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Sub-national deficits in European countries: The impact of fiscal rules and tax autonomy

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ABSTRACT

This paper empirically examines how fiscal rules and tax autonomy influence deficits of sub-national sectors across European countries. I use a new panel-data set to measure tax autonomy and the stringency of fiscal rules for EU15 regional and local government sectors over the period 1995 to 2008. I apply an instrumental variables approach to obtain an unbiased estimate of the impact of fiscal rules on deficits. I use political variables describing the central governments characteristics as instruments for fiscal rules at the sub-national level. The results show that the effectiveness of fiscal rules and tax autonomy depends on the constitutional structure. Fiscal rules decrease deficits only in unitary countries. Deficits of sub-national sectors in federations can be avoided through tax autonomy.

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1. Introduction

The differences in the fiscal performance of sub-national governments across European countries are widely unexplored. The explanation of a sub-national bias towards deficits by institutional settings, such as fiscal rules and autonomy over tax instruments, is the utmost concern of the present paper. The empirical results explain why some countries are more affected by a deficit bias than others. Sub-national sectors in federations which have substantial autonomy over their tax instruments have lower deficits than those which have not. This paper also shows that only deficits in unitary countries can be avoided by tying the governments' hands with fiscal rules, while they are ineffective in federations.

Since the early 1990's much attention has been devoted to explain why certain countries have experienced long periods of budget deficits that accumulated in high levels of public debt while others did not. The focus has been mainly on political and institutional factors, since even countries with similar underlying economic conditions showed a widespread variation in debt levels. The design of the institutions responsible for the budgetary process is considered one major determinant of the cross-country heterogeneity in fiscal positions (among others, see von Hagen and Harden, 1994, 1995; von Hagen, 2002, 2005; Alesina and Perotti, 1996, for this line of argument).

Most of the literature, both theoretical and empirical, focused on the central or general budget and national fiscal policy. Instead, the links between sub-national debts and deficits, their institutions, and in particular the restrictions imposed on them by fiscal rules, have not yet been explored in depth. The institutional background of the latter differs from the former because of the crucial role that vertical relationships play between different layers of government. This paper aims at investigating empirically the underlying forces from the perspective of sub-national jurisdictions.

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The differences in fiscal positions below the national level can be caused by a deficit bias due to a common pool externality. Budgetary inflows may arise, to a certain extent, from a common source in the form of transfers or grants, while budgetary outflows are targeted to specific regions or municipalities. Often, sub-national entities have no direct influence over the instruments generating a substantial share of their revenues. von Hagen and Eichengreen (1996) introduced the idea of the local or regional tax base being responsible for bailout expectations and being connected, through this channel, to the deficit bias. Indeed in a dynamic context, they argue, budget constraints may become soft when governments are highly dependent on revenues that are not generated by their own instruments. Sub-national decision makers might expect, ex-ante, to be bailed out ex-post by a higher-level government if they cause a large and unsustainable deficit. In other words, the central government cannot credibly commit to a no-bailout policy, if the respective lower level governments have no power to solve fiscal problems on its own. Instead, when a large proportion of sub-national revenues comes from own tax resources, the central government may successfully persuade sub-national jurisdictions that, in case of excessive debt, they have to balance their budget by increasing tax rates under their control (von Hagen and Eichengreen, 1996).

A recent attempt to mitigate this time inconsistency problem of soft budget constraints was to impose fiscal rules on sub-national governments. The idea of fiscal rules is to force local or regional governments to act in the way the central level desires. The number of fiscal frameworks which impose balanced budget or debt rules on lower governmental sectors has substantially increased over the last two decades. The introduction of the Maastricht Treaty and the Stability and Growth Pact could be seen as the turning-point in the implementation of such rules applied to the sub-national sector.

As a first step, I analyze the reasons driving countries to adopt, keep, or strengthen their framework of rules. This is an important task that helps overcome a potential problem of endogeneity. Stricter rules may be adopted by governments with stronger preferences for fiscal discipline or a severe need for consolidation. The first case could create an omitted variable bias and the second case might create a problem of reversed causality. The first concern is usually addressed with fixed effects. I tackle the second identification problem by using political characteristics of the rule imposing level as instruments for the rules themselves at the lower governmental level. They fulfill the exclusion restriction since these political variables might have an impact on the fiscal outcome of the central level, but not on the deficits of sub-national governments.

I use a panel-data set of the sub-national sectors of the EU15 countries, covering data for fiscal rules, tax autonomy, and political and fiscal variables over the period 1995–2008. Regressions of the deficits of sub-national sectors on measurements of the strictness of rules and the discretion to tax show that the effectiveness of fiscal rules and the impact of tax autonomy depend crucially on the constitutional structure and division of powers. Fiscal rules work in unitary countries and not in federations. Implicit restrictions in the form of higher tax autonomy are an effective way to constrain excessive spending for the federal countries in my sample.

This paper is organized as follows: Section 2 motivates my research question by presenting stylized facts for sub-national public finances of the EU15 countries and presents the underlying theory and the related literature. Section 3 explains my identification strategy. Section 4 presents the data-set, and my results are presented and discussed in Section 5. Section 6 concludes.

2. Motivation and related literature

2.1. Stylized facts and theoretical background

European countries differ substantially in the level of sub-national debt which they have accumulated in the past. Fig. 1 shows the level of debt outstanding in 2008 as a share of GDP in the top panel.

The figure shows that a substantial part of the total debt in European countries is due to sub-national borrowing.[1] Most federal countries, and in particular Germany, show relatively large ratios of debt to GDP. However, this measure can be misleading, since it does not take into account the actual size of the sub-national sector. Therefore, the bottom panel depicts the outstanding debt as a share of revenues for the same year at the sub-national sector. Denominating fiscal variables in this way captures two important dimensions. First, it indicates the relevance of debt in terms of the capacity to generate budgetary inflows. Second, this measures the size of the sub-national sector as mentioned before.[2] While the ranking for federal countries remains largely the same, this illustrates further the differences in unitary countries. Even though the Nordic countries have much larger sub-national sectors relative to the general government sector, their debt is lower compared to countries such as Portugal or France, which are less decentralized.

Since debts are (at least formally)[3] the accumulation of deficits over time, the following questions arise. First, why did some federal countries, such as Germany, have on average larger deficits than other federal countries? And second, what drives the pattern of deficits over time in the unitary countries, even though the differences in decentralization have been taken into account? To sum it up, it is important to explore why sub-national sectors in some countries are exposed to a larger bias towards deficits than others.

A well-established reasoning for differences in debts and deficits at any level of government is that the respective decision makers do not fully internalize the costs of the public goods they acquire. This is known as the common pool problem of public budgeting. Since costs are shared by the whole population, theoretical models, as those of von Hagen and Harden (1995), Velasco

[1] The importance of the sub-national sector from the perspective of the general government also varies substantially. For example, the German sub-national sector accounts for almost 40% of total debt while for Greece this share is as little as 1%.

[2] The actual size might be also depicted in terms of expenditures, but note that the ordering of countries does not change if I do so.

[3] See von Hagen and Wolff (2006) for a discussion of creative accounting and stock-flow adjustments.

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