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Decentralisation in times of economic and fiscal strain

Incentive design: how decentralisation offenses may turn into national fiscal distress

Rui Nuno Baleiras
Executive Member

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1. Introduction

- Gratitude
- Fiscal councils
- Work on local and regional finance

2. Topic

- Theme
  - Care about decentralisation in times of fiscal strain
  - the dangerous temptation of cutting on decentralisation to improve public finance positions
  - Pay attention to appropriate incentive design
- Widespread political and economic relevance in EU
- Portuguese experience as an illustration

3. Basic institutional facts about the illustrative case

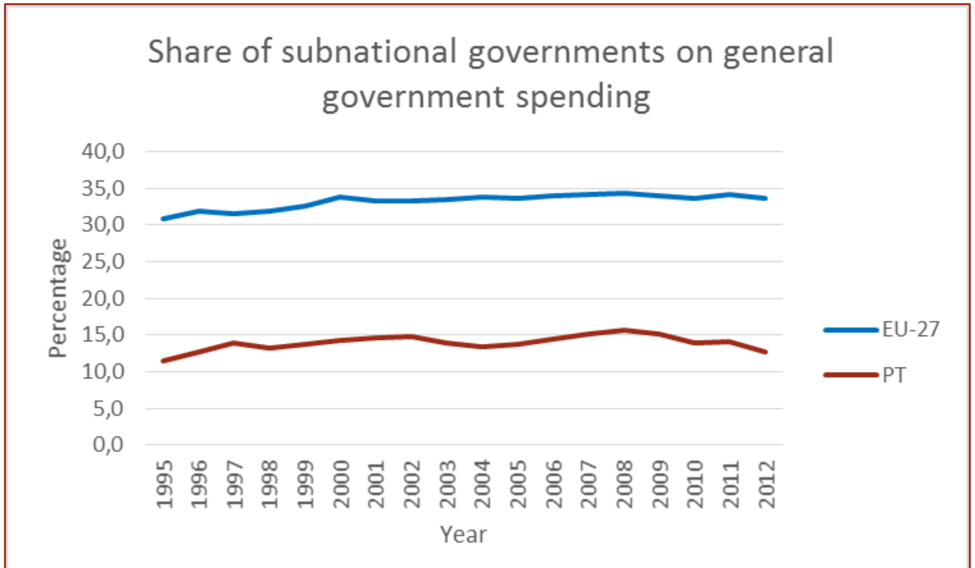
Table 1: No. of subnational governments

	local	intermediate	regional
Austria	2,354		9
Belgium	589	10	6
Bulgaria [1]	264		
Cyprus [2]	524		
Czech Republic	6,253		14
Denmark	98		5
Estonia	226		
Finland	320		1
France	36,786	101	26
Germany	11,252	295	16
Greece	325		13
Hungary	3,175	19	
Ireland	80	34	10
Italy	8,092	110	20
Latvia	119		
Lithuania [1]	60		
Luxembourg	106		
Malta [1]	68		5
Netherlands	408		12
Poland	2,479	380	16
Portugal [1]	308		2
Romania [1]	3,181	41	
Slovakia	3,028		8
Slovenia	211		
Spain	8,167		19
Sweden	290		20
United Kingdom [1]			
- England	353		1
- Northern Ireland	26		
- Scotland	32		
- Wales	22		
TOTAL EU 27	89,196	990	203

[1] Existence of a structured sub-municipal level (communities, localities, settlements)
[2] 9 municipalities and 135 communities, whilst maintaining their legal status, are displaced from the area which is not under the control of the Government of the Republic of Cyprus. The council members are elected through separate elections in the free part of Cyprus.

Source: Council of European Municipalities and Regions (2013), *Factsheets: A figure-based portrait of local and regional Europe*, 11 January, as available online on 19 Sep 2013.

Figure 1: An indicator of fiscal decentralisation: PT vs EU



Notes: annual public administrations data according to the national accounting standard ESA-95; general goverment spending is consolidated across public sub-sectors.
Source: Eurostat, *Government Finance Statistics database*, as available online on 17 Sep 2013.

4. The rationale for fiscal decentralisation

Allocative function of the public budget: provision of collective goods and services

… subject to major political and economic principles

5. Basic public finance principles at subnational levels

1) Efficiency in resource allocation ("subsidiarity or fiscal equivalence principle"): citizens' satisfaction
   - Practical implication: the geographical incidence of the benefits of a public policy should coincide as much as possible with the jurisdiction of the government operating and financing it
2) Political ownership and accountability: requires that
   - Subnational decision-makers have sufficiently strong political incentives to deliver what voters demand
   - Voters are able to judge the performance of their government
   - Subnational communities have a say on both sides of subnational budgets
3) Fiscal framework stability
4) Finance sustainability: the unavoidable constraint

6. Wrong central government decisions

A. Formal reality: right fiscal rules
   1. Transfers from central government (formula-based)
   2. Local and regional debt ceilings
B. Actual policy actions: wrong discretion
   1. From 2000 to 2012: rules changed almost every year…
   2. Justification (for the prevalence of discretion over rules): need to consolidate national public finances
C. Additional mistakes in institutional design (turn out very costly in times of economic and fiscal strain)
   1. Fictitious budgeting practices (systematic optimistic projection of revenues and spending)
   2. Debt rule flaws (limitation of Eurostat standards)
   3. Ever increasing administrative controls and finance minister's case-by-case authorisations

7. Perverse outcomes

- Subnational governments tend to converge to a worse average fiscal performance
- Deficits increase
- Payment arrears extend
- Ultimately, central governments need to lend money to and eventually to bail out local and regional governments (in P, 110 out of 308 municipalities and the 2 regional governments have signed rescue contracts under the PAEL facility-2012 and 2013)

8. Conclusions

- Great care with institutional design is a must
- Credible environments require stable rules
- Fidelity to fiscal decentralisation engagements is a virtue for democratic societies
- Generally speaking, *sound* public finances require *better* decentralisation rather than less decentralisation
- Failure to understand this is dangerous: *decentralisation offenses may turn into national fiscal distress*