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

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This paper investigates local government budgeting and local debt with three preoccupations
(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 paper. Ten key issues are formulated in section 2. Owing to the heterogeneity of the accounting systems of local finance in Europe, some common definitions are necessary and are given in section 3. Section 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 5. Tentative results are discussed in section 6.

1 This paper is an abstract from chapter 1, Dafflon (ed.) 2002, pp. 1-14

1 INTRODUCTION

The starting point is the situation of local public finance in Europe at the beginning of the 90's, 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.

The Maastricht Treaty

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).

Public Deficits

2 The Maastricht Treaty was signed on 7 February 1992 and came into force on 1 January 1993. Convergence conditions for entering the EMU (European Monetary Union) on 1 January 1999 were analysed in the 1997 public accounts. These conditions are given in the Protocol 5 about excessive deficits and indebtedness. See also Conseil de l'Europe (1997, 14).

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. This essay is an attempt to organise a comparison on these issues at the local level in European countries on the basis of an agenda of ten key issues.[3] It could certainly help to set the case for local public finance in the Lithuanian context.

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

3 In the same vein, see Conseil de l'Europe (1992).

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 for budget responsibility and budget discipline.

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 is presently used for restoring comparability.

The following statement 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 many Swiss cantons;
- similar to the two previous points, but (...) is written in the capital account;
- interest payment + contractual repayment of the debt.

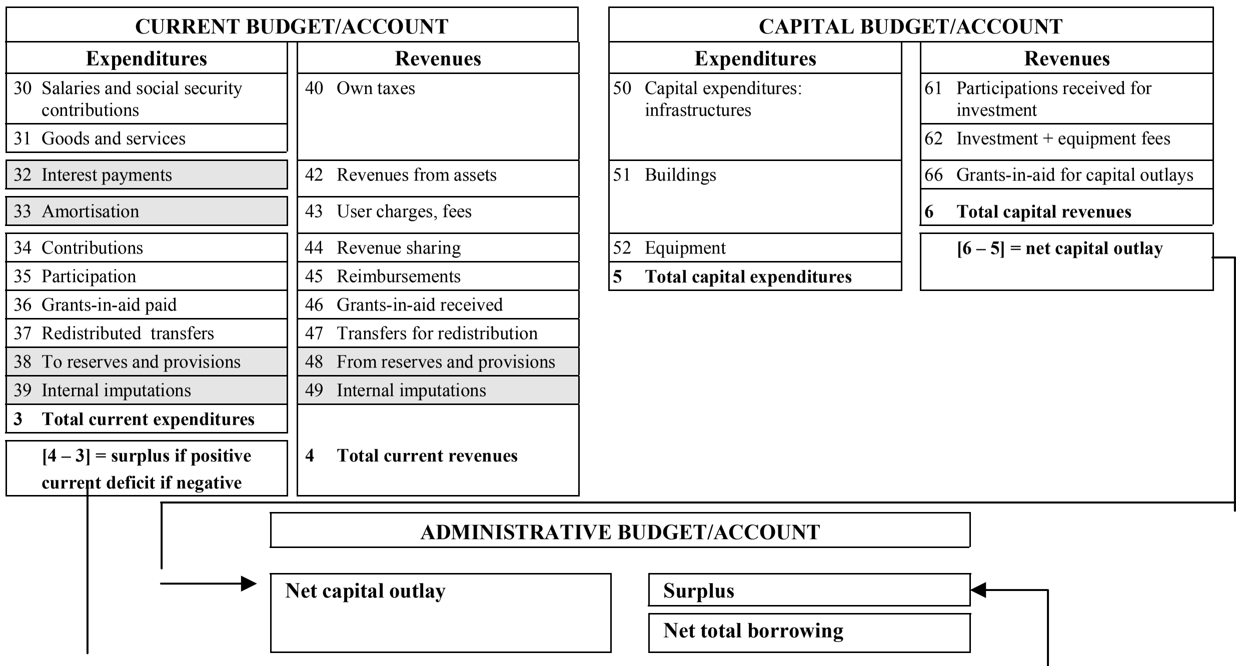
In this example, one sees that “interest payment” is always present. But the concept of amortisation taken in addition varies widely: formal amortisation “in the book” only, amortisation in comparison to depreciation, amortisation compared to effective debt repayment, in the current or in the capital account, and amortisation compared to the contractual annual repayment of the debt. For each of the other terms, the scope for interpretation and the variations in the definitions and uses of concepts are quite amazing. This is at the very least a cause for thought and scepticism about the validity of many comparative studies on European local public finance which ignore these aspects. Thus one can refer to the definitions used in individual countries in the E.U. or elsewhere in Europe for the compliance of the national public finance (adding all government layers + social security) with the Maastricht criteria.

The primary balance is the sum of the effective monetary revenues in the current and the capital accounts, minus the sum of effective expenditures, also in both accounts, but without interest payments (accounting item number 32 in figure 1) and amortisation (33). Pure bookkeeping entries without monetary content (38, 39, 48 and 49) are not considered. Explicitly, these six items in Figure 1 are excluded from the primary balance.

Investment revenues (61, 62 and 63) are directly balanced against capital expenditure in the year of reference, disregarding the fact that in most cases those revenues are earmarked for specific investment items. This also means that the "net capital outlay" is purely a treasury concept without economic significance.

The "balanced budget/account" requirement is computed from the previous result, but taking into account the interest payments (32). This result, if negative, should not exceed 3 per cent of GDP.

Comparing the definition given in italic above with other European definitions immediately signals some controversial issues: the extent of the balanced budget requirement, current or current + capital; amortisation; and investment revenues, if they are earmarked. Differences in the accounting system of European countries, at the local level, make additional difficulties for those comparisons. Compare, for example, figure 1 which presents the analytical framework for local public budget and account in Switzerland with figure 2, which gives the analogous bases for Germany and the model which is proposed in the European Union. In Germany, the accounting of a deficit in the previous year and that of amortisation is completely different, with net borrowing corresponding to the net result of the capital account. In the E.U. model, the absence of distinction between current and capital accounts makes it particularly tricky to evaluate the results and the fiscal position of local government.



Note: Numbers refer to the categories and items in the harmonised accounting system that is used in the Swiss cantons and communes.

Figure 1 *Analytical framework for a public budget and account*

German model

current account

30 wages
31 goods and services
32 interest payments
36 grants-in-aid paid

deficit previous year

surplus: goes to capital budget

40 own taxes
42 revenues from assets
44 revenue sharing
45 reimbur-sements
46 grants-in-aid received

capital account

33 amortisation
56 grants-in-aid paid
gross investment

current budget surplus
66 grants-in-aid received
68 real reserves or/and capital sales
borrowing

EU model

current account expenditures

30 wages
31 goods and services
36 grants-in-aid paid

capital account expenditures

56 grants paid
investment expenditures

primary balance

40 own taxes
42 revenues from assets
44 revenue sharing
45 reimbur-sements
46 grants-in-aid received

current account revenues

66 grants-in-aid received
68 capital sales

capital account revenues

interests

primary balance

overall fiscal result*

* (-) deficit = borrowing requirement
(+) surplus

Figure 2 Comparison of the German and E.U. local public account

4 PROCEDURE

The procedure which serves as a starting point for the purpose of obtaining valid comparisons in the national definitions is given in figure 3 (Dafflon, 1996, p. 240). Six solutions are possible. Solution 1 corresponds to the absence of any constraint. The other solutions present increasingly tighter constraints, with solution 6 giving the strictest rules. The final position of a particular canton or commune depends on the answers to the following six questions.

1. Is a balanced budget required? Is the requirement extended to the actual account?

2. If the affirmative holds, the rules must define the extent to which the balance is required: total (current + capital) budget or current budget only.

With the current balanced budget requirement, local governments can legitimately borrow to finance genuine capital investments. Taxpayers during the immediate period of revenue are not charged with the full costs of public projects that promise to yield benefits over a whole sequence of time periods. The intergenerational equity problem can be solved with appropriate rules of amortisation.

3. Is amortisation of the debt included in the outlays of the current budget (which must be balanced)?

In the affirmative, taxpayers and beneficiaries in periods following the debt issue are faced with contractually committed interest and amortisation charges that are offset by income or utility yielding public assets. The life of the capital public investment, thus the duration of amortisation, should be measured not in terms of physical depreciation but in terms of its economic usefulness following a pay-as-you-use path.

4. If the rule of a balanced budget is constitutionally or legally fixed, is this an immediate or a medium-term requirement, that is, should each successive annual (current) budget be balanced, or is the balance required on average for a sequence of time periods, or is the balance to be recovered for the last annual exercise in a sequence of several predetermined years?

The rule of annual balance produces a tighter constraint and leaves no inter-temporal budget flexibility to smooth over irregular current outlays and revenues. If the balance is required on average for several current budgets in a row, it introduces more flexibility in budget policies, but it also softens budget discipline and opens the door to political leeway and interest groups' strategies. Hence the importance of the next question.

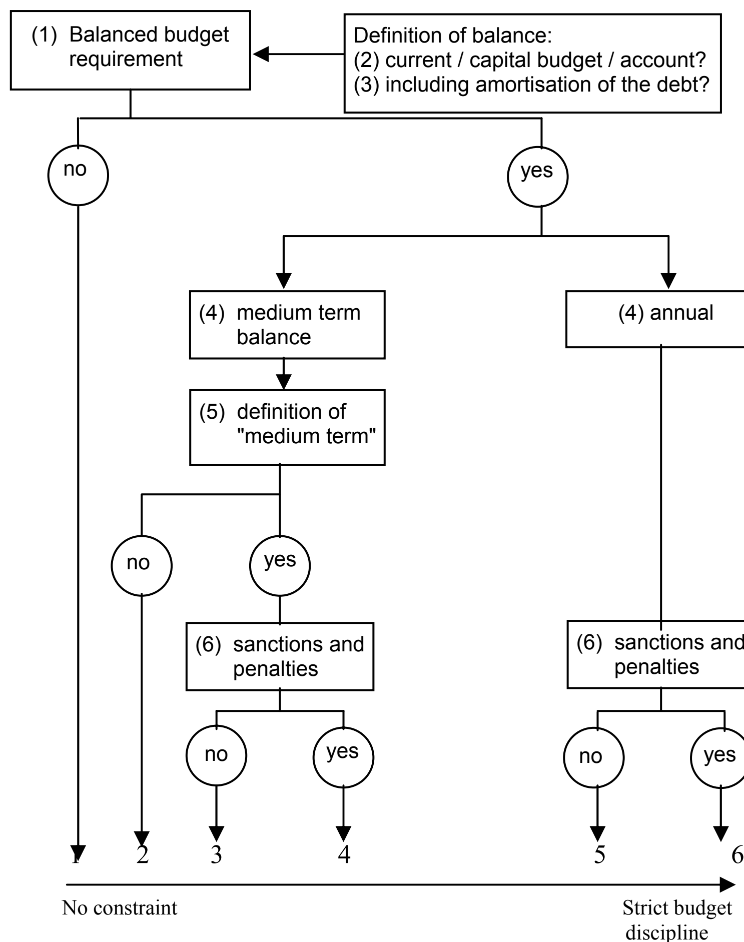


Figure 3 Six paths towards a strict budget discipline

5. In the case of a medium-term balance requirement, is the medium term properly delimited?

Limitation must make explicit the beginning of the sequence of time periods and the number of periods. Ideally, these should correspond to terms of office. If, on the contrary, the political time horizon and the balanced budget time horizon do not coincide, asymmetry introduces a premium for the former and debt illusion on deficits in current budgets is likely.

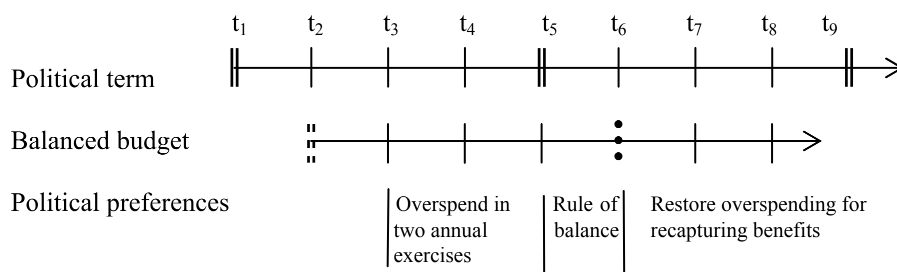


Figure 4 *The problem of delimiting the proper medium term*

Consider that the political term is four years, beginning in t_1 (see figure 4). Suppose the periods over which the current budgets must balance on average are also four years long but do not coincide (t_2 to t_5). What will happen? Simple public choice concepts, such as the proclivity of politicians to spend and their reluctance to increase taxes in order to remain in favour with their constituency, explain the prevalence of budget deficits with this asymmetry (of time periods and of behaviour). Politicians will overspend in years t_3 and t_4, incurring budget deficits, leaving their successors to restore the balance. But the medium-term balanced budgets must be obtained by the end of year t_5, which corresponds to the first year of the new political term. Why should newly elected politicians promote a tight budgetary policy to free tax revenue surpluses in order to repay the debt due to past current deficit? And if they obey the rule, why should they not recapture political benefits by overspending even more in years t_6 and t_7, leaving their followers to re-equilibrate, and so on. Who will say how much overspending in years t_6 and t_7 is too much? This attitude will be reinforced if either the length of the “medium-term” or the beginning of the period (the two conditions are not cumulative) are not explicitly defined. Without legally binding definitions, the requirement for balance in a sequence of current budgets is an empty concept.

6. The last question concerns the sanctions and penalties that could be imposed on local governments when the requirement of a balanced budget or the limits of local indebtedness are not respected.

The public choice argument is that political sanctions for deficit spending and excessive debt, or political rewards for budgetary discipline, are not likely at the time of election and are not sufficient anyhow because of the time lag between annual budget and periodical elections. Sanctions should apply immediately. The standard penalty is that if a current budget deficit is incurred, local expenditures should be cut and/or taxation would have to be increased. If local authorities do not follow this rule, the higher government can decide to raise the annual coefficient of taxation in place of the commune. Sometimes, in addition, communal investments and debt financing must be authorised by ad hoc special decree of the higher authorities. If this is so, the latter authority might enforce and control pay-as-you-use finance, that is the coincidence between the residual value of use of the investments and the net amount of indebtedness (or the equivalence between booked amortisation and the effective annual repayment of the debt). If the amount of net debt is higher than the residual value of the investments, the pay-as-you-use rule is not respected. The higher government may defer any new authorisation until the overdue amortisation is paid; meanwhile new investments financed by further borrowing would not be possible.

Paths 1, 2, 3 and 5 in figure 4 might be grouped together. They lead to a situation where no balanced budget is required. The requirement of a medium-term balance in current budgets without explicit definition of the beginning and the length of the period (path 2), or without penalty if adequate measures to eradicate chronic deficit spending are not fixed (path 3), opens the way to any possible budgetary policy. It does not mean that balanced budgets are never implemented, but only that there is no obligation and no constitutional guarantee, so that equilibrium is rather unusual. Unconstrained budgetary discipline is highly vulnerable. Neither does this mean that unconstrained solutions give greater importance to Keynesian demand management policies. Fiscal constitutions without a balanced budget requirement never subject local governments to stabilisation policies which would be decided at higher levels of government. Yet, such a requirement could be a particular case of path 4. Paths 4 and 6 lead to budgetary discipline; the choice between them depends only on whether the current budget/account (path 6) or the current + capital budgets/accounts (path 4) is/are considered.

5 STRUCTURE AND ORGANISATION OF LOCAL PUBLIC FINANCE

An additional domain of study is to scrutinise whether specific national structures and organisations of local public finance influence budget results, borrowing and indebtedness in the selected countries. The sequence which we want to explore is the following:

- share of local public expenditures in the total public expenditure, in percentage of GDP;
- share of local public capital expenditures in the total amount of government investment;
- share of local public investments in total local public expenditures.

From this starting point, we consider local public revenues: how much is financed by own revenues (taxes, fees and tariffs, revenues from patrimonial assets), grants-in-aid (specific, conditional or general) and borrowing. Local tax autonomy is defined as the possibility to increase tax revenues by raising exclusive taxes or supplementary (piggyback) tax rates. What we need to know is how much of the local revenue sources higher government controls; what share of total local revenues is obtained through grants-in-aid and revenue sharing? How much credit and loan do higher government levels control? Other possible, but not exclusive considerations, are:

- debt policy:
  – what sorts of expenditures (current or capital) are thus financed?
  – which debt ratios must be respected?

- credit rules:
  – access to credit institutions
  – what sorts of loan?
  – which interest rate?

- technical control of higher government:
  - authorisation prior to the expenditure and a priori control of fiscal capacity
  - a posteriori control and sanctions.

6 INCIDENCE OF BUDGET DISCIPLINE OR RESPONSIBILITY

The last objective of the study is to verify whether stricter rules of control over deficit and borrowing are effective in the sense that the general level of indebtedness is lower where the rules are the more stringent. This could be a more difficult part of the study since the preconditions of deficit financing at local level vary from one nation to another, a situation that complicates international comparisons even with identical rules and definitions. Also several explicative variables are at hand which are difficult to isolate one from another. One set of reasons is probably given by selective access to the capital market, the monopoly power of specific national lenders, the borrowing guarantee given by higher rank government when approval procedure are needed, and extended access to loans at reduced rates (sometimes even negative in real terms).

The growing support for the view that political and institutional settings have a role to play in ensuring fiscal performance has paradoxically been accompanied by an increasing lack of confidence in the results achieved. Apparently, political institutions and budgetary institutions seem to be crucial for fiscal discipline. But, if certain institutions are more favourable to fiscal discipline, it would be possible that these mechanisms have been adopted because voters or politicians in this jurisdiction are more conservative in their attitude toward debt financing than in other jurisdictions with more "debt-friendly" settings. Poterba is, to our knowledge, the first author to raise this potential mis-specification of the models, pointing out the problem in a very clear way:

The critical question for policy evaluation is how to interpret this correlation between budget institutions and fiscal-policy outcomes. It is possible that the correlation simply reflects correlation involving fiscal discipline, fiscal institutions, and an omitted third variable, voter tastes for fiscal restraint. Voters in some jurisdictions may be less inclined to borrow to support current state outlays or to use deficits to shift the burden of paying for current state programs to the future. If these voters are also more likely to support the legislative or constitutional limits on deficit finance, then the observed link between fiscal rules and fiscal policy could be spurious. (Poterba, 1996, p. 399)

If this was the case, public or political preferences could become in the end a main factor explaining the comparative evolution of debt. The argument could be presented in the following simplified way. Let us call "A" the voters' preferences for fiscal restraint, "B" the budgetary or fiscal rules or institutions and "C" the fiscal policy outcome. The possible sequences of argument are: C = function of (B), in this case preferences have no influence; C = f(A), fiscal institutions play no role; and C = f(A,B), both are simultaneously important. The observed correlation could appear as C = f(B) formally, but in fact reflect either C = f(A) or C = f(A,B). Empirical evidence suggests that the political configuration can influence fiscal performance (that is, minority governments, coalition governments and in some cases left-wing governments are related to more deficits, *ceteris paribus*, while direct democracy reinforces debt control). Also, budgetary engineering seems to influence the final fiscal imbalances

(negotiations dominated by the prime minister or the minister of finance are related to less indebtedness, and the same occurs if the executive body controls the budgetary process over the legislative branch). As expected, empirical evidence shows that the more a formal rule is stringent against debt financing, the less the level of deficits.

At this stage, the intermediate conclusion is that local practices vary widely from one country to another, and even within the same country in federal states when the intermediate level (Länder, cantons, provinces) sets its own particular rules for local finance. There seems, as a first rough estimate, that although there exist strategic behaviours of local governments when the rules of the game are not precisely defined or with anticipated changes of the rules in the long run, there is no evidence that less control from the centre leads to disastrous effects and excessive indebtedness. No financial crisis or mismanagement on any grand scale have been observed.

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