GNP between 1992 and 1996. Due to the constraint caused by the need to stabilise the financial balance for local authorities, the remainder of the improvement in the global primary surplus, namely 1.3% of GNP in four years, is the responsibility of Social Security and the Federal authorities.

   Three norms have been defined in order to achieve this ambitious aim:

   - unitary elasticity of fiscal revenue as a proportion of GDP,

- zero growth in real terms in overall primary expenditure by the federal authorities, with a particularly strict norm for stabilisation in nominal terms of the national defence budget, transfers to Social Security and ongoing subsidies to public enterprises,

- financial equilibrium in social security which, in view of the non-indexation of the federal contribution, allows average maximum growth in expenditure in real terms of 1.6 percent.

The plan also gives a new mission to the "Financing requirement" section of the Higher Finance Council: to issue an opinion each year on the implementation of the convergence plan and, in the event of slippage, to estimate the corrections that need to be made.

b. From *April 1993* onwards, the Government had to *update the convergence plan* because, instead of the deficit of 5.7% of GNP scheduled for 1992, it was necessary to cope with a net financing requirement of 6.9% of GDP, broken down into 11.2% of interest charges and only 4.3% of primary surplus. This deterioration was partly (0.4%) due to statistical updates (utilisation of the GDP as defined by the ESA, in accordance with the norms of the Maastricht Treaty as a denominator) but above all due to a less good economic climate than forecast (0.6%) and a rise in interest rates (0.2%). Reformulation of the intermediate targets for the years from 1993 to 1996 also had to take into account the major deterioration of the GDP forecasts for 1993 (GDP growth of only 0.5%[16]). Hence, while maintaining the same norms as before, the Government has implemented a series of supplementary measures, mostly structural, for a total of 110 billion, during the budgetary control process in spring 1993. A new series of measures, the Global Plan, was then decided upon at the end of 1993, taking effect from 1994 onwards.

c. *Belgium's new convergence programme*, which was submitted on *19 December 1996*, covered the year 1997 since the budgetary convergence targets had in fact been postponed by one year by the European authorities. It also defined the new budgetary norms for the years from 1998 to 2000. Regular monitoring of actual figures and corrective measures taken each year since 1993 had made it possible to reduce the deficit to 3.4% of GDP in 1996, which is slightly below the target. The Government took a further series of measures covering 80

[16] Which ultimately turned out to be negative: -1.5%.

billion to reach a deficit of 2.9% in 1997, including 5.8% of primary surplus and 8.6% of interest charges.

For the following years the Government defined *new budgetary norms*, taking into account, on the one hand, the conclusions of the European Summit in Dublin in relation to the future Stability Pact concerning a structural budgetary balance close to equilibrium in the medium term and also the situation in the Belgian public finances, which was characterised by a very high level of indebtedness and also by a primary surplus significantly higher than in the other European countries.

- For the *Federal authorities and Social Security* (Entity I), the Government undertakes to *stabilise the primary surplus at the* - high - *level forecast for 1997* (5.3% of GDP) between 1998 and 2000. This new norm, which is less strict than the preceding ones to the extent that it allows growth in primary expenditure equal to the growth in nominal GDP (with revenue at an unchanged proportion of GDP), but still guarantees the continuation of the process of reducing indebtedness to the extent that any potential reduction in interest charges as a percentage of GDP will be allocated to the reduction of the deficit. In order to deal with the fluctuations in the economic climate, the new convergence programme also stipulates that this primary surplus from Entity I *may increase if GDP growth is higher than its structural evolution but up to a maximum of 5.7% of GDP*[17]. Three economic scenarios were marked out for the years from 1998 to 2000. As a result, the application of this norm would give rise to a net financing requirement (BNF) for all public administrations of between 1.1% and 1.6% of GDP in 2000.

- For the Communities and the Regions, the previous targets continued to be applicable: compliance by all of them with the specific norms recommended by the Higher Finance Council, should reduce their net financing requirement to equilibrium from 1999 onwards.

- The local authorities are obliged to respect the equilibrium rule in their ordinary budgets.

[17] By applying economic bonus rules defined by the "financing requirement" section of the CSF, according to which the primary surplus norm for Entity I should increase by half the difference between real GDP growth and 2% (which is presumed to be the potential growth) to "neutralise" the effect of growth.

d. The *Stability programme 1999-2002 for Belgium* was filed *on 18 December 1998*. The budgetary results for 1997 and 1998 (with a net financing requirement of 1.9% of GDP in 1997 instead of 3 percent) actually allowed Belgium to become one of the first 11 member countries of EMU. Belgium has therefore committed itself "definitively" to "comply with a budgetary position close to equilibrium or in surplus in order to allow the automatic stabilisers to operate during periods of economic slow-down and to guarantee the sustainability of its public finances on a lasting basis".

   The norms that are selected correspond to those in the last convergence plan, the target of a primary surplus of 6% of GDP for all public administrations (of which 5.3% for Entity I) becoming the new anchoring-point for budgetary policy. The stability programme also adapts the rule concerning the use of economic bonuses. Considering that the GDP growth trend for Belgium is 2.3 percent from 2000, the Government stipulates that the spontaneous rise in the primary surplus resulting from a rise in GDP above this level must be allocated partly to reducing the deficit (i.e. at a rate of at least one-third if the expected growth is from 2.3 to 2.7%, or in full if the growth is higher than 2.7 percent).

e. The *Stability Programme for 2000-2003,* submitted *on 23 December 1999* confirms the norm for stabilisation of the primary surplus at about 6% given a neutral economic climate and supplements it by the desire to reach equilibrium in the financing balance in 2002 in a "prudent" macroeconomic context (2.5% of GDP growth on average) and a limited surplus (0.2% of GDP) in 2003. It stipulates the contribution expected from authorities on different levels.

   - While respecting the new norms defined by the "Financing Requirement" section of the Higher Finance Council (see section I.4.b), the financial balance of the Communities and Regions must be in balance from 2000 to 2003 and their primary surplus must be stabilised around 0.4% of GDP.

- The accounts of local authorities must have a balance which is slightly in surplus (0.15% of GDP)[18] in 2000 and 2001, and it must subsequently be at equilibrium.

- The net financing requirement of Entity I will be brought to equilibrium in 2002 and a surplus in 2003, thanks to the fall in interest charges and the increase in the primary balance.

III. The consolidation of public finances during the 1990s

The historical data on public finances used in this section come from the latest annual accounts published in 2000. The methodology used to work out the national accounts has been changed significantly due to the new accounting rules introduced by EUROSTAT, the statistics bureau of the European Communities. Belgium has been applying the ESA95 rules since 1999 and the components making up the public accounts have been altered with retroactive effect.

The four levels of public authority defined in the national accounts (federal authority, social security, federated bodies and local authorities) are arranged into two groups below: Entity I, on the one hand, which consolidates the accounts of the federal and Social Security authorities, and Entity II, which consolidates brings together the operations of the Regions and Communities and those of the local authorities. Apart from the benefit of simplification, this presentation is justified in Belgium on the basis of the close financial and even decision-making relationships linking together the individual parts of each of these two Entities.

After a brief comparison between the results of public finances achieved by Belgium between 1992 and 1996/1997 and the targets from the successive convergence plans, we will look more specifically at the relative contribution from the various levels of power towards the improvement of public finances between 1991 and 1999. Initially, the following graphs will make it possible to situate the Belgian public finances over the last decade in the context of its evolution during the past 30 years.

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[18] For more than 20 years a fall has been observed in investment by local authorities after the municipal elections, which most recently took place in 2000.

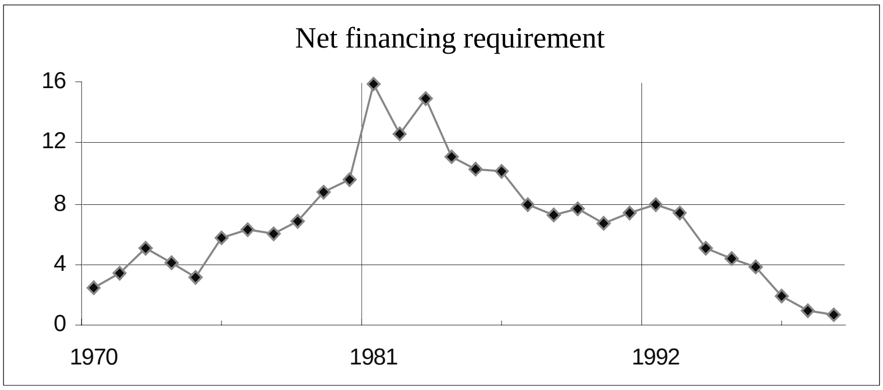
1. *Norms in convergence plans and realisation of the "Maastricht target"*

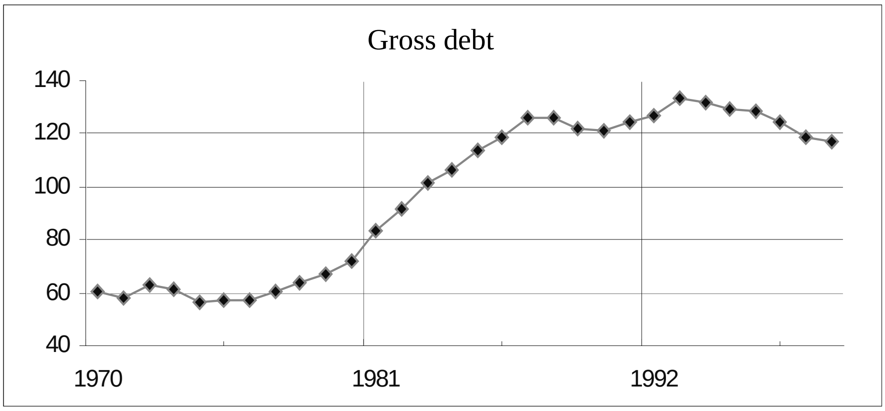
According to the latest annual accounts, the net financing requirement of the public authorities is valued at 8% of GDP in 1992 (instead of 7% of GDP according to the data set out in ESA79, the point of departure for the convergence plan updated in 1993), 3.8% in 1996 and 1.9% in 1997. This reduction by 4.2% of GDP between 1992 and 1996 was achieved thanks to the improvement in the primary surplus of 1.9% of GDP and also by the fall in the interest charge by 2.3% of GDP.

Figure 3

Synthetic overview of Belgian public finances from 1970 to 1999

(percentage of GDP)





As shown by Table 1 below, the contribution of the fall in interest charges to the consolidation was 0.5% of GDP more than what was forecast in the scenario of the convergence plan updated in 1993, mainly thanks to the significant fall in market interest rates from 1992 onwards. The improvement in the primary balance, on the other hand, is 0.3% of GDP less than the target. It is also the result of very different developments in the constituent parts. With an average annual growth rate of 1.7% at constant prices, the share of GDP accounted for by primary expenditure has therefore increased by 0.8% while, according to the first convergence plan, it was expected to fall by 1.9% of GDP, with a real average growth rate of 1.25%. Revenue, on the other hand, increased significantly, by 2.7% of GDP. These divergencies can be accounted for largely by the decline in economic growth in comparison with the expectations that were prevalent when the convergence plans were drawn up (cf. table 2). Average annual GDP growth at constant prices was only 1.3% between 1992 and 1996, instead of the 2.5% expected in the 1992 plan and 1.9% in the updated 1993 plan. The GDP deflator was also found to be lower than internal inflation, following a deterioration in the terms of trade. In order to reach the target imposed by the Maastricht Treaty, the Government had to resort to a number of measures, particularly tax increases. The elasticity ex post of tax revenue actually reached 1.85 between 1992 and 1996 (4.0 for the single year 1993).

Table 1 also shows that, at the end of the improvement in the net financing requirement (BNF), each of the Entities exceeded the targets in the Convergence Plan, and this was a result of the lowering of interest charges for Entity I and an improved primary balance for Entity II.

2. Contribution of the levels of authority towards the consolidation during the 1990s

The analysis covers the evolution of public finances between 1991 and 1999. In view of the staggering of the transfer of resources relating to investment to the Regions from 1989 to 1991 and the statistical problems inherent in setting up new relationships between the federal authority and the federated bodies, it is actually preferable, in a study focusing on the contribution from authorities at different levels towards the evolution of public finances, to eliminate the first three years of the institutional reform from the scope of the analysis.

Table 1

Actual consolidation and targets in convergence plans

	Variations			
	1992-1996			1992-1997
	Convergence plans		Observed	Observed
	From 1992	From 1993		
Revenue	0.0	N/a	2.7	3.1
Primary expenditure	-1.9	N/a	0.8	0.1
Primary balance	1.9	2.2	1.9	2.9
- Entity I	1.3	N/a	1.1	2.0
- Entity II	0.6	N/a	0.8	0.9
Interest charges	-0.8	-1.7	-2.3	-3.1
Net financing requirement	2.7	3.9	4.2	6.1
- Entity I	2.2	3.4	3.5	5.1
- Entity II	0.5	0.5	0.7	1.0

Table 2

Macro-economic developments observed and hypotheses for convergence plans

	Average growth rates - variations			
	1993-1996			1993-1997
	Convergence plans		Observed	Observed
	From 1992	From 1993		
GDP (GNP in Plan 92)	5.8	5.0	3.4	3.7
Volume	2.5	1.9	1.3	1.7
Deflator	3.2	3.1	2.1	2.0
Inflation	3.2	3.1	2.2	2.1
Implicit interest rate (change)	-0.3	-0.8	-2.1	-2.4

Over the whole period under consideration, the improvement in the overall balance of public finances (6.7% of GDP) mainly comes from Entity I (5.7% of GDP), primarily thanks to the fall in interest charges (by 4.1% of GDP), 4.0% of which at the level of Entity I). Since the vast majority of Belgian public debt is owed by the federal authorities, it is this level that benefits (or suffers) from fluctuations in interest rates. The fall in interest rates seen during the 1990s has therefore benefited Entity I, particularly since it has been accompanied by modernisation in the methods of debt management used by the federal administration. Even though the change in interest charges also reflects the rationalisation of the individual Entities (indirectly, through public debt), their respective contributions towards the consolidation of public finances are mainly perceived through their participation in improving the primary surplus.

The increase by 2.6% of GDP in the primary balance between 1991 and 1999 comes 1.7% from Entity 1 and 0.9% from Entity II. Overall it gives rise to an increase in revenue of 2.9% of GDP, while primary expenditure rose by only 0.3% of GDP but the contribution from these components to the primary balance for each Entity is fundamentally divergent. Entity I reduced its expenditure by 0.7% of GDP and its revenues increased by only 1.0% of GDP; on the other hand expenditure by Entity II increased by 1% of GDP, but its revenue increased even more, by 1.9% of GDP.

2.1 Revenue

The increase in revenue for all public administrations amounting to 2.9% of GDP is lower than the sharp increase in fiscal revenue (3.6%) as a result of the reduction of Social Security contributions and other revenues (-0.4% each). The reduction in non-fiscal or parafiscal revenues, which consist mainly of real estate revenues, are linked to their very nature: indeed, except in the case of exceptional revenues, they tend to increase more slowly than GDP. On the other hand the reduction in contributions as a percentage of GDP mainly comes from cuts implemented by the Government since 1994 (the Global plan) to create jobs and encourage business competitiveness. Other Government measures - in the opposite direction - have also contributed towards the sustained increase in fiscal revenue. Due to the very unfavourable economic context during the first few years of the Convergence Plan, achieving the budgetary target set out in the Maastricht Treaty required many fiscal adjustments such as the

Table 3

Evolution of the public finances for each Entity from 1991 to 1999 (*)

	Level as % of GDP						Change as % of GDP			Growth rate		
	1991			1999			1999-1991			Real annual average		
	Total	Ent.I	Ent.II	Total	Ent.I	Ent.II	Total	Ent.I	Ent.II	Total	Ent.I	Ent.II
1. Net financing requirement (-) or contribution (+)	-7.4	-6.8	-0.6	-0.7	-1.1	0.4	6.7	5.7	1.0			
2. Interest charges	11.3	10.6	0.7	7.2	6.5	0.6	-4.1	-4.0	-0.1	-3.6	-3.9	0.4
3. Primary balance	4.0	3.8	0.1	6.5	5.5	1.0	2.6	1.7	0.9			
External (A-B)	4.0	4.3	-0.4	6.5	6.0	0.5	2.6	1.7	0.9			
Balance of internal transfers (A'-B')	-	-0.5	0.5	-	-0.5	0.5	-	0.0	0.0			
A. External revenue	44.0	31.9	12.1	46.9	32.8	14.0	2.9	1.0	1.9	2.9	2.4	4.0
1. Fiscal	27.4	15.9	11.5	30.9	17.7	13.3	3.6	1.7	1.8	3.6	3.4	4.0
2. Parafiscal	14.9	14.9	0.1	14.5	14.5	0.0	-0.4	-0.4	0.0	1.7	1.7	
3. Other external revenues	1.7	1.1	0.6	1.4	0.7	0.7	-0.3	-0.4	0.1	-0.1	-3.5	4.5
A'. Transfers rec'd from the other Entity	-	0.2	0.7	-	0.1	0.6	-	-0.1	-0.1	-	-4.9	0.4
A". Total revenues by Entity	-	32.1	12.8	-	32.9	14.6	-	0.9	1.8	-	2.4	3.8
B. Primary final expenditure	40.0	27.6	12.5	40.3	26.9	13.5	0.3	-0.7	1.0	2.2	1.7	3.1
Non-discretionary	*2.2*	*2.2*	-	*2.4*	*2.4*	-	*0.2*	*0.2*	-	*3.1*	*3.1*	-
1. Unemployment benefits	2.1	2.1	-	1.9	1.9	-	-0.2	-0.2	-	1.1	1.1	-
2. GNP contribution to the EU	0.1	0.1	-	0.5	0.5	-	0.3	0.3	-	19.3	19.3	-
Discretionary	*37.8*	*25.4*	*12.5*	*37.9*	*24.5*	*13.5*	*0.1*	*-0.9*	*1.0*	*2.1*	*1.6*	*3.1*
1. Investments by local authorities	0.7	-	0.7	0.9	-	0.9	0.2	-	0.2	5.1	-	5.1
2. State pensions	1.6	1.4	0.1	1.7	1.6	0.1	0.2	0.2	0.0	3.4	3.5	2.5
3. Other	35.6	23.9	11.6	35.3	22.9	12.4	-0.3	-1.1	0.8	2.0	1.5	2.9
B'Transfers to the other Entity	-	0.7	0.2	-	0.6	0.1	-	-0.1	-0.1	-	0.4	-4.9
B"Total primary expenditure by sector	-	28.3	12.7	-	27.5	13.6	-	-0.8	0.9	-	1.7	3.0

(*) Interest charges, like real-estate income, are net of interest paid between different public administrations. The taxes allocated to the European Union are not included. Capital disposals are included in revenue, but sales of goods and services are still under operating costs (<0). Pensions from Entity II which are payable by the federal authorities are treated as final expenditure for Entity I: in relation to the national accounts, they are therefore taken from transfers from Entity I to Entity II and final expenditure by Entity II.

increase in indirect tax rates, the suspension of the indexation of personal income tax scales or the introduction of new taxes: the supplementary crisis contribution and the special social security contribution. The elasticity of total fiscal revenue therefore reached 1.4% between 1991 and 1999, of which 1.6 from 91 to 93, 1.4 from 94 to 97 and 1.2 from 98 to 99[19].

From 1991 to 1999, the revenues of Entity I increased by 1.0% of GDP and the revenues of Entity II increased by 1.9%. This distribution, which was unfavourable to Entity I, is mainly due to the fact that it alone has borne the cut in contributions and the fall in non-fiscal and parafiscal revenues. The change in its fiscal revenue, however, (1.7% of GDP) is also lower than the change in Entity II (1.8% of GDP).

- Of the change in the fiscal revenue of Entity II, 0.3% comes from local authority taxes. These mainly consist of surcharges (on personal income tax and real estate withholding tax) and they have benefited indirectly from tax-raising measures in these areas. The fiscal revenue of the Communities and the Regions has increased by 1.5% of GDP. This consists of 1.1% of GDP for the share of P.I.T. (1.7%) and VAT (-0.7%) allocated to them and 0.2% of GDP for regional taxes (basically the net radio and TV license fee and registration duties). It is also necessary to stress the increase in their own fiscal revenue (not circumscribed by the Financing Act) of 0.2% of GDP (which corresponds to an average annual growth rate of 22.6% at constant prices). The federated bodies themselves have also implemented a discretionary increase in taxes.

- The fiscal revenue of Entity I consists of the difference between the taxes which it levies and what is allocated to Entity II in accordance with the law. By defining a very high rate of growth for fiscal revenue transferred to the Communities and the Regions until 1999 and only creating a very tenuous link between this process and economic activity (cf. section I), the 1989 institutional reform obliged Entity I on its own to deal with the effects (both negative and positive) of the

[19] The table in the appendix breaks down the variations and the average growth rates in table 3 into three sub-periods: 1992-1993, 1994-1997 and 1998-1999. Between 1991 and 1993 the average annual GDP growth rate was zero due to the economic crisis in 1993, but it was 2.5% and 2.6% during the following sub-periods. It was from 1994 onwards that the special law of July 1993 had an effect on the resources available to the Communities and Regions. And 1998 and 1999 benefited from the meeting of the "Maastricht" target in 1997. It should also be noted that the first and last sub-period identified here were two years prior to municipal elections (in 1994 and 2000).

economic climate on fiscal revenue and to carry out the consolidation that is necessary in order to achieve the Maastricht targets. We should also state that within Entity I, the change in fiscal revenue amounted to 1.9% of GDP for social security, but it was negative (-0.1% of GDP) for the federal authorities, mainly due to the increase in alternative financing of Social Security (1.4% of GDP between 1991 and 1999), which is intended to compensate for reductions in social security contributions.

2.2 Primary expenditure

In order to compare the behaviour of the two Entities in terms of primary expenditure, it is necessary to "eliminate" expenses over which the authorities have little or no decision-making power. From this point of view, two categories of expenditure which are payable by Entity I can be identified from table 3: unemployment benefits and also the GNP contribution towards the financing of the European Union: the change in these is mainly[20] the result of economic activity, either through the change in the unemployment rate or on the basis of the calculation rules defined by the European Union. Between 1991 and 1999, unemployment expenditure fell by 0.2% of GDP (in fact from 1994 onwards, after a significant rise from 1991 to 1993, cf. table in the appendix) and the GNP contribution towards the financing of the EU rose by 0.3% of GDP. Without these two elements, "discretionary" primary expenditure rose by only 0.1% of GDP overall, with a change in opposite directions in the two Entities: a fall of 0.9% in Entity I and a rise of 1% of GDP in Entity II.

Amongst the items of discretionary expenditure which are not influenced by economic activity, it is useful to pick out two components that might bias the analysis of the possible impact of State reform on the evolution of expenditure: these are investment by local authorities and state pensions. Investment by local authorities has developed in a rather specific cyclical way for many years in the sense that is linked to the cycle of local elections. In the period under review, the 0.2% rise in these investments was due to the fact that the previous year (1999) was the year before an electoral year, while 1991 fell between two election years. (see also table in the appendix). As for State pensions, they are paid by the federal

[20] Although unemployment benefits have also been the object of specific restrictive measures; for a very detailed analysis of the discretionary and non-discretionary aspects on expenditure due to under-employment (and on all elements of the primary balance) cf. Savage R. (2000).

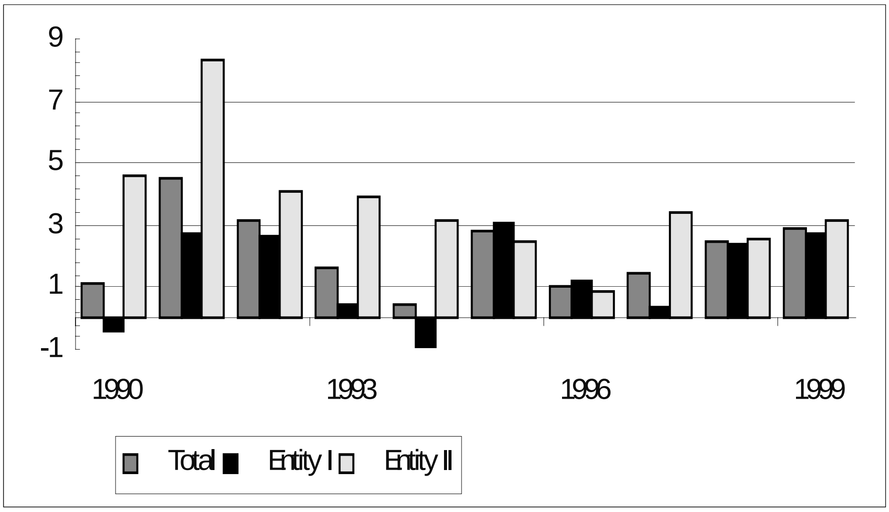
authorities alone (apart from a minimum share, 0.1% of GDP, which is payable by local authorities) while they also, and even as a majority, involve those who have worked for the federated bodies[21] or for the local authorities (subsidised education). The increase in these is also 0.2% of GDP.

Apart from these factors, it is clear from table 3 that primary expenditure by Entity I fell by 1.1% of GDP over eight years, while expenditure by Entity II rose by 0.8%. The real average growth rate has been 1.5% for Entity I and 2.9% for Entity II.

Figure 4

Annual evolution of expenditure for each Entity from 1990 to 1999

Rate of growth in discretionary expenditure at constant prices (line B.3 in table 3)



[21] In order to prevent an "excessively" generous policy on the part of the federated bodies in terms of wages having a damaging effect on the federal budget once their civil servants reach retirement age (since the level of their pensions is largely determined by the level of the final salary), a "responsibility contribution" towards the federal authorities was introduced in 1994. This has, however, only been very limited until 1999.

It should be noted, however, that the divergent development of these items of expenditure by the two Entities has become less severe in recent years: while the average real growth rate between 1991 and 1993 was 1.6% for Entity I and 4.0% for Entity II, and then 0.9% and 2.5% respectively between 1993 and 1997, they came closer together in 1998 and 1999 at a rate of 2.6% for Entity I and 2.9% for Entity II (see also the table in the appendix).

It does, therefore, seem that since the realisation of the "Maastricht" target, the degree of constraint in terms of primary expenditure has been slackened for Entity I.

2.3 Conclusions

It is clear from the analysis set out above that it is Entity I which has made the consolidation efforts necessary to meet Belgium's budgetary targets.

It has not only taken some important measures in the area of revenue to support employment and competitiveness (reducing contributions) while ensuring legal financing of the federated entities and the financial equilibrium of the social security sector (through adjustments in various withholding taxes) but at the same time it has limited the growth in its own expenditure, particularly on social benefits (mainly at the expense of Social Security) and public service operating costs (salaries and net purchases of goods and services).

Entity II on the other hand, which is already benefiting from the strong revenue growth guaranteed by the Financing Act, has further increased its own taxes without achieving any apparent savings in expenditure. In particular it is surprising to note the difference between the real growth rate in operating costs in relation to those of Entity I, which was 2.6 as an annual average rather than 0.9%, both for wages and salaries (2.4 rather than 1.3) and for other costs (4.0% instead of zero growth).

This observation is an immediate consequence of the modalities of the institutional reform which has taken place since the beginning of the 1990s. This does not mean, however, that no consolidation measures have taken place within federated Bodies, but it is impossible to clarify this point on the basis of the national accounting data which is currently available, since the accounts are not analysed by Community and Region.

It can be supposed, however, that the federated bodies whose funds are increasing most slowly, in particular the French Community, which is primarily responsible for education, have consequently adjusted the growth in their expenditure because they have all met the recommendations concerning the deficit set out by the "financing requirement" section of the Higher Finance Council (CSF).

What is more, despite more "spending-oriented" behaviour, Entity II has exceeded its target of improving the primary surplus that was assigned to it by the Convergence Plans (cf. point 1 above). Should it be concluded from this that the target was not ambitious enough, or in other words that the norms recommended by the CSF could have been more constrained view of the need for consolidation due to the poor economic climate during the first years of the convergence plans?

In any case, the deed is done now, since the transitional period of the Financing Act which predetermined the (high) rate of growth in the funds made available to all the federated bodies in a way that was virtually independent of economic activity, came to an end in 1999. From now on Entity I will share more with Entity II (as regards the share of personal income tax transferred) the effects - both positive and negative - of economic growth on fiscal revenue. It would, of course, be desirable for an increased sharing of responsibilities in the area of anti-cyclical policy to be linked to a new stage in Belgian federalism in order to ensure that the structural public finance targets set out in the Pact for Stability and Growth are met.

IV. The Stability Pact and the budgetary policy of the federated bodies: new questions

Budgetary policy in Belgium is going to face some others challenges. The Pact for Stability and Growth requires the Member States to maintain a structural balance which is either in equilibrium or in surplus. There are two aims to this recommendation.

On the one hand, it is necessary to create sufficient room for manoeuvre in order to pursue a policy that can cope with the cyclical evolution of the economy, without going beyond the deficit threshold of 3 percent of GDP, and to avoid the situation where it is necessary to respond to economic setbacks in a pro-cyclical way.

On the other hand, it is also appropriate to reduce public debt in order to release funds to finance the ageing of the population after 2010.

The Federal Government has produced its stability programme in a way that takes these two aims into account. Based on a cautious spending and public revenue forecast based on a growth trend of 2.5 percent per annum, there is some room for manoeuvre, part of which will be allocated to increasing the budgetary surplus while the other part will be used mainly to reduce the tax and parafiscal burden and to “refinance” the Communities, most of whose funds have so far only been indexed to prices.

In this context, two new questions arise. On the one hand there is the question of the “golden rule”, and on the other hand there is the management of the budgetary policy of the federated bodies through the economic cycle.

As regards the golden rule, it is appropriate first to make two comments:

- First of all, net public investment (after deducting the amount of depreciation) has been either negative or close to zero for a number of years during the period of consolidation. The need to catch up with the accumulated backlog is becoming more and more pressing, particularly when the budgetary situation is positive.
- Secondly, this need is further accentuated by the fact that the majority of public investment is within the competence of the regions, and certain regions will reach a low level of indebtedness quite quickly.

On the other hand, the faster reduction in the level of indebtedness is still a priority, particularly in view of the question of ageing. It is also necessary to meet the target set out in the Stability Pact. Consequently, if we wish to authorise financing at the regional level by borrowing the amount of net investments, it will be necessary for the federal authorities to compensate for the regional deficits by maintaining a structural surplus. In order to share the burden of the overall structural deficit between the Regions, co-ordination of all budgetary policy should be based on net investment ceilings.

In formal terms, the justification for the compensation by the federal level for an authorisation to maintain a structural deficit on the part of the Regions can be found in the need to form a reserve fund for ageing, the cost of which will fall to the federal level, which is responsible for the redistribution function. In this way it would be possible to compensate for investment expenditure, whose burden should be spread in future by means of reserves intended for pre-financing of future expenditure on pensions and healthcare.

In the Belgian situation, the question of sharing the overall constraints between federated bodies can only take place on the basis of rules which are clear and considered to be fair. In political terms it would be impracticable to use any concepts of larger or smaller investment requirements in each Region. What is more, the classification of expenditure under the heading of "investment" will lead to debate. On the other hand, it is possible to draw some inspiration from the Maastricht constraints and to determine a maximum regional structural deficit which is compatible with the overall objective of the Stability Pact and with the compensation provided by the federal sector. Such co-ordination is possible, but it does raise some delicate questions in relation to arbitration between investment, fiscal reform, reducing indebtedness and financing ageing. So far we can see that in order to avoid these difficult areas of arbitration, which also create the risk of slippage, the recommended target is structural equilibrium for all the entities.

Stabilisation

While remaining true to its commitment to the Stability Pact, the Belgian Government determines the budgetary target for all administrations each year taking into account automatic stabilising mechanisms. In principle the allocation of the effect of the stabilising mechanisms ought to take place pro-rata in accordance with the revenue received at different levels of authority. This does not happen, however.

In the first place, the financial resources transferred to the Regions are calculated on the basis of data from previous years[22]. This mechanism creates cyclical changes in financing resources and regional expenditure which are not in accordance with the automatic stabilising mechanisms.

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[22] The new special draft law to be voted in 2001 modifies this rule. The macro-economic parameters which have provisionally been used to estimate the funds to be transferred will be based on the forecast of the economic budget for the current year and no longer on the parameters seen during the past year.

Secondly, the budgetary balance of the local authorities follows a political cycle which is based on the dates of elections.

As a result, in order to pursue a policy of stabilisation, the federal government should compensate for these contradictory developments, which may represent very significant amounts. The process of considering this question is now beginning. The most widely accepted line of thought is to regulate the growth in expenditure at various levels of authority in accordance with the objective of a structural balance, which lightens the load of federal stabilisation policy. The use of stabilisation funds or "rainy day funds" suggested by Balassone & Franco in this book and used in the United States may supplement this prior co-ordination procedure in relation to expenditure by the various levels of authority, but it cannot replace it. Their role is not to pursue the policy of macro-economic stabilisation, but to ensure that cyclical deficits are compensated for by cyclical surpluses over the whole cycle.

Annex: Variation of the public finances for each Entity (per sub-period)

	1991-1993						1993-1997						1997-1999					
	Level as % of GDP			Growth rate real annual average			Level as % of GDP			Growth rate real annual average			Level as % of GDP			Growth rate real annual average		
	Total	Ent. I	Ent. II	Total	Ent. I	Ent. II	Total	Ent. I	Ent. II	Total	Ent. I	Ent. II	Total	Ent. I	Ent. II	Total	Ent. I	Ent. II
1. Net financing requirement	0,0	0,5	-0,5				5,4	4,3	1,1				1,3	0,9	0,3			
2. Interest charges	-0,2	-0,3	0,1	0,3	-0,3	9,9	-3,1	-3,0	-0,1	-5,9	-6,2	-1,8	-0,9	-0,8	-0,1	-2,7	-2,6	-4,2
3. Primary balance	-0,1	0,2	-0,3				2,3	1,3	1,0				0,4	0,2	0,2			
External (A-B)	-0,1	0,2	-0,4				2,3	1,3	1,0				0,4	0,1	0,3			
Balance of internal transfers (A'-B')	-	0,0	0,0				-	0,0	0,0				-	0,0	0,0			
A. External revenue	1,5	0,9	0,6	2,8	2,5	3,6	1,0	0,2	0,9	2,8	2,3	3,9	0,3	-0,1	0,4	3,2	2,7	4,4
1. Fiscal	1,1	0,6	0,5	3,1	2,8	3,5	1,9	1,0	1,0	3,9	3,7	4,2	0,5	0,2	0,3	3,7	3,4	4,2
2. Parafiscal	0,5	0,5	0,0	2,8	2,8	-0,7	-0,8	-0,8	0,0	0,8	0,9	-32,7	-0,1	-0,1	0,0	2,4	2,4	-12,3
3. Other external revenues	-0,1	-0,2	0,1	-2,4	-8,2	7,3	-0,1	-0,1	0,0	0,7	0,3	1,1	-0,1	-0,1	0,1	0,6	-6,3	8,7
A'. Transfers rec'd from the other Entity	-	0,0	0,0	-	0,8	2,9	-	-0,1	-0,1	-	-16,8	-1,6	-	0,0	0,0	-	17,2	1,7
A". Total revenues by Entity	-	0,9	0,6	-	2,5	3,6	-	0,1	0,8	-	2,2	3,6	-	-0,1	0,4	-	2,8	4,3
B. Primary final expenditure	1,6	0,7	1,0	3,1	2,3	5,0	-1,3	-1,1	-0,1	1,4	1,1	1,9	-0,1	-0,2	0,2	2,8	2,4	3,4
Non-discretionary	0,3	0,3	-	8,7	8,7	-	-0,1	-0,1	-	1,5	1,5	-	-0,1	-0,1	-	1,0	1,0	-
1. Unemployment benefits	0,2	0,2	-	6,5	6,5	-	-0,2	-0,2	-	-0,5	-0,5	-	-0,1	-0,1	-	-0,9	-0,9	-
2. GNP contribution to the EU	0,1	0,1	-	37,0	37,0	-	0,2	0,2	-	16,0	16,0	-	0,1	0,1	-	9,9	9,9	-
Discretionary	1,3	0,3	1,0	2,8	1,7	5,0	-1,2	-1,1	-0,1	1,4	1,1	1,9	0,0	-0,1	0,2	2,9	2,6	3,4
1. Investments by local authorities	0,3	-	0,3	18,8	-	18,8	-0,3	-	-0,3	-5,2	-	-5,2	0,2	-	0,2	14,1	-	14,1
2. State pensions	0,1	0,1	0,0	4,9	4,1	12,6	0,1	0,1	0,0	3,3	3,7	0,2	0,0	0,0	0,0	2,1	2,6	-2,6
3. Other	0,9	0,2	0,7	2,4	1,6	4,0	-1,0	-1,2	0,1	1,4	0,9	2,5	-0,1	-0,1	0,0	2,7	2,6	2,9
B' Transfers to the other Entity	-	0,0	0,0	-	2,9	0,8	-	-0,1	-0,1	-	-1,6	-16,8	-	0,0	0,0	-	1,7	17,2
B" Total primary expenditure by sector	-	0,7	1,0	-	2,3	5,0	-	-1,2	-0,2	-	1,1	1,7	-	-0,2	0,2	-	2,4	3,5
GDP in constant prices				0,0						2,5						2,6		

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COMMENTS ON SESSION IV:
FISCAL RULES IN A DECENTRALISED FRAMEWORK

Daniela Monacelli[*]

1. Introduction

The papers presented in this session raise some interesting issues, which many of us, especially those from EMU countries, will most certainly have to deepen in the near future. In my opinion, there are three main questions to be answered.

The first one has to do with EMU fiscal rules: is decentralisation necessarily a problem for EMU-specific rules and, if so, what should we really worry about? The second question concerns the need for measuring the deficit contribution of lower levels of Government: how are we to build good indicators and what do we mean by a "good" indicator? The third refers to the implementation of a sanction system vis-à-vis the decentralised bodies: is it necessary, useful, or feasible and, if so, what is the most efficient way to design it?

All the papers give interesting hints about these questions.

2. Decentralisation and EMU fiscal rules compliance

In their paper, Balassone and Franco analyse the problem of the possible inconsistency between the decentralisation processes, characterising most European countries, and the main goal of the Stability and Growth Pact (SGP), i.e. the need to re-assess sufficient margins for counter-cyclical policies at the national level.

In my opinion, the preliminary question to address concerns the implications of decentralisation for fiscal policy, in general. Therefore, in my discussion I would like to start by adding some points to what expressed in the papers about the general issue. I will then turn to the more

[*] Banca d'Italia. The opinions expressed are those of the author and do not commit the Banca d'Italia. This version has benefited of discussions with the authors of the session during the Conference.

specific aspects of policy co-ordination among different levels of government related to EMU fiscal rules and domestic stability pacts.

2.1 Collective goods provision

I would rather think of the “difficult union” mentioned in the title of the first paper in terms of the very traditional “Musgravian” sharing of functions between central and local levels of government, where the first is better suited for the stabilisation branch and the second for the allocative one. Unfortunately, such a normative approach does not give suggestions in case the different public sector’s goals turn out to contrast with each other. It is left to whatever collective choice mechanism to ensure the best solution. The “difficult union” is therefore nothing more than the problem of striking a balance in the trade-off between stabilisation and efficient allocation of resources.

Actually, the argument could be generalised, considering the “difficult union” as “the” problem always arising when the central government sets any target or fiscal rule applying to the entire public sector. The solution greatly depends on the accepted notion of decentralisation and, as I will try to argue, does not necessarily find an obstacle in higher degrees of decentralisation.

In analysing this issue, we need to go back to the never-ending question of the “preferred” or “optimal” degree of decentralisation. The problem is tackled from an efficiency perspective. In my opinion, the most useful approach is by the “fiscal equivalence” principle, as formulated by Mancur Olson: collective goods should be provided avoiding both externalities and internalities. In other words, the “boundaries” of the benefit area from the collective good should spread neither outside nor inside the “boundaries” of the government bodies providing it. In principle, “*… there is a need for a separate governmental institution for every collective good with a unique boundary, so that there can be a match between those who receive the benefits of a collective good and those who pay for it*[1].” Centralisation is just a special case, concerning those collective goods for which the boundaries of the benefit area coincide with the entire country. In general: “*It is… evident that both the ‘centralizing’ and*

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[1] See Olson, M., “The principle of ‘fiscal equivalence’: the division of responsibilities among different levels of Government”, in *The American Economic Review Paper & Proceedings*, No. 2, Vol. 59, May 1969.

'decentralizing' ideologies are wrong, or at any event entail inefficiency. Only if there are several levels of government and a large number of governments can immense disparities between the boundaries of jurisdictions and the boundaries of collective goods be avoided. ... It is also evident that some of the complaints about the proliferation of governments and the overlapping boundaries of different types of governments need to be greeted with skepticism."

The most interesting insight of Olson's approach is in his understanding of the decentralisation as a dynamic process, stemming from interactions among economical, political and cultural forces acting in democratic societies. Consequently, to *gain efficiency* one country may need a more decentralised government than others[2], whenever the presence of much differentiated cultural patterns ask for a more articulated set of collective goods[3].

Moreover, in setting the boundaries of the benefit from a collective good it is the *perceived* benefit rather than the *actual* benefit that matters. People may find the provision of particular collective goods desirable, although they do not directly benefit from them. Somehow, the equity aspects can fit into this "efficiency" framework. Consider, for example, the redistribution or the supply of those particular collective goods which a country may decide to guarantee to all citizens according to a uniformity principle (as in the German Constitution) or by a minimum standard (as in some Italian legislation). A comparative reading of the papers by Tannenwald, Gordo-Hernandez De Cos and Wendorff gives a very good example of the relevance of this issue, especially when describing the different arrangements chosen by their respective countries as far as education and health care are concerned.

To conclude, the main implication of Olson's approach is that "*... fiscal equivalence normally calls for larger, pluralistic jurisdictions as well as smaller ones matching cultural communities*[4]". It is unquestionable that democracies have actually evolved according to such a principle since

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2 "*Since different racial and ethnic groups often have different cultural backgrounds and tastes, they may want different types of collective goods. In cases where the sense of ethnic identity is very strong or where there is antagonism among different social groups, this is particularly important.*" Olson (1969).

3 See Olson (1969).

4 See Olson, M., "Towards a more general theory of governmental structure", in *The American Economic Review Paper & Proceedings*, No. 2, Vol. 76, May 1986.

the second half of the last century. In other words, the only possible generalisation is in that some degree of decentralisation is needed. Unfortunately, such a general model of decentralisation as the most efficient in absolute terms does not exist.

2.2 The financing aspects

Obviously, the convergence toward an efficient process is not an easy task to achieve. There could be cases where difficulties in applying the fiscal equivalence criterion are overwhelming. A crucial role under this respect is played by the institutional arrangements of the financial aspects.

There is a tendency among local public finance economists to consider tax autonomy more efficient than central government's transfers or public debt. In principle, any source of finance could be efficient. Public transfers, for example, prove to work much better than full tax autonomy when local supply is constrained (in quantity and/or quality) by the central level.

In asserting what is an efficient arrangement of public goods provision we preliminary need to focus on the choices underlying the collective goods provision. Among the others: the extension of the boundaries of benefits; the degree of responsibility in the supply at the decentralised level of government; technical difficulties arising in supplying the goods; any possible overlapping in the different goals satisfied by the collective good provision. Only relating to these characteristics of the public goods provision, is it possible to ascertain the matching between supply and financing capable of reaching efficiency.

In suggesting how intergovernmental financial relationships should be designed, economists need to bear in mind that efficiency usually results from two types of decisions. Sometimes, governments have to choose what goods and how much of each good has to be supplied, given a budget constraint. Sometimes, they need to implement the most "economical" use of the "flexible" resources available to them, given exogenous constraints on the level of the supply. Both situations happen to arise, depending on the characteristics of the specific collective goods. What is crucial, in this context, is that the two decisions are quite different in terms of the incentives or disincentives needed to improve efficiency. One consequence is that much differentiated financial arrangements prove necessary.

2.3 Does decentralisation necessarily endangers compliance with "central Government" fiscal rules?

Having clarified the underlying notion of "decentralisation", we can go back to the original question, i.e. whether, *in general*, central government fiscal rules compliance finds an obstacle in decentralisation. If decentralisation is needed to promote efficiency in public good provision and if an efficient decentralisation can actually require several levels of government, as we argued so far, the *general* answer should be no.

Unless central fiscal rules are deeply in contrast with the target of allocative efficiency, it seems difficult to contend that *as a principle* decentralisation is going to endanger their compliance. It will depend on the fiscal rule. Actually, it could very well be the case that efficiency itself is the target pursued by the central government fiscal rule. Obviously, agency problems may arise, which could give incentives for decentralised governments to pursue different goals. However, they would have implications only as far as the dynamic process of decentralisation is particularly far from an efficient frontier and is hardly converging towards it. This could be the case, for example, when financial intergovernmental relationships are not sufficiently well designed.

Actually, it is very difficult to draw conclusions simply by analysing a pure static picture of the dynamic process of allocation over different levels of government. It is certainly true that from this kind of analyses there is a general tendency towards more decentralisation emerging in most developed countries. However, the observation of this phenomenon could simply pick up transitory situations where, for example, moves towards greater financial responsibility of local governments are just to complete previous moves toward greater responsibility in local collective good provision.

Whether this is bad or good for central government fiscal rules compliance, it is very hard to say. In Italy, the nineties' were characterised by structural reforms of the local public finance that moved exactly on these lines. Economists had advocated them for a very long time. Many of us would find it hard to argue that such reforms have made it more complicated for the Italian central government to implement the fiscal consolidation needed to join the EMU. However, the decentralisation process is still going on and new issues are now arising, which will certainly deserve much of our attention.

2.4 How decentralisation may endanger EMU-specific fiscal rules?

As to the EMU-specific fiscal rules, therefore, it is questionable that decentralisation *per se* entails a compliance problem. However, some issues raised by decentralisation are still relevant. They mostly concern the implications from the EMU imposing to the European central governments a new common rule that is often *different* from the previous ones set at the domestic level. Many countries, indeed, had to switch from some form of explicit or implicit "golden rule" to a "balanced budget rule" applying over the cycle.

Changing the rule means changing one of the central government targets, and therefore means also changing the way public sector has to strike the balance among its different goals. Under these circumstances, it is very unlikely that the design of decentralisation is not affected, as in many cases allocational efficiency will require a re-shaping of the institutional arrangements. This process is slow and costly and could prove irreversible for some aspects.

Therefore, the relevant question has to do with the appropriateness of the rules set up at the super-national level in the first place. It is necessary to assess whether these rules are likely to be changed again in the near future or not, before embarking on deep amendments of the decentralisation system. The debate on the effects of the "balanced budget rule" on the public investment decisions, for example, moves exactly on these lines.

Finally, a second EMU-specific problem related to decentralisation arises because of the need to decide how to handle possible EU sanctions, but I will consider this point in par. 4.

3. Measuring the decentralised governments deficits

Despite the different views about the issue of fiscal rules in a decentralised framework, there is still a common problem to confront with, concerning the need for good indicators of decentralised governments' policy action and, particularly, of their contribution to the deficit of the public sector.

Availability of such indicators is indispensable in order to ascertain the potential problem we might face; to give a dimension to it; to make it feasible for the central government to apply rules vis-à-vis the decentralised bodies if necessary.

In building up such indicators, several aspects have to be considered.

3.1 The fiscal rule

The choice of the right variable to look at will obviously depend on the specific fiscal rule set by central government. As we heard from previous papers, rules could be set in a variety of ways, sometimes putting quantitative targets in terms of specific aggregates.

However, the rules set for the decentralised governments do not have necessarily to coincide with rules set at the central level, as long as consistency is preserved. Actually, central governments can more fruitfully translate their own rules into a different set of constraints, which they can specifically fine-tune on the local governments operating routines.

3.2 The decentralisation scheme

The fine-tuning argument brings us to the second relevant aspect when choosing a good indicator, that is the decentralisation arrangement each country has chosen. To begin with, the budget items that are "controllable" by the local bodies need to be singled out from the items that are "uncontrollable". Only by doing so, we can get an accurate measurement of the impact of decentralised governments' policy action. If not so, we would actually end up by measuring not only the policy contribution of decentralised bodies, but also the contribution of the central government through its interrelations with the decentralised governments.

The identification of the "controllable" items in the budget gives a first idea of how severe the problem of decentralisation could be in terms of fiscal rules compliance. Such an exercise facilitates detecting the dimension of the problem and identifying those items that, among the others, need to be more carefully checked upon. It could help the central government in calibrating a successful fiscal rule vis-à-vis the decentralised government. For example, in cases of relatively weak tax autonomy, a *rule set at the central level* in terms of *deficit* could be better attained by a *rule set at the local level* in terms of *expenditure caps*.

The Italian Domestic Stability Pact moves from a similar viewpoint. Indeed, it considers a particular definition of local governments' deficit, excluding all the intergovernmental transfers and, since 2001, the health expenditure (as it is still too much a rigid item in the regions budget to be included).

More generally, accurate analyses of accountancy aspects may prove very important. There is much to be gained from a better understanding of the relationships between the different stock definitions and the corresponding flow ones, or from deeper scrutiny of the methodology in sharing those aggregates among the different levels of government. Issue such as the choice between cash as opposed to accrual accounting can have relevant implications as well, as Robinson stressed in his paper with reference to the Australian experience. The more we know from numbers about the results of each decentralised body's policy, the more we are able to implement the preferred rules.

3.3 Other objectives of the central government

In choosing both the items and the methodology to build up the indicators, central government can decide to attach discretionary weights to each specific aspect of local government action. By doing so, central government realises its attitude towards local problems.

It is not rare for a country to show different degrees of willingness to adjust for different deficit originating conditions. Actually, several examples can be found of a "buffer" use of the central government deficit for local government deficit. Some act "vertically", the weights being differentiated according to functions. Others act "horizontally", the weights being differentiated by governments, within the same functions.

One case of the second type is that of countries characterised by deep initial inequalities in the regional distribution of resources. Under such conditions, central governments may want to recognise some extra-financing to the poorer regions, also by allowing higher deficit caps. Other cases, on the same wave, arise when extra-ordinary situations occur, like natural disasters, particularly bad economic shocks hitting only some areas, political crises, and so on.

Obviously, this is the most complex and maybe slippery of the aspects to consider in choosing an indicator of the decentralised governments' policy action. It actually deepens into the trade-offs in public sector's targets, thus requiring explicit value judgements.

3.4 Monitoring

Another relevant aspect is the need for monitoring the chosen indicators. Some of them are better available during the year, while others can only be known with some time lag.

Usually, but not necessarily, the indicators we can check in a shorter time are less accurate than those we would actually like to target. However, the most urgent the need for monitoring, the more prone the central government is to accept an indicator which is far from the preferred target. In other words, sometimes there is no real choice for the central government administrators.

This issue becomes of vital importance when a sanction system is envisaged: the lack of good controllable proxies for the decentralised governments' action might be responsible for a total failure of the disincentives we would like to implement.

As a general conclusion, central governments should check for a wide range of indicators, each of which is chosen as the best appropriate in giving specific pieces of information. The strategy should be one of looking at all the indicators simultaneously, in order to draw together a satisfactory picture to rely upon when taking decisions.

4. A sanction system vis-à-vis the decentralised governments

As to the sanction system, there are two preliminary questions to ask: whether sanctions vis-à-vis decentralised bodies are necessary and, if it is so, whether they are feasible. By feasible we mean that we can actually design them so that they are successful in establishing the incentives or disincentives the central government wants to implement.

Several papers of this session discuss the implementation of a "Domestic" SGP: Balassone and Franco for Italy, Gordo-Hernandez De Cos for Spain and Wendorff for Germany. Current legislation in these countries does not seem to envisage very much structured sanction systems. It is difficult to understand whether the reason relies on the legislator's belief that sanctions are not necessary or on some objective difficulty in calibrating them.

In tackling these issues, the central government has to take into consideration what role is expected to be played by the sanction system and what degree and kind of decentralisation characterises the public sector.

The *role of the sanction* can respond to very different requirements.

To one extreme, for example, we can envisage a system working *ex-post* as a mere *cost-sharing device* to simply redistribute the extra-cost of non-compliance with the central government fiscal rule. Costs could stem from a super-national sanction like in the EMU case or just from the undesirable economic effects from not meeting the policy target.

To the other extreme, we can think of a system working *ex-ante* as a *disincentive*. In this case, the central government pursues the compliance to a given public sector's target (a general government deficit, for example), independently of the existence of super-national sanctions like in the EMU.

In this case, the sanctions vis-à-vis the decentralised governments are just a mechanism to ensure reaching the desired policy targets in a decentralised framework. However, sanctions, in the sense of monetary sanctions as we seem to imply in our discussion here, are only one possible option. Other forms of "punishing" procedures could be enforced, like for example decreasing the power in the decision-making process. Such a solution could be adopted when there are institutional places constitutionally devoted to confrontation between decentralised governments and the central government.

More generally, central government must not necessarily rely on sanctions. Sometimes, better results could be achieved by implementing self-rewarding mechanisms into the policy action options of the single governments, i.e. by using incentives rather than disincentives.

The *decentralisation arrangements* affect both the feasibility and the role of the sanction system. They are critical in choosing the criteria for determining the distribution of sanctions among the single decentralised governments, as well. Here again, we have a wide range of possibilities.

From one side, we can envisage a pure "transfers criteria" scheme, where the sanctions are determined according to the same principles underlying the transfer distribution from central government. In other words, sanctions would be treated just as negative transfers. This settlement could be desirable in situations characterised by low decentralisation in financing due, for example, to severe equalisation problems hampering a satisfactory fiscal autonomy to all of the local bodies.

This scheme is equivalent to having a central government that buffers entirely the “non-compliance” costs by reducing the overall amount of transfers to the lower levels of government. Alternatively, central government could choose to reduce other expenditures set at the central level.

At the opposite side, we can conceive a “non-compliance participation” scheme, where the sanction is distributed according to each government-specific contribution to the target failure (for example a “deficit participation” scheme where the sanction is tied to the excess deficit formation by each decentralised body). This criterion is appropriate in cases of high decentralisation in both expenditure and financing responsibilities, where “participation” in “non-compliance” is the result of authentically discretionary decisions by the decentralised governments. It obviously calls for very reliable indicators of the decentralised policy action.