

## Chapter 8

# Fiscal Responsibility and Multi-Level Governance: Bridging the Gap between Policy and Management

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### **ABSTRACT**

*Public-policy assumptions regarding sub-national governments' financial behavior are based on economic rationality. Therefore, to achieve fiscal stability at the macro level, central governments use fiscal rules both to constrain the behavior of local policymakers and to resolve deficit/debt biases. Using the Italian fiscal governance system as an illustrative example, this chapter considers both the tensions derived from achieving fiscal responsibility at the national level in a decentralized environment and the difficulties of maintaining adequate performance at the local government level. It is argued that the public management perspective can be helpful not only at the micro level but also at the macro level in developing public policies to promote fiscal stability. It is suggested that public policy should adopt a more holistic approach toward fiscal responsibility in multi-level governance environments. Such an approach requires a deep understanding of the determinants of financial viability of public sector organizations.*

### **INTRODUCTION**

Fiscal stability (i.e., having a balanced budget) has become the new theme of government rhetoric worldwide. In recent decades, many states' public debt to gross domestic product (GDP) ratios have shown an upward trend. Recently, the financial and economic crisis has forced both politicians and the public to be aware that ever-expanding public sector debt entails a growing burden on future generations, po-

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tentially resulting in long-term financial unsustainability (Posner & Blöndal, 2012). The crisis has also dramatically demonstrated the close link between fiscal instability and the real economy (Guarini, 2013).

Because policymakers are intent upon reducing the alleged burden of public debt, there is a new emphasis on fiscal relations between central and local governments. According to economic theory, regardless of whether sub-national governments benefit from central transfers and enjoy substantial fiscal autonomy (i.e., the power of taxation and borrowing), governments might have an incentive to be fiscally irresponsible (e.g., to under-tax and overspend), shifting the burden to other jurisdictions' taxpayers, a possibility that is referred to as the "risk of moral hazard". In this context, the general government's fiscal outcomes are expected to be highly dependent on the financial behavior of sub-national governments (International Monetary Fund [IMF], 2009) and a balanced budget at the macro (i.e., national) level cannot be achieved in the absence of responsible behavior by local government units (Oates, 2006). However, this responsibility cannot be taken for granted.

In general, decentralized countries in which sub-national governments enjoy substantial fiscal autonomy are expected to have greater exposure to the potential misuse of fiscal discretion than do centralized systems. As soon as sub-national governments obtain market access, there is some degree of market control (Breton, 1977). Financial markets constrain sub-national fiscal behaviors by imposing higher borrowing costs for unsound fiscal choices (Inman, 1996). However, the market's strength and effectiveness as a tool for fiscal stability cannot easily be measured outside of crisis episodes.

To address these problems, governments resort to institutional arrangements that are based primarily on fiscal rules whose aim is to achieve budgetary co-ordination among various levels of government. Fiscal rules impose permanent constraints on key budget aggregates such as annual budget balances, expenditures and borrowing (Hallerberg, Strauch, & von Hagen, 2007).

Fiscal rules are not new to government and there is evidence that countries use several types of rules to guide public finances. The most common of these rules establish budget-balance requirements or borrowing constraints and limits on sub-national governments' spending or debt accumulation (IMF, 2009). In OECD countries, fiscal rules that guide sub-national governance have gained greater attention as the autonomy granted to sub-national governments has increased through the decentralization of the power to tax and spend (Sutherland, Price, & Joumard, 2005). There are approximately 138,000 sub-national governments in OECD countries (primarily at the local level) (OECD, 2015). On average, those government units represent 16.6% of GDP, 31.7% of public tax revenues, and approximately 40% of public spending. They are responsible for approximately 59% of public investment, although among the OECD countries, the public-investment situation varies widely (OECD, 2015). In the context of the European Union (EU), fiscal consolidation requirements that apply to the Member States have provided strong motivation both for the introduction of domestic fiscal rules and for the implementation of those rules at the sub-national level.

The literature on this subject has developed primarily under the research stream of economic studies, focusing on the design of fiscal arrangements and their effectiveness at controlling fiscal outcomes at the macroeconomic level (Auerbach, Gokhale, & Kotlikoff, 1994; Bohn & Inman, 1996; Cukierman & Meltzer, 1989; Inman, 1996; Musgrave, 1959). Regardless of whether public expenditure, taxation, and borrowing decisions are made by central or local governments, economic theory has focused on the economic impact of economic actors' fiscal behaviors. This literature's basic assumption is that rational economic choices and fiscal constraints must be imposed on local government to control public taxation, spending, and borrowing. According to this perspective, the government's fiscal position in the economy (here referred to as the "macro" level) is interpreted as the aggregate fiscal behaviors of

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