



Local Public Finance in Europe

BALANCING THE BUDGET AND CONTROLLING DEB

Edited by
BERNARD DAFFLON

STUDIES IN FISCAL FEDERALISM AND
STATE-LOCAL FINANCE

Series Editor:
Wallace E. Oates

Local Public Finance in Europe

Balancing the Budget and Controlling Debt

Edited by

Bernard Dafflon

*Professor of Public Finance, University of Fribourg,
Switzerland*

STUDIES IN FISCAL FEDERALISM AND STATE-LOCAL FINANCE

Edward Elgar

Cheltenham, UK • Northampton, MA, USA

© Bernard Dafflon 2002

All rights reserved. No part of this publication may be reproduced, stored in a retrieval system or transmitted in any form or by any means, electronic, mechanical or photocopying, recording, or otherwise without the prior permission of the publisher.

Published by
Edward Elgar Publishing Limited
Glensanda House
Montpellier Parade
Cheltenham
Glos GL50 1UA
UK

Edward Elgar Publishing, Inc.
136 West Street
Suite 202
Northampton
Massachusetts 01060
USA

A catalogue record for this book
is available from the British Library

Library of Congress Cataloguing in Publication Data

Local public finance in Europe : balancing the budget and controlling debt / edited
by Bernard Dafflon.

p. cm. — (Studies in fiscal federalism and state-local finance)

Includes bibliographical references and index.

I. Local finance—Europe. 2. Local budgets—Europe. I. Dafflon, Bernard.

II. Series.

HJ9415 .L627 2002

3366'.0144—dc21

2002019151

ISBN 1 84064 878 3

Printed and bound in Great Britain by Biddles Ltd, www.biddles.co.uk

List of contributors

- Lars-Erik Borge**, Associate Professor, Department of Economics, Norwegian University of Science and Technology, Trondheim, Norway.
- Bernard Dafflon**, Professor of Public Finance, Centre for Studies in Public Sector Economics, University of Fribourg, Switzerland.
- Gisela Färber**, Professor of Public Finance, German Post-Graduate School of Administrative Sciences Speyer, Speyer, Germany.
- Angela Fraschini**, Professor of Economics, Faculty of Political Sciences, University of Eastern Piedmont “Amedeo Avogadro” and Department of Public Economics, University of Pavia, Italy.
- Stefan Garbislander**, Research Assistant, Institute of Public Finance, University of Innsbruck, Austria.
- Guy Gilbert**, Professor of Economics, Department of Economics, Department of Social Sciences, Ecole Normale Supérieure ENA-Cachan, France.
- Alain Guengant**, Director of Research, CNRS-CREREG, Department of Economics, University of Rennes I, France.
- Dieter-Jörg Haas**, Research Assistant, Institute of Public Finance, University of Innsbruck, Austria.
- Niels Jørgen Mau Pedersen**, Head of Division, Department of Economics, Ministry of Interior and Assisting Professor, Institute of Economics, University of Copenhagen, Denmark.
- Carlos Monasterio-Escudero**, Professor of Public Finance, Department of Economics, University of Oviedo, Spain.
- Jørn Rattsø**, Professor, Department of Economics, Norwegian University of Science and Technology, Trondheim, Norway.
- Sergio Rossi**, Senior Lecturer, Department of Economics, Università della Svizzera Italiana, Lugano, Switzerland.
- Javier Suárez-Pandiello**, Professor of Public Finance, Department of Economics, University of Oviedo, Spain.
- Erich Thöni**, Professor of Public Economics and Public Finance, Department of Public Economics, University of Innsbruck, Austria.
- Jacques Vanneste**, Professor of Public Finance, Department of Economics, University of Antwerp, Belgium.
- Peter A. Watt**, Senior Lecturer, Institute of Local Government Studies, University of Birmingham, United Kingdom.

Acknowledgement

This study on local public finance in selected European countries includes Austria, Belgium, Denmark, England, France, Germany, Italy, Norway, Switzerland and Spain. The problems with comparative analysis lie in the diversity of definitions and functions of local authorities between countries or between levels of government within a country, and also with the application of various accounting system and rules. Thus some common stakes were necessary to give a framework to this collection of national case studies. It was not evident from the beginning that the contributors would accept these passage points in order to gain in coherence and comprehensiveness. I would like to thank all of them who have accepted this exigency and played the tune.

We first discussed the issues of balancing the local budget and controlling debt in 1997 at a Seminar in Champéry, where members of the Association of Local Public Economics (ALPES) met at a workshop for post-grade researchers, sponsored by the Conference of the Universities of West Switzerland. We then worked and exchanged ideas for about two years. The decision to collect the research in a volume was taken at the 1999 ALPES Seminar in Rennes, France. Some papers have been presented in other conferences. We would like to thank the numerous participants who made critical comments and suggestions, which certainly improved the end product.

Thanks in particular to Roberto Abatti, from the BENEFRI Centre of Studies in Public Sector Economics for his technical expertise and diligence in preparing the camera-ready copy of the draft papers sent by the contributors. This was not an easy task, but it has been achieved with talent and good spirits. Thanks also to the editorial staff of Edward Elgar Publishing for their helpful assistance and to Wallace E. Oates, for accepting this collection of papers in the Studies in Fiscal Federalism and State-Local Finance Series.

Contents

<i>List of figures</i>	viii
<i>List of tables</i>	ix
<i>List of contributors</i>	xii
<i>Acknowledgement</i>	xiii
1 The requirement of a balanced budget and borrowing limits in local public finance: setting out the problems <i>Bernard Dafflon</i>	1
1.1 Introduction	1
1.2 Ten key issues	3
1.3 Definitions	5
1.4 Procedure	8
1.5 Structure and organisation of local public finance	11
1.6 Incidence of budget discipline or responsibility	12
2 The theory of subnational balanced budget and debt control <i>Sergio Rossi and Bernard Dafflon</i>	15
2.1 Introduction	15
2.2 The normative analysis	16
2.3 The positive analysis	27
2.4 Conclusion	37
3 Local budgeting and local borrowing in Austria <i>Erich Thöni, Stefan Garbislander and Dieter-Jörg Haas</i>	45
3.1 Introduction: the structure of local governments	45
3.2 The local functions and the Austrian constitution	47
3.3 Local fiscal structure and local budgeting	50
3.4 Local fiscal structure and instruments of local borrowing	54
3.5 Budget discipline and budget responsibility of Austrian local governments	59
3.6 Conclusion: budget discipline versus budget responsibility?	68
4 Local public finance in Belgium: structure, budgets and debt <i>Jacques Vanneste</i>	75
4.1 Introduction	75
4.2 The local public sector and fiscal federalism in Belgium	75
4.3 The local public sector in Belgium: an institutional and managerial approach	80
4.4 Local public debt and capital expenditure	86
4.5 Summary and conclusions	90

5	Local government and debt financing in Denmark	93
	<i>Niels Jørgen Mau Pedersen</i>	
5.1	Introduction	93
5.2	The Danish model of local governments – tasks and responsibilities	94
5.3	The financial system of the local governments	97
5.4	The borrowing regulations of the local governments	100
5.5	Macroeconomic control via negotiations	105
5.6	Some statistics: local government borrowing and debt levels	107
5.7	Policy discussion	109
5.8	Conclusion	111
6	The public debt of local governments in France	115
	<i>Guy Gilbert and Alain Guengant</i>	
6.1	Introduction	115
6.2	Audit and control on the balance of annual local accounts	116
6.3	Fiscal sustainability of the local governments	120
6.4	The present state of French local governments' finances	126
6.5	Local public debt and local public finance in France in the Maastricht Treaty Perspective	130
6.6	Concluding remarks	132
7	Local government borrowing in Germany	135
	<i>Gisela Färber</i>	
7.1	Constitutional reform of public sector finance in 1969/70 and the development of local debt	135
7.2	Some theoretical considerations	142
7.3	Local budget and borrowing regulation by state laws	143
7.4	Problems of local budget and borrowing regulation	152
7.5	State indebtedness instead of local debt? Perspectives of reform by rebuilding the German fiscal constitution	161
8	Local borrowing: the Italian case	165
	<i>Angela Fraschini</i>	
8.1	Introduction	165
8.2	The structure of local governments	166
8.3	The present rules	177
8.4	Local authority bonds	182
8.5	Concluding remarks	183
9	Local government budgeting and borrowing: Norway	191
	<i>Lars-Erik Borge and Jørn Rattsø</i>	
9.1	Introduction	191
9.2	The financing of the local public sector	193
9.3	The regulatory framework of the local public sector	195
9.4	The performance of the local public sector	196
9.5	Experience at national level	200
9.6	Experience at local government level	202
9.7	Reform debate	205
9.8	Concluding remarks	207

10	Capital expenditures and financing in the communes in Switzerland	209
	<i>Bernard Dafflon</i>	
10.1	Introduction	209
10.2	Local public finances: an overview	210
10.3	Budget orthodoxy at the local level	214
10.4	The "golden rule" revisited	218
10.5	Results	223
10.6	Conclusion	228
11	Local government financing and borrowing: Spain	231
	<i>Carlos Monasterio-Escudero and Javier Suárez-Pandiello</i>	
11.1	Introduction	231
11.2	Local authorities: constitutional restrictions and administrative characteristics	235
11.3	The local finance system	240
11.4	Regulation of local borrowing: objectives and limits	242
11.5	The evolution of local borrowing and BCP compliance	248
11.6	Conclusions and future perspectives	253
12	Local government capital expenditure in England	257
	<i>Peter A. Watt</i>	
12.1	Introduction	257
12.2	The recent historical pattern of local authority capital expenditure	258
12.3	A brief history of capital expenditure control	261
12.4	The current system of control	263
12.5	The private finance initiative	271
12.6	Proposals for change	273
13	Fiscal controls in Europe: a summary	277
	<i>Jørn Rattsø</i>	
13.1	Introduction	277
13.2	European versus US local public finance	278
13.3	Varying fiscal controls in Europe	280
13.4	Future research	284
13.5	Concluding remarks	288
	<i>Name Index</i>	291
	<i>Subject Index</i>	295

List of figures

1.1	Analytical framework for a public budget and account	7
1.2	Six paths towards a strict budget discipline	8
1.3	The problem of delimiting the proper medium term	10
3.1	"Functional" share	48
4.1	Local public sector investment 1990–1999	90
5.1	Long-term debt of local governments, percentage of tax base, 1983–1998	108
5.2	Loans raised by governments, percentage of investments, 1989–1998	108
5.3	Investments versus loans, individual municipalities, 1995	109
5.4	Danish interest rates, 1982–1999	111
6.1	Intertemporal fiscal equilibrium: local public sector 1970–1997	123
6.2	Intertemporal fiscal equilibrium: communes over 10,000 inhabitants in 1995	123
6.3	Leverage effect of local public debt	127
6.4	Financing of local public investment	128
6.5	Local public investment (volume)	129
6.6	Ratio of debt to GNP	130
6.7	Borrowings and local fiscal surplus	132
7.1	Real investment expenditures and net borrowing of local and total government	140
7.2	General local budget frame of current and capital accounts	147
8.1	Percentage composition of local government's finance account – 1999	171
8.2	Local government expenditures	173
8.3	Local government borrowing	175
10.1	Comparative growth of debt, Confederation, cantons and communes, 1980–1998	213
10.2	Excess indebtedness in % of net debt	228
11.1	Administrative decentralisation in Spain	236
11.2	Structure of local government revenue (1998)	241
12.1	Local government expenditure as a percentage of all domestic expenditure in the UK	259
12.2	Local government capital as a percentage of all local government expenditure, UK	260

List of tables

3.1	Distribution of local government size in Austria	46
3.2	Local governments in the Länder of Austria	46
3.3	Local responsibilities: constitutional and in practice	49
3.4	Structure of ordinary local revenues 1998	51
3.5	Exclusive local taxes 1998	52
3.6	Local financial debt and local debt service	55
3.7	Development of financial local debt under consideration of the debt structure	56
3.8	Schedule of local governments' creditors	56
3.9	The "Maastricht deficit" and its division between government levels	57
3.10	The Maastricht deficit of State, local governments and social insurance institutions	58
3.11	The derivation of the local "Maastricht revenues and expenditures"	59
3.12	The Tyrolean scheme of local debt appraisal	62
3.13	The instability of an Austrian stability pact without (political) effective sanctioning measures	63
3.14	The division of the 0.11 per cent deficit quota between the Länder	65
3.15	The division of the 0.10 per cent deficit quota of the local governments by Länder	65
3.16	The increasing rigidity of local budgets	66
3.17	The surplus of the "current budget" as an indicator for local budgetary flexibility	67
4.1	Revenue, expenditure and net financial balance by government level	77
4.2	Net financing capacity or need by government level	78
4.3	Budgetary path for the public authorities: cautious economic scenario	80
4.4	Provincial expenditure: functional classification	81
4.5	Municipal expenditure shares according to the functional classification	83
4.6	Municipal expenditure shares according to the economic classification	83
4.7	Public centres for social welfare: 1997 current budget	84
4.8	Public centres for social welfare: expenditures, municipal deficit covering and population size	85
4.9	Intermunicipal agencies: financial statements by sector of activity	86

4.10	Gross and net local public debt 1995–1999	87
4.11	The financing structure of municipal investments in Belgium	90
5.1	Tasks of municipalities and counties, 1999 accounts: Gross operating costs	97
5.2	Finance of local government, 1999 accounts	98
5.3	Discretionary permissions for loans, municipalities, annual maxima: annual real growth of GDP	103
7.1	Public sector debt 1950–1999	137
7.2	Local government borrowing and debt indicators in West and East Germany	139
7.3	Total amount and structure of government debt in Germany at the end of December 1999	141
7.4	Total debt in DM per inhabitant of city governments on 31 December 1998 and 1994	154
7.5	Current account deficits of selected cities in 1998	158
8.1	Local government finance account – absolute data and percentage composition, 1999	170
8.2	Local government current revenues, 1987–1999	172
8.3	Ratio of grants from central government to local government own resources	172
8.4	Local government borrowing at 1 January, absolute data and percentage, 1977–1999	174
8.5	Local government borrowing at 1 January, percentage, 1977–1999	176
9.1	Sources of income, municipalities and counties, 1998	194
9.2	GDP growth, revenues growth, investment and debt in the Norwegian local public sector, 1980–1998	197
9.3	Fixed capital investment, net borrowing and operating surplus, municipalities and counties, 1991–1998	198
9.4	Proportion of investments financed by borrowing, municipal averages, 1991–1998	199
9.5	Correlation matrix for revenues, operating surplus, investments and borrowing; municipalities, 1991–1998	199
9.6	Growth in nominal tax revenue for the local public sector, actual and predicted, 1986–1999	201
9.7	Control of municipal budgets and borrowing, 1994–1998	202
9.8	The number of years with an operational deficit, municipalities, 1980–1998	203
10.1	Growth of the public sector 1970–1998	211
10.2	Deficits and the evolution of public debt 1980–1998	212
10.3	Respect of the Maastricht criteria	214
10.4	Communal accounts in the canton of Fribourg, 1979–1999	225
10.5	Number of communes with current budget deficit and excess indebtedness	226
11.1	Evolution of public expenditure decentralisation in Spain	232
11.2	Municipal responsibilities	237

11.3	Structure of municipalities in Spain by autonomous communities	239
11.4	Revenue structure of Spanish local governments (1998)	240
11.5	Local deficit and borrowing and economic convergence in the EU	248
11.6	Targets for local public sector	249
11.7	Evolution of real public investment by public sector agents	250
11.8	Budgetary investments by local governments	251
11.9	Local public borrowing	252
11.10	Structure of Spanish local debt (1997)	253
12.1	Local authority investment 2001/2–2003/4 – major spending areas	261
12.2	The finance of capital expenditure: 1995/96 to 1999/00, England	266

1. The requirement of a balanced budget and borrowing limits in local public finance: setting out the problems

Bernard Dafflon

The idea of this comparative study goes back to the 1997 ALPES¹ Seminar in Champéry (Switzerland) where several scholars presented individual papers on local government budgeting and local debt with similar preoccupations and questions, such as (i) the existence of any legal requirement for a local balanced budget, (ii) a possible control from higher government levels on local budgeting and borrowing and (iii) the implementation of the Maastricht convergence criteria for local public finance. The framework of discussion is given in six sections. The introductory section recalls two issues, Maastricht and recurring public deficits, which give the general background to the chapters. Ten key issues are formulated in section 1.2. Owing to the heterogeneity of the accounting systems of local finance in Europe, some common definitions are necessary and are given in section 1.3. Section 1.4 presents a sequence of six questions with the intent of assessing the degree of budget discipline in the particular country. Questions about how the budgetary rules influence the budgetary position and the fiscal outcome of the communes in one country are presented in section 1.5. Tentative results are discussed in section 1.6.

1.1 INTRODUCTION

The chapter starts with two considerations: one is the local concern with the enforcement of the Stability Pact for the European Monetary Union (EMU), the other is the painful necessity of reversing the recent trend towards growing public deficits.

According to article 109 J (1) of the Maastricht Treaty,² the general government's financial position of any Member State must be sustainable,

that is (i) the ratio of government deficit to Gross Domestic Product (GDP) must not exceed the reference value of 3 per cent and (ii) the ratio of government debt to GDP must not exceed the benchmark value of 60 per cent. The idea is that there should be budgetary discipline and a procedure to avoid excessive deficits and indebtedness if the Stability Pact is to be successfully enforced and a unique monetary currency created. In the Treaty, "general government" means the public sector in general (central administration, regional and local governments and social security), excluding commercial activities. Yet, the open-ended definitions of the required budgetary discipline to be secured across the whole euro area and the shortcomings of the excessive deficit and indebtedness procedure that will be enforced through the planned Stability and Growth Pact create problems. The European Council in Dublin (December 1996) and in Amsterdam (June 1997) endorsed the same conclusion that a "dissuasive set of rules should have a deterrent effect and put pressure on Member States adopting the Euro to avoid excessive budgetary deficits or to take corrective measures if they occur ... Each Member State will commit itself to aim for medium-term budgetary position close to balance or in surplus".

How is the "medium term" defined? Which "budgetary position" (current or including the capital account) should be close to balance or how much in surplus? To what extent might a deficit be considered as "close to surplus"? When considering the dynamics of general government debt and the sustainability of fiscal positions, the EMI (1996, p. 24) uses a number of locutions such as "actual primary balance", "overall balance excluding interest payments", "required primary balance (typically a surplus) in order to reduce the debt ratio", "sufficiently high primary surplus to regain budgetary room for manoeuvre in the medium term", so it is difficult to organise this into a clear-cut analytical picture. Not surprisingly, the first consideration of the ALPES Seminar was that used at the local level in various national circumstances, the same technical vocabulary has not the same signification (as for example: debt servicing, amortisation, debt instalment, gross savings, the distinction between current and capital accounts, or the requirement of balance in the actual accounts compared to simply a balanced budget).

At the same time, and especially since the beginning of the 1990s, important public deficits have occurred in most European countries at the three levels of government – central, regional and local – as well as in the social security accounts. The average fiscal deficit for the European Union (EU) as a whole widened rapidly from 2.4 per cent of GDP in 1989 to a peak of 6.1 per cent in 1993. At that point in time, most countries faced major challenges in reversing what was clearly an unsustainable trend. National authorities had to take corrective measures in an effort to place their

government deficits on a downward path. This has been partly achieved, with an EU-wide budget deficit of 5.0 per cent in 1995, cut down to 2.4 per cent in 1997, unfortunately using also one-off measures and other accounting tricks to qualify for the EMU (Dafflon, 1999). In the same period, the general government gross debt as a percentage of GDP rose from 60 per cent (1990) to 72 per cent (1997) (European Commission, 1998, p. 124). Local governments have been in the forefront in reacting to the trend of growing deficits in their annual accounts and in devising sets of ratios intended to prevent excessive borrowing. Yet, although much has already been said about local budgetary policy-making, and about the policy effects of budget deficits and public debt in fiscal federalism, few empirical studies have been conducted in order to explore how budgetary discipline really functions at the local level. Thus here the attempt is made to organise a comparison on this issue at the local level in ten European countries – Austria, Belgium, Denmark, France, Germany, Italy, Norway, Switzerland, Spain and England – on the basis of an agenda of ten key issues.³

1.2 TEN KEY ISSUES

In order to make possible the comparison, questions have been formulated in ten broad key issues. The objective is to compare the issues, both at normative and practical levels, and the solutions in selected European countries. Discussion should include the questions of local budgeting (in particular the rule of a balanced budget) and of borrowing either from the point of view of local government or under regulation (if any) of the regional (central) government. The economic consequences of regulation as well as the institutional concepts and possible sanctions are of interest.

1. In local public finance, one may distinguish between budget responsibility and budget discipline. Budget responsibility is assumed to intervene for each financial decision where self-assessment of benefits and costs intervenes, as for individual investment decision-making. Budget discipline is related to any kind of institutional rules which limit in advance the possibility of deficit spending or borrowing. Is such a distinction of importance in your country? How is it applied and by which level of government?
2. Is the current budget distinct from the capital budget? Is borrowing limited to investment in a pay-as-you-use formula, or is it accessible for financing current deficit? What is the relation (or the compromise) between the rule of a balanced current budget (if it exists) and public investments?

3. How is the capital budget decided? Is there any local discretion in investment decision-making? Does the decision concern the whole capital budget or individual items of the capital budget? Is it necessary to present a programme of investment for each of them? (Such a programme describes the kind of investment, the cost of investment, its duration, depreciation and the future running cost.)
4. Is a separate vote needed or does the referendum exist (i) for the current budget, (ii) for taxes in the current budget, (iii) for particular items of the capital budget or (iv) for the total capital budget?
5. Is a rule of balance imposed on the current (the whole) local public budget? Which level of government sets the rule? What are the reasons for or against such a rule? Is borrowing by local government regulated: if so, by whom and how? Does the rule apply *ex ante* on the budget and/or *ex post* on the actual account? Does the rule allow actual deficit to be carried over into the following exercises (and if so, into how many years?) or must a deficit be repaid *within the next exercise*?
6. Is there any conceptual link between borrowing, debt management and capital expenditures? What is the role of amortisation as a link between investments and debt? Is there a link between amortisation in the books and the financial (annual) repayment of the local public debt?
7. What is the policy of capital amortisation at the local level: the systems of amortisation, the rates of amortisation, the coincidence between amortisation and annual repayment, the duration of debt repayment according to depreciation?
8. The political autonomy of a decentralised government may run against the regulation of budgeting and borrowing: are the rules the same between the local and regional, as between regional and central government levels?
9. How is the local public debt defined? Does a concept of “gross public debt minus capital = net public debt” exist? These concepts are relevant when some kind of limit is set up against borrowing. Do such limits exist in your country, and which ones?
10. How are the Maastricht rules (deficit < 3 per cent of GDP) and (total debt < 60 per cent of GDP) going to be divided between the layers of government?

Starting from the possible answers to these questions, the study explores four main lines:

- definitions;
- the budgetary procedure;
- the structure and organisation of local government finance;

- the incidence of possible rules, budget discipline or responsibility.

1.3 DEFINITIONS

The heterogeneity of local public finance in the EU is reflected in various systems of public accounting at local level, a wide variety of specific concepts and a disparate vocabulary. In consequence, the first objective is to organise an analytical framework that allows comparison not only in term of statistical data and results, but also in term of public finance terminology and bookkeeping definitions. The argument is that if the definitions are not clear, and if the accounting procedures vary widely, then the financial results, and the statistical data based on them, are not comparable. Figure 1.1 is presently used for restoring comparability.

The example of Norway (Chapter 9) will illustrate this issue:

The key financial control is a balanced budget rule implying that current revenues in local governments must finance current spending inclusive of debt servicing. Investments are to a large extent financed by loans, but there is a formal approval procedure for loan financing. The financing of investment is spread over time and the design is assumed to stimulate inter-temporal efficiency.

The questions to be answered are: (i) whether this statement is acceptable for other European countries, (ii) which meaning is given to the key words in each country?

Take the concept of “debt servicing”. We found that it can be defined in a number of ways:

- interest payment of the existing debt;
- interest payment + bookkeeping amortisation of the capital assets contained in the opening assessment sheet;
- interest payment + (amortisation in the book = annual regular instalment of the debt, for the current account);
- interest payment + (amortisation in the book = depreciation of capital assets = annual regular instalment of the debt, for the current account), as it is the case in Norway and in many Swiss cantons;
- similar to the two previous points, but (...) is written in the capital account;
- interest payment + contractual repayment of the debt.

In this example, one sees that “interest payment” is always present. But the concept of amortisation taken in addition varies widely: formal amortisation