René Geissler
Gerhard Hammerschmid
Christian Raffer *Editors*

Local Public Finance

An International Comparative Regulatory Perspective

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Editors

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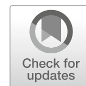
Introduction: The Relevance and Conceptualisation of Local Finance Regulatory Regimes



René Geissler, Gerhard Hammerschmid, and Christian Raffer

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

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1 The Relevance of Local Government Finance

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

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

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

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

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

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

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

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

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

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

2 Financial Decentralisation: Needs and Consequences

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

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

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

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

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

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

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

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

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

3 Fiscal Decentralisation Trends in Europe

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

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

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

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

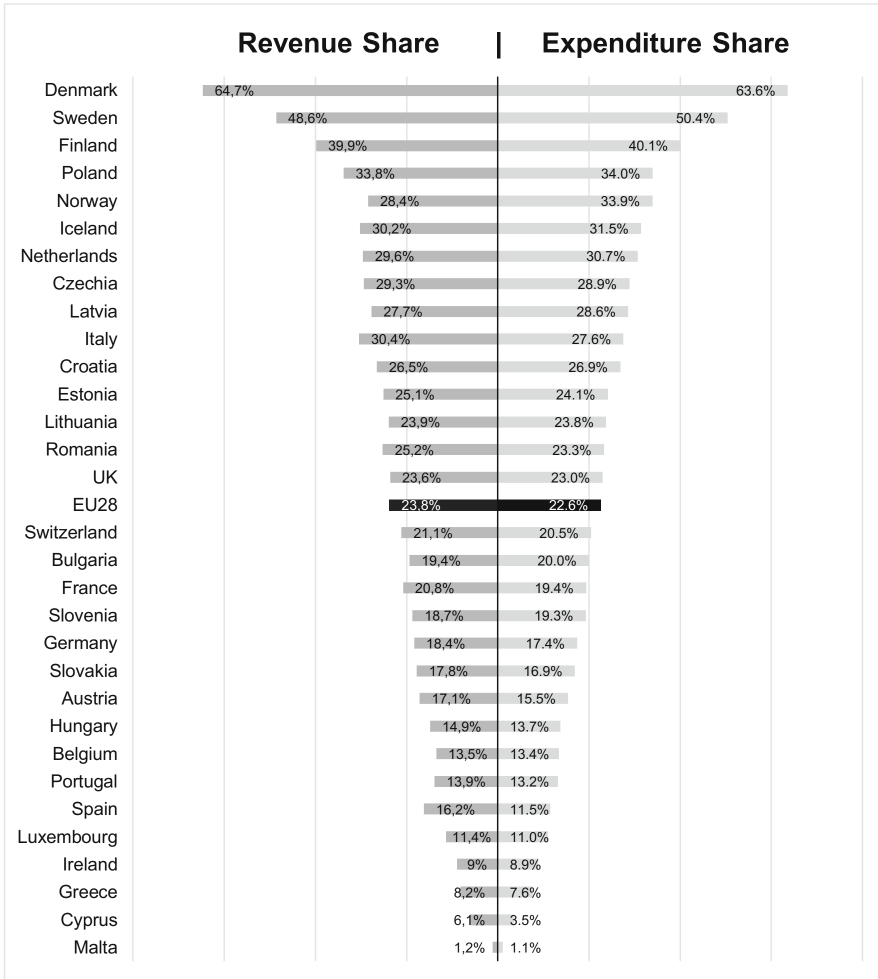

Fig. 1 Local government total revenue as share of consolidated general government revenue versus local government consolidated expenditure as share of general government consolidated expenditure. Own figure; Data: Eurostat Annual Government Finance Statistics

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

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

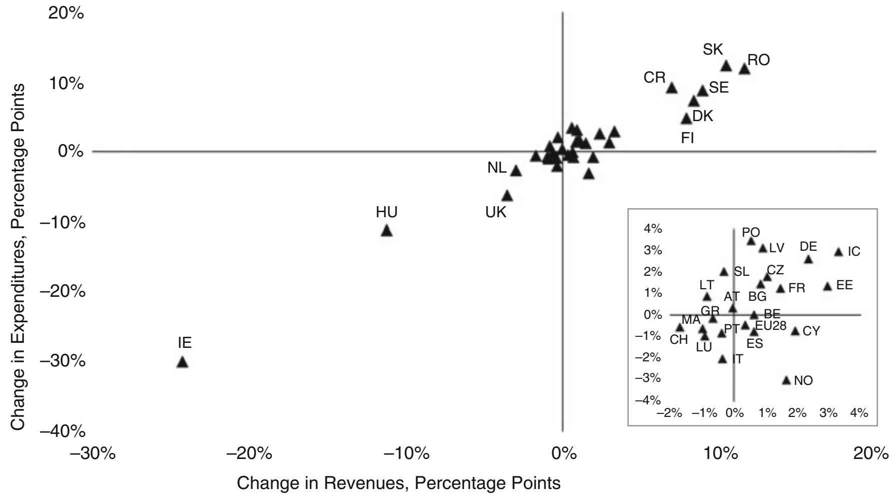

Fig. 2 2000–2018 changes of expenditure and revenue share. Own figure; Data: Eurostat Annual Government Finance Statistics

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

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

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

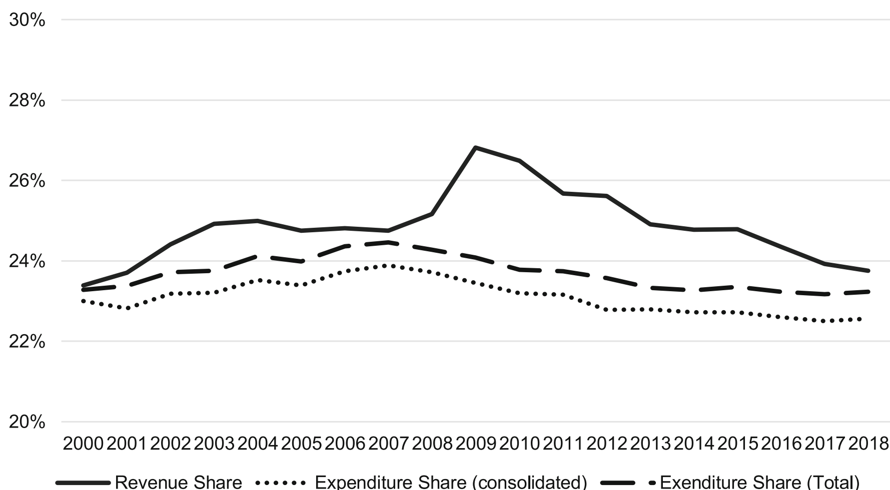

Fig. 3 EU28 Expenditure versus revenue shares (2000–2018). Own figure; Data: Eurostat Annual Government Finance Statistics

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

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

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

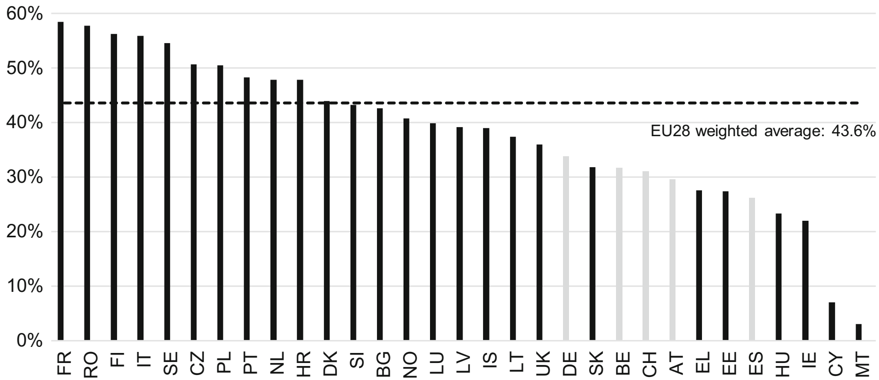

Fig. 4 Local government capital investment (Defined as gross capital formation and acquisition less disposals of non-financial non-produced assets) as share of general government capital investment. Own figure; Data: Eurostat Annual Government Finance Statistics

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

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

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

4 Key Components of Regulatory Regimes

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

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

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

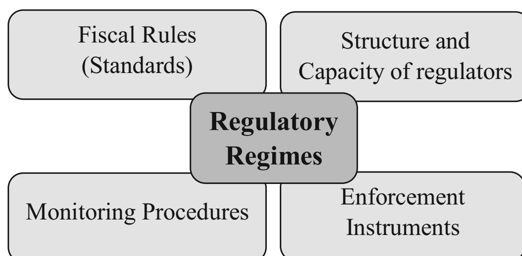

Fig. 5 Key components of regulatory regimes. Source: own

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

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

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

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

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

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

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

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

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

5 Guiding Questions and Chapter Previews

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

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

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

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

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

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

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

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

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

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

6 Conclusion and Outlook

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

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

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

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

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

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

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

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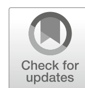
Part I
Concepts of Regulation

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



Gerard Turley, Christian Raffer, and Stephen McNena

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

1 Introduction

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

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