

Introduction: how multi-level finance has contributed to the crisis and is affected by it

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1. EUROPE AND THE CRISIS

The financial crisis that swept the world economy in 2008 has produced some paradoxical results that would have been impossible to predict, and indeed were not predicted, at the time. The European Union compact was based on principles of economic and political integration. However, sustainability entailed adherence to fiscal rules at national and sub-national levels together with the assumption that national governments would have the incentive and ability to implement them. It also assumed that sub-national entities would have an incentive to comply with the broad directions of the European compact, and how they managed their affairs was largely their business. The financial crisis exposed several limitations inherent in those assumptions, particularly the futility of fiscal rules in the face of poor information flows on liabilities at the sub-national level as well as state-owned enterprises. These have permitted the effective buildup of risks to the overall macroeconomic framework that in many cases had become unsustainable.

The 2008 crisis originated in the US as a result – with the benefit of hindsight – of overly generous monetary policy and poor regulation of the financial markets and of the banking sector. Many scholars at the time thought that the crisis meant the end of the market-style, financially ruled, deregulated Anglo-Saxon capitalism. Indeed, at the outset of the crisis, most continental European leaders dismissed it as essentially a problem for the US, and presented it as a clear proof of the superiority of the more socially oriented European market system. Yet, almost a decade later, it appears clear that the adjustment in Europe is far from complete, and there is increasing resistance to the cuts in employment, public services and living standards that the adjustment may require. The needed adjustments

threaten the European compact. However, the US appears to have weathered the crisis and has seen a resumption of growth and employment generation.

Interestingly, the European country that performed best after the crisis was the UK, which had opted out of several EU regulations. Although the UK had not joined the common currency, it maintained its position as one of the largest financial markets in the world. There are also clear winners and losers within the Euro area. Germany and, to a lesser extent, some of the smaller Northern European countries quickly recovered from the crisis and resumed a growth path, albeit historically quite limited. In the periphery, the recovery in the Southern European countries has been much slower.

At the time of writing, real GDP in Italy is still 10 percentage points lower than in 2007 and 25 percentage points lower in Greece. Other countries, such as France or Belgium, have stagnated, with output levels that have only now reached the 2007 levels. Green shoots are appearing in Portugal and Spain, but with accentuated separatist tendencies in the latter. But more generally, all of the Euro area seems to be caught in a vicious circle of deflation, sluggish demand, low investment, high unemployment, and increasing social conflict and centrifugal tendencies. Indeed, the needed adjustments, including at sub-national level, concerning basic public services and employment, have added to the stresses on the Euro compact.

The crisis presented a picture that is a far cry from the promises of harmony and prosperity that were at the basis of the European Union and even more of the Euro area. This dismal situation is reflected in an amazing loss of consensus for the European project and the European institutions. The European Parliament increasingly includes parties that are explicitly anti-Euro and anti-EU; the UK is facing a referendum about continued membership amid a backlash against European migrants; and, at the time of writing, while the threat of a 'Grexit' has receded, the country's position remains precarious.

2. INTERGOVERNMENTAL FISCAL RELATIONSHIPS IN EUROPE AND THE CRISIS

The weakness of institutional arrangements in Europe is often ascribed to the limited effective political sovereignty – i.e., the absence of a federal or con-federal structure of government (Eichengreen 2015). Despite Eurostat standards, the effective generation and coordination of information flows was largely left to governments at different levels. It had been assumed

that coordination would result from broad Maastricht rules regarding levels of debt, and that deficit constraints would suffice to ensure the necessary macroeconomic coordination needed to underpin a common currency area. The importance of uniform standards of information on public finances across and within countries was not fully appreciated. The pervasive lack of standardized information flows across and within countries, especially at different levels of government, enhances both the incentives and ability to engage in game-play. Consequently, a degree of game-play resulted, with varying concealment of liabilities in and across the Eurozone, and open disregard of the rules including by the strongest members – Germany and France.

The game-play has both exacerbated the underlying fissures that led to the crisis, and the effect of adjustments to the crisis. The open disregard by Germany and France of the need to respect the Maastricht Treaty rules on public deficit in 2004 led to a decision by the Council to revise the Stability and Growth Pact to avoid imposing sanctions on the two most influential countries in the EU. This represented a turning point in economic relationships inside the Euro area. It signaled to markets the lack of credibility of the European fiscal rules. It also signaled to other countries that it was fine to evade the fiscal rules and to accumulate fiscal and external imbalances. These proved to be disastrous as the contagion from the crisis spread from the US to the Eurozone.

The problems in Germany in 2004 reflect the financial and political relationships and imbalances between the Bund and the Länder that lay in the post-World War II Constitution of West Germany. These were exacerbated by the absorption of the Eastern Länder following the collapse of the Berlin Wall. The imbalances in intergovernmental fiscal relations were clearly recognized, and there were attempts to address all the aspects sequentially during the period of the coalition governments, 2005–09 (Föderalismus I and II). The Commissions largely failed to reach agreement on any of the substantive (16 issues) under discussion, but adopted the Swiss ‘debt brake rule’ (see below) to come into operation in 2020. As argued by Milbradt (Chapter 3 in this volume) and Spahn (Chapter 4 in this volume), the underlying characteristics in Switzerland were quite different to those obtaining in Germany. The adoption of the debt brake rule, as part of a Constitutional Reform to take effect in 2020, amounted to one of several measures that ‘kicked the can down the road’. As pointed out by both Milbradt and Spahn, the consequences of the debt brake rule without reforms to intergovernmental structures are likely to be dire. Yet, the same rule has become the basis for revisions to the Fiscal Compact across the Eurozone and none of the underlying fissures has been addressed. In particular, the incentives for ‘game-play’ remain, especially without a standard

recognition of liabilities, e.g., with respect to public–private partnerships (PPPs), or adoption of a common reporting standard that also governs the coverage of the budget.

Another example of ‘game-play’ lies in the accumulation of bubbles in the real estate market crisis in Spain. Again this reflects the specific political and fiscal relationships between Madrid and the regional governments, particularly the powerful Autonomous Communities (see Lago-Peñas and Solé-Ollé, Chapter 8 in this volume). And even the fiscal problems of the weakest economy, Greece, would be hard to understand without considering the lack of financial control that the Greek central government historically had over its municipalities (see Chortoreas and Logothetis, Chapter 6 in this volume). While the Troika has focused on rationalizing the number of municipalities and their functions, a ‘safety valve’ has emerged in the privatization of local functions with the establishment of enterprises that provide local services, largely financed by the center, and that help evade strictures on local employment and budgets. The political costs of the reform agenda, and the consequent attempts by the Greek government to contain them, were not well understood by the Troika and the problems remained, leading to a backlash by voters.

The European experience represents a good opportunity for the analysis of the impact of a macroeconomic crisis on intergovernmental relationships. A deep and prolonged recession is bound to induce severe strains on the internal organization and operation of governments. It is interesting to analyze how the different intergovernmental systems in individual countries, involving own-source revenues, responsibilities and information flows, affected incentives for different levels of government. We also examine how financing, transfers, fiscal rules and political relationships managed to cope with the crisis and how they were reformed as a consequence. This volume attempts to disentangle these strands in the individual countries and their consequences for the Euro compact.

3. MANAGING SUB-NATIONAL LIABILITIES IN EUROPE

3.1 One or More Crises?

Teresa Ter-Minassian sets the stage for the volume in Chapter 1, providing trends on the fiscal stance of national and sub-national levels of government in the Euro area since the inception of the crisis in 2008. She shows that fiscal policy in Europe went through two separate and different stages. In the first period, all countries attempted to run an anti-cyclical

fiscal policy to support aggregate demand. This varied across countries, depending on their respective fiscal space available and on the extent of adjustment that had been carried out before the crisis broke. Sub-national governments were doubly affected. Most were responsible for a significant proportion of spending, including social protection measures that increased significantly as a result of the crisis. In addition, sub-national tax revenues were also adversely affected. The response was to increase central transfers to the regional and local levels. In addition, there was an easing of the regulations that forbid local governments access to the credit market or to run deficits. This, in turn, had the effect of increasing both national and sub-national debt levels. The poor information flows helped to 'kick the can down the road', and the crisis continued.

Many of the accommodative counter-cyclical measures, especially in Southern Europe, were rolled back in the second period from 2010, as debt sustainability became a concern and large capital outflows led to a crisis of market confidence. In 2010–11, the Greek crisis, and the poor management of the response by European and international authorities, introduced serious fears of a breakup of the Euro area. This forced the countries affected (including Ireland and, out of the Euro area, the UK) to implement strong and rapid macro-fiscal adjustments in order to improve market confidence. As a result, transfers were cut, taxes increased and expenditures curbed, with restrictions that were usually tighter on municipalities and regional governments than national ones. There was no time or inclination to address the deeper structural problems that largely remain. The contractionary fiscal stance, occurring simultaneously in countries with strong interdependencies among them, had a negative effect on growth and output levels. This perversely resulted in increasing debt relative to GDP in these countries. On the whole, the debt–GDP ratio in the Euro area increased by over 30 points during this period.

Ter-Minassian also provides a taxonomy of the different fiscal rules on local levels used in Europe, discusses their ability to function during the period, and illustrates the characteristics of the new European pact. The amended Fiscal Compact arose as a result of the crisis, and most European countries (all the Euro countries plus some Eastern European countries) adopted it in 2012. The new pact focuses on structural budget balances (i.e., netting the effects of the macroeconomic cycle on budgets). It also gives larger executive powers to the European commission on the monitoring of the pact and imposing sanctions. The requirements of the pact were also directly inscribed in the constitutions of the member countries, affecting sub-national entities as well. Ter-Minassian discusses the difficulty of effectively implementing the pact at sub-national levels, and raises the issue of the pro-cyclicality of fiscal rules and the difficulty of maintaining an

adequate level of financing for local investments, already severely reduced during the crisis. Finally, she also raises issues of implementation, such as lack of proper accounting standards and information. This lacuna has allowed local governments in Europe to avoid national and supranational rules, moving part of their liabilities out of their budget, for instance, to 'publicly controlled' private firms.

3.2 Governance and Institutions

Chapter 2 by Ehtisham Ahmad takes up the issue of sub-national institutions and incentives. He argues that appropriate institutional measures affecting management of expenditure and tax assignments, as well as policy design, are needed to provide proper incentives to sub-national governments, e.g., by expanding own-source taxation at lower levels, and by adopting more flexible but also more effective budget management requirements. These must be accompanied by uniform budget standards, such as the IPSAS accounting rules, particularly for PPPs, and the IMF's GFSM2014 standards, to limit the problems with asymmetric information and consequent game-play between enterprises and the public sector in general and between the center and lower levels of administration. The chapter offers several examples, from both Europe and other regions, of sub-national governments reacting to controls on indebtedness by parking liabilities in activities or vehicles that are difficult to monitor. Political gaming operates even in Germany, when local governments resisted the adoption of IPSAS Standard 32 that required disclosure of the liabilities of PPPs in the balance sheets of the relevant levels of government – with appropriate provisioning. This resistance would have taken the deficit of general government further above already high levels (e.g., in 2004), and would also have limited the flexibility of local governments to carry out needed infrastructure investments. Thus, a weakening of standards by the most 'responsible country' in Europe was to have a demonstrably bad effect on the weaker countries, reducing incentives for responsible behavior. This ability to continue kicking the can down the road also limited the incentive to carry out meaningful structural reforms of intergovernmental fiscal relations, and reduced the effectiveness of those proposed or imposed, e.g., by the Troika on Greece.

3.3 Intergovernmental Structure and Fiscal Rules – What About the German/EU Debt Brake?

Georg Milbradt (Chapter 3) offers a fascinating story of the evolution of budget rules and national and sub-national debt in the German context

after World War II, emphasizing the absence of effective reforms on the key structural issues. He focuses on the difficulties of controlling general government finances in a federation, where both the federal and state governments cannot be linked by a hierarchical relationship. The lack of accountability is reflected in the absence of own-source tax powers at the Länder level, lack of a tax administration at the federal level, and complicated and overlapping competencies. He describes in detail the two constitutional reforms (Föderalismus I and II) that were attempted in the 2000s by a national coalition government of the two main parties. These reforms were intended to enforce, first, a stricter separation of competencies and the reduction of co-financing between the Länder and the Bund. None of the structural measures was passed, and as a compromise, the parties agreed to introduce the Swiss model of a 'debt brake rule'¹ for both federal government and the Länder. However, without the structural reforms intended under Föderalismus I and II, the characteristics of the German and Swiss federations differ significantly, and this will lead to problems with the implementation of the 'debt brake' in the future. He focuses in particular on the lack of own-source revenues at the state level that will make it difficult for them to adjust to downturns. However, German municipalities remain *de facto* free from fiscal rules. There will, thus, be a tendency to push deficits down to municipalities, made easier by the lax rules on PPPs. He also questions the extension of the 'debt brake' to the other European countries (the 'Fiscal Compact'). This discussion illustrates the tendencies of politicians to make commitments that do not disturb existing allocations of resources and competences – in effect protecting existing power bases – and leave it to future governments to face the consequences. The absence of much-needed structural intergovernmental reforms remains a challenge in individual countries and for the European experiment. As a result, centrifugal forces are becoming more apparent in the EU as well as in individual countries, as the levels of popular dissatisfaction increase with the cuts imposed on pensioners and in local public services.

4. INCIPIENT PROBLEMS IN THE BIGGEST EUROPEAN COUNTRIES

It is generally believed that the Northern European countries behave in a more responsible manner than other EU members, and have thus managed to escape the worst effects of the crisis. As we see below, the intergovernmental structures are critical in explaining schisms and weaknesses, and the Northern European countries continue to face serious challenges ahead,

whereas some countries in Southern Europe have taken serious measures to address imbalances and hence may have improved their long-term prospects.

4.1 Germany

Paul Bernd Spahn (Chapter 4) discusses in more detail the case of Germany during the crisis. He shows that the adjustments of the German public sector, forced by Unification, left public finances in a better condition in comparison to the overall fiscal position of the other European governments. This allowed for a quick anti-cyclical response by the federal government that supported, with increased transfers, state and municipal expenditure, in particular on social assistance. The policies implemented not only followed the usual Keynesian guidelines, but were also combined with gradual adjustments that had enhanced the competitiveness of German companies. However, these measures could not prevent a sharp increase in total debt and a fall in local investments. The intergovernmental reform agenda did not make much progress, however, and Spahn raises concerns similar to those of Milbradt regarding introduction of the constitutional 'debt brake'.

Spahn's conclusion is that Germany will be propelled toward crisis by the debt brake – or by the incomplete measures taken to avert the crisis. This strengthens the conclusions of Milbradt that the structural intergovernmental schisms need to be addressed as a matter of priority in the little time left to make adjustments.

4.2 France

Pierre Garelo (Chapter 5) discusses the case of France, which, like Germany, was able to defy the European Commission (EC) in 2004 and get away with it. There is a very complex network of sub-national governments in the country (an ever-changing *millefeuille*) and recent, and often contradictory, reforms. These begin with the Constitutional reform of 2003 and the further proposed reforms, affecting the ability of this system to cope with the crisis.

The basic conclusion is that the existence of four levels of sub-national government (municipalities, associations of municipality, *départements* and regions) and the overlapping of functions and tax bases between all these governments (for instance, the residential property tax is shared by three local governments out of the four) reduces accountability and transparency. Most worryingly, in 2010 a sub-national tax (the *tax professionnelle*) was eliminated and substituted by a very complex system of

intergovernmental transfers. This further reduced transparency in inter-governmental fiscal flows.

The fact remains that, in spite of the multiplicity of governments and several attempts to move toward decentralization, France remains a strongly unitary country. With a combination of law, fiscal rules and administration, as explained in the chapter, the central government maintains a strict control on local public finances. This explains why French local governments fared relatively well during the crisis (for instance, local public investments did not fall as much as in the other EU countries). But the costs were borne by the central government and this led to a breach of EC limits on general government debt. In a situation of overall deteriorating general government public finances, France might eventually be sanctioned by the European Commission. It is not clear how the intergovernmental institutions will respond if that happens. As it is, unemployment pressures and rising xenophobia are contributing to a backlash against immigrants – especially of non-European descent – leading to a real prospect that the anti-EU National Front might be voted into power.

5. THE TROUBLED COUNTRIES OF SOUTHERN EUROPE

5.1 Greece

Georgios Chortareas and Vassileios E. Logothetis (Chapter 6) address the fascinating (and clearly tragic) case of Greece. The country has been characterized by weak political institutions and widespread rent-seeking and clientelistic practices that affect central and local governments alike. Management of local public finance was weak and hiring at the municipal level has often been used to buy political influence, a practice made easier by the fact that part of the labor costs at local level were, and still are, actually borne by the central government and did not appear as local spending, even though local service delivery was the object of that spending. As a consequence of the crisis and the Memorandum of Understanding (MoU) signed by the country with the European institutions in exchange for financial help, a rationalization policy for local governments was also implemented. The number of municipalities has been largely reduced, eliminating the smallest units (communes) and merging others, so that there are now only 325 local governments (reduced from more than a thousand at the beginning of the crisis). This has been accompanied by a disentangling of functions, with municipalities formally assuming more power in fields such as public health, social welfare, urban development,

environmental supervision and public education. Furthermore, fiscal rules constraining debt at local levels, as well as imposing layoffs of thousands of local employees, have also been implemented.

A political game has been played with the Troika that focused on formal local budgets. Many local functions were privatized, and thereby taken off the books of local governments, but continued to be supported by central subsidies. This remained the main safety valve in the face of crumbling safety nets, cushioning the worst effects of the crisis on the living standards of the poor and vulnerable, particularly the unemployed. Consequently, opacity in intergovernmental fiscal relationships remains, and the authors are skeptical about the long-term results of the reforms, incomplete institutions and information flows.

The Syriza government faced the difficult choice of either having to impose further pain on an exhausted population that they were elected to protect, or face the economic chaos and the political risks (from the coming to power of hard-line nationalist or proto-fascist parties) of an exit from the Eurozone. The austerity choice has taken new strength after the very recent national election when the Syriza party secured a large share of the vote, but political pressures against it remain.

5.2 Portugal

Mário Fortuna (Chapter 7) discusses the case of Portugal. He provides a historical discussion of the structure of the country, made up of Continental Portugal and the two autonomous regions of Madeira and Azores since the establishment of democracy in 1974. He provides a detailed discussion of the evolution of both regional and municipal financing, including the evolution of rules for the transfer mechanism. The general picture is of one of poorly designed accounting rules; structural problems concerning the sustainability of local finance, particularly in the autonomous region of Madeira; and poorly managed equalization transfers, leading to an effective soft budget constraint at the sub-national level. When faced with stricter fiscal rules, municipalities and regions made extensive use of PPPs, hiding liabilities in publicly owned enterprises, and other off-budget practices, to circumvent the rules.

The chapter also details the changes in intergovernmental relationships induced by the crisis and by the MoU with European institutions following Portugal's access to ESM financing. This included the reform of the budget framework law, reduction in transfers and wage cuts at the local level, more encompassing budget rules to eliminate off-budget practices, and more detailed information on fiscal flows and local taxes. There is also a provision for the future reduction in the number of municipalities.

The problems in Madeira were addressed with a tight IMF-style program administered by the Central Government in Lisbon. However, proposals to introduce significant structural changes in the intergovernmental design made by the Fiscal Council were not adopted by Parliament.

Although the tighter fiscal management by the Central Government has helped to smooth over the worst effects of the crisis, the absence of meaningful structural reforms remains a cause for concern.

5.3 Spain

Santiago Lago-Peñas and Albert Solé-Ollé take up the case of Spain (Chapter 8). They argue that the current crisis in public finances has both external and domestic origins. The real estate bubble at the beginning of the 2000s was induced by the flows of international capital after the accession of Spain to the Eurozone. They also carefully analyze some of the main domestic causes, due to the design of the decentralization process in the regions and municipalities, in particular concerning tax design and equalization transfers.

With the decentralization of the 1990s, Autonomous Regions have been given significant responsibilities in the management of important social policies, such as health and education. However, they were assigned resources that were strongly pro-cyclical, and had limited tax autonomy. The exceptional buoyancy of revenues induced by the real estate boom (paradoxically, with the exception of the property tax, whose base was adjusted only partially and with lags following the appreciation in house prices) induced overspending by all levels of government. There was a strong increase in corruption cases among local and regional politicians, mostly again linked to the real estate sector (e.g., money in exchange for an increased number of building permits). Tellingly, the level of overspending appears to be higher where the quality of political accountability (as measured by reported corruption cases) is lower.

Incidentally, the crisis was not foreseen, as Spain continued to be complemented by the IMF in 2008 for meeting Maastricht limits on stock of debt and deficits. With the bursting of the real estate bubble, all levels of government experienced a severe financial crisis, with rapidly increasing deficits and debt levels. Consequently, general government debt and deficits quickly exceeded the Maastricht limits.

According to Lago-Peñas and Solé-Ollé, the central government, led by a center right party, seized this opportunity to recentralize the system, exchanging financial support to regions for severe cuts in local and regional expenditure and letting regions take the blame for the reduced level of services. However, this strategy might well not succeed, as shown by the rise of

populist parties opposed to remaining in the EU (Podemos) and the resurgence of a strong secessionist movement in Catalunya (Catalonia). The results of the October 2015 elections led to the separatist parties obtaining the majority of seats in the Regional Council. This threatens the unity of the country, if not its continued membership in the Eurozone.

5.4 Italy

The case of Italy, discussed by Maria Flavia Ambrosanio, Paolo Balduzzi and Massimo Bordignon in Chapter 9, has some similarities with Spain, given the inadequate intergovernmental structure. Unlike in Spain, the dire situation of public finances did not allow the country to operate a counter-cyclical policy when the crisis first hit it in 2008. This led to massive output and employment losses, which were only partially recovered by 2010. But the Euro crisis in 2011 led to massive capital flight and raised doubts as to the sustainability of the huge national public debt. This forced the country to embark on a severe fiscal adjustment program that plunged the country into an even more serious recession.

Some signs of easing of the crisis appeared only at the beginning of 2015. Taxes were sharply increased, capital expenditures more than halved, and current expenditures frozen in nominal terms, with an impact more or less equally distributed between the center and sub-national governments. However, the latter were not just simply 'squeezed' by the central government, but were also forced to raise money, through enforced savings, to finance the general government budget.

The crisis effectively changed the *de facto* balance of power between levels of government leading to recentralization. It appears increasingly likely that this new equilibrium will also be consolidated *de jure* by a further constitutional reform, currently under review in parliament. This is expected to further reduce functions and resources of regions. Yet, not all the proposed interventions have negative implications. As a consequence of the increased financial effort imposed on local governments, the central government was forced to increase tax autonomy at the local level, improve accounting procedures, and rationalize the number of governments, with the elimination of an intermediate level of government (Provinces) and the forced aggregation of small municipalities in political 'unions' for the provision of basic services. The silver lining is that these beneficial structural reforms have finally been forced as a result of the crisis, and this may eventually lead to a return to sustainable growth in the medium-term if there is no further external turbulence.

6. CITIES, THE OLYMPICS AND GROWTH

Cities have a major impact on decentralization prospects, and the needed investments are critical in ensuring sustainable growth and revitalization of depressed regions. It is useful to juxtapose the country case studies with the effects of significant investments in cities in order to host the Olympics. The choice of Italy and Spain for the case studies also permits us to juxtapose the experience of the Olympics in Barcelona and in Turin with the overall trends in each country.

Giorgio Brosio, Stefano Piperno and Javier Suarez Pandiello (Chapter 10) look at the ways in which Barcelona and Turin managed the problems of organizing and financing the Olympics (Summer Games in the first case, and the Winter Olympics in the second). They address the long-lasting effects of the two events, both financially and economically. Interestingly, Barcelona provides support for the Peacock and Wiseman theory of a displacement effect due to an exceptional event (such as a war), with citizens that, even after the event is concluded, still accept the need to pay (partially) the higher taxes required to finance the event. However, Turin does not fit that model. The long-term economic consequences also seem to have been different.

The concentration of investment in the depressed areas of Barcelona helped to regenerate the city, and subsequently led to sustained growth. This may also explain the willingness of citizens to continue to pay higher taxes for the benefit of better public services, which in turn attracts further investments and growth. In Turin, perhaps due to the dissipated nature of the events for the Winter Games, the investments did not have the same regenerative impact, and the city was unable to regain its role as the regional hub as the main automotive and textile industries continued to decline.

7. ACCESSION STATES

Would the crisis in Europe have an impact on the accession countries? What measures should they take in relation to structural issues that are not formally part of the accession criteria but which might be to their benefit in the longer run?

Marjan Nikolov (Chapter 11) looks at the case of Macedonia, which is not yet a member of the Euro area (it is still an EU Candidate country). Interestingly, many policies affecting local governments during and after the international crisis do not look that different from the policies followed by the Eurozone countries. Thus, the higher autonomy offered to local

governments in connection with property tax allowed them to better cope with the crisis, in spite of falling transfers from the center. A similar measure may help in cushioning the effects of a possible exit of a country from the Eurozone.

On the other hand, it would make for a more robust entry into the EU if the structural intergovernmental reforms in Macedonia were well established. This is not normally a formal criterion for accession, but we argue that it is quite important.

8. SOME GENERAL LESSONS

8.1 Political Economy

The political economy underpinnings of successful intergovernmental transformations are clearly important, as we see from the country case studies and the difficulties faced in countries from Germany to Greece. These are also relevant in multi-level countries around the world – including in China and Indonesia, or federations such as India, Brazil, Mexico or Nigeria.

Alex Mourmouras and Peter Rangazas (Chapter 12) analyze some of the incentive effects underlying the changes, and provide thought experiments as to the critical elements involved. These issues will come into play not just in Greece, as it struggles to stabilize within the Eurozone or out of it, but they are also relevant for Germany as it seeks to avoid the negative impact of the ‘debt brake’ that is likely to put the federal structure under severe stress in a relatively short period of time.

Mourmouras and Rangazas look at the interactions between central and local governments in the allocation of grants with special emphasis on the poorest regions. They use a political economy framework, in which the relations between levels of governments are framed by clientelistic politics. More specifically, politicians operating at different levels collude by exchanging transfers for electoral support. The political setting is also characterized by corruption, particularly at the local level and in the backward regions. The combination of clientelistic politics and corruption allows the authors to reach interesting results. These also reflect the experience in the EU with the allocation and the use of structural funds and other transfers. For example, while the allocation of transfers is also determined by political influence, i.e., the capacity of local politicians to provide electoral support to those operating at upper levels, the corruption at the local level undermines their capacity to produce results required by the center (or Brussels), as resources are channeled to the private benefit

of local politicians. This kind of clientelistic politics also undermines the working of fiscal institutions, weakening, e.g., the budget constraint and other fiscal rules. The chapter also advances some policy suggestions, such as greater use of co-financing schemes instead of pure transfers, although these schemes disadvantage the poorest regions, whose resource constraints were the motivation for the transfers in the first place. This issue remains a promising area for further research.

8.2 Asymmetric Information and Soft Budget Constraints

Following on from the themes in the country studies concerning incentives and circumventing budget constraints, Leo Fulvio Minervini and Annalisa Vinella (Chapter 13) explore and build on some of the recent literature on the political economy of soft budget constraints. They show that in some limited cases, there is a welfare gain for the central government to guarantee critical investments, even if this results in a softening of the budget constraint at the sub-national level. However, the general prescription against generating soft budget constraints remains a good guide to policy making, as Ter-Minassian reminds us, and we see from the case studies.

Building on the general theme, Minervini and Vinella also examine issues related to asymmetric information in relation to PPPs that might lead to game-play and evading hard budget constraints. This has major consequences not just in Europe but also in other parts of the world, where there is an increasing focus on the need for sustainable investment, and PPPs are seen as an easy solution to an increasingly difficult problem. The game-play needs to be addressed in contract design and the role of incentives that are governed by full information, non-distorting transfer systems and availability of own-source revenues at the margin, without which sanctions and strictures from higher levels of government are simply not credible.

8.3 Common Themes

The experiences of the different European countries during and after the crisis have clearly differed, depending on institutional and historic heritage. Much depended on how severely the 2008 international crisis struck them, and on the fiscal space that different countries had in facing this crisis. Moreover, contrary to the international financial crisis of 2008, which was a global phenomenon affecting all EU countries simultaneously, the Euro crisis of 2011–12 severely affected some countries in the Eurozone more than others. It might actually have benefited a few, like Germany, e.g., which as a safe haven attracted much of the capital escaping from

the troubled countries of the Euro area during the crisis. Yet, in spite of all these differences, we derive some common trends and themes that contributed to the crisis or were aggravated as a result of it.

First, there is a constitutional issue. The difficulties of managing sub-national finances properly have their roots firmly in ill-defined constitutional assignments of functions, resources and powers. Germany had to change its constitution twice in order to impose fiscal rules on the Länder. However, the basic schisms remain unaddressed – despite repeated attempts to reform – and the lack of a hierarchical relationship between the Bund and the Länder remains the main threat to the fulfillment of the new debt regulations, and to Germany's continued growth potential.

Similarly, Italy is attempting to revise its 2001 Constitution, which created too many overlapping competencies between the center and the regions. This, in effect, further reduced the already low level of efficiency of public administration. Similarly, the recentralization of intergovernmental relationships in Spain finds its roots in a constitution that does not sufficiently 'protect' the autonomous regions, allowing the central government to impose expenditure mandates without guaranteeing adequate levels of finance and own-sources of revenue. Re-centralization, or the introduction of more severe controls on sub-national governments, has been a common theme of all countries during the crisis, and might have long-lasting consequences in terms of stability of existing political orders. Separatist tendencies have appeared in the UK, with a narrow decision in the Scottish Referendum to remain as part of the UK. The sweeping victory of the Scottish National Party in the General Election in 2015 suggests a difficult period of adjustment in intergovernmental fiscal relations ahead in the UK. A similar situation arose in Spain, with the 2015 elections in Catalonia.

A second theme concerns the number of levels of local government as well as the number of governments at each level. Too many levels of government lead to overlapping of competencies, loss of information, and to a reduction in accountability. Having too many small and fractured local governments does not allow individual governments to reach a scale sufficient for an efficient provision of services. Not surprisingly, a common trend during the crisis has been the attempt to reduce both levels and numbers of sub-national governments. France is again trying to come to terms with its extremely complex structure of local governments, reforming and streamlining their functions and reducing their number; Italy abolished a level of government, and forced small municipalities to offer their services jointly; the number of municipalities has been dramatically reduced in Greece; and similar provisions are likely in Portugal. In many unitary states, there is an attempt to create an effective regional

tier to anchor convergence of investment and growth – this is apparent in England and Portugal, but also in Latin America from Colombia to Chile.

A third element that emerges from the analysis is the importance of sub-national taxes and own-source revenues – at both regional and local levels – for a proper functioning of intergovernmental relationships. Again, it is not obvious how the German Länder will cope with the debt brake regulations and also control the fiscal behavior of their municipalities, lacking any flexibility in their resources. Insufficient access to own sources of revenues for local governments is also a problem in Spain, Portugal, France, and part of Italy. The problem is exacerbated by an inadequate design of transfers that vitiate incentives to use any tax handles, even if they were available.

A related issue concerns the proper source of taxation for effective local government. It is commonly argued in the literature that taxation of immobile property is a good local tax; because it is easy to administer, the tax base reflects the local services offered and can thus fulfill the benefit principle, and it is less subject to tax competition problems. Still, the experience of Spain shows that local governments whose revenues are strongly indexed to the values of real estate (through the stamp duty, taxes on the transaction of real assets, permits, etc.) were likely to be adversely affected once the bubble in asset prices burst. Paradoxically, the property tax behaved better, but only because the tax base was not revised fast enough to follow the appreciating values of the assets, and was less affected by the downturn. On the other hand, it was precisely because the property tax base did not reflect the increasing value of assets that cities such as Turin ended up in financial difficulties, as they were unable to fully recover the costs of investments involved.

A fourth common element is the difficulty in imposing binding fiscal rules on local governments. In virtually all countries, sub-national governments appear to be engaged in game-play, trying to escape from regulations on expenditures, hiring, or deficits. This is typically done by parking liabilities in activities or vehicles that are difficult to monitor, or by using publicly owned private enterprises to act on their behalf. Publicly owned private enterprises, PPP agreements, arrears and window-dressing, financial derivatives, etc. have been extensively used to this purpose everywhere. Not surprisingly, the central governments have tried to react by improving accounting rules and information requirements and by forcing the local governments to adopt more encompassing budget rules. This has happened in Greece, Portugal and Italy for instance, where the use of derivatives by sub-national governments has been prohibited or strongly regulated.

But the issue seems to be largely unsolved, as the rules have to be standardized across the Eurozone for yardstick competition to work effectively.

This begs the question as to whether the EC can persuade countries and local governments to adopt internationally accepted norms such as the IMF's GFSM 2014 framework or IPSAS rules on PPPs. This may be easier in federal countries than in currency unions, although it is not impossible to envisage rules such as the Sixth Directive regarding VAT across the EU.

A final issue concerns the fiscal rules themselves, and in particular the new European Fiscal Compact. These affect the general government finances of the Euro countries, and thus also need to be implemented at regional and local levels. The new rule does not forbid borrowing, but allows it only for addressing a downturn in economic activity, as shown by the structural balances of each government. But structural balances are controversial and difficult to build even at the national level, and are basically impossible to compute and enforce at sub-national levels.

The risk therefore remains that the new pact might end up by prohibiting borrowing even for useful public investment purposes. This is worrying from the perspective of the future growth of the Euro area, as public capital expenditure has already fallen dramatically everywhere in Europe during the crisis, endangering the future prosperity of the continent.

NOTE

1. This is a rule introduced in Switzerland. It aims at a structurally balanced budget in the short run by annually setting a cyclically adjusted expenditure ceiling. It also puts a brake on the accumulation of public debt via corrections of future expenditure targets for past deviations from projected fiscal balances.