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Financial Management and Governance across Levels of Government

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Abstract

Financial management across levels of government requires mechanisms and processes of coordination that must reflect the aggregate control needs at the central government level. This is a critical element in ensuring good governance as well as efficiency of activities across government tiers. Further, financial management at the local level of government also has relevant implications for overall fiscal stability that concerns the central government. In this perspective, there is a strong link between government financial management, the macro-economy and public finance. Nevertheless, this link has been largely neglected because the literatures have mostly been developed as separate areas of interest. This chapter seeks to fill this gap by framing governance issues in the perspective of public financial management, and by studying how lower levels of government are affected by financial mechanisms for aggregate coordination and control of public resources. The key components of financial management and governance across government tiers are identified, with a particular focus on budgetary rules.
3.1 Rationale for financial management across levels of government

Financial management is at the core of public sector reforms in most nations around the world. With the growing challenges of budgetary crises, fiscal shocks, and popular demands to improve government services - the need for enhanced financial management techniques is increasingly felt in developing countries and transitioning economies.

Financial management entails the development of laws, organizations and systems to enable sustainable, efficient, effective and transparent management of public resources. At the basis of financial management lies the core principle of ‘financial viability’ or ‘financial sustainability’ (in this chapter the term financial viability and financial sustainability are used interchangeably). According to this concept, in order to fulfill its mission in the long run a government should be able to achieve an adequate balance (revenues should be large enough to cover their expenses) as well as an adequate liquidity (ability to meet current liabilities when due), without systematically relying to financial support from third parties (i.e. higher levels of government or from the market). Conversely, systematic deficits (revenues lower than expenses) would produce increasing debt and interests, future losses and negative cash flows. The inability to pay its obligations could hinder government access to the financial market. In the long run recurring deficit and increasingly debt require a bailout by upper levels of government or by supranational institutions.

The principle of financial viability points out the issue of financial autonomy of government entities i.e. the fiscal system (e.g. the allocation of taxing authority across levels of government) must ensure tax power and fiscal resources being in line with activities and responsibilities. Otherwise, lower tiers of government may have an incentive to overspend for those local activities financed by central transfers rather than by local tax autonomy (e.g. health and transportation). In general, decentralized or federal countries, where sub-national governments have substantial fiscal autonomy, are expected to be more exposed to deficit bias than centralized systems, thereby making the context for financial coordination rules.

In order to secure the financial viability of government layers on a permanent basis, a financial governance and control system is needed at national and sub-national level. This system is fundamentally based on financial rules and targets which set financial requirements on the government budget, such

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1 The principle of financial viability is central in the theoretical tradition of Economia Aziendale, the Italian management theory developed since the mid-1920s. Advances of Economia Aziendale in the study of public administration are summarized by Anessi-Pessina.
as the deficit, borrowing, debt or a major component thereof. When rules have been adopted, the budget must be prepared and executed according to these rules.

A financial governance system has two distinct dimensions: first, the budgetary rules and systems set to enhance budgetary discipline within a government entity and second, all the fiscal, legislative and procedural rules set for coordination and control of the budgetary policy across layers of government (central/local) at national or supra-national level. These two dimensions of financial governance are reciprocally linked and occur regardless of the federalist or unitary form of government.

Uncontrolled access to capital markets and mismanagement of budgets by local government may compromise the financial viability at the macro-level. If the fiscal condition deteriorates one government could attempt to blackmail the others and requests funding. The blackmail could also be directed at the central bank, especially when the accumulated debt is large (Wyplosz, 2013).

Recently, the financial and economic crisis has showed dramatically the close linkage between financial instability and the real economy. In this perspective, there is a strong link between government financial management, the macro-economy and public finance (Bergmann, 2009). Nevertheless, this link has been largely neglected because the literatures have mostly been developed as separate areas of interest.

3.2 Multi-level financial management and governance: A conceptual framework

In a multi-level government setting, whatever the form of government (federal or unitary), financial management is aimed to allow any level of government to take responsibility for its actions. This is concerned with several issues.

First, the set up of mechanisms for appropriation of resources to each level of government and its responsibility on operations. This issue relates particularly to the form of government and its fiscal system. Another aspect relates to the coordination needs emerging from the process of budgeting and its execution that has to be developed in a multi-level setting. Budgetary outcome at the aggregate central level of government depends on the budgetary positions of all the component jurisdictions. Whatever the form or government or the number of government tiers, the control of aggregate budgetary outcome requires budgetary rules to ensure the financial accountability of lower tier gov-
ernments. And a standardized basis for budgetary measures is particularly needed in order to assessing results of government activities.

Particularly important under this scheme are the requirements for accounting transparency, independent monitoring and timely reporting of results to the respective political constituencies and higher levels of administration.

Without the budgeting, measurement and control mechanism, it is unlikely that autonomy of lower-tiers of government and effective central governance would be realized. Incentive and sanction schemes are also useful to reinforce the control mechanism. All these elements of financial management shape a financial governance system between the ‘central’ and the ‘local’ government, and must be enshrined in a constitution or in higher level laws. It influences how budgetary policy is planned, approved, carried out and monitored in a multi-level setting.

According to the management theory, a fiscal governance system should be designed as a managerial control system in the context of the multi-level governance institutional setting (Figure 3.1). Management control systems are mechanisms for measuring and evaluating performance that are used to guide and direct the behaviour of management in order to achieve an organization’s goals.

A management control system is characterized by an organizational structure, some numerical targets, a measurement system and mechanisms for performance evaluation and ensuing rewards or penalties (Anthony and Dearden, 1976). This approach seems to be consistent with financial coordination needs of a multi-level setting. This idea is reinforced by the fact that a fiscal governance framework provides individual governments with autonomy and also imposes goal-setting and budgetary planning, monitoring, and evaluation. Individual elements of this system are analysed here following.
3.2.1 Budgeting and control in a multi-level setting

The intersection of policy and budgetary cycles and levels of government shape a management control system in terms of time horizon, actors and goals (Figure 3.2). This framework is relevant for both unitary and federal government systems. The typical stages of budgeting include the preparation and appropriation stage, the execution and monitoring. Those arrangements governing all these stages constitute the medium-term budgetary frameworks (MTBFS).

In centralized settings such as the unitary states the problem of budgetary coordination is limited since local governments act mainly as agents of centrally-driven budget decisions. In federal settings, where sub-national governments share some tax powers, the need for budgetary coordination is higher.
and rules should be set in order to ensuring multi-level accountability throughout the entire budget process.

Figure 3.2 Financial management and governance in a multi-level setting

Source: Adapted from Lorange (1980).

A single budgetary year is not sufficient for planning and evaluating of policy measures and to ensure fiscal discipline. Therefore, MTBFS complement the annual budget law by extending the horizon for fiscal policy making beyond the annual budgetary calendar (European Commission, 2009). As a result, MTBFS contain both expenditure and revenue projections and the budget balance targets. These arrangements may help ensure the sustainability of budgetary positions by showing the impact of current policies on the government budget balances in the coming years.
The existence of coordination mechanisms between general government layers prior to setting the medium-term budgetary targets for all government tiers, and the monitoring and enforcement mechanisms of multi annual budgetary targets are critical elements to ensure the quality of national MTBFs. These elements are also considered by supra-national institutions (e.g. European Union, International Monetary Fund etc.) for financial control and monitoring of national governments' budgetary outcomes.

**Box 3.1**

*Levels of Government*

The issue of budgetary coordination across tiers of government lies in the perspective of 'central' government regardless its unitary or federalist form. But what tier is 'central' or 'local' depends on how the sovereignty in a territorial government is stratified between a central governing authority and its political constituent units. In unitary states both elements are overlapping so the central government coincides with the nation's central governing authority, and the sub-national government level normally coincides with local government entities and other 'non-territorial' government authorities and agencies. On the contrary, in federalist systems the power to govern is shared between the national/federal ('central') and self-governing provincial/state ('local') government. Hence, from the perspective of the federal government, all the state governments and its own layers are sub-national governments. Examples of federalist systems are the US, Canada, Australia, Brazil, Germany, Switzerland, Mexico. Europe is a special case as it takes the form of a permanent union of sovereign states for common actions and, in some way, may be considered a federal system. In such systems, rules for budgetary coordination may be set by the federal government and spread to state governments which in turn set autonomously rules to lower tiers.

**3.2.2 Budgetary accountability**

Budget transparency is an essential requisite for ensuring political accountability. Elected politicians and public officials have an accountability duty to explain their use of resources to the legislature and the public. The framework for budgetary accountability usually includes a combination of political, legal
and administrative mechanisms which vary from country to country.

A particular mechanism to ensuring budgetary transparency is the set up of independent fiscal institutions (also called fiscal councils). These are non partisan public agencies, other than central bank, government or parliament that prepare unbiased macroeconomic forecasts for the budget, fairly monitor fiscal performance and/or advise the government and the public on budgetary measures and policy (European Commission, 2009). Among others, a well-known institution of this kind is the Congressional Budget Office of the United States. Fiscal councils have long been active in a number of countries but in most cases they do not provide binding macroeconomic forecasts for the budget. Recently have been required by the European Union for Member States in order to monitor compliance with common budgetary coordination rules.

3.2.3 Standards for budgetary consolidation

Budgetary coordination of sub-national governments requires prompt and reliable information. If such system is scarce or absent then financial coordination is weak. A critical issue here, especially in unitary countries, is the balance between standardization and flexibility allowed at lower-tiers in the generation of budgetary information.

First, a standardized budget classification is the basis for central and local budget consolidation. Second, budget execution requires prompt information on revenue and expenditures at sub-national level in order to timely monitoring consolidated budgetary outcomes on a quarterly basis. In unitary states, the responsibility for establishing standards for the accounting and reporting systems of all levels of governments is in charge of the central level. In federal settings, it is the responsibility of all levels of government to share the minimum requirements for common information standards. The problem of budgetary consolidation is a matter of the unification or harmonisation of different budgetary and accounting systems.

Some central governments set uniform budget schemes and accounting systems for all levels of governments while others leave local governments some flexibility to set their own system with minimum requirement of item classification and periodic information upwards. Apart from standardized
budget information the unification of accounting systems rises several problems.

While accrual accounting allows more accurate data on commitments and liabilities, the consolidation of information requires real-time sharing of financial information systems among tiers of government which is costly. Hence, cash-based Integrated Financial Management Information System (IFMIS) has been emerging in most countries as a common practice for ongoing budgetary monitoring and control across government levels. Nevertheless, these systems require standardized budget classification.

Another issue is the choice of accounting standards. The publication of International Public Sector Accounting Standards (IPSAS)\(^1\) has raised some international debate about the harmonization of accounting systems (Benito et al., 2007; Bergmann, 2009; Caperchione and Rocher, 2012). Following to this standards, a uniform budgeting and accounting standards for governments is currently being discussed on EU level with the development of accrual-based European Public Sector Accounting Standards (EPSAS)\(^3\). This development constitutes a further step in the direction of the international convergence of financial reporting.

Another emerging practice of consolidation is to establishing a unified structure of government banking accounts through a Treasury Single Account (TSA) (Pattanayak and Fainboim, 2011). This cash management system implies that all local government revenues’ flow is centralized to the TSA whereas all expenditures at the local level are made out of the TSA. Through this system government cash balances are centrally managed to reduce borrowing costs or to optimize returns on cash surpluses.

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\(^1\) The IPSAS are a set of accrual-based accounting standards for use by government entities around the world for the preparation of financial statements. IPSAS have been issued by the IPSAS-Board which is the international standard-setter for public accounting.

\(^3\) The European Union allows every member state to apply its own budgeting and accounting system. Consolidation of government accounting data is based on a common system of statistical data, the European System of National and Regional Accounts, abbreviated as ESA95.
Case 3.1
Standardization of budgeting and accounting systems: Country examples

Federal and unitary states shows different patterns of budgetary and accounting standardization.

**Germany.** In Germany, a federal law governs budgetary management at all levels of government, mandating the use of a detailed budgetary classification, a uniform cash-based accounting system, as well as a multiannual financial planning. The law also obliges all levels of government to provide the Financial Planning Council with all necessary information to monitor fiscal developments for the nation as a whole. Lander must provide all relevant information on behalf of their municipalities (Lienert and Yung, 2004).

**United States.** All US states are free to determine the way their budget are prepared, adopted, executed and reported. There is no constitutional or legislative requirement to harmonise accounting standards. However, state and local governments follow accounting standards developed by the private non profit Governmental Accounting Standard Board (GASB) in line with generally accepted accounting principles (GAAP).

**Canada.** Similarly to the US states, Canadian provinces have voluntarily adhered to the standards of the Public Sector Accounting Board, the independent and authoritative standard-setting body for the public sector of Canada.

**Australia.** In Australia, Commonwealth States and Territories report a minimum amount of financial information in a uniform presentation framework (UPF). While many states and territories continue to prepare heir budget using different budget classification and accounting standards, each jurisdiction attaches data in the UPF format to their budgets.

**Argentina.** Sub-national governments are totally free to define their own budget and accounting systems. As a result, local fiscal data is characterized by large inconsistencies in terms of how revenues and expenditures are reported in public accounts. In addition, the lack of an agreed framework or guidelines for presenting state-level fiscal data makes it very difficult to consolidate fiscal accounts at the national level.

**Denmark.** In Denmark, a unitary state, municipalities and counties are required to use the standard budgeting and accounting systems defined by the centre. However, local councils are free to adapt the accounting system to suit their local needs. Information based on the standard accounting system is collected by the central authorities to monitor development in local government’s expenditure and revenue.

Source: (Ahmad et al., 2005).
3.3 Multi-level fiscal governance: The European case

The European Union fiscal governance is based on a system of fiscal rules, enforcement mechanisms and procedural requirements. The Stability and Growth Pact (SGP) has been at the core of these arrangements since its adoption in 1997.

In Europe, budgetary rules were introduced at the supra-national level with the 1992 Maastricht Treaty, which established fiscal criteria for membership of the Economic and Monetary Union. These rules require general government debt to be below 60% of GDP and deficits not to exceed 3% of GDP. The Maastricht rules were further specified in the SGP, explaining the commitment of each Member State to approach agreed targets.

Each Member State must submit a ‘Stability Programme’, showing how it intends to achieve or safeguard sound fiscal positions in the medium term. Multi-year budgetary targets refers to a budgetary position “close to balance or in surplus”, and reduction of debt towards the threshold of 60% of GDP. The Stability Programme is subject to a review by the European Commission and it is updated annually. To prevent the occurrence of an excessive deficit, an early warning can be addressed by the European Council, on the basis of a proposal by the Commission. Furthermore, the Commission can directly address policy advice and recommendations to a Member State as regards the broad implications of its fiscal policies.

An ‘excessive deficit procedure’ is triggered in cases where a deficit breaches the 3% ceiling. The Council issues recommendations for correcting the excessive deficit and gives a timeframe for doing so. Non-compliance with the recommendations triggers further steps in the procedure, including the possibility of sanctions. Monitoring government deficits is exercised by the Commission only at national level. Following the recent crisis and also some past failure to apply rules effectively, the EU fiscal framework is being strengthened by the new Treaty on Stability, Coordination and Governance signed on March 2012. Two relevant requirement have been introduced. First, Member States with debt over 60% ceiling must follow a new numerical budgetary rule requiring the debt ratio must fall each year by an amount of one-twentieth of the debt excess. Second, a balanced-budget rule requiring the budget position be ‘balanced or in surplus’ must be included in national law and be of binding force, preferably constitutional.

Domestic budgetary rules pre-existed both at national and sub-national level in EU countries and these rules were not replaced by EU fiscal arrangements. Member States adopted different strategies for framing EU fiscal rules across levels of government in the domestic setting. These strategies ranged
from top-down to cooperative target-setting arrangements and most countries settled their domestic fiscal framework in order to ensuring the EU fiscal targets.  

Many policy debates now centre on the respect of these targets. This is the case at national level, where debates in many countries concentrate on compliance with national expenditure ceilings, debt rules or fiscal targets for lower levels of government, as well as at European level, where policy discussions on the opportunity for compliance take place in the context of stimulus packages.

4.4 Budgetary rules for financial viability

A basic principle of financial management across government tiers is the autonomy of each level of government (Anessi-Pessina, 2002). According to this principle a local government which is responsible for expenditure decisions should be responsible for raising revenues to balance expenditures and should have responsibility and control over revenue sources.

A complement to this principle is the budget responsibility to balance the budget: spending decisions must indicate how the resources to finance expenditures will be obtained; if elected officials want to reduce taxes, they need to say what spending they will do without. If the budget is not balanced government will carry-over a deficit to the next fiscal years. A recurring practice of this kind will inevitably result in a financial distress in the long run so undermining the financial viability of the government. This is particularly important in the public sector because of the size of the government units and of the consequent risk of default on the economy.

The key financial control on the government financial viability are budgetary rules which set permanent constraints on the key budget aggregates such as the annual budget balance, expenditures and borrowing. These rules have a clear procedure of implementation monitoring and enforcing, as well as an explicit cost (i.e. sanctions) if the rule is not followed. Budgetary rules can be adopted by governments at the supra-national, national or sub-national level. Their main objective is to establish incentive and constraints on budgetary policy-making of lower tiers of government in order to promote coordination across layers of government and long-term financial sustainability. In the public finance literature, budgetary rules are commonly identified with the term

Illustrative cases of cooperative arrangements are Germany, Austria and Spain.
‘fiscal rules’ (Kopits and Sumanski, 1998). There is also a prevalence in the use of this term when referring to supra-national fiscal frameworks.

Budgetary rules are often translated in numerical targets or ceilings for budgetary aggregates, but they should not be confused with general fiscal targets set by governments on an annual basis for policy measures, which may be revised frequently without any restriction.

What distinguishes a budgetary rule (or ‘fiscal rule’)
5 from the usual fiscal target is that there should be a quantitative constraint on one of the key fiscal performance aggregates and that this constraint should be set for a certain period (medium- to long-term). An example of permanent constraint is a ceiling on a budget aggregate as a percentage of Gross Domestic Product (GDP) (e.g. ‘a maximum deficit-to GDP rate of X%’ or ‘a maximum debt-to-GDP rate of Y%’). A target has the advantage of simplicity and of being easily understood by the wider public (Table 3.1).

Table 3.1  Budgetary rules and target definition.

<table>
<thead>
<tr>
<th>TYPE OF RULE</th>
<th>TARGET DEFINITION</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balanced-budget</td>
<td>Operating balance (golden rule)</td>
</tr>
<tr>
<td>Expenditure</td>
<td>Expenditure growth rate ceiling</td>
</tr>
<tr>
<td>Debt</td>
<td>Debt ceiling as % of GDP</td>
</tr>
</tbody>
</table>

a: Usually takes the form of a balanced-budget requirement set on the ‘net operating balance’.

1 In this chapter the term budgetary rule and fiscal rule are used interchangeably.
The advantage of budgetary rules is that they introduce budgetary discipline. Rules influence the behaviour of governments since they set goals of fiscal policy. Their disadvantage is that they might be implemented as highly inflexible so that they could not allow for prompt anti-cyclical behaviour. Some debate has recently emerged on the fallacy of austerity-based fiscal consolidation on economic growth (IMF, 2010; Ball et al 2011; Wren-Lewis, 2011). This is of course a matter of how fiscal rules are designed and implemented, but rules have just an instrumental role in implementing fiscal policies. In our view, what is relevant of this debate is how fiscal policy is designed and implemented in different settings and the benefit of budgetary coordination through fiscal rules should not be not questioned.

Another disadvantage of the budgetary rules is that they tend to create incentives to evade them through creative accounting. Examples of these practices are several: the withdrawal of certain expenses from the budget, the manipulation of the macroeconomic estimations for the budget preparation, the underestimation of expenditures, the exclusion of contingent debts from the budget, such as government guarantees to the state-owned companies, to the private companies or the sub-national governments.

Budgetary rules have gained greater attention in OECD countries as the autonomy granted to sub-national governments has increased by decentralization of powers of taxation and spending responsibilities. In the context of the European Monetary Union, the fiscal consolidation requirements introduced at the supranational level for the Member States have been a strong motivation for the introduction of domestic budgetary rules as well as for spreading of these rules at the sub-national government level.

According to the European Union’s Stability and Growth Pact, fiscal targets are set on the consolidated general government deficit and debt and the existence of different levels of government is not taken into account. This has made national governments accountable for deficit bias incurred by sub-national governments, as well as for the cost of non-compliance (either in terms of sanctions or reputational cost). Budgetary rules for sub-national governments can be set in many different ways depending on the financial aggregate to be considered, the legal basis of the rule and the time horizon.

### 3.4.1 The balanced-budget rule

The key financial control on the government financial viability is a balanced budget rule. This rule has a constitutional rank in most countries and it requires that the state cannot spend more than its revenue. The budget aggregate to control is the budget balance which expresses the difference between
revenue and expenditure, and reveals how much of the revenue raised by government remains within a financial year after its spending activities are fulfilled. It provides an indication of the financial sustainability of the existing level of government services.

If expenditures are above revenues a deficit occurs and it means a potential short-term borrowing need. The budget balance can be split in the operating budget and the capital budget.\(^6\) Operating budgets include annual expenditures such items as salaries and wages, welfare services, and other expenditures that are repeated from year to year. Capital budgets include capital expenditure, mainly for land, highways, and buildings, which is largely financed by debt. Figure 3.3 shows the basic elements of the budget balance in a budget account and its alternative accounting basis are summarised in Box 3.2.

What of the budget balance has to be balanced varies considerably across countries, also depending on the level of government and the accounting basis (Table 3.2).\(^7\)

For example, in the OECD countries some balanced-budget requirements target the operating budget alone, which allows sub-central governments to borrow for public investment. In this case expenditures funded by long-term debt are excluded from calculations whether a budget is balanced.

In the European System of National and Regional Accounts (ESA95) operations are recorded on accrual basis, and the overall result of a country’s general government balance is differentiated by the primary balance and structural balance (also known as cyclically-adjusted balance) of the general government.

The primary budget balance equals the government budget balance (operating and capital budget) before interest payments, without distinction between current and capital accounts. The EU SGP’s balanced-budget requirement is calculated by the primary balance less the interest payments. In Figure 3.3, the EU budget balance equals (a) minus (b) minus (e) minus (f) minus interests. This result, if negative, means a borrowing requirement i.e. a deficit which should not exceed 3\% of GDP.

\(^6\) When interests are included the operating budget is usually referred as ‘current budget’.

\(^7\) In the following Tables 3.1 and Table 3.2, the label ‘state’ indicates intermediate tier governments (states, provinces, lander, regions, counties), while ‘local’ stands for lower tier governments (local, municipal, communal). Each country-tier applied to diverse budget requirements in the tables means that its tier governments are subject to different state-rules.
The structural budget balances attempts to adjust for the impacts of the real GDP changes in the national economy. Conversely, in local governments, the balanced-budget rule might require that current revenues must balance current expenditures inclusive of debt servicing.
Table 3.2  Budget balance requirements: coverage and duration.

<table>
<thead>
<tr>
<th></th>
<th>Current budget balance</th>
<th>Current budget balance and capital account</th>
</tr>
</thead>
<tbody>
<tr>
<td>Annual</td>
<td>Germany local</td>
<td>Canada state</td>
</tr>
<tr>
<td></td>
<td>Japan local</td>
<td>Czech Republic local</td>
</tr>
<tr>
<td></td>
<td>Netherlands local</td>
<td>Denmark local</td>
</tr>
<tr>
<td></td>
<td>Italy state</td>
<td>Germany state</td>
</tr>
<tr>
<td></td>
<td>France local</td>
<td>Korea local</td>
</tr>
<tr>
<td></td>
<td>New Zealand local</td>
<td>Portugal local</td>
</tr>
<tr>
<td></td>
<td>Sweden local</td>
<td>Poland local</td>
</tr>
<tr>
<td></td>
<td>Switzerland local</td>
<td>Turkey local</td>
</tr>
<tr>
<td>Multi-annual</td>
<td>Canada local</td>
<td>Austria state</td>
</tr>
<tr>
<td></td>
<td>Finland local</td>
<td>Canada local</td>
</tr>
<tr>
<td></td>
<td>Norway local</td>
<td>Spain state</td>
</tr>
</tbody>
</table>

Source: Sutherland et al. (2005).

Another relevant issue is the time horizon of the balanced-budget (Table 3.3). There are two general kinds of government balanced budget requirements. The first is that the budget must be balanced when it is introduced by the executive or passed by the legislature. The second is that the budget must be balanced also at the end of a fiscal year, so that no deficit can be carried forward. If it is just the enacted budget to be balanced, a government may carry deficit into the next fiscal year for resolution.

In some countries the budget period at the local level has a multi-annual basis, partially following trends in central government budgetary practice. Targets set on the budget balance are consistent with the principle of financial autonomy since adjustments can be made on both side of the budget. However, when the tax autonomy is restricted, this rule is de facto not much different from an expenditure rule. In almost all cases, budget balance requirements are imposed by higher levels of government. Self-imposed requirements are about limited to intermediate governments in federal states (Sutherland et al., 2005). According to the study of Bohn and Inman (1996), effective
rules do not allow deficit carried forward. Governments with the power to extend a deficit from one fiscal period into the next can accumulate debt if the process is repeated. Anyway, sanctions for violating the budget rules are a deterrent for deficit behaviours.

Table 3.3  Budget balance requirements: time horizon.

<table>
<thead>
<tr>
<th></th>
<th>Submitted budget</th>
<th>Approved budget</th>
<th>Realised budget with carry-over allowed</th>
<th>Realised budget with no carry-over allowed</th>
</tr>
</thead>
<tbody>
<tr>
<td>Imposed by higher levels of government</td>
<td>Czech Republic local</td>
<td>France local</td>
<td>Canada local</td>
<td>Denmark local</td>
</tr>
<tr>
<td></td>
<td>Turkey local</td>
<td>Korea local</td>
<td>Norway local</td>
<td>Germany local</td>
</tr>
<tr>
<td></td>
<td>Greece local</td>
<td>Portugal local</td>
<td>Finland local</td>
<td>Netherlands local</td>
</tr>
<tr>
<td></td>
<td>Poland local</td>
<td></td>
<td>New Zealand local</td>
<td>Spain local</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Sweden local</td>
<td>Slovak Republic local</td>
</tr>
<tr>
<td>Self-imposed</td>
<td>Poland local</td>
<td>Canada state</td>
<td>Canada state</td>
<td>Canada state</td>
</tr>
<tr>
<td></td>
<td>Switzerland state</td>
<td>Germany state</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Japan local</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Negotiated binding</td>
<td></td>
<td>Austria state</td>
<td>Spain state</td>
<td></td>
</tr>
</tbody>
</table>

Source: Sutherland et al. (2005).

If governments must pay heavy sanctions, the balanced-budget rule is likely to be more effective, even if it is imposed *ex ante* and not *ex post*. Anyway a relevant issue is that budgets may be balanced by window-dressing behaviours, such as overestimation of revenues and/or underestimation of expenditures, so that external controls on possible manipulation of accounting data
should be arranged.⁶

In many countries the governments can revise budgets after they are enacted to bring them into balance. Such requirements can be either constitutional and statutory, but are more solid if they are constitutional since they are not subject to legislative amendment.

Budget revisions are in charge jointly on the legislature and the executive. Requiring legislative consent for every change in a budget would impose delays therefore, many constitutions or statutory rules allow executives some flexibility to revise budgets after they have been enacted to bring expenditures into line with revenues.

⁶The European Commission have the power to investigate where there are ‘serious indications’ of possible manipulation of statistics, which may be sanctioned with a fine of up to 0.2% of GDP (OECD, 2012).
Box 3.2

Measuring the deficit: Accounting basis of the budget balance

The two possible systems of measuring the budget balance are cash and accrual. Both systems consider the same underlying government activities, but the differences lie in the timing of when costs and revenues are recognized. Cash and accruals measures of the budget balance serve different purposes. The cash deficit is an accepted proxy measure of the government’s borrowing need so it is useful for understanding its effect on financial markets. Accrual measures are useful for understanding the net cost of current government activities and the liabilities that will have an impact on the budget in future fiscal years. Therefore, both measures provide complementary information for the assessment of the government’s financial viability. In the perspective of national and supra-national tiers of government, the higher availability of cash data and the need for timely monitoring suggests that rules could be defined on a cash basis with a parallel indirect mechanism of reconciliation into the accrual basis.

Cash-based balance.

In using the cash basis of accounting, revenues are recorded only when cash is received, and expenditures are recorded when cash is disbursed. In this case the budget balance shows the cash flow of the year and in case of a deficit (cash outflows exceeding cash inflows) it closely approximates the government annual borrowing needs. Outstanding obligations, in the form of contracts or orders issued, are not reflected in the budget balance. Consequently, the available budget balance might be overstated, which can lead to overspending in the next year. In order to avoid this shortcoming, most government budget use separate obligations-based accounting, which records an obligation against available funds when a commitment (i.e. legal liability) is created.

Accrual-based balance.

In contrast to the cash flow, the concern with accrual basis is to measure the net operating cost of government activities. In full accrual systems, revenues are recorded when earned and expenditures when a liability is incurred regardless of cash. Expenditure include also estimates of amount that will be outlays in the future (i.e. maintenance, credit losses etc.). The accrual deficit is the amount by which expenditures exceed revenues. It approximates liabilities that will have an impact on the government’s fiscal condition in future years.

Modified accrual-based balance.

Budget balance might be measured according to a mixed basis. Expenditures are accrued, as in the accrual-based system, whereas some type of revenues are accounted for on a cash basis because their amount cannot be accurately estimated in advance of due dates. Example of this kind are income taxes, fines etc. This means that these revenues are basically recorded when collected but an adjustment is made when measuring the balance.
3.4.2 Expenditure rules

Expenditures are the main source of the deficit and constitute the budget item that is mainly under direct government control. Expenditure rules set targets on the overall spending ceiling of a government, or major policy areas (e.g. social security, agriculture etc.), or type of expenditure (e.g. operational or capital), or specific expenditure items (e.g. salaries, purchase of good and services, transfers etc.), making the government fully accountable for their achievement. The spending target can be expressed in terms of a ceiling (real or nominal), or as a maximum growth rate.

The main objective of these rules is to ensure budgetary coordination across government levels through improved expenditure control. At the same time, these rules can be instrumental in limiting the size of government or prioritizing expenditures. A spending rule can be established for the entire general government sector or being differentiated by each level of government. In order to be effective expenditure rules requires a clear allocation of responsibility for public functions across layers of government. Overlapping of activities and spending powers should be avoided in order to increase transparency and financial accountability. An adequate degree of tax autonomy to lower levels of government should also be considered to avoid a mismatch in revenue powers and spending responsibilities (i.e. the so-called ‘vertical fiscal imbalance’).

When designing a ceiling on growth of public spending the government have to decide over which period the target is set to be achieved and how to ensure compliance with the rule. These two issues are interlinked. An annual spending rule may be easily circumvented by postponing recording of expenditure items to the following fiscal year. Another common practice is to arbitrarily reclassifying expenditure items into aggregates excluded from the ceilings. For example, since a ceiling is put just on operating expenditures, government entities might reclassify operating expenditure items such as current asset maintenance into capital spending and finance them via deficit. Another, somewhat different behaviour is to reallocating expenditures off the entity’s budget. One common practice is the outsourcing of services to ad hoc settled in-house companies, if these are excluded from fiscal rules.

On the contrary, multi-annual expenditure targets may better be embedded in a medium-term financial strategy so making structural adjustments more feasible. In fact, should the deviation stem from temporary and non-systematic causes there is no need for automatic adjustment in the domestic fiscal frameworks (Ayuso-i-Casals, 2012). Incentives and mechanisms for providing policy responses to past deviations from the expenditure rule are al-
so an important element for ensuring its credibility, and should be incorporated in any financial governance system.

3.4.3 Debt financing and control

Balancing the budget can be a choice as to whether the balance is achieved through taxation or borrowing and it has relevant implications for equity in society. It is a critical decision especially with regard to capital expenditures. Taxation implies that public money is increased by reducing current taxpayers’ resources. Requiring taxation for matching capital expenditures it means asking government for self-financing so that public debt and interest payments are avoided. But, this rule has some shortcomings.

First, it assumes that a government entity has sufficient means to carry out current operations plus an excess to meet investments requirements. It also means that current taxpayers are required to paying for the free benefits that future users of capital facilities will take advantage. Second, it avoids borrowing when it is necessary and convenient (e.g. when interest costs are negative). On the other hand, by borrowing the relevant financial burden is put on future taxpayers. Indeed, the debt burden equals the amount of taxes that taxpayers are required to provide in order to finance outstanding debt service. By borrowing, the basic assumption is that the future tax base growth or user charges will offset the increased liability for debt service. It also facilitate the user-benefits equity over the life of capital facilities.

Debt service (interests and annual repayment of the debt) raised by taxes in subsequent periods is therefore considered a fundamental element of inter-generational fiscal exchange induced by the decision to finance a capital project (Buchanan, 1967). But, relatively high levels of debt represent a significant call on future revenue flows limiting a government’s flexibility to deliver tax cuts or spending on core services.

Aside from the financial autonomy principle, without any financial rules governments have the incentive to generate budget deficits and borrowing in response to services demand from voters. This issue raises the necessity for the central government – even within federal systems - to arrange legal constraints on local budget and deficit-financing powers to ensure that borrowing is not excessive in aggregate. A relevant theoretical and practical problem is that of determining the overall debt limit and its allocation among the different levels of government.

This aim is pursued by requiring government budgets to borrowing only for investments and not to fund operating deficits (the so-called ‘golden rule’ of public finance). Essentially the rule indirectly attempts to equate current spending with current revenues. Of course, operating budget surpluses can be used to finance capital expenditures.

Another form of legal constraints on local government borrowing is the re-
quirement of achieving of a ‘net operating balance’ in that current revenues must balance current expenditures inclusive of debt servicing (interests and annual debt reimbursement). This requirement is generally in force for the enacted budget but it is more efficient if it has to be achieved the end of the fiscal year. This is because it forces local governments to accumulate operating surpluses adequate to fund current expenditures and the debt service.

In a capital budgeting perspective, this rule should lead local governments to showing they are able to generate persistent and positive net operating balances in the future, as a precondition for borrowing. Moreover, since the debt service should be paid out of current tax revenues, another indirect way to limit local government borrowing is to set a control rule for the cost of debt service. According to this rule, new borrowing is allowed only if the overall cost of debt service (i.e. interests on outstanding debt and new instalment) rests below a pre-set percentage of current revenues. This rule does not prevent local government to borrow beyond the debt-carrying capacity, especially in times of low interest rates, so forcing higher levels of government to continuously revise that percentage.

Finally, another form of control on borrowing is to put an explicit limit on the stock of debt or the rate of new debt creation and to require preventive debt authorization from the central government.

### 3.5 The design of budgetary rules

According to the management theory, the budgetary rules should be designed considering requirements of autonomy and reliability in the system. The issue of reliability is connected to the effectiveness of any control system which is strongly based on the clarity and the rigor of performance measurement rules (Flamholtz, 1979). Hence, if fiscal rules are unstable, the control system loses credibility and it is no longer felt to encourage virtuous behaviour. Further, if national fiscal rules bring rigid and arbitrary constraints to the managerial autonomy of sub-national governments, then rules can be circumvented by local decision-makers and it could be difficult to achieve positive effects at the macroeconomic management level.

Thus, to be effective, numerical fiscal rules should be shaped by negotiation across government layers and respecting the management responsibility of individual governments in target setting. In the context of the European Union, where it is difficult to balancing political integration and domestic sovereignty, policymakers have expressed a strong preference for nominal fiscal targets because of their greater political acceptability.
In other countries such as Latin America, Argentina, Brazil and Mexico, political and legal difficulties to implement top-down fiscal rules that apply to all levels of government have given birth to a ‘contractual approach’. In this case, fiscal targets are agreed by sub-national government following a central government plan of debt rescheduling and fiscal adjustment.

Arguments in favour of such an approach are the lack of flexibility that budgetary constraints impose on macroeconomic policy and ineffectiveness of rules because of elusive practices (von Hagen, 1992).

The effectiveness of fiscal rules for the control of budgetary outcomes has been largely investigated by public finance scholars (Bohn and Inman, 1996; Debrun at al., 2008). This research has showed that their efficacy depends strongly on a number of features such as the statutory basis of the rule, the budgetary control against the fiscal targets, and the existence of corrective mechanisms in case of non-compliance (Inman, 1996; von Hagen and Wolff, 2006; Ayuso-i-Casals et al. 2009). According to the existing literature, all these features should be taken into account in the design of fiscal rules to ensure their effective influence on the conduct of fiscal policy. Box 3.3 summarises the key elements in the design of effective fiscal rules.
Box 3.3

Key elements in the design of fiscal rules.

**Statutory base**: Ideally, any rule should be backed by strong legal provisions signaling the importance attached by the government to fiscal consolidation (e.g., a law of fiscal responsibility). The legal statutory base should clearly establish the requirements for amending the rule, in order to enhance credibility. It should also specify the monitoring mechanisms and the pre-established enforcement procedures in case of non-compliance.

**Multi-annual character**: Rules embedded into a medium term budgetary framework, as a part of a comprehensive fiscal strategy, may better adapt to economic and country specific circumstances, and may facilitate the internalisation of the budgetary effects of current policies over the medium term. A multi-annual timeframe may limit the potential circumvention of the rule by postponing the recording of expenditures or the implementation of structural adjustments.

**Monitoring**: The effectiveness of monitoring relies on two elements. First, in order to monitor compliance with the rule in an effective manner, updated and reliable data must be available. Where they are not, compliance can only be assessed with considerable delays. Second, an independent monitoring body is more likely to result in necessary adjustments of budgetary trends being implemented once they have been identified.

**Enforcement mechanisms**: The design of corrective and enforcement mechanisms is an important feature to ensure the proper functioning of fiscal rules. The actions to be taken in case of non-compliance should always be defined ex-ante so as to make the rule credible and enforceable. Otherwise, the cost of non-compliance would be only reputational, which is insufficient in the presence of acute fiscal distress and weak budgetary institutions. The enforcement of corrective measures ought to be ensured by a non-partisan institution, legally endowed with the requisite competencies. Monitoring and enforcement could be carried out by the same independent body.

**Sanctions**: In the case of non-compliance with the rule, pre-established sanctions may supplement the enforcement mechanisms. They may adopt two different forms. In developed nations, non-compliance sanctions typically apply to institutions, comprising fines, automatic withholdings of transfers, restrictions on debt insurance etc. In developing countries, personal sanctions prevail, including dismissal procedures, obligations to resign, fines, or lower wages.

Source: (European Commission, 2010).
3.6  The operationalization of budgetary constraints across government layers

The contribution of each level of government to the overall general government budgetary position must be specified in order to engage the fiscal responsibility of lower government tiers. While this process would require collaboration and negotiation among government tiers, different approaches might be considered for the operationalization of targets.

First, the duplication of the general government targets at the local government level. This is a very simple and transparent method but may be very costly in case of a large number of local governments. Further, due to the small size of most local-tier entities (i.e. municipalities), both the measurement and the meaningfulness of GDP may be difficult.

Second, the introduction of a market for deficit permits among mid- and local-tiers governments. This is after all a simple method but it bears high political cost in the initial allocation of permits (Casella, 1999).

Third, the introduction of administrative controls on the indebtedness of lower-tier governments, but it may be in conflict with constitutions or laws in some federalist settings. Finally, another method consists in setting targets for the reduction of budget balance of local governments on a yearly basis. This method requires three progressive steps. Table 3.4 give a streamlined example of the process. First, it requires the definition of the budgetary aggregate, its accounting basis and the calculation of the consolidate target for the overall government. Budgetary aggregates for involving lower-tiers in deficit reduction are several (i.e. expenditure, budget balance, cash position, borrowing, debt etc.). As discussed before (paragraph 2.4), an adequate budget component is the net operating budget balance, which equals the difference between operating revenues, net of state transfers and the operating expenditures, net of interest on debt. Then a consolidated target for the first three years in the total government deficit should be calculated and split in annual reduction targets as “% of of GDP” for single levels of government (vertical allocation, FY n+1, column 1 and 2 of Table 3.4). Drivers for this allocation are the tier’s GDP or expenditure on an annual or multi-annual basis. In Table 2.4 the deficit reduction (FY n+1, column 1) is calculated in nominal terms and past expenditure is used as a baseline for the allocation of the budgetary adjustment (FY n+1, column 2).

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* This is for example the case of the EU SGP as deficit and debt targets are referred to the general government of each country.
The resulting targets for each tier of government must be further translated into specific targets for each tier’s single entity (horizontal allocation, FY n+1, column 3 of Table 3.4). Since a limited number of entities is normally included in the central government, it is not a difficult task to set up specific sub-targets for each entity in this tier (e.g. ministries, state departments, agencies). Conversely in local government, given the large number of local entities, the setting of uniform targets is the most widespread way to allocate budgetary adjustments to tier’s entities. Uniform targets in this case may be slightly differentiated according to some attributes such as the type of entity (e.g. regions, municipalities), the budgetary component (e.g. expenditure items, budget balance), the baseline for target calculation (e.g. annual, multiannual), the accounting basis (e.g. cash, accrual, modified accrual). Some important issues for the acceptability of fiscal constraints are the transparency of whole process and the fair calculation of fiscal targets.

Table 3.4 Operationalization of budgetary rules across levels of government.

<table>
<thead>
<tr>
<th>Government Level</th>
<th>FY n</th>
<th>FY n+1</th>
</tr>
</thead>
<tbody>
<tr>
<td>general</td>
<td>100</td>
<td>-20</td>
</tr>
<tr>
<td>central</td>
<td>60</td>
<td>-15</td>
</tr>
<tr>
<td>local</td>
<td>40</td>
<td>-5</td>
</tr>
</tbody>
</table>

3.6.1 Transfers of ‘right to run a deficit’

In order to partially overcome the rigidity of uniform targets at the local level the domestic fiscal framework might be supplemented by a complementary mechanism of transfers of ‘rights to run a deficit’ across governments tiers of the same territory. The use of such a system for budgetary coordination has been implemented mainly in Austria and Italy at the local government level.
The mechanism is shown in the following example and illustrated in Table 3.5. The case considers a regional government with jurisdiction over three municipalities, each having deficit targets (cash-basis) set by the central government. The regional government can allow municipalities to reduce their budgetary constraints but it must tighten up its own deficit target for the same amount. This means that more cash payments can be executed by municipalities out of the initial limits whereas an extra-surplus is expected from the regional government. The allocation of deficit permits to municipality A (i.e. 60) and B (i.e. 40) is made by the regional government according to its own territorial arrangement (vertical transfer). Another mechanism is the transfer of deficit permits between municipalities in the same jurisdiction (horizontal transfer).

Table 3.5  Flexibility in budgetary constraints.

<table>
<thead>
<tr>
<th></th>
<th>Budgetary coordination</th>
<th>Regional government</th>
<th>Municipalities</th>
<th>Jurisdiction balance</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td>A</td>
<td>B</td>
</tr>
<tr>
<td>a</td>
<td>Initial fiscal targets</td>
<td>100</td>
<td>200</td>
<td>400</td>
</tr>
<tr>
<td>b</td>
<td>Vertical transfer</td>
<td>+100</td>
<td>-60</td>
<td>-40</td>
</tr>
<tr>
<td>c</td>
<td>Horizontal transfer</td>
<td>-40</td>
<td>-60</td>
<td>+100</td>
</tr>
<tr>
<td>d=b+c</td>
<td>Regional adjustment</td>
<td>+100</td>
<td>-100</td>
<td>-100</td>
</tr>
<tr>
<td>a+d</td>
<td>Adjusted fiscal targets</td>
<td>200</td>
<td>100</td>
<td>300</td>
</tr>
</tbody>
</table>

The mechanism is similar and the transfer of rights is managed under the governance of the regional government. In this case the municipality C tightens up its target by 100 which is subsequently allocated to municipality A (i.e. 40) and B (i.e. 60) by the regional government. There is a unique distribution of deficit permits so that the algebraic sum of target adjustments within the regional territory must equals to zero, i.e. deficit permits cannot exceed extra-
surplus. It is relevant to notice that any distribution of deficit permits leads to the same initial overall balance for the jurisdiction. Regional adjustments and new targets are reported to the central government in order to control for the achievement of the general government SGP budgetary targets.

3.7 Effects of uniform budgetary constraints on government operations

This final paragraph is intended to give a picture of the complex interaction between central rigid rules and the financial behaviour of local governments. Budget targets set with a uniform approach might lead to a number of constraints affecting the financial management of lower-tier government as well as contradictory consequences on the overall general government budgetary position regardless the kind of fiscal rule in force.
Budgetary rules setting a fixed percentage of improvement on the basis of the past fiscal aggregate might cause unbalanced opportunities for management actions, regardless the size of entities and past performance. A description of a typical situations is as follows (Table 3.6). The first is a budget balance rule case. Assume two entities A and B with a similar level of deficit but a different expenditure level (A>B), and a budget balance rule that claims the same amount of adjustment. Because a budget balance improvement is offset by cutting expenditures or increasing tax, the budget balance rule might favour entities with higher expenditures. Note that because the deficit adjustment is 1 as a result of the 10% target, operations are affected for only 1% of past expenditure (adjustment divided by expenditure) in entity A but 2% in entity B.

**Table 3.6** Effects of uniform budget balance constraints.

<table>
<thead>
<tr>
<th>Government</th>
<th>Past financial position</th>
<th>Budgetary target = 10% improvement</th>
<th>Effect on operations</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Expenditure</td>
<td>Budget balance</td>
<td>Expected budget balance</td>
</tr>
<tr>
<td>A</td>
<td>100</td>
<td>-10</td>
<td>-9</td>
</tr>
<tr>
<td>B</td>
<td>50</td>
<td>-10</td>
<td>-9</td>
</tr>
</tbody>
</table>

In contrast, the second example is an expenditure rule case (Table 3.7). The shift in the fiscal rules to a ceiling on expenditure favours entities holding lower expenditure but higher deficits, even though the overall objective is a deficit reduction. Assume entity A holds a surplus and entity B holds a deficit. Entity A, with higher expenditure is paradoxically asked for a larger adjustment than entity B with lower expenditure but a deficit.
Table 3.7  Effects of uniform expenditure constraints.

<table>
<thead>
<tr>
<th>Government</th>
<th>Past financial position</th>
<th>Budgetary target = 10% improvement</th>
<th>Effect on operations</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Expenditure</td>
<td>Budget balance</td>
<td>Expected expenditure</td>
</tr>
<tr>
<td>A</td>
<td>100</td>
<td>+10</td>
<td>90</td>
</tr>
<tr>
<td>B</td>
<td>50</td>
<td>-10</td>
<td>45</td>
</tr>
</tbody>
</table>

Another potential consequence of uniform budgetary targets seems to have a perverse effect on the financial viability of local governments. The combined effect of undifferentiated constraints and potential elusive behaviours of local governments might be twofold. First, it might cause major capital projects contraction and delaying of payments in capital spending. If ceilings are set on the cash budget balance, one potential elusive practice is to slide the current year’s payment of commitments into next year’s fiscal target.

Another not elusive operation is to shape the debt service by refinancing debt. Both these operations allow local government to get free cash flow to comply with fiscal rules and slide the cutbacks into the next fiscal year.

Table 3.8 gives an example of a typical case in which these kinds of financial management are stimulated by numerical fiscal constraints. Assume a local government where its tax power is limited, borrowing is allowed without prior authorisation but with a limit on debt service, and the budgetary target is set by the central government on the overall budget balance, i.e. total revenues less total expenditures (operating plus capital expenditures). In fiscal year N+1 this local government refinanced its debt and, thanks to a lower debt service, increased the stock of debt to finance new capital expenditures. Note that this practice resulted in a cutback of discretionary programs, such as capital projects, and a rise of operating expenditures on mandatory services. At a glance, a free cash flow in the budget balance allowed the local government to achieve both fiscal targets and a balanced budget, even if operating expenditures and debt increased.
Table 3.8  Contradictory effects of uniform budgetary constraints.

<table>
<thead>
<tr>
<th>FY</th>
<th>Financial position</th>
<th>Budgetary target FY N+1</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Revenue</td>
<td>Operating expenditure</td>
</tr>
<tr>
<td>N</td>
<td>100</td>
<td>60</td>
</tr>
<tr>
<td>N+1</td>
<td>100</td>
<td>65</td>
</tr>
</tbody>
</table>

While these strategies allow a local government to achieve nominal fiscal targets its financial condition might be undermined.  

In fact, a lower debt service allows governments to raise the stock of debt. This case shows how in a context of revenue reduction and limitations on local tax autonomy, the achievement of uniform budgetary targets paradoxically might stimulate local government borrowing, undermine the financial condition and increase the stock of debt of the general government.

### 3.8 Conclusion

Financial management across levels of government requires mechanisms and processes of coordination that must reflect the aggregate control needs at the central government level. This is a critical element in ensuring good governance as well as efficiency of activities across government tiers. Budgetary coordination arrangements must be designed consistently with the conditions for government financial viability.

These conditions are financial autonomy and responsibility. The management control conceptual framework is useful for this purpose. Contradictory

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"The financial condition of a government is linked to the debt repayment capacity which is measured by the net operating balance (operating balance less debt service).

"Apart from the EU budgetary targets, most domestic legislation set just a nominal ceiling on borrowing at a fixed percentage ratio of interest charges to operating revenues."
results may occur when the central government uses an undifferentiated approach in budgetary constraints setting, regardless the kind of fiscal rule in force. These include inequality of constraints on operations, elusive practices, the deterioration of financial condition and debt increase. Attempts at the central level to impose financial constraints while ignoring local government-level factors and incentives can lead to unintended overall fiscal instability.

Public financial management reforms should design fiscal governance frameworks so that it will be more advantageous to achieve budgetary rules rather than trying to circumvent them. What should be the design of intergovernmental financial arrangements in a decentralized setting? Using propositions from management theory, there are several.

First, enacting budgetary coordination rules across levels of government requires a negotiated agreement between the central and sub-national governments. To be effective it has to be politically transparent and to stimulate mutual accountability across governance levels.

Second, budgetary constraints must be designed consistently with government financial viability conditions. Budgetary targets that are rigid or that require costly measures are likely to be ineffective because of the strong temptation for government entities to circumvent them. The key issue here is that fiscal targets should be accomplished in a way that reinforces rather than threatens local conditions and viability. Rules that leave flexibility and managerial autonomy in expenditure or budget balances to be shifted across budget years may be easier to improve budgetary responsibility. Nevertheless, budgetary targets should be stable over the years in order to assure the reliability of the control system across governance levels. In this perspective, policy coordination across government layers is the most appropriate way to embed sub-national governments in medium-term fiscal stability frameworks.

Third, an agreed medium-term cap on local government debt dynamics should be adopted. A numerical target on deficit reduction might be too weak an indirect rule for debt control in a setting of local government borrowing without prior authorization. In fact, such an indirect rule may led to undermine financial condition. Budgetary targets should be simplified by leaving only a ceiling on local governments’ debt growth rate. A process of bottom-up debt-budgeting should be arranged, thereby allowing local governments to plan and making the general government’s budgetary consolidation easier. Under this regime, intermediate levels of government would play a major role in the coordination of budgetary discipline of local entities within their jurisdiction. Further studies should conveniently test these propositions and explore these issues in a comparative perspective.
References


