



Munich Personal RePEc Archive

**Vertical aspects of sub-national deficits:  
the impact of fiscal rules and tax  
autonomy in European countries**

Foremny, Dirk

University of Bonn, Center for European Integration Studies

26. August 2011

Online at <http://mpra.ub.uni-muenchen.de/32998/>  
MPRA Paper No. 32998, posted 26. August 2011 / 17:26

**Vertical aspects of sub-national Deficits:  
The Impact of Fiscal Rules and Tax Autonomy in European  
Countries**

Dirk Foremny\*

This Version: August 2011

**Abstract**

This article offers an empirical answer to the question of which institutional arrangements can help to keep the accounts of sub-national governments in balance. I take into consideration the autonomy that these governments have in raising their revenues and fiscal rules as formulated in law or constitutions. The former works as an implicit constraint since governments with more autonomy might assume higher responsibility for accumulated deficits. The latter works as a direct explicit constraint on sub-national borrowing, but might be subject to endogeneity through preferences for fiscal responsibility. This potential source of bias is taken into account by using IV techniques for fiscal rules. Results from my original dataset, covering full information for 14 years of all EU15 countries, show that the effectiveness of tools depends critically on the federal background. Fiscal rules work in unitary countries, while higher tax autonomy yields lower deficits in federations.

**Keywords:** sub-national deficits, fiscal rules, soft budget constraints, fiscal federalism

**JEL Classification Numbers:** H71, H74, E61

---

\* University of Bonn, Germany, e-mail: [dforemny@uni-bonn.de](mailto:dforemny@uni-bonn.de)

# 1. Introduction

This paper tackles the questions of why the aggregated fiscal performance of sub-national governments in European countries differs, and how this can be explained by different institutional settings, such as fiscal rules and autonomy over tax instruments.

Much research has been done since the early 1990s which dealt with the question of why certain countries have experienced a large period of budget deficits that accumulate in high levels of public debt while others did not. Attention was focused on political and institutional factors, since even countries with similar underlying economic conditions showed a widespread variation in debt levels. It has been argued that to a large extent the design of institutions, which govern the budgetary process, are the underlying reason for the cross-country heterogeneity in fiscal positions.

While much attention, both theoretical and empirical, has been spent on the central or general budget and national fiscal policy, the link 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 in this context is different to that of the central level because vertical relationships between the levels of government play a crucial role. This paper aims at a closer empirical investigation of the underlying forces.

The differences in fiscal positions below the national level can be caused by a deficit bias due to a common pool externality: budgetary inflows come to a certain extent in almost all countries from a common source in the form of transfers or grants, while budgetary outflows are targeted to specific regions or municipalities. To be precise, a substantial share of revenues is generated with instruments that sub-national entities have no direct discretion over. Putting this in a dynamic context, the budget constraints of governments which are highly dependent on revenues that are not generated by their own instruments might become soft. The respective decision maker on the sub-national level might expect ex-ante, that if he causes a large and unsustainable deficit, the resulting outstanding debt would have to be bailed out ex-post by a higher level of government. In other words, the central government cannot credibly commit itself to a no-bailout policy, if the respective lower level government has no power to solve fiscal problems on its own because instruments to do so are not available once fiscal trouble has emerged. If instead a large proportion of sub-national revenues comes from own tax resources, this might work as an implicit way of the central government to communicate that sub-national entities should act on their own behalf. In this case, they can be asked to implement adjustments by increasing tax rates under their control. Low fiscal autonomy might therefore be connected to higher deficits, since budget constraints are soft.

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 a way the central level disires. The number of fiscal frameworks which impose balanced budget or debt rules on lower governmental sectors has increased over the last two decades. The introduction of the Maastricht Treaty and the Stability and Growth Pact could be seen as the cornerstone in the interest of such rules, which restrict governments in the way they should keep their books balanced. The European Monetary Union creates a framework where one should keep a check on the fiscal policy of member states to avoid negative externalities. In recent years a fierce increase in the number of fiscal rules at the national level can be observed. The goal of these rules, often called "national stability pact", could easily be jeopardized if the budgetary policies of sub-national governments do not act in concert, hence making relationships between different governmental levels important. Therefore, almost all of these national pacts impose restrictions on lower level governments as well.

According to this, the driving forces behind sub-national deficits I explore in this paper are twofold. On the one hand, I focus on the autonomy that these governments have in raising their revenues. This autonomy might constrain sub-national sectors as a form of an implicit rule, since higher autonomy goes along with higher own responsibility for results of their fiscal policy. On the other hand, I also focus on explicit fiscal rules, as formulated in law or constitutions, covering restrictions imposed on the sub-national sector to harden the budget constraint.

I also analyze what drives countries to adopt, keep, or to strengthen their framework of rules. This is an important task that helps to overcome a potential problem of endogeneity, which is well known in this strand of literature. Stricter rules may be adopted by governments with stronger preferences for fiscal discipline or a severe need for consolidation. I show that good instrumental variables for sub-national rules exist, which can help to solve this potential endogeneity problem. The main reasoning of the paper in this dimension is that political characteristics of the rule imposing level might be good 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 derive my results from 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 measurements of the strictness of rules and the discretion to tax on deficits of sub-national sectors show that the effectiveness of fiscal rules and the impact of tax autonomy depend critically on the federal structure of the respective country. As a main result, fiscal rules work in unitary countries and not in federations, but implicit restrictions due to higher tax autonomy are an effective way to constrain excessive spending for the federal countries in my sample.

This paper is organized as follows: the next section presents stylized facts over sub-

national public finances of the EU15 countries. Section three summarizes the underlying theory and the related literature. The empirical analysis starts in section four with explanation of my identification strategy. Section five presents my dataset, and my results are shown and discussed in section six. The paper comes to a close in the last section.

## 2. Stylized facts

The structure of European countries differs in many respects. One of the most important distinctions is the role and status of the sub-national sector. On the one hand, three countries out of the EU15 are original federations as written down in the respective constitution (Austria, Belgium, Germany), and another country (Spain) has a very regionalized structure. All these countries have had handed over important responsibilities to the regional and local level, and these sub-national governments have significant own legislative powers.

[Table 1 about here]

Therefore, I treat this group of countries as federations in my analysis. The other group of countries consists of unitary countries, but those may have a different number of sub-national levels. While Finland has only a local level sector, the remaining unitary countries (Denmark, France, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Sweden, and the United Kingdom) have at least another regional level, but with limited autonomy, compared to their federal counterparts. Hence, as indicated in table 1, I group all these countries as unitary ones.

[Figure 1 about here]

European countries also differ substantially in the level of debt which they have accumulated in the past. Figure 1 shows the level of outstanding debt in 2008 as a share of GDP in the top panel. This indicates that a substantial part of the total debt in European countries is due to sub-national borrowing. Most federal countries, and in particular Germany, show relatively huge ratios of outstanding 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. Measures in terms of revenues capture two important dimensions. First, they indicate 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.<sup>1</sup> While the ranking for federal countries remains largely the same, this illustrates the differences in unitary countries further. Even though the Nordic countries have much larger sub-national sectors relative to the general

---

<sup>1</sup>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.

government sector, their debt is lower compared to countries such as Portugal or France, which are less decentralized.

Since debts are the accumulation of deficits over time, the paper aims at answering the following questions. 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, I will explore why sub-national sectors in some countries are exposed to a larger bias toward deficits than others.

### 3. Theoretical motivation and related empirical literature

A well-established reasoning for differences in debts and deficits at any level of government is that the respective members of the legislature do not fully internalize the costs of the public goods they acquire. This is known as the common pool resource problem. Since costs are shared by the whole population, theoretical models, as those of [Velasco \(2000\)](#), [Hallerberg et al. \(2009\)](#), and [Krogstrup and Wyplosz \(2010\)](#), emphasize that these costs are not fully internalized by the spending claims of individual spending ministers, in the sub-national context by members of local or regional councils. This results in overspending, since only a small part of the additional social costs of raising the tax burden are taken into account, eventually creating a problem of  $1/n$ . The more interest groups that are involved in deciding the budget, the more fragmented the budget process becomes, and the higher the deficit bias due to individual spending claims. This is a result of a horizontal externality since it occurs within one government.

That point, applicable to every level of government, is supplemented by one that especially lets sub-national governments be inclined to overspend and borrow extensively. This might occur because several sub-national entities are grabbing for resources out of a national common pool. In this case the existence of soft budget constraints creates a vertical externality. [Borgdignon \(2006\)](#) provides a survey of this literature. When a budget constraint is considered to be soft, a sub-national government can increase expenditures without facing the full additional social costs. A hard budget constraint instead makes the entity internalize the full additional social costs, since it expects to be responsible for the consequences of its spending plans ([Rodden et al., 2003](#)). The underlying problem is of a dynamic nature: sub-national governments can accumulate unsustainable debt levels if they expect ex-ante that the central government might wish to bail them out once fiscal obligations can no longer be fulfilled ex-post. In other words, sub-national governments might expect that under certain circumstances the central government is responsible as a last resort for the liabilities they accumulate. Thus, there is a link between expectations over the behavior of a higher gov-

ernmental level in the future and the fiscal policy chosen at present. Among other factors, one main channel of these expectations is intergovernmental fiscal transfers. The probability that a sub-national entity is not responsible for its fiscal decisions taken today is higher, the lower the share of own-source revenues is. In other words, the higher the dependency on central governmental grants and transfers, the higher the expectation of a bail-out. This is because the central level has less room to ask for adjustments in sub-national taxes in the case of fiscal trouble, resulting in a dynamic game between the two actors.

This 'default-bailout game' between the central and sub-national level is formalized by [Inman \(2001\)](#) and [Kornai et al. \(2003\)](#). The center commits itself in the first stage to a no-bailout policy. The sub-national level instead chooses to spend at a level where the local marginal benefit is higher than the marginal social costs if it has a strong belief that the commitment of the center in the first stage is not credible. Finally, the central government has to decide whether to provide additional transfers to the lower level in order to reduce the deficit there. If the center has strong incentives to do so, its actions will be anticipated by the lower level government. The budget constraint is the softer, the lower the costs of the center to provide additional funds compared to leaving the sub-national government alone with its deficits. Several papers formalized the problem in partial equilibrium models in order to analyze the effects of different issues on the prevalence of soft budget constraints (see [Vigneault \(2006\)](#) for an extensive overview over theoretical considerations). The model of [Goodspeed \(2002\)](#) for example shows that a bail-out forced by incentives of a lower level government to accumulate high debt has to be paid partially by other regions through increased taxation. Furthermore, [Wildasin \(1997\)](#) focuses on the size and structure of jurisdictions, [Köthenbürger \(2007\)](#) on the impact of fiscal equalization schemes, and [Breuillé et al. \(2006\)](#) investigate the impact of horizontal and vertical tax competition. For federal systems, [Breuillé and Vigneault \(2010\)](#) have recently shown that the soft budget problem can be worse in a multi-tier system if regional level governments have discretion over transfer policies. In that case a soft budget constraint on the regional level yields even softer budget constraints on the local level.

The theoretical interest over soft budget constraints in the context of fiscal federalism has also triggered empirical contributions in this area. These studies focus either on cross-country evidence over aggregated fiscal policy on the sub-national level, or country specific case-studies. [Rodden et al. \(2003\)](#) provide a collection of mostly descriptive case studies. Additional country specific evidence for sub-national bailouts is provided by [von Hagen et al. \(2000\)](#) for German states, Italian regions, Australian and Swedish local jurisdictions. National evidence for Sweden is found by [Dahlberg and von Hagen \(2004\)](#). They find that the ability of the central Swedish government to commit to a no-bailout policy is rather weak, while the high degree of tax autonomy at the local level helps to harden budget constraints. A recent study by [Pettersson-Lidbom \(2010\)](#) identifies the expectations of



local Swedish governments over a future discretionary grant by an instrumental variable approach. He uses the grants received by neighboring municipalities as an instrument for the anticipation of own additional future discretionary grants. A significant soft budget effect is found, and on average debt is increased by 20 percent when the budget constraint becomes soft. Apart from these studies, there is not much more empirical evidence at the country level. The lack of empirical work can be explained by the fact that expectations over the additional allocation of funds are not easy to measure, and as shown in the various case studies, numerous aspects of intergovernmental relations can create this effect.

However, in order to solve the soft budget problem of time inconsistent behavior, countries characterized by little revenue raising power at sub-national levels might impose more restrictions through fiscal rules on lower level governments in order to commit the local or regional level to fiscal discipline. Indeed, [von Hagen and Eichengreen \(1996\)](#) show that borrowing limits are more prevalent in countries where the share of sub-central government's own-source resources is small. This is because if own taxes could be adjusted, the central government could deny a bail-out. It has been also pointed out that these incentives might be different according to the federal organization of countries.

Empirical contributions that are closely related to this paper perform cross-country comparisons, rather than investigating sub-national sectors of individual cases. This literature focuses on the differences across countries in order to investigate which institutional elements have an impact on sub-national fiscal policy. [Rodden \(2002, 2006\)](#) uses a panel-data set of forty-three OECD, developing, and developed countries over ten years (1986 to 1996). A first set of results is based on ten-year average regressions, capturing long-run effects. He finds that vertical fiscal imbalance (i.e. the share of grants and shared taxes in revenues) is positively related to deficits. For a second set of results all countries are grouped in two categories: countries with high and low borrowing autonomy. For the former he finds that vertical fiscal imbalance is still a driving force of deficits, while there is no effect for the latter. As already mentioned in the conclusion of that paper, more work should be done to investigate the effects of tax autonomy, and in particular the changes over time and the different degrees of borrowing autonomy. [Plekhanov and Singh \(2006\)](#) analyze with a panel dataset over 1982-2000 which specific institutional design of borrowing constraints prevents large sub-national deficits. Their classification of fiscal rules is based on dummies according to the way the rules are imposed. This paper finds, while averaging over all years for each country, that rules imposed by the center and cooperative agreements might reduce deficits when the vertical imbalance is large.

These days, however, almost all European sub-national governments are constrained by some restrictions, and the pure classification into categories as in [Plekhanov and Singh \(2006\)](#) is not without ambiguity. Another probable shortcoming of the existing empirical literature is that none of the papers provide a panel analysis which takes the changes over



time into account. This is either because time invariant indicators are used, and hence institutional changes are neglected, or between estimations were carried out. Furthermore, fiscal rules differ over time and how stringent and transparent they are applied. In particular European countries introduced numerous rules for sub-national sectors over the last two decades. Therefore, I use a continuous index, rather than a categorical approach, to investigate whether the strictness of rules has an impact. Similar arguments apply to the characterization of own-source revenues. The concept of vertical fiscal imbalance should be carefully reconsidered, since it was not accounted for shared taxes. But shared taxes, collected by the center and then redistributed to the lower level sectors, might not be any different from grants in terms of incentives as tax rates cannot be decided at the sub-national level. I rather focus on the development of own-source taxes, which takes into account the distortionary nature of taxes, when central governments ask for adjustments by increasing tax rates rather than providing additional funds through bail-outs or by increasing grants. This is even more important since the underlying problem of soft budget constraints is a dynamic one. Solving these issues is one of the main contributions of this paper. I estimate panel models where I carefully construct the tax autonomy of sub-national sectors, the different strength of borrowing restrictions in the form of fiscal rules, and explicitly take into account the variation over time. This can be interpreted as comparing the outcome for times before major reforms in rules and tax autonomy were implemented with the time after implementation.

A further well known problem in the literature on fiscal rules is that their impact on deficits does not necessarily have to be causal. Studies on the national level have highlighted the lack of good quality instruments in order to address a problem of endogeneity. This explicit sub-national context, however, allows finding variables that are correlated with the fiscal rules index, but are orthogonal to the error term. I exploit the fact that fiscal rules are in almost all cases imposed by a higher level of government. Earlier contributions have shown that political economy variables are able to explain the stringency of fiscal rules (see [Debrun et al. \(2008\)](#), for instance). However, on the national level these variables might not be simultaneously uncorrelated with budgetary outcomes. Although this is true on the national level, in the case of sub-national sectors the decision maker over rules (the central government) and the decision maker over budgetary policy (the sub-national entities) are unconnected. I will make use of the fact that the characteristics of central governments, which impose rules on the sub-national one, are unlikely to be correlated with their budgetary outcomes, but describe well the prevalence of rules. The attempt to solve this endogeneity problem is another contribution of this paper compared to the existing literature.

## 4. Identification

The main objective of this paper is to analyze whether a measure of the budgetary position can be explained by autonomy over taxation and fiscal rules, as tools which might restrict governments from profligacy. I estimate a reduced form model of a fiscal reaction function according to equation (1):

$$D_{i,t} = \gamma tax_{i,t-1} + \delta rules_{i,t} + \beta \mathbf{X}_{i,t} + \mu_i + \eta_t + \varepsilon_{i,t} \quad (1)$$

The dependent variable is a measure of the budget deficit  $D_{i,t}$  at the sub-national level. The impact of the tax-structure in terms of sub-national autonomy is captured by the parameter  $\gamma$ . I estimate the reaction to a lagged variable of the share of taxes which are under discretion of the respective government. I argue that using the one period lag is important since policy makers will use their knowledge from the past to build their expectations about the future. A high dependency on own-source taxes in the past indicates that it is likely that current deficits must be paid back by own resources instead of expecting to receive transfers from the central government. The parameter  $\delta$  captures the impact of fiscal rules, as an explicit way to restrict public finances. The data section spends special attention to the question how the variables *tax* and *rules* are constructed. The impact of other explanatory control variables is measured by the parameters in the vector  $\beta$ .  $\mu_i$  and  $\eta_t$  are individual and time fixed effects, respectively.

The inclusion of individual fixed effects is, besides capturing unobserved heterogeneity, important to focus on the dynamic nature of the underlying problem. I aim at an estimate of the impact of changes in the institutional framework on budgetary outcomes in the form of annual deficits. Hence, the question is how rules and autonomy affect deficits in the short run, and the inclusion of fixed effects captures all time invariant factors.

In addition, it is important to take the connection of the sub-national level to the higher level of government into account. Basically, the mechanism to tie lower levels hands by giving them autonomy might work pretty well in federations, where lower levels have a substantial degree of freedom over their policies. On the contrary, in unitary countries the sub-national level is more or less the extension of central governmental policies. When the sub-national level is not much more than a branch of the central one, a credible commitment of the center to a no-bailout strategy might be impossible in any case (even in line with a positive impact of autonomy on deficits).

$$D_{i,t} = \gamma \Phi' tax_{i,t-1} + \delta \Phi' rules_{i,t} + \beta \mathbf{X}_{i,t} + \mu_i + \eta_t + \varepsilon_{i,t} \quad (2)$$

To capture these effects, I estimate models according to equation (2) and interact a set of

dummies  $\Phi$  with the main variables of interest.

$$\Phi' = \begin{bmatrix} \Phi_1 \\ \Phi_2 \end{bmatrix} \text{ and } \begin{array}{l} = 1 \text{ if unitary country, 0 otherwise} \\ = 1 \text{ if local or regional level in a federal country, else 0} \end{array}$$

These dummies classify the respective form of government, as given in table 1. Eventually I end up with separate coefficients on tax autonomy and fiscal rules for federal and unitary countries.

To address problems of autocorrelation and heteroskedasticity, I estimate cluster-robust forms of the variance-covariance matrix. In some cases the small number of groups relative to coefficients does not allow to cluster over countries. In that case I estimate the variance-covariance matrix according to [Newey and West \(1987\)](#) with standard errors that are robust to both, heteroskedasticity and autocorrelation (HAC). As a robustness check, I also estimate dynamic models with a lagged dependent variable. Unfortunately, this implies an additional problem, since fixed effects estimates are likely to be biased as long as the time span is short ([Nickell, 1981](#)). To control for the bias introduced by the lagged dependent variable together with fixed effects, I use the bias-corrected version constructed by [Bruno \(2005\)](#) and bootstrap the standard errors. [Judson and Owen \(1999\)](#) show that this is the appropriate choice for a panel with my characteristics, i.e. when neither N nor T is large.

The possibility that fiscal rules are the result of, rather than the reason for fiscal performance, requires a careful analysis of causality. I use an instrumental variable approach to overcome this hurdle. Therefore, I estimate the factors determining the fiscal rules index. I include political determinants of the level of government which introduces the rules, indicators of the general fiscal stance of the respective country, as well as dummies for different time periods (the time of the Stability and Growth Pact, for instance) and further controls into the model. According to equation (3), I estimate a model for each value of the fiscal rules index  $j$  across countries, using the average of covariates during the time when the rule was applied:

$$rules_j = \gamma \overline{pol_j} + \delta \overline{budget_j} + \theta \overline{time_j} + \beta \overline{X_j} + \varepsilon_j \quad (3)$$

Furthermore I estimate a fixed effects model to capture the variance in rules over time according to the model in equation (4):

$$rules_{i,t} = \gamma pol_{i,t} + \delta budget_{i,t} + \theta time_{i,t} + \beta X_{i,t} + \mu_i + \varepsilon_{i,t} \quad (4)$$

Ideally, this step offers candidates for instruments. Finally, I re-estimate equation (1) and use instruments for the fiscal rules index. I spend additional attention to the validity of instruments in section 6.3.

This identification procedure corrects some drawbacks of former empirical approaches.

First, the focus on the within variance with time-varying indicators allows identification of the effects in the short run. Second, including the lagged value of tax autonomy creates a better reflection that decision makers form their expectations by observed values from the previous period. Finally, the proper choice of instruments can eliminate a potential source of endogeneity.

## 5. Data

I use aggregated data for sub-national sectors to investigate the deficit bias which might occur due to the relationships between different governmental layers in European countries. All EU15 members are included over a period ranging from 1995 to 2008. I include regional and local governments as separate observations in the four federal organized member states. This provides 19 observations per year and 266 in total.

The dependent variable is a measure of the budgetary position in each year. While several possible definitions are at hand, I chose to use annual deficits as a share of revenues. Other possibilities included defining the dependent variable as the deficit per capita or as a share of GDP. I took the decision in favor of my choice, since this measure incorporates differences in capabilities to raise revenues, as the deficit is expressed as a share of the revenue capacity in a given year.<sup>2</sup>

Two important indicators have to be computed in order to investigate the effects of fiscal rules and tax autonomy. I construct both indicators as a time-varying index that captures the development for each country over the entire time period.

First, an indicator of tax autonomy is needed to test whether the dependency on own tax resources creates incentives not to balance the books. The smaller the share of revenues from own-source taxation is, the higher the expectation over a bailout in times of fiscal stress. I compute an indicator of the share of own-source tax revenues in total revenues on each governmental level, respectively. The classification of own-source revenues is, unfortunately, not straightforward. Other studies rely on the degree of vertical imbalance or the share of taxes in total revenues, which can be misleading.<sup>3</sup> It is important to distinguish real own-source revenues from revenues which arise due to tax-sharing arrangements, i.e. taxes collected by a higher level and automatically transferred to the lower one. The [OECD \(1999\)](#) provides a classification of the taxing power of sub-national levels. Unfortunately, their *Fiscal Decentralization Database* provides only information for two or at most three years, 1995, 2002, and 2005. I use the *Revenue Statistics* of the OECD, the *Taxes in Europe*

---

<sup>2</sup>Taking deficits as a share of revenues or expenditures as the dependent variable follows the previous studies in this literature. However, the correlation with other possible measures, as expressing deficits as a share of GDP or in per capita terms, is high. See table 2 for details.

<sup>3</sup>A good example are German federal states. Their share of tax revenues on total revenues is substantial, but almost all tax revenues are distributed to this level by transfers from the central or local level. The share of real own-source taxes is close to zero.

database of the European Commission, numerous national sources over changes in tax-systems, and the information provided by Stegarescu (2005) to construct an indicator over the entire 14 years of the sample.<sup>4</sup> I treat all taxes over which either discretion on rates, reliefs, or both are under the power of the sub-national entity as own-source tax revenues. This measure does not overestimate the revenue autonomy in the presence of shared taxes.

[Figure 2 about here]

Figure 2 provides a graphical representation of this indicator. The Nordic countries are characterized by the largest share of autonomous revenues while German states, both Austrian sectors, Ireland, and the Netherlands have on average very little discretion over their revenues. Variation in the indicator is generated due to two different effects. On the one hand, the tax-system can be changed, equipping lower level governments with a richer set of instruments or more autonomy over existing taxes. Some governmental sectors, such as the Spanish regions and the sub-national Italian sector have implemented considerable changes within this period. On the other hand, the share of other revenues could also shift when the center allocates resources to lower level tiers. Thus, an increasing value of this indicator represents a higher responsibility at the sub-national level and might help to avoid soft budget constraints.

I construct a second indicator to depict the strength of fiscal rules, i.e. how stringent borrowing is regulated. Fiscal rules are nowadays a frequently used tool on the sub-national level in European countries (European Commission, 2009, 2008, 2006; Sutherland et al., 2005), with the attempt to mitigate a deficit bias and to harden the budget constraint by imposing numerical targets on budgetary variables or limiting the access to credits. I use the data provided by the European Commission (2009) to create an index that indicates the strictness of these rules. All fiscal rules which may have an impact on the deficit are included in the calculation of the index. These are balanced-budget-rules, debt breaks, and other restrictions on borrowing.<sup>5</sup> The original EU index is adjusted to the situation of sub-national levels. In the non-federal countries, an average of the rules applying to different levels, weighted by their share of expenditures in the total sub-national budget, is used.<sup>6</sup> Figure 3 shows the development of this indicator.

[Figure 3 about here]

The restrictions are relatively stable over time in one group of countries (Belgium, Germany, Denmark, France, and Finland) while another group (Austria, Spain, Ireland, Italy, Portugal, and Sweden) has increased the strictness of rules in recent years. Most of these

---

<sup>4</sup>The dataset and a comprehensive overview which taxes and changes in tax codes are taken into account will be shortly available online.

<sup>5</sup>Expenditure ceilings are very rare at the sub-national level and, as in the original EU variable, excluded for the main analysis of the impact of rules on deficits.

<sup>6</sup>The construction of this index is described in detail in Appendix D.

countries introduced national stability pacts as an answer to the limitations arising from EU rules. A third group (Greece, Luxemburg, the Netherlands, and the United Kingdom) goes without strict rules. When these fiscal arrangements worked as an effective tool to dampen a deficit bias, a negative coefficient is expected.

The other controls are summarized in table 3. The fiscal position of the central government *def\_cg\_rev* is included to capture a copycat effect. Sub-national governments that observe a loose fiscal policy at the national level can just follow the example given by the central government, expecting that they are not sanctioned if the higher level is profligate as well.

[Table 3 about here]

The degree of decentralization is taken into account by the share of sub-national expenditures in general government expenditures *edec*. Unfortunately, this indicator is not able to distinguish between expenditures that could be categorized as compulsory or those that are optional. Nevertheless, the share of expenditures captures the weight of the sub-national sector in the general budget and how spending proportions are shared between the governmental levels. These shares differ across European countries, with varying responsibilities and discretion over their exercises.

[Figure 4 about here]

Figure 4 shows the country means over my period of study. The Nordic countries, for instance, are characterized by a high level of services and responsibilities on the local level. Danish sub-national governments spend on average more than every second *Danske kroner*, followed by their Swedish and Finnish neighbors. The regional levels of Belgium, Spain, and Germany are responsible for approximately one quarter of total expenditures, accompanied by their local governments with additional, but lower expenditure shares. The less decentralized countries are France, Portugal, Luxemburg, and Greece. The plot against the average of own-source tax revenues indicates that in many cases higher expenditure decentralization is accompanied by a higher degree of autonomy over tax revenues. As noted before, this is not the case for some countries, in particular for the German federal states, but also not for Austria, Ireland, and the Netherlands.

Additional covariates are included to capture cyclical and institutional effects and to consider the spending needs of lower-level governments. I include the output gap *outgap*, the unemployment rate *unempl*, the ratio of the working age to total population *depratio*, the log of total population *ln\_totpop*, and interest expenses *intexp\_rev*. All fiscal variables are computed as share of revenues.

Table 4 summarizes the additional political variables, which I take into account for the estimation of fiscal rules themselves. The motivation for the central government to impose restrictions on lower level governments could be determined by the perception that a soft

budget problem is at hand. Thus, the federal structure itself plays a role and several determinants of the deficit might also be crucial for the strictness of rules. These issues are taken into account by using some of the variables already discussed. However, the center must also believe that fiscal rules are a mean to cure the problem and must be able to implement the rules through the legislature. Hence, political variables which characterize the central government and its preferences are related to fiscal rules, since they describe general preferences for a rules based framework. Most of the data is obtained from the World Bank Database of Political Institutions 2009 (Beck et al., 2001).

[Table 4 about here]

To control for whether the ideological orientation of the government plays a role, an index over the two main government parties, reaching from zero (left-wing, single party government) to one (right-wing, single party government), is calculated. A general perception is that conservative governments show a tendency towards lower deficits, and might impose stricter rules, but cross-country evidence on that is rather mixed. Nevertheless, the partisan relation could represent preferences for fiscal stability, with the result that right-wing governments might opt for more stringent rules to restrain the sub-national level.

The Herfindahl index measures the fractionalization of the ruling coalition. A single party government yields a value of one, while values close to zero indicate a more dispersed government. This index can be interpreted as the probability that two randomly picked members of the ruling coalition belong to the same party. The expected sign of this variable is not clear. On the one hand, a more fragmented government could be willing to restrict lower levels, because they are able to blame other coalition members when local or regional politicians complain about new rules. On the other hand, a less fragmented government might find it easier to pass new rules through the legislature.

The district magnitude measures the average number of seats in the parliament per electoral district. Beside the impact on the effective number of parties,<sup>7</sup> the district magnitude might have an additional impact in the sub-national context. A higher value indicates that more seats are allocated within one electoral district. Hence, the connection between local politics and the politicians elected into the central parliament might be loose. On the contrary, a small district magnitude means that the representative in the central legislature could be seen as directly responsible for the respective district. A strong connection to the sub-national level might cause representatives to be cautious with imposing strict rules, because they do not want to cross with local politicians, and neither voters.

Finally, I include the predicted form of fiscal governance, according to von Hagen and Harden (1995), Hallerberg et al. (2007), and Hallerberg et al. (2009). This literature characterizes whether a delegation or contract approach of fiscal governance is appropriate in

---

<sup>7</sup>The idea was developed by Duverger (1954), tested empirically by Taagepera and Shugart (1993) and put in the context of budgetary politics by Hallerberg and von Hagen (1999).



different countries. Centralizing the budget process could be done by the former approach under which governments give authority to one special member that is vested with special strategic power. On the national level the finance minister is typically in charge of this special function. The latter approach instead relies on contracts between all members of the cabinet with spending rights. I include the indicator developed in this literature to investigate whether central governments that are assumed to be contract countries follow this approach when designing rules for sub-national levels.

## 6. Results

This section presents the results of my estimations. After estimating the baseline model in the first subsection, I investigate the factors which determine the strictness of fiscal frameworks in the second subsection. The goal is to identify the driving forces behind fiscal rules in order to use them as instruments for the estimations, when fiscal rules are treated as endogenous. The results from these estimations are presented in the last subsection, where I also discuss my findings in more detail.

### 6.1. The impact of sub-national fiscal rules on budgetary outcomes

Table 5 presents the results of the regressions on budgetary outcomes. The dependent variable in any model is the share of the annual deficit in revenues at the respective sub-national sector. Positive values arise if expenditures exceed revenues and all coefficients with a negative sign improve the budgetary position by reducing deficits.

[Table 5 about here]

The first two columns show results from regressions according to equation (1), while the first column (a) does not include neither individual nor time fixed effects, but panel-corrected standard errors (PCSE). I find neither significant effects of the lagged tax autonomy nor the strength of fiscal rules when I pool all observations and include a dummy variable for federal countries. As mentioned earlier, including fixed effects is superior to cross section models since the variation within groups over time is important. In addition, an F-test ( $F_{(18,216)}=6.21$ , p-value 0.00) indicates that significant individual effects are at present, thus simple cross section estimations are not sufficient. Therefore, I turn to fixed effect models in columns (b) to (e), since a Hausman test rejects the appropriateness of random effects ( $\chi^2_{(12)}=42.49$ , p-value=0.00).

Results of model (b) are similar to those from the cross section without any significant effect of tax autonomy or fiscal rules on deficits. However, the means to cure the deficit bias

might be different depending whether the respective country is a unitary one or a federation. To control for the likely different effects I turn to the estimation of specification (2) from column (c) onwards.

These estimations show encouraging results. The lagged tax autonomy is significant for any type of government. Interestingly, coefficients are different across the groups. According to the hypothesis of soft budget constraints, sub-national governments in federations run lower deficits when their share of own-source tax revenues in the previous year has been a relatively large share in total revenues. Hence, given an increase in the share of revenues directly at their hands, it might be perceived that these own generated revenues also have to be used for potential future liabilities, causing lower present deficits. Sub-national sectors in unitary countries instead show up with an opposing behavior. These governments might anticipate that they are more or less the extension of the central government and giving them more autonomy does not constrain them sufficiently from profligate spending. Nevertheless, when I estimate the model with cluster robust standard errors in column (d), or a dynamic specification in column (e), tax autonomy in unitary countries is not significant anymore. These findings are in line with those of [Rodden \(2002\)](#): more autonomy over revenues generated by own-source taxation is an implicit tool to constraint sub-national governments in federal organized countries. Although effective in federations, this does not seem to work for unitary countries.

Fortunately, fiscal rules do, but only for the group of unitary countries. Sub-national governments in non-federal states overspend less when fiscal rules are stricter and hence the access to borrowing is limited. In this case, fiscal rules are an effective tool to mitigate a deficit bias, although tax autonomy is not. However, this does not hold true for entities in federal organized states, where in no specification a significant impact is detected. The result of the dynamic model in column (e) corroborates this result. Fiscal rules prevent only sub-national sectors in non-federal countries from running deficits. For the rest of the paper, I take model (d) as the preferred benchmark estimation.

After all, there seems to be a way to control sub-national public finances for each type of country and a careful consideration of the intergovernmental relations is required when such rules should be implemented. Given the overall autonomy, which is characteristically for federal countries, higher autonomy over taxes yields on average lower deficits. Not being shy with autonomy is the way to go in this case. On the other hand, a framework based on fiscal rules works well in unitary organized countries. This is likely to be the case because these governments have no instruments or enough legal autonomy to circumvent the limitations.

The other covariates are in line with expectations. Lower level governments follow the example of the center, since larger deficits on that level are positively correlated with those on the sub-national level. Countries that are more decentralized in terms of expenditure shares also run on average higher deficits. Demographic changes reveal two interesting insights.

First, when the total population grows, so do deficits. Local services are often connected to the number of people that call for them; hence more people represent larger spending needs. Second, when the share of the working population grows, budgetary positions improve. All other variables do not have an impact on deficits which is significantly different from zero in either model.<sup>8</sup>

However, here the potential endogeneity of fiscal rules is still unsolved. I will spend more attention on the interpretation of results once this problem is solved after the following sub-section.

## 6.2. The determinants of sub-national fiscal rules

Whereas national fiscal rules are often self imposed, sub-national rules are not. They are almost always imposed by the central level, and institutional and political variables of that level might have an impact on the strictness of the rules themselves. Even though one can argue that in federal countries the regional level could impose rules on the local one, this is not observed over the last decades. The new fiscal frameworks in Spain and Austria for instance, were both imposed on sub-national levels by the central government. Also the municipal codes of German local governments show little variation across federal states with respect to fiscal rules.<sup>9</sup> This section explores which factors induce a higher reliance on rules, and what circumstances might trigger the adoption of rules.

[Table 6 about here]

The first column of table 6 presents the results from an OLS regression according to equation (3) of each single outcome of the fiscal rules index on the average values over the period where one set of rules was in force in a given country.<sup>10</sup> In other words, each value of the fiscal rules index appearing in a country is regressed on the average values of all other covariates during that time. This simple approach reveals interesting insights, at which I look with more sophisticated methods according to equation (4) in columns (b) to (e), while the first two remaining models provide cross-sectional evidence, and the last two show results from fixed effect estimations. Models (c) and (e) include also the lagged value of the rules index in order to account for the persistency of this variable.

---

<sup>8</sup>The dynamic model shows only a significant effect of total population, while for all other variables estimates are not significantly different from zero.

<sup>9</sup>Self imposed rules of particular regional governments and their local counterparts are a somewhat new phenomenon. My sample covers data up to 2008, and none of the rules was self imposed by a regional level or imposed by that level on the local government sector. Recently, a referendum in one federal state in Germany (Hesse) has voted for the first regional rule which is not common to all states. I am looking forward to investigate the effectiveness of these new fiscal arrangements once enough data is available.

<sup>10</sup>The interpretation of dummies that vary over time such as elections or the stability and growth pact are in this estimation an indicator over the relative number of events in the respective time span. For example, *sgp* takes the value 0.6 if the rules was valid during 6 years of the Stability and Growth Pact.

The top panel of the tables shows the impact of political variables on the rules index. The first variable *herfgov* is significant and negative in almost all specifications, except the dynamic specifications in models (c) and (e). According to that, a government which consists of a single party or of one big and one small coalition member, represented by a higher value of the Herfindahl fractionalization index (i.e. a less fractionalized one), tends to impose less strict rules. One-party governments might receive more leeway from their sub-national counterparts and might try to avoid this conflict. Countries that are supposed to follow a contract approach of fiscal governance on the central level (Hallerberg et al., 2009) impose less strict rules on their sub-national governments. The district magnitude also becomes significant and positive in the panel specifications.<sup>11</sup> This supports the view that rather loose connections to lower level politics increase the use of fiscal rules at the sub-national level.

The other political variables, and neither budgetary ones, do not have an impact on the rules themselves. It is important to note that this implies that sub-national deficits do not have a feedback effect on rules. The only budgetary variable which is significant in at least one specification is the lagged debt level of the general government in the panel specification (d). Thus, central governments impose restrictions when general fiscal stress is at hand, but do not react to deficits at the sub-national level.

In terms of timing, the introduction of the Stability and Growth Pact has (from 1999 onwards) increased the strength of rules. This effect is not surprising since most national stability pacts were introduced as an answer to the EU fiscal framework in order to force the lower level governments not to counteract central level fiscal policies. Also not surprising is that rules increase over time, as indicated by the included linear trend. Out of the other control variables only the demographic structure, the population size, the sub-national tax autonomy, and unemployment have an increasing impact on the implementation of fiscal rules.

To sum up, the fractionalization of the government in power, the district magnitude, and the predicted form of fiscal governance determine the strictness of sub-national fiscal rules. Ideology of the central government and national elections instead do not. Neither do the budgetary variables, beside the lagged overall level of debt, as long as a static model is estimated. However, constituencies in federal countries, as indicated by the two dummies against the base group of unitary countries, rely more on rules than their non federal counterparts. Given the results over the effectiveness of fiscal rules from the previous section, those countries seem to back the wrong horse. This also could indicate that the political actions of the center to implement rules in unitary and federal countries might be different. In particular, the timing when the center implements rules, and thus whether the present

---

<sup>11</sup>Due to the little within variance, I check whether this result is robust when I include time dummies. The parameter is still significant at the same level.

or lagged political variables matter, may differ as the ultimate results have suggested.

[Table 7 about here]

The estimations presented in table 7 show that this is indeed the case. Model (a) to (e) include separate coefficients for federations and unitary states as well as their one period lag for one of the political variables per estimated equation, respectively. For example, column (a) shows a regression with four different coefficients for the impact of the Herfindahl index on rules: the current value of federal countries, the lagged value of federal countries, the current value of unitary countries, and finally the lagged value for this group. Models (b) to (e) continue with this procedure for the other covariates. Column (f) shows the estimates of the full model, including lagged and current values of all variables simultaneously.

Model (a) shows that it is rather the one period lag than the current value of the Herfindahl index which matters. Furthermore, it can be seen that federal countries do not follow the direction described above. In this case there is a positive relationship, indicating that less fractionalization is associated with stricter rules. In federal countries the central government might impose those stricter rules in order to tie the hands of sub-national politicians, which might belong to a different party. A ideological position of central governments which is contrary to the majority of sub-national ones is a frequently observed feature in federal countries. Surprisingly ideology is now marginal significant at the 90% level for unitary countries when the lags of all variables are included in the model as shown in (f). Election year effects (b) instead are still not observable. As for fragmentation, also the district magnitude seems to be more important one period lagged for unitary countries, but according to estimation (d) and (f) signs do not change. A higher value of this variable is still increasing the rules index. The contract approach in central governments' fiscal policy instead is different for both types of countries with respect to the timing. For the federal ones the actual one is significant and negative, while for the unitary states the one period lagged value matters.

These results, while interesting on its own, are important to answer a last open question, namely the causality between rules and fiscal outcomes. My instrumental variable approach, presented in the next sub-section, builds heavily of the results derived above. Most importantly, the proper choice of instruments can be different for the two distinct types of countries.

### **6.3. Endogeneity, IV results, and discussion**

The relationship between budgetary outcomes and fiscal rules might be confounded by potential endogeneity of the latter. The enacted fiscal policy could be the cause for, rather than the result of, the adoption of fiscal rules. In this case countries with fiscal difficulties at the sub-national level might impose stricter rules. The different stringency of fiscal rules

across countries could be also driven by an omitted variable, in particular preferences for fiscal discipline, as noted by [Poterba \(1996\)](#). If balanced budgets attain an outstanding status in some states, those countries might impose stricter rules according to their preferences. At the same time, according to their preferences, deficits might be lower per se. Hence, it has to be secured that the impact of rules on deficits, as estimated in [section 6.1](#), is indeed going from tighter rules to better budgetary positions (at least in unitary states) and not that countries with a preference for lower deficits just impose stricter rules. However, the direction of the bias is not clear at this stage, since the two possible explanations given above would either bias the impact of rules towards or away from zero.

I use an instrumental variables approach to solve this question. Variables that satisfy the two properties of valid instruments, namely being uncorrelated with the error of the regression of [equation \(2\)](#), but highly correlated with the rules index, must be found. This is usually regarded as a complicated task: explanations for the prevalence of fiscal institutions, for instance political variables which reflect preferences, might be simultaneously connected to the result of fiscal policy. This would imply that they are correlated with the variable that captures fiscal rules, but also with the error term. The context of sub-national budgetary outcomes instead offers a convenient feature to tackle this hurdle. Rules and institutions for lower level governments are introduced by a higher level of government. Thus, the characteristics that drive the introduction of the rules, as worked out in [section 6.2](#), are correlated with the rules itself (and might be correlated with the budgetary outcomes of that higher governmental level), but not with the budgetary position of the governments where the rules are imposed on. Fortunately, the previous section has shown that political characteristics of the central government are indeed related to the strictness of rules. In addition, there was no feedback effect of deficits, what excludes that central governments introduce rules when sub-national deficits are regarded as unsustainable. Hence, there are possible candidates for a set of excluded instruments which are correlated with the endogenous fiscal rules variables, but are not correlated with the error term in the explanatory equation. In other words, those variables are likely to be in line with the exclusion restriction in instrumental variable regressions.

[Table 8 about here]

I use the variables which are, according to the previous section, found to be correlated with the fiscal rules index as instruments for the interacted fiscal rules index. These are the interacted district magnitude, the form of fiscal governance, and the Herfindahl index of government fractionalization. The results of these regressions are shown in [table 8](#).<sup>12</sup> Column (a) repeats the estimation without instruments for comparison. Models (b) and (c) differ only in the way how standard errors are computed. The set of instruments for these

---

<sup>12</sup>I report the first stage estimations for all regressions using instruments in [Appendix A](#).

two estimations contains the actual political variables for federations, but the one-period lag for unitary countries. The absolute value of the coefficient on fiscal rules in unitary countries is now more or less twice as large as before. This indicates that the earlier estimate was biased towards zero. In terms of significance both models make the same predictions, and surprisingly also tax autonomy in unitary countries is gaining significance. The positive coefficients, however, indicates that higher autonomy in this group of countries does not work as a limitation but rather as an augmentation for deficits. This opposing effect is in line with expectations: in contrast to federations, sub-national governments in unitary countries are more or less a branch of the center, and hence they assume the center to take over liabilities anyway.

The model in column (d) uses the full set of instruments (i.e. lagged and current values) for both, the federal and unitary fiscal rules index. Results are pretty similar to the previous ones, but the validity of instruments changes slightly. While neither of the models seems to be affected by overidentification (note that the Hansen J-test does always accept the null of joint validity<sup>13</sup>), the Kleibergen-Paap F-Statistic for weak identification in models (b) and (c) is superior to (d). Since the models with different instruments for the unitary and federal index works better, all instruments might not be suited equally well for the two groups.

[Table 9 about here]

To show this in detail, I present separate regressions for each type of country in table 9. Therefore the estimations labeled 'I' include only the unitary countries, while those labeled 'II' include local and regional sectors of federations. Models (a) use the full set of instruments, while (b) involves only current values and (c) only lagged values, respectively. Signs and significance of the two main variables of interest do not change compared to the estimations before. A higher degree of tax autonomy is still mitigating the deficit bias in federations and exaggerating deficits in unitary countries. Rules continue to prevent deficits in unitary countries in all specifications, but with the additional insight that the proper choice of instruments depends the type of country. The Kleibergen-Paap statistic reveals that actual values are better suited as instruments for federal organized countries, while this is true for the one period lags for estimating the effect in unitary countries. Also control variables behave differently, and federal countries respond stronger to cyclical elements such as the output gap, unemployment, and deficits at the central level. At the end of the day these regressions confirm and robustify the earlier conclusions, while indicating that the timing of instruments is important in this context.

[Figures 5 and 6 about here]

---

<sup>13</sup>The joint null is that the instruments are valid instruments, i.e. both requirements are fulfilled: they are uncorrelated with the error term, and the excluded instruments do not have to be included into the estimated equation.



These results are encouraging for policy makers. Figure 5 depicts the marginal effect of stricter rules in unitary countries and figure 6 the effect of tax autonomy in federations. The bars on the left show the actual value of the fiscal rules index and tax autonomy in the year 2008. Significant improvements of budgetary positions are potentially feasible through reforms of rule frameworks and the structure of tax systems. This is particularly true for countries which currently make little use of those mechanisms. A one standard deviation in unitary countries (0.303, cf. table 3) increase in the rules index decreases the annual share of deficits in revenues on average by 2.7 per cent. A one standard deviation increase in the tax autonomy of federations (0.122, cf. table 3) causes a reduction of deficits of about 3.5 per cent, *ceteris paribus*. Hence changes in the institutional framework, in particular the adoption of another set of fiscal rules or changing autonomy over taxes, can help to reduce deficits in the short run and debts in the long run.

A last issue is whether these two instruments work in isolation or whether there is an interplay between the two. To check for this, I re-estimate the model and allow for interaction between the fiscal rules index and tax autonomy.<sup>14</sup>

[Figures 7 and 8 about here]

Figure 7 shows a plot of the marginal effect of fiscal rules in unitary countries. The interaction term is not significant in this case (p-value=0.6, cf. table 13 in the appendix). The negative impact on deficits remains more or less the same in terms of magnitude when tax autonomy varies. Tax autonomy itself was instead identified as the proper tool for federal countries. The marginal effect in this case is depicted in figure 7. Here the interaction term is significant (p-value=0.03, cf. table 13 in the appendix) and the figure shows that this tool becomes more effective when fiscal rules are tighter. That is, even though rules themselves do not help, an increase in tax autonomy should be considered together with the rules framework. In the policy arena, these results and in particular the fact that the effectiveness of tools to restrict deficits depends on the countries' type should be carefully taken into consideration.

## 7. Conclusion

The main goal of this paper is to explore which institutional arrangements help to keep the books of sub-national governments in balance. I focused on two different mechanisms which are potentially able to constrain the sub-national sector from fiscal profligacy. On the one hand I investigated the role of own tax resources, since less autonomy creates incentives to run deficits because of bail-out expectations. On the other hand, I studied the impact of fiscal rules, which a central government might impose to restrict the sub-national sector.

---

<sup>14</sup>Estimates are shown in table 13 of appendix C.

My main findings are that a well designed framework of fiscal rules works in unitary countries, but not per se in federations. Because of the higher autonomy which local and regional governments in federal countries enjoy, a rules based framework does not help in this case. Here, it is rather higher autonomy over tax instruments that might prevent large deficits at the sub-national sector. These findings suggest that the choice of tools depends critically on the type of government and the federal background. This complements the literature of fiscal rules on the general government level, where the political environment and the electoral system, for instance, are important determinants for the effectiveness of fiscal rules (Hallerberg et al., 2007). As a result, a suitable framework needs to be tailored to the characteristics of a specific country. More stringent rules might not always result in more desirable outcomes and neither does a restriction of tax autonomy. Both instruments need to be considered together with the other institutional arrangements of the respective country.

This article is a further step in sub-national public finance in order to explore how deficits could be avoided and large debts prevented. My findings suggest several issues for future research. The next step should be to make use of decentralized data for several European countries, rather than the aggregated sub-national sector. This allows investigating additional effects which occur horizontally within the sub-national governments in combination with the vertical dimension between governmental levels, as explored in this paper. Another interesting point is the recent introduction of self-imposed fiscal rules in some regions of federal countries. Federations often grant autonomy to sub-national governments which allows them to adopt rules by themselves. The German state of Hesse for example, has held a referendum and 70% of voters opted for the introduction of a fiscal rule into the regional constitution. Since self-imposed rules might be an important signal to the markets, and also do reflect the preferences of voters, effects might differ from those of centrally imposed rules in federations. The evaluation of the effectiveness might be an interesting task for future research, once enough data is available.

By all means, the recent development in European public finances has shown that the debate over public deficits and debts, in particular in the context of multi-tier governments, will remain on the schedule for the upcoming years. The results of this work might be of particular interest when it comes to the design of fiscal relationships between the supra-national and national level. The experience from one step below as in this paper can help to propose ideas how such a system can work properly.

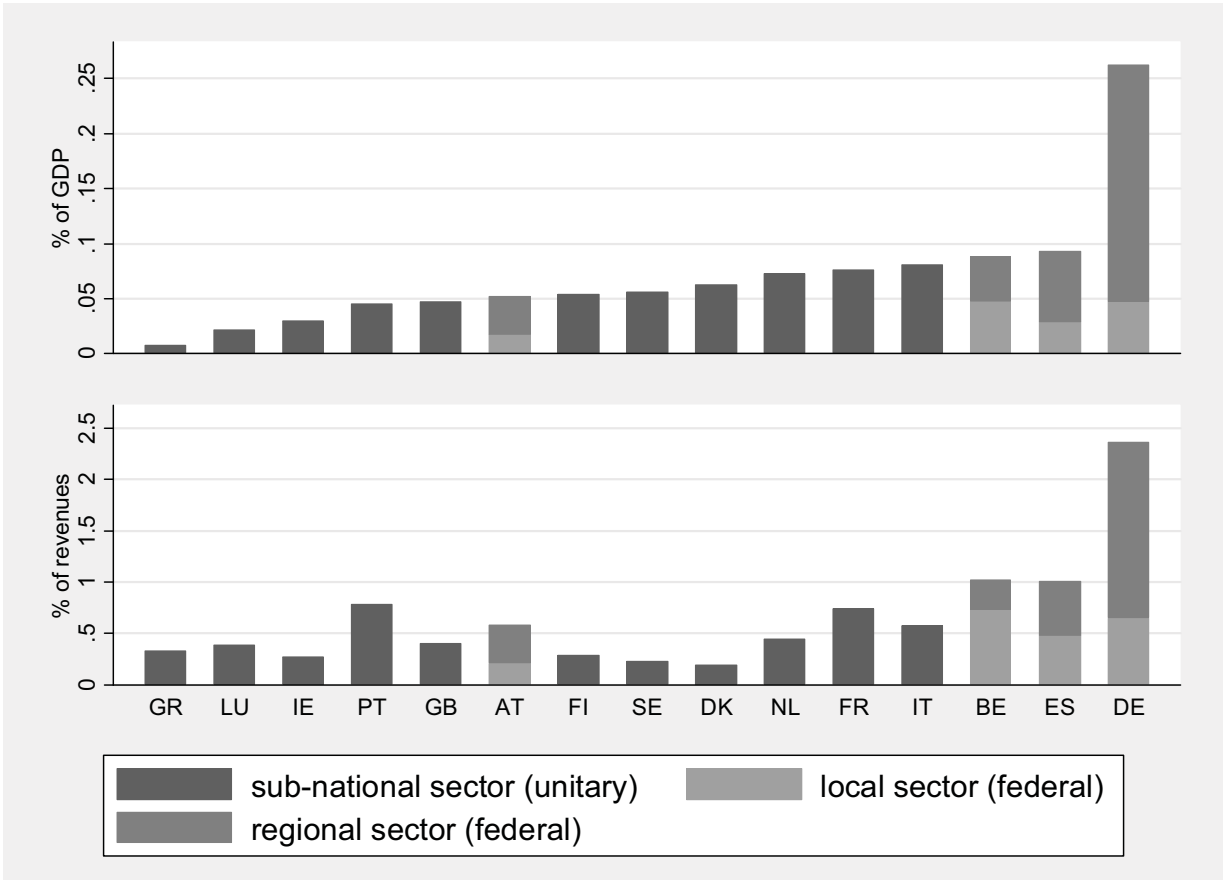
## References

- Beck, T., Clarke, G., Groff, A., Keefer, P., Walsh, P. 2001. New tools in comparative political economy: The database of political institutions. *The World Bank Economic Review*, 15 (1), pp. 165–176.
- Borgdignon, M. 2006. Fiscal decentralization: How to harden the budget constraint. In E. F. Peter Wierds, Servaas Deroose, A. Turrini eds. *Fiscal Policy Surveillance in Europe*, New York, Palgrave Macmillan, Chap. 6, 109–136.
- Breuil  , M.-L., Vigneault, M. 2010. Overlapping soft budget constraints. *Journal of Urban Economics*, 67 (3), 259–269.
- Breuil  , M.-L., Madi  s, T., Taugourdeau, E. 2006. Does tax competition soften regional budget constraint? *Economics Letters*, 90 (2), 230 – 236.
- Bruno, G. S. 2005. Approximating the bias of the lsdv estimator for dynamic unbalanced panel data models. *Economics Letters*, 87 (3), 361 – 366.
- Dahlberg, M., von Hagen, J. 2004. Swedish local government: is there a bailout problem. In P. Molander ed. *Fiscal Federalism in Unitary States*, Kluwer, Chap. 3, 47–76.
- Debrun, X., Moulin, L., Turrini, A., Ayuso-i Casals, J., Kumar, M. S. 2008. Tied to the mast? national fiscal rules in the european union. *Economic Policy*, 23, 297–362.
- Duverger, M. 1954. *Political Parties Their Organization and Activity in the Modern State*. Routledge Kegan & Paul.
- European Commission 2006. National numerical fiscal rules and institutions for sound public finances. In *Public Finances in EMU - 2006* In , *European Economy* (3), Brussels, European Commission.
- European Commission 2008. Fiscal rules in the eu at national level: experiences and lessons. *Presupuesto y Gasto P  blico*, 51 (2), 60–82.
- European Commission 2009. Fiscal rules, independent institutions and medium-term budgetary frameworks. In *Public Finances in EMU* In , *European Economy* (5), Brussels, European Commission.
- Goodspeed, T. J. 2002. Bailouts in a federation. *International Tax and Public Finance*, 9, 409–421.
- Hallerberg, M., von Hagen, J. 1999. Electoral institutions, cabinet negotiations, and budget deficits in the european union. In *Fiscal Institutions and Fiscal Performance*, National Bureau of Economic Research, Inc, 209–232.

- Hallerberg, M., Strauch, R., von Hagen, J. 2009. *Fiscal governance in Europe*. New York, Cambridge University Press, 230.
- Hallerberg, M., Strauch, R., von Hagen, J. 2007. The design of fiscal rules and forms of governance in european union countries. *European Journal of Political Economy*, 23 (2), 338–359.
- Inman, R. P. 2001. Transfers and bailouts: Institutions for enforcing local fiscal discipline. *Constitutional Political Economy*, 12, 141–160. 10.1023/A:1016602220782.
- Judson, R. A., Owen, A. L. 1999. Estimating dynamic panel data models: a guide for macroeconomists. *Economics Letters*, 65 (1), 9–15.
- Kornai, J., Maskin, E., Roland, G. 2003. Understanding the soft budget constraint. *Journal of Economic Literature*, 41 (4), 1095–1136.
- Krogstrup, S., Wyplosz, C. 2010. A common pool theory of supranational deficit ceilings. *European Economic Review*, 54 (2), 273 – 282.
- Köthenbürger, M. 2007. Ex-post redistribution in a federation: Implications for corrective policy. *Journal of Public Economics*, 91 (3-4), 481 – 496.
- Newey, W. K., West, K. D. 1987. A simple, positive semi-definite, heteroskedasticity and autocorrelation consistent covariance matrix. *Econometrica*, 55 (3), pp. 703–708.
- Nickell, S. J. 1981. Biases in dynamic models with fixed effects. *Econometrica*, 49 (6), 1417–26.
- OECD 1999. Taxing powers of state and local government. In , *Tax Policy Studies* (1), Paris, OECD.
- Petterson-Lidbom, P. 2010. Dynamic commitment and the soft budget constraint: An empirical test. *American Economic Journal: Economic Policy*, 2 (3), 154–79.
- Plekhanov, A., Singh, R. 2006. How should subnational government borrowing be regulated? some cross-country empirical evidence. *IMF Staff Papers*, 53 (3).
- Poterba, J. M. 1996. Budget institutions and fiscal policy in the u.s. states. *The American Economic Review*, 86 (2), pp. 395–400.
- Rodden, J. A. 2002. The dilemma of fiscal federalism: Grants and fiscal performance around the world. *American Journal of Political Science*, 46 (3), 670–687.
- Rodden, J. A. 2006. *Hamilton’s Paradox: The Promise and Peril of Fiscal Federalism*. Cambridge Studies in Comparative Politics, Cambridge University Press.

- Rodden, J. A., Eskeland, G. S., Litvack, J. 2003. *Fiscal Decentralization and the Challenge of Hard Budget Constraints*. The MIT Press.
- Stegarescu, D. 2005. Public sector decentralization: Measurement concepts and recent international trends. *Fiscal Studies*, 26 (3), 301–333.
- Sutherland, D., Price, R., Joumard, I. 2005. Fiscal rules for sub-central governments: Design and impact. OECD Economics Department Working Papers 465, OECD, Economics Department.
- Taagepera, R., Shugart, M. S. 1993. Predicting the number of parties: A quantitative model of duverger’s mechanical effect. *The American Political Science Review*, 87 (2), pp. 455–464.
- Velasco, A. 2000. Debts and deficits with fragmented fiscal policymaking. *Journal of Public Economics*, 76 (1), 105 – 125.
- Vigneault, M. 2006. Grants and soft budget constraints. In R. Boadway, A. Shah eds. *Intergovernmental Fiscal Transfers: Principles and Practice*, World Bank Publications, Chap. 5, 133–171.
- von Hagen, J., Eichengreen, B. 1996. Federalism, fiscal restraints, and european monetary union. *American Economic Review*, 86 (2), 134–38.
- von Hagen, J., Harden, I. J. 1995. Budget processes and commitment to fiscal discipline. *European Economic Review*, 39 (3-4), 771 – 779. *Papers and Proceedings of the Ninth Annual Congress European Economic Association*.
- von Hagen, J., Bordignon, M., Grewal, B. S., Petterson, P., Seitz, H., Dahlberg, M. 2000. *Subnational Government Bailouts in OECD Countries: Four Case Studies*.
- Wildasin, D. E. 1997. Externalities and bailouts: Hard and soft budget constraints in intergovernmental fiscal relations. *Policy Research Working Paper Series 1843*, The World Bank.

# Graphs and Tables

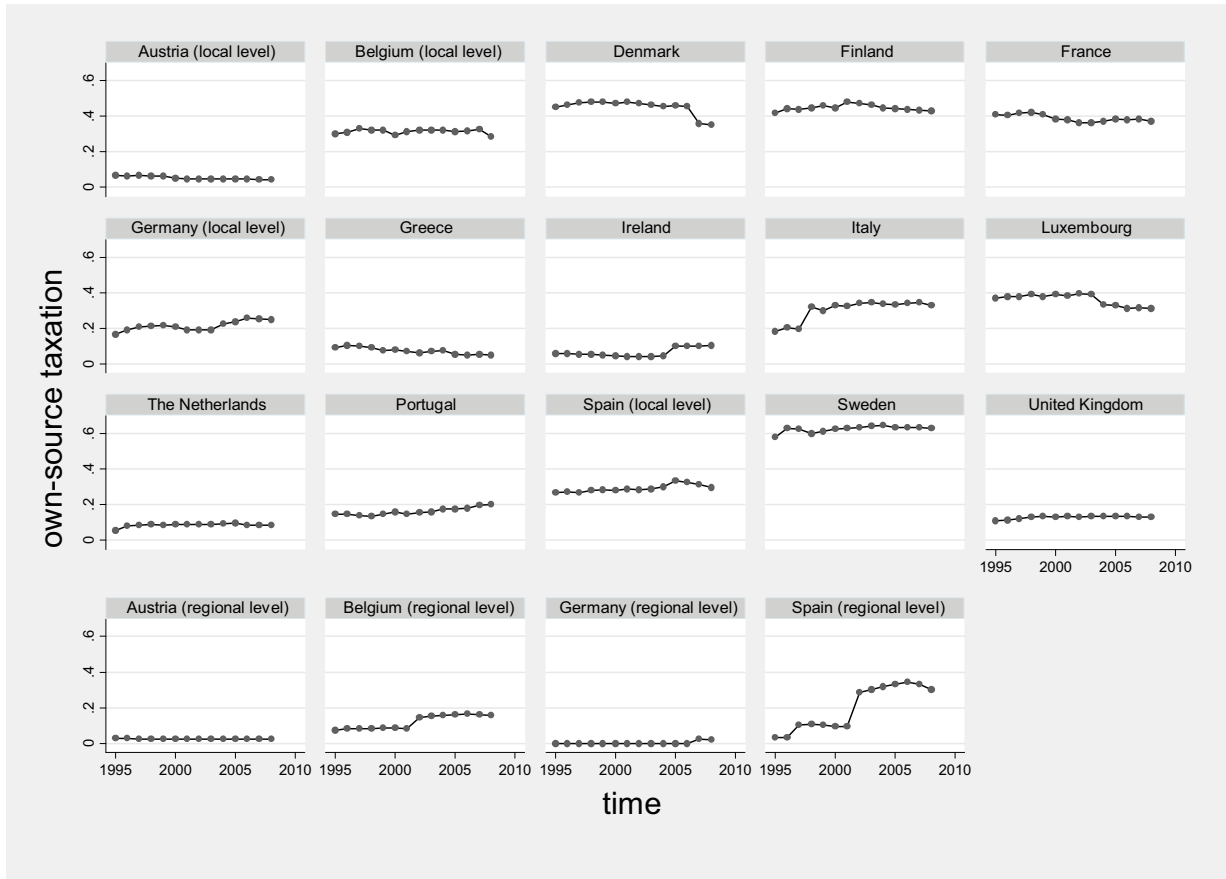


Notes: Consolidated outstanding debt in 2008. Top panel: as a share of GDP. Bottom panel: as share of revenues collected at the respective level of government.

Figure 1: Sub-national outstanding debt

federal countries	Austria, Belgium, Germany, Spain (local and regional levels included separately)
unitary countries	Denmark, Finland, France, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Sweden, United Kingdom (consolidated sub-national values included)

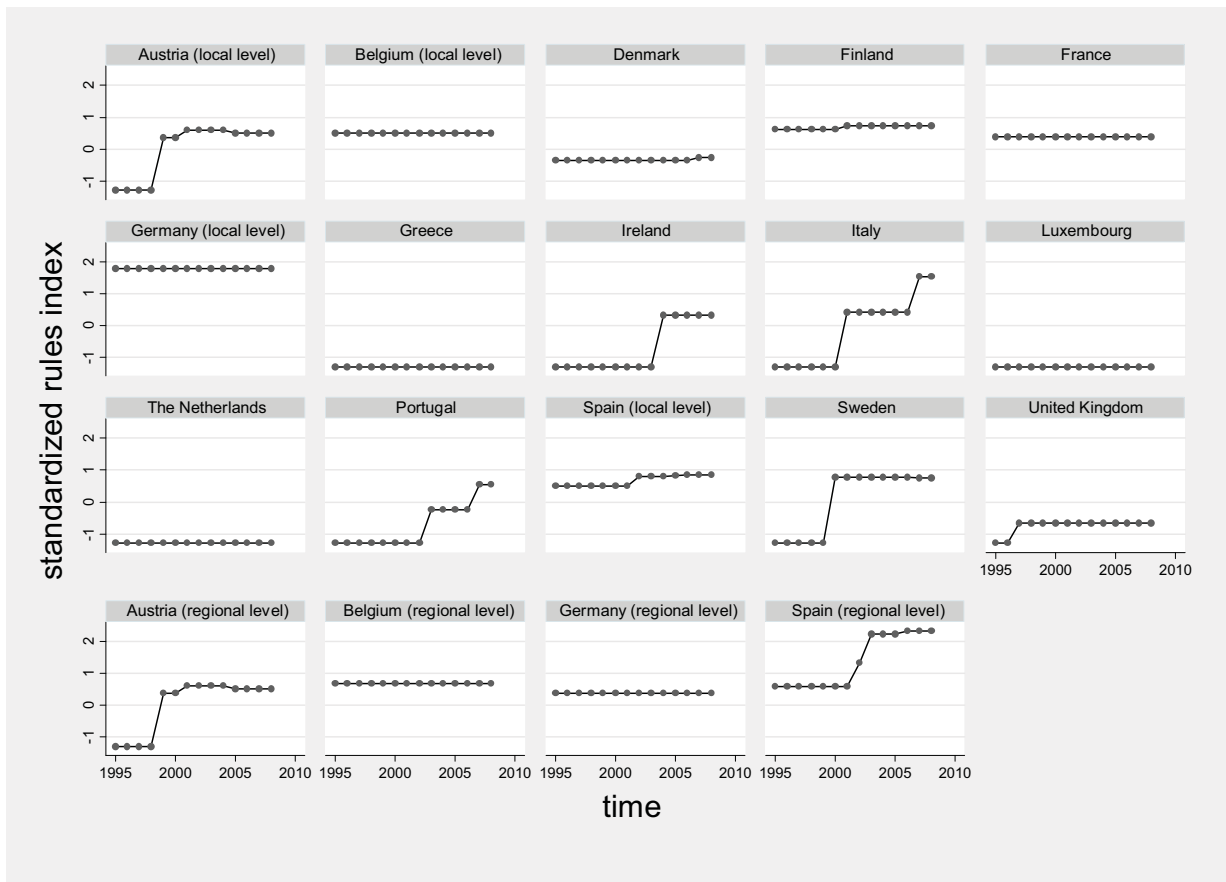
Table 1: Unitary and federal classification



Notes: Share of tax revenues under discretion of the respective governmental level. Classification of autonomy according to the OECD fiscal decentralization database and national tax legislation.

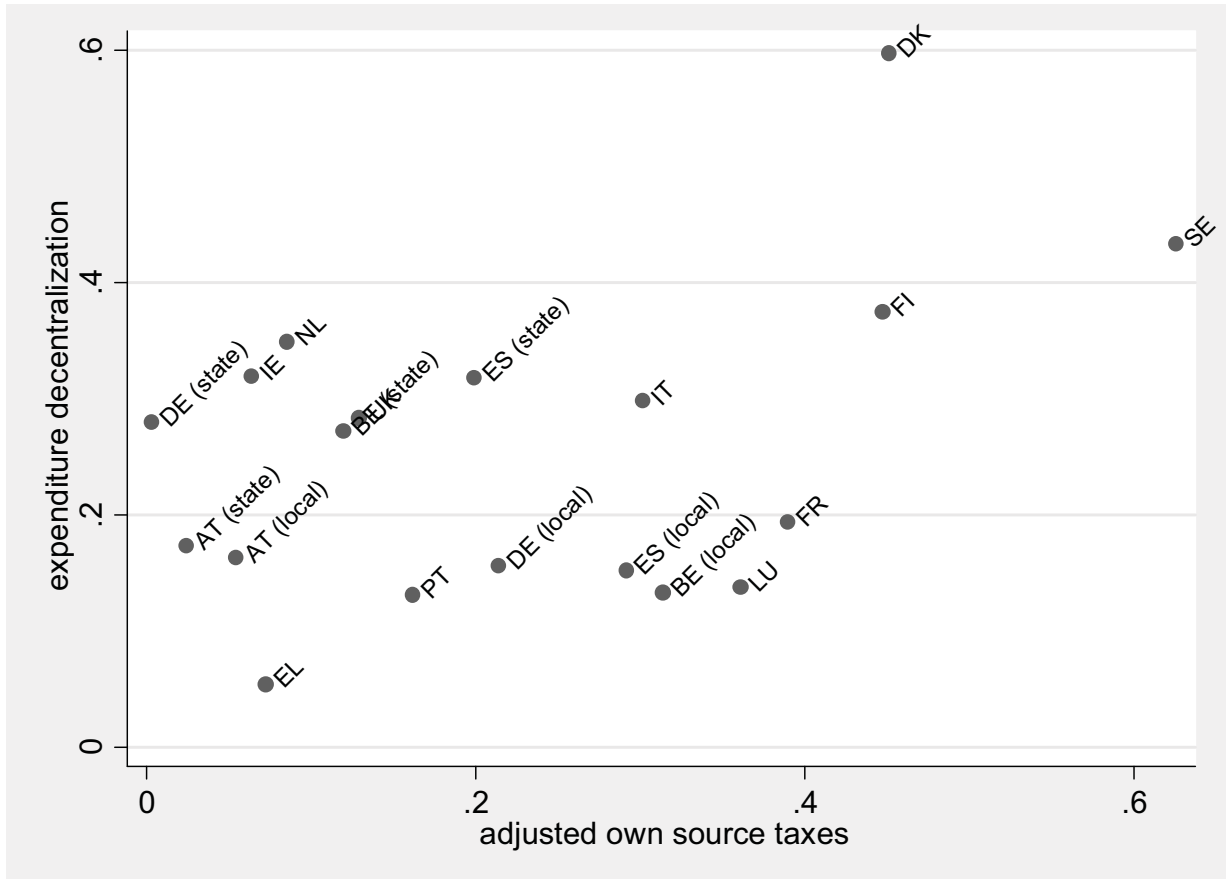
Figure 2: Revenues from own-source taxation





Notes: Standardized fiscal rules index. Survey information is taken from [European Commission \(2009\)](#). Own calculations according to appendix D.

Figure 3: Fiscal rules index



Notes: Mean by country over 1995-2008. Vertical axis: share of expenditures in general government expenditures, horizontal axis: revenues from own-source taxation as share of total sub-national revenues.

Figure 4: Decentralization over 1995-2008

Deficit	(1)	(2)	(3)
as share of revenues	(1) 1.000		
in Euro per capita	(2) 0.887	1.000	
as share of GDP	(3) 0.900	0.955	1.000

Table 2: Correlation of deficit measures

Variable	Source		Mean	Std. Dev.	Min	Max
<b>Dependent variable</b>						
<i>deficit/revenues</i>	Eurostat	overall	0.006	0.034	-0.100	0.112
		between		0.022	-0.042	0.062
		within		0.026	-0.087	0.101
<b>Tax autonomy</b>						
<i>tax</i> <sup>1</sup>	OECD, own calculations	overall	0.227	0.172	0.000	0.646
		between		0.173	0.003	0.625
		within		0.037	0.061	0.370
<i>tax * federal</i>		overall	0.152	0.122	0.000	0.343
<i>tax * unitary</i>		overall	0.281	0.184	0.041	0.646
<b>Fiscal rules</b>						
<i>rules</i> <sup>2</sup>	EC, own calculations	overall	0.459	0.357	0.000	1.284
		between		0.311	0.000	1.100
		within		0.188	-0.014	1.061
<i>rules * federal</i>		overall	0.699	0.277	0.000	1.284
<i>rules * unitary</i>		overall	0.284	0.303	0.000	1.008
<b>Controls</b>						
<i>def_cg_rev</i> <sup>3</sup>	Eurostat	overall	0.081	0.113	-0.189	0.621
		between		0.074	-0.031	0.276
		within		0.087	-0.169	0.556
<i>edec</i> <sup>4</sup>	Eurostat	overall	0.254	0.131	0.043	0.659
		between		0.131	0.054	0.598
		within		0.029	0.116	0.360
<i>intexp_rev</i> <sup>5</sup>	Eurostat	overall	0.942	1.307	0.004	5.875
		between		1.303	0.007	5.382
		within		0.306	0.042	2.256
<i>outgap</i>	Eurostat	overall	0.374	1.648	-4.707	5.209
		between		0.372	-0.111	1.429
		within		1.608	-4.540	5.376
<i>ln_totpop</i>	Eurostat	overall	16.496	1.290	12.913	18.229
		between		1.323	12.999	18.225
		within		0.028	16.410	16.614
<i>depratio</i> <sup>6</sup>	Eurostat	overall	0.670	0.012	0.636	0.690
		between		0.011	0.646	0.685
		within		0.006	0.640	0.687
<i>unempl</i> <sup>7</sup>	Eurostat	overall	0.075	0.031	0.019	0.184
		between		0.027	0.034	0.123
		within		0.017	0.036	0.137
N=19, T=14 (1995-2008), n=266						

Definitions: <sup>1</sup>revenues from own-source taxes as share of total revenues; <sup>2</sup>fiscal rules index; <sup>3</sup>central government deficit as share of revenues; <sup>4</sup> share of sub-national expenditures in general government expenditures; <sup>5</sup> interest expenditures as share of revenues; <sup>6</sup> share of working population in total population; <sup>7</sup>unemployment rate

Table 3: Summary statistics: Deficit estimation

Variable	Source		Mean	Std. Dev.	Min	Max
<i>ideology</i> <sup>1</sup>	World Bank, own calculations Beck et al. (2001)	overall	0.376	0.327	0.000	1.000
		between		0.131	0.089	0.589
		within		0.301	-0.213	1.171
<i>herfgov</i> <sup>2</sup>	World Bank Beck et al. (2001)	overall	0.666	0.270	0.181	1.000
		between		0.257	0.221	1.000
		within		0.101	0.350	1.004
<i>disctrict</i> <sup>3</sup>	World Bank Beck et al. (2001)	overall	9.402	6.050	1.000	22.500
		between		5.712	1.000	20.300
		within		2.364	5.052	25.352
<i>contract</i> <sup>4</sup>	Hallerberg et al. (2009)	overall	0.425	0.495	0.000	1.000
		between		0.465	0.000	1.000
		within		0.199	0.068	1.282
<i>debt_gg_gdp</i> <sup>5</sup>	Eurostat	overall	0.634	0.265	0.061	1.304
		between		0.255	0.071	1.102
		within		0.091	0.406	1.019
N=19, T=14 (1995-2008), n=266						

Definitions: <sup>1</sup>index from zero (single party left-wing) to one (single party right-wing); <sup>2</sup>Herfindahl measure of fractionalization (probability that two randomly chosen individuals belong to different political groups); <sup>3</sup>district magnitude; <sup>4</sup> form of fiscal governance; <sup>5</sup>debt at the general government level as share of gdp

Table 4: Summary statistics: Central government characteristics

Dependent Variable	Cross Section		Panel Model		
	(a)	(b)	(c)	(d)	(e)
<b>Tax autonomy</b>					
<i>tax</i> <sub>(t-1)</sub>	-0.006 (0.023)	-0.101 (0.061)			
<i>tax</i> <sub>(t-1)</sub> * <i>unitary</i>			0.195** (0.098)	0.195 (0.120)	0.153 (0.096)
<i>tax</i> <sub>(t-1)</sub> * <i>federal</i>			-0.272*** (0.069)	-0.272*** (0.056)	-0.159* (0.087)
<b>Fiscal rules</b>					
<i>rules</i>	-0.012 (0.011)	-0.016 (0.010)			
<i>rules</i> * <i>unitary</i>			-0.043*** (0.014)	-0.043*** (0.014)	-0.033** (0.015)
<i>rules</i> * <i>federal</i>			0.002 (0.014)	0.002 (0.015)	0.006 (0.020)
<b>Controls</b>					
<i>def_cg_rev</i>	0.066** (0.028)	0.087** (0.037)	0.076** (0.036)	0.076* (0.040)	0.060* (0.035)
<i>edec</i>	0.100*** (0.026)	0.147* (0.088)	0.214** (0.087)	0.214*** (0.074)	0.127 (0.078)
<i>intexp_rev</i>	0.002 (0.004)	-0.002 (0.007)	-0.001 (0.007)	-0.001 (0.007)	-0.003 (0.009)
<i>outgap</i>	-0.001 (0.002)	-0.001 (0.002)	-0.000 (0.002)	-0.000 (0.002)	-0.000 (0.002)
<i>unempl</i>	0.173 (0.123)	-0.036 (0.216)	-0.047 (0.209)	-0.047 (0.187)	0.001 (0.193)
<i>ln_totpop</i>	0.007* (0.004)	0.365** (0.180)	0.520*** (0.167)	0.520*** (0.136)	0.324** (0.133)
<i>depratio</i>	0.326 (0.258)	-0.565* (0.322)	-0.603* (0.331)	-0.603* (0.356)	-0.356 (0.396)
<i>trend</i>	0.002*** (0.001)	0.004 (0.008)	0.005 (0.007)	0.005 (0.005)	-0.000 (0.001)
<i>federal</i>	0.005 (0.009)				
<i>constant</i>	-0.391** (0.187)				
LDV					0.368*** (0.069)
Year Dummies	No	Yes	Yes	Yes	Yes
Fixed Effects	No	Yes	Yes	Yes	Yes
R-squared	0.181	0.223	0.270	0.270	
Standard errors in parentheses, see notes for details					
*** p<0.01, ** p<0.05, * p<0.1, n=247 N=19 T=14					

Notes: Model (a): pooled regression with panel corrected standard errors; Model (b) and (c): fixed effect estimation with standard errors robust to heteroskedasticity and autocorrelation (Newey-West); Model (d): clustered standard errors at the individual level; Model (e) dynamic panel data estimation, bias correction initialized by Arellano and Bond estimator, bootstrapped standard errors with 1000 repetitions, LDV is the lagged dependent variable.

Table 5: Regressions of deficits

Dependent Variable	Cross Section			Panel Model	
	(a)	(b)	(c)	(d)	(e)
Rules Index					
<b>Political variables</b>					
<i>herfgov</i>	-0.641** (0.231)	-0.226** (0.091)	-0.066 (0.074)	-0.394*** (0.131)	-0.138 (0.087)
<i>election</i>	-0.139 (0.233)	0.014 (0.011)	0.016 (0.012)	0.019 (0.016)	0.015 (0.015)
<i>ideology</i>	-0.112 (0.103)	-0.014 (0.034)	-0.014 (0.027)	0.036 (0.028)	0.011 (0.024)
<i>district</i>	0.014 (0.008)	0.003 (0.006)	0.004 (0.003)	0.018*** (0.006)	0.007* (0.003)
<i>contract</i>	-0.501** (0.182)	-0.150** (0.070)	-0.064 (0.057)	-0.281*** (0.069)	-0.006 (0.051)
<b>Budgetary variables</b>					
<i>def_rev</i>	-0.710 (1.754)	-0.160 (0.256)	-0.156 (0.244)	-0.119 (0.269)	-0.094 (0.320)
<i>def_rev</i> <sub>(t-1)</sub>		-0.195 (0.262)	-0.111 (0.247)	-0.356 (0.313)	-0.045 (0.291)
<i>debt_gg_gdp</i> <sub>(t-1)</sub>	-0.036 (0.169)	-0.004 (0.094)	-0.011 (0.048)	0.384** (0.153)	0.083 (0.132)
<b>Timing</b>					
<i>sgp</i>	0.374** (0.156)	0.050* (0.028)	0.061** (0.025)	0.063* (0.038)	0.072** (0.028)
<i>trend</i>		0.018*** (0.005)	0.002 (0.003)	0.020*** (0.006)	-0.003 (0.006)
<b>Controls</b>					
<i>depratio</i>	2.210 (3.315)	3.487* (2.077)	0.565 (1.164)	7.055** (2.816)	0.805 (1.978)
<i>outgap</i>	0.050 (0.036)	-0.005 (0.007)	0.001 (0.006)	-0.012 (0.008)	-0.005 (0.007)
<i>unempl</i>	3.337* (1.833)	0.490 (1.155)	0.242 (1.120)	0.848 (1.757)	-0.597 (1.412)
<i>unempl</i> <sub>(t-1)</sub>		0.688 (1.080)	0.301 (0.993)	-1.464 (1.528)	0.520 (1.300)
<i>tax</i>	0.879** (0.363)	0.538* (0.318)	0.422 (0.339)	0.717* (0.398)	0.717* (0.390)
<i>tax</i> <sub>(t-1)</sub>		0.561* (0.313)	-0.135 (0.339)	1.350*** (0.407)	-0.097 (0.383)
<i>ln_totpop</i>	0.066 (0.051)	0.083*** (0.029)	0.030* (0.016)	-0.022 (0.821)	0.580 (0.681)
<i>edec</i>	0.597 (0.359)	0.200 (0.197)	0.147 (0.109)	-0.594 (0.362)	-0.070 (0.324)
<i>local dummy</i>	0.203* (0.100)	0.353*** (0.068)	0.101** (0.040)		
<i>regional dummy</i>	0.291*** (0.102)	0.436*** (0.067)	0.117*** (0.043)		
<i>LDV</i>			0.698*** (0.067)		0.803*** (0.065)
<i>Constant</i>	-2.484 (2.350)	-3.780** (1.591)	-0.920 (0.874)		
Fixed Effects	No	No	No	Yes	Yes
R-squared	0.888	0.501	0.853	0.637	

Robust standard errors in parentheses, \*\*\* p<0.01, \*\* p<0.05, \* p<0.1  
(1) n=41, (2)-(5) n=247 N=19 T=14

Notes: Model (a): aggregated estimation according to equation 3; Models (b) and (c): pooled regression with panel corrected standard errors; Model (d): fixed effect estimation with standard errors robust to heteroskedasticity and autocorrelation (Newey-West); Model (e): bias correction initialized by Arellano and Bond estimator, bootstrapped standard errors with 1000 repetitions, LDV is the lagged dependent variable.

Table 6: Determinants of fiscal rules

Dependent Variable Rules Index	Fixed Effect Panel Model					
	(a)	(b)	(c)	(d)	(e)	(f)
<b>Herfindahl index (fractionalization)</b>						
<i>herfgov</i>		-0.381*** (0.129)	-0.387*** (0.124)	-0.443*** (0.132)	-0.358*** (0.132)	
<i>herfgov * federal</i>	-0.006 (0.114)					-0.078 (0.116)
<i>herfgov<sub>(t-1)</sub> * federal</i>	0.313*** (0.106)					0.359*** (0.102)
<i>herfgov * unitary</i>	-0.335 (0.229)					-0.233 (0.189)
<i>herfgov<sub>(t-1)</sub> * unitary</i>	-0.482* (0.274)					-0.641*** (0.244)
<b>Election year</b>						
<i>election</i>	0.016 (0.014)		0.017 (0.015)	0.021 (0.016)	0.014 (0.016)	
<i>election * federal</i>		0.038 (0.028)				0.038 (0.025)
<i>election<sub>(t-1)</sub> * federal</i>		0.011 (0.021)				-0.008 (0.016)
<i>election * unitary</i>		0.003 (0.024)				-0.004 (0.021)
<i>election<sub>(t-1)</sub> * unitary</i>		-0.010 (0.027)				-0.012 (0.023)
<b>Ideology (1=right-wing single party)</b>						
<i>ideology</i>	0.056** (0.027)	0.041 (0.028)		0.082*** (0.027)	0.029 (0.028)	
<i>ideology * federal</i>			-0.063 (0.040)			0.027 (0.030)
<i>ideology<sub>(t-1)</sub> * federal</i>			0.021 (0.032)			-0.011 (0.030)
<i>ideology * unitary</i>			0.055 (0.052)			0.075* (0.041)
<i>ideology<sub>(t-1)</sub> * unitary</i>			0.069 (0.048)			0.057 (0.042)
<b>District magnitude</b>						
<i>district</i>	0.019*** (0.006)	0.018*** (0.006)	0.020*** (0.007)		0.017*** (0.006)	
<i>district * federal</i>				-0.005 (0.007)		0.009 (0.007)
<i>district<sub>(t-1)</sub> * federal</i>				0.006 (0.005)		0.009** (0.005)
<i>district * unitary</i>				0.011* (0.006)		0.007 (0.005)
<i>district<sub>(t-1)</sub> * unitary</i>				0.019*** (0.004)		0.021*** (0.003)

table continues on next page

cont'd	(a)	(b)	(c)	(d)	(e)	(f)
<b>Contract</b>						
<i>contract</i>	-0.290*** (0.068)	-0.281*** (0.068)	-0.302*** (0.065)	-0.282*** (0.068)		
<i>contract * federal</i>					-0.346*** (0.089)	-0.351*** (0.080)
<i>contract<sub>(t-1)</sub> * federal</i>					-0.003 (0.033)	0.057 (0.037)
<i>contract * unitary</i>					-0.090 (0.056)	-0.095 (0.070)
<i>contract<sub>(t-1)</sub> * unitary</i>					-0.073 (0.086)	-0.233** (0.098)
<b>Controls</b>						
<i>def_rev</i>	-0.217 (0.241)	-0.153 (0.278)	-0.283 (0.264)	0.054 (0.252)	-0.170 (0.273)	-0.121 (0.223)
<i>def_rev<sub>(t-1)</sub></i>	-0.293 (0.275)	-0.352 (0.318)	-0.321 (0.320)	-0.264 (0.307)	-0.254 (0.313)	-0.340 (0.275)
<i>unempl</i>	-1.005 (1.466)	0.561 (1.782)	1.345 (1.803)	0.542 (1.828)	0.459 (1.770)	-1.387 (1.441)
<i>unempl<sub>(t-1)</sub></i>	-0.291 (1.256)	-1.205 (1.541)	-1.895 (1.603)	-0.856 (1.530)	-1.134 (1.526)	-0.168 (1.268)
<i>tax</i>	0.613* (0.329)	0.779* (0.403)	0.877** (0.389)	0.875** (0.386)	0.794* (0.412)	0.642* (0.363)
<i>tax<sub>(t-1)</sub></i>	1.190*** (0.371)	1.336*** (0.407)	1.351*** (0.389)	1.309*** (0.392)	1.322*** (0.409)	1.139*** (0.383)
<i>depratio</i>	5.510** (2.422)	6.750** (2.795)	8.374*** (2.837)	8.798*** (2.913)	6.536** (2.862)	7.166*** (2.476)
<i>outgap</i>	-0.007 (0.007)	-0.009 (0.008)	-0.007 (0.008)	-0.008 (0.008)	-0.008 (0.008)	-0.007 (0.007)
<i>debt_gg_gdp</i>	0.428*** (0.128)	0.354** (0.153)	0.410*** (0.148)	0.300** (0.152)	0.299* (0.155)	0.482*** (0.141)
<i>ln_pop_tot</i>	0.273 (0.658)	-0.134 (0.800)	-0.706 (0.850)	0.067 (0.784)	-0.034 (0.809)	-0.055 (0.702)
<i>edec</i>	-0.630* (0.360)	-0.552 (0.363)	-0.678* (0.384)	-0.423 (0.386)	-0.544 (0.375)	-0.642* (0.372)
<i>sgp</i>	0.054 (0.036)	0.061* (0.036)	0.081** (0.037)	0.053 (0.038)	0.057 (0.038)	0.050 (0.036)
<i>trend</i>	0.016*** (0.006)	0.019*** (0.006)	0.019*** (0.006)	0.015** (0.006)	0.017*** (0.006)	0.017*** (0.006)
R-squared	0.702	0.636	0.647	0.654	0.642	0.735
Number of Observations	247	247	247	247	247	247

Robust standard errors in parentheses  
\*\*\* p<0.01, \*\* p<0.05, \* p<0.1

Notes: Specification according to model (d) in table 6. Fixed effect estimation with standard errors robust to heteroskedasticity and autocorrelation (Newey-West).

Table 7: Determinants of fiscal rules II



Dependent Variable	IV 2SLS Panel Model			
	(a)	(b)	(c)	(d)
<b>Deficit/Revenues</b>				
<b>Tax autonomy</b>				
$tax_{(t-1)} * unitary$	0.195 (0.120)	0.365* (0.190)	0.365** (0.148)	0.334** (0.141)
$tax_{(t-1)} * federal$	-0.272*** (0.056)	-0.284*** (0.073)	-0.284*** (0.075)	-0.289*** (0.075)
<b>Fiscal rules</b>				
$rules * unitary$	-0.043*** (0.014)	-0.088** (0.041)	-0.088*** (0.026)	-0.079*** (0.024)
$rules * federal$	0.002 (0.015)	-0.007 (0.027)	-0.007 (0.021)	-0.001 (0.021)
<b>Controls</b>				
$def\_cg\_rev$	0.076* (0.040)	0.076* (0.042)	0.076** (0.037)	0.077** (0.036)
$edec$	0.214*** (0.074)	0.197** (0.085)	0.197** (0.088)	0.201** (0.088)
$intexp\_rev$	-0.001 (0.007)	0.003 (0.008)	0.003 (0.007)	0.002 (0.007)
$outgap$	-0.000 (0.002)	0.000 (0.002)	0.000 (0.002)	0.000 (0.002)
$unempl$	-0.047 (0.187)	-0.097 (0.215)	-0.097 (0.215)	-0.092 (0.214)
$trend$	0.005 (0.005)	0.006 (0.005)	0.006 (0.007)	0.006 (0.007)
$ln\_pop\_tot$	0.520*** (0.136)	0.544*** (0.160)	0.544*** (0.168)	0.542*** (0.167)
$depratio$	-0.603* (0.356)	-0.429 (0.404)	-0.429 (0.377)	-0.481 (0.359)
Year Dummies	Yes	Yes	Yes	Yes
Fixed Effects	Yes	Yes	Yes	Yes
Excluded Instruments	none	$herfgov_t * federal$ $district_t * federal$ $contract_t * federal$ $herfgov_{(t-1)} * unitary$ $district_{(t-1)} * unitary$ $contract_{(t-1)} * unitary$	$herfgov_t$ $district_t$ $contract_t$ $herfgov_{(t-1)}$ $district_{(t-1)}$ $contract_{(t-1)}$	
R-squared	0.173	0.134	0.134	0.147
Hansen J	.	3.799	6.083	12.64
Hansen J p-value	.	0.434	0.193	0.245
K-P Weak Id. F	.	29.97	10.70	10.01

Robust standard errors in parentheses  
\*\*\* p<0.01, \*\* p<0.05, \* p<0.1, n=247 N=19 T=14

Notes: Two stage least square estimations. First stage regressions are presented in table 10 of appendix A. Model (a): repetition of the estimation without instrumenting the rules index; Model (b): cluster-robust standard errors, using the Herfindahl index, the form of fiscal governance and the district magnitude as instruments for federal countries. For unitary countries the one time lag of these variables is included; Model (c): same as two but with with standard errors robust to heteroskedasticity and autocorrelation (Newey-West); Model (d): present and lagged values are used as instruments in both first stage equations, standard errors robust to heteroskedasticity and autocorrelation (Newey-West).

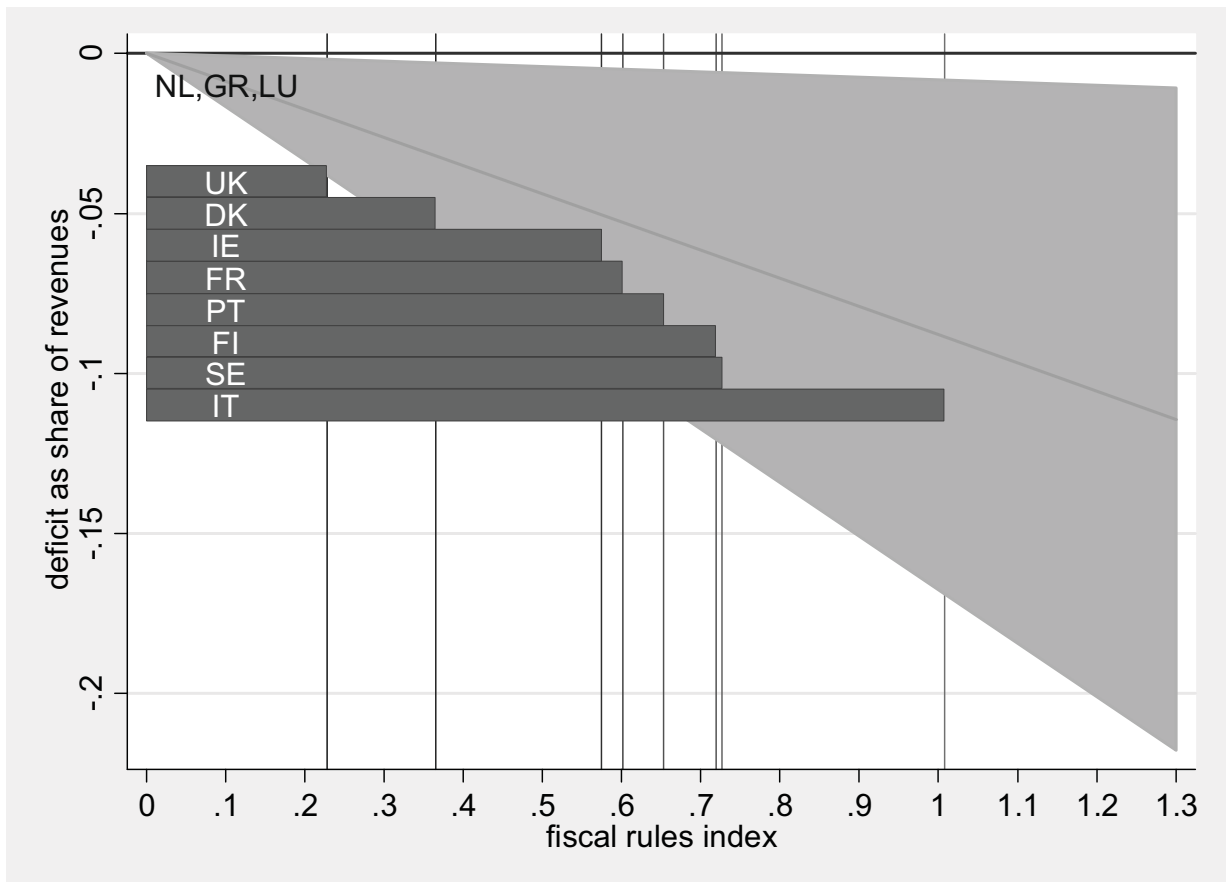
Table 8: IV regressions

Dependent Variable	IV 2SLS Panel Model					
	(a.I) federal	(a.II) unitary	(b.I) federal	(b.II) unitary	(c.I) federal	(c.II) unitary
<b>Tax autonomy</b>						
<i>tax</i> <sub>(t-1)</sub>	-0.267** (0.110)	0.316** (0.136)	-0.259** (0.108)	0.291** (0.131)	-0.238** (0.119)	0.321** (0.142)
<b>Fiscal rules</b>						
<i>rules</i>	-0.027 (0.023)	-0.091*** (0.027)	-0.031 (0.023)	-0.085*** (0.027)	-0.043 (0.036)	-0.093*** (0.028)
<b>Controls</b>						
<i>def_cg_rev</i>	0.162*** (0.044)	0.028 (0.051)	0.159*** (0.044)	0.029 (0.052)	0.155*** (0.049)	0.028 (0.051)
<i>edec</i>	0.376* (0.227)	0.021 (0.101)	0.378* (0.226)	0.028 (0.102)	0.381* (0.223)	0.020 (0.102)
<i>intexp_rev</i>	-0.011 (0.011)	0.012 (0.009)	-0.010 (0.011)	0.012 (0.009)	-0.009 (0.011)	0.013 (0.009)
<i>outgap</i>	0.017*** (0.004)	-0.001 (0.002)	0.017*** (0.004)	-0.001 (0.002)	0.017*** (0.004)	-0.001 (0.002)
<i>unempl</i>	1.262*** (0.290)	-0.318 (0.238)	1.287*** (0.294)	-0.309 (0.238)	1.347*** (0.322)	-0.319 (0.238)
<i>ln_pop_tot</i>	1.113*** (0.172)	0.238 (0.239)	1.115*** (0.172)	0.240 (0.237)	1.119*** (0.172)	0.237 (0.239)
<i>depratio</i>	0.884 (0.823)	-0.638* (0.351)	0.992 (0.811)	-0.658* (0.341)	1.258 (1.053)	-0.634* (0.355)
<i>trend</i>	0.005 (0.010)	0.004 (0.009)	0.005 (0.010)	0.004 (0.009)	0.005 (0.010)	0.004 (0.009)
Year Dummies	Yes	Yes	Yes	Yes	Yes	Yes
Fixed Effects	Yes	Yes	Yes	Yes	Yes	Yes
Excluded Instruments	<i>herfgov<sub>t</sub></i> <i>district<sub>t</sub></i> <i>contract<sub>t</sub></i>		<i>herfgov<sub>t</sub></i> <i>district<sub>t</sub></i> <i>contract<sub>t</sub></i>		<i>herfgov<sub>(t-1)</sub></i> <i>district<sub>(t-1)</sub></i> <i>contract<sub>(t-1)</sub></i>	
R-squared	0.623	0.235	0.624	0.246	0.623	0.232
Hansen J	6.180	2.149	0.822	0.118	0.919	1.452
Hansen J p-value	0.289	0.828	0.663	0.943	0.632	0.484
K-P Weak Id. F	7.491	8.637	14.08	7.975	4.680	16.38

Robust standard errors in parentheses  
\*\*\* p<0.01, \*\* p<0.05, \* p<0.1, n=104/143 N=8/11 (federal/unitary) T=14

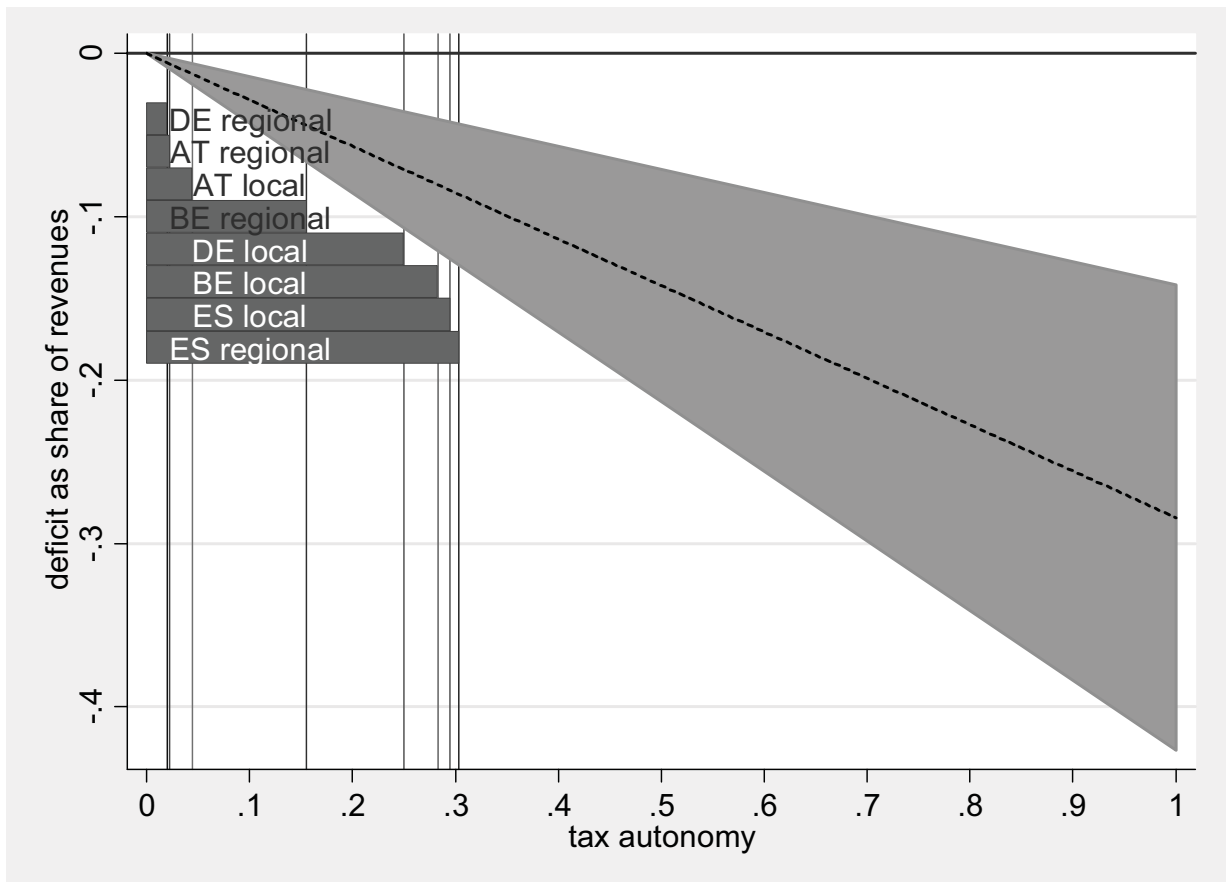
Notes: Two stage least square estimations. First stage regressions are presented in table 13 of appendix A. Separate regressions for federal (a)/(c)/(e) and unitary (b)/(d)/(f) countries. Model (a)/(b): Actual and lagged instruments; Model (c)/(d): only actual instruments; Model (e)/(f): only lagged instruments. Standard errors robust to heteroskedasticity and autocorrelation (Newey-West).

Table 9: IV regressions



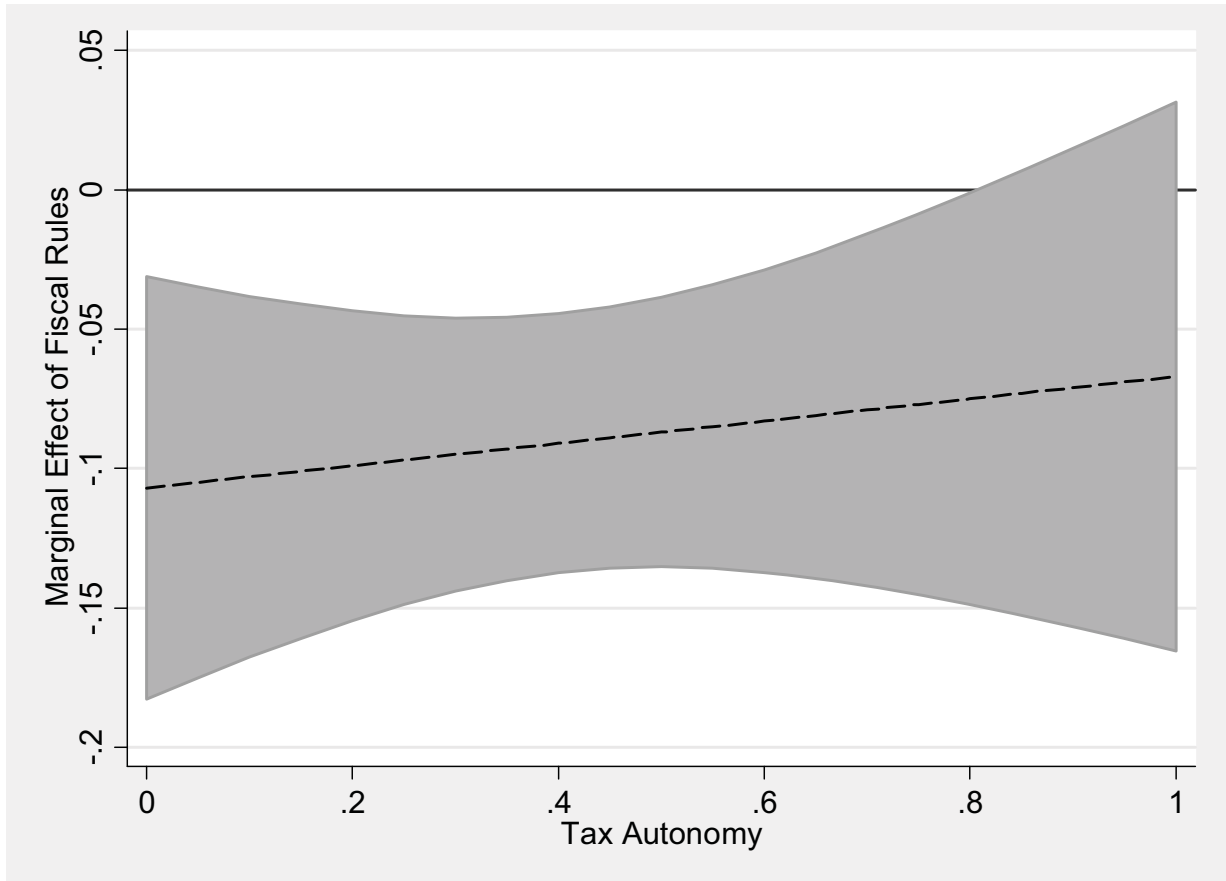
Bars: Value of the rules index in 2008. Marginal effect according to model (b) in table 8

Figure 5: Effect of fiscal rules in unitary countries



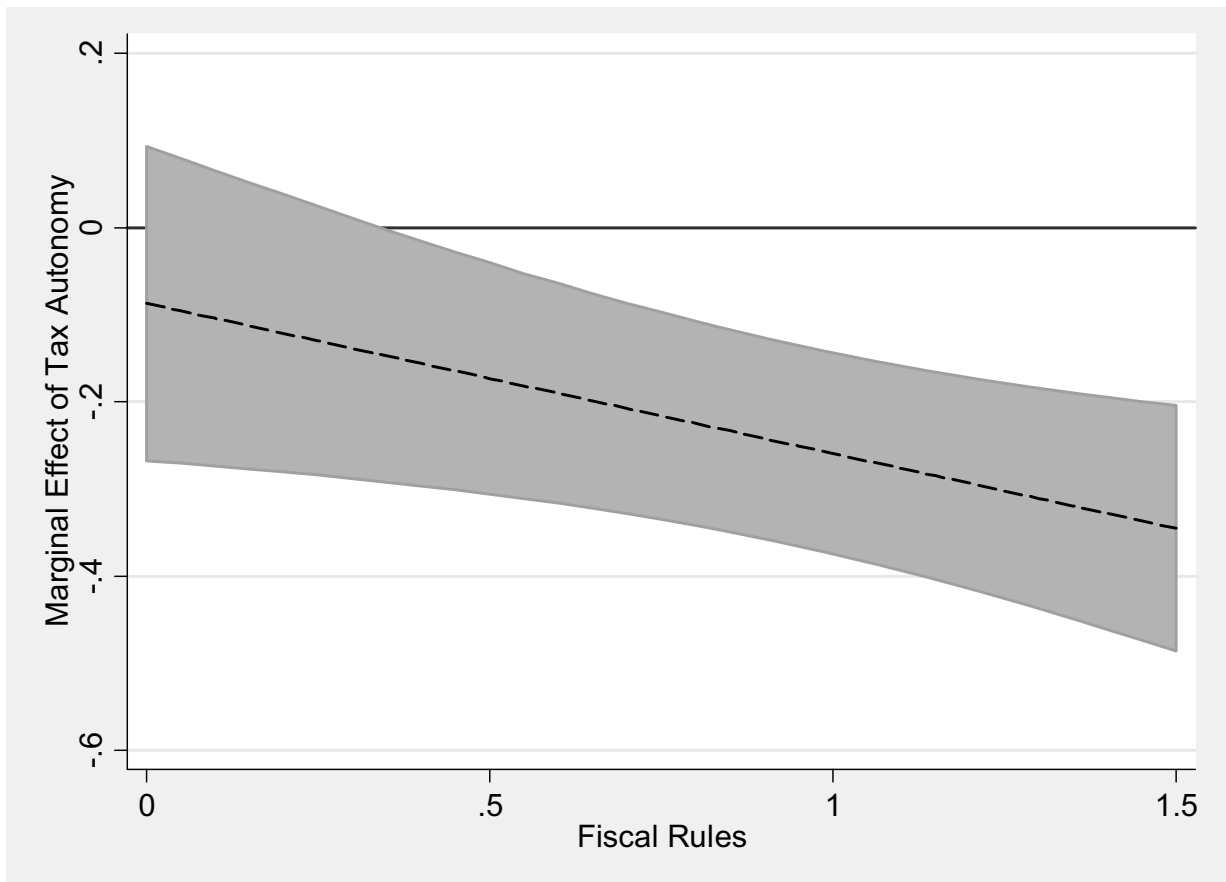
Bars: Value of tax autonomy in 2008. Marginal effect according to model (b) in table 8

Figure 6: Effect of tax autonomy in federations



Plot of the marginal effect of fiscal rules while allowing for interaction with tax autonomy

Figure 7: Marginal effect unitary countries



Plot of the marginal effect of tax autonomy while allowing for interaction with fiscal rules

Figure 8: Marginal effect federal countries





## A. First stage regression results

Equation: <i>rules*</i>	Model (b)		Model (c)		Model (d)	
	<i>unitary</i>	<i>federal</i>	<i>unitary</i>	<i>federal</i>	<i>unitary</i>	<i>federal</i>
<b>Excluded instruments</b>						
<i>herfgov * federal</i>	-0.187* (0.098)	0.221*** (0.058)	-0.187* (0.108)	0.221*** (0.073)	-0.168 (0.116)	0.067 (0.063)
<i>herfgov<sub>(t-1)</sub> * federal</i>					-0.022 (0.098)	0.255*** (0.082)
<i>contract * federal</i>	0.119** (0.061)	-0.502*** (0.025)	0.119*** (0.046)	-0.502*** (0.093)	0.033 (0.037)	-0.447*** (0.085)
<i>contract<sub>(t-1)</sub> * federal</i>					0.114*** (0.038)	-0.053*** (0.018)
<i>district * federal</i>	-0.000 (0.004)	0.007* (0.004)	-0.000 (0.005)	0.007** (0.004)	-0.008 (0.005)	0.011** (0.005)
<i>district<sub>(t-1)</sub> * federal</i>					0.010* (0.005)	-0.002 (0.004)
<i>contract * unitary</i>					-0.061 (0.071)	0.019 (0.022)
<i>contract<sub>(t-1)</sub> * unitary</i>	-0.265** (0.126)	0.032 (0.025)	-0.265*** (0.103)	0.032 (0.020)	-0.216** (0.107)	0.026 (0.018)
<i>district * unitary</i>					0.008* (0.005)	0.001 (0.001)
<i>district<sub>(t-1)</sub> * unitary</i>	0.022*** (0.002)	0.001 (0.001)	0.022*** (0.004)	0.001 (0.001)	0.016*** (0.002)	-0.000 (0.001)
<i>herfgov * unitary</i>					-0.256 (0.175)	0.044 (0.046)
<i>herfgov<sub>(t-1)</sub> * unitary</i>	-0.771*** (0.258)	0.005 (0.025)	-0.771*** (0.177)	0.005 (0.024)	-0.557** (0.224)	-0.026 (0.039)
<b>Other</b>						
<i>tax<sub>(t-1)</sub> * unitary</i>	2.083** (0.822)	0.017 (0.078)	2.083*** (0.668)	0.017 (0.096)	2.117*** (0.610)	-0.026 (0.108)
<i>tax<sub>(t-1)</sub> * federal</i>	-0.604* (0.338)	1.839*** (0.326)	-0.604** (0.246)	1.839*** (0.189)	-0.538** (0.243)	1.840*** (0.174)
<i>def_cg_rev</i>	-0.047 (0.222)	-0.001 (0.033)	-0.047 (0.162)	-0.001 (0.044)	-0.093 (0.160)	0.016 (0.046)
<i>edec</i>	-0.594** (0.260)	0.158 (0.177)	-0.594* (0.345)	0.158 (0.129)	-0.686* (0.354)	0.121 (0.121)
<i>intexp_rev</i>	0.004 (0.055)	0.013 (0.016)	0.004 (0.038)	0.013 (0.014)	0.004 (0.040)	0.011 (0.014)
<i>outgap</i>	0.004 (0.010)	0.000 (0.002)	0.004 (0.008)	0.000 (0.002)	0.004 (0.008)	0.000 (0.002)
<i>unempl</i>	-0.860 (1.644)	0.087 (0.399)	-0.860 (1.171)	0.087 (0.274)	-0.538 (1.140)	-0.147 (0.252)
<i>ln_pop_tot</i>	0.421 (0.909)	0.313 (0.459)	0.421 (0.625)	0.313 (0.324)	0.277 (0.630)	0.196 (0.312)
<i>depratio</i>	4.733* (2.664)	0.180 (0.747)	4.733** (2.285)	0.180 (0.546)	4.897** (2.380)	0.388 (0.653)
<i>trend</i>	-0.003 (0.016)	-0.003 (0.005)	-0.003 (0.028)	-0.003 (0.007)	-0.001 (0.028)	0.002 (0.009)
R-squared	0.588	0.748	0.588	0.748	0.608	0.763

Robust standard errors in parentheses  
\*\*\* p<0.01, \*\* p<0.05, \* p<0.1

Notes: First stage regressions for the results presented in table 8. Endogenous variables in the second stage is the fiscal rules index for both types of government.

Table 10: First stage regressions I

Equation: <i>rules</i>	Model (a.I)	Model (a.II)	Model (b.I)	Model (b.II)	Model (c.I)	Model (c.II)
<b>Excluded instruments</b>						
<i>herfgov</i>	0.079 (0.096)	-0.260 (0.170)	0.168 (0.105)	-0.649*** (0.148)		
<i>herfgov</i> <sub>(t-1)</sub>	0.279** (0.118)	-0.619*** (0.229)			0.242* (0.132)	-0.828*** (0.184)
<i>contract</i>	-0.450*** (0.088)	-0.067 (0.082)	-0.488*** (0.109)	-0.189** (0.091)		
<i>contract</i> <sub>(t-1)</sub>	-0.077* (0.039)	-0.196** (0.097)			-0.372*** (0.107)	-0.251*** (0.094)
<i>district</i>	0.020* (0.012)	0.004 (0.004)	0.010 (0.008)	0.015*** (0.006)		
<i>district</i> <sub>(t-1)</sub>	-0.009 (0.010)	0.015*** (0.003)			0.011 (0.008)	0.018*** (0.003)
<b>Other</b>						
<i>tax</i> <sub>(t-1)</sub> * <i>unitary</i>		2.101*** (0.540)		2.749*** (0.450)		2.048*** (0.584)
<i>tax</i> <sub>(t-1)</sub> * <i>federal</i>	1.448*** (0.302)		1.445*** (0.326)		1.553*** (0.415)	
<i>def_cg_rev</i>	0.006 (0.139)	-0.242 (0.236)	-0.135 (0.154)	-0.190 (0.227)	0.043 (0.224)	-0.255 (0.242)
<i>edec</i>	1.434* (0.831)	-0.812** (0.408)	1.278 (0.852)	-0.911** (0.433)	1.267 (1.058)	-0.787* (0.408)
<i>intexp_rev</i>	0.057* (0.030)	-0.018 (0.056)	0.062* (0.034)	0.022 (0.055)	0.086* (0.049)	-0.014 (0.053)
<i>outgap</i>	0.016 (0.015)	0.000 (0.008)	0.026 (0.017)	0.003 (0.009)	0.047** (0.023)	0.000 (0.008)
<i>unempl</i>	0.585 (1.380)	-1.686 (1.723)	2.276 (1.545)	-1.104 (1.457)	2.775 (1.898)	-1.864 (1.704)
<i>ln_pop_tot</i>	1.023 (0.664)	0.835 (1.201)	1.968*** (0.706)	0.257 (1.137)	1.490* (0.887)	0.898 (1.173)
<i>depratio</i>	-1.038 (4.082)	3.185 (2.697)	-0.024 (3.286)	3.492 (2.705)	4.702 (5.066)	3.073 (2.528)
<i>trend</i>	0.010 (0.020)	-0.004 (0.047)	-0.002 (0.017)	0.006 (0.044)	0.006 (0.028)	-0.002 (0.048)
R-squared	0.846	0.729	0.831	0.686	0.772	0.722
Robust standard errors in parentheses *** p<0.01, ** p<0.05, * p<0.1						

Notes: First stage regressions for the results presented in table 9. Endogenous variables in the second stage is the fiscal rules index for both types of government.

Table 11: First stage regressions II



## B. Robustness check: federal specification

Dependent Variable	Fixed Effects Panel Model		
	(1)	(2)	(3)
Deficit/Revenues			
<b>Tax autonomy</b>			
$tax_{(t-1)} * unitary$	0.195** (0.098)	0.186* (0.099)	0.194** (0.097)
$tax_{(t-1)} * federal$	-0.272*** (0.069)	-0.309* (0.180)	
$tax_{(t-1)} * regional$			-0.300*** (0.076)
$tax_{(t-1)} * local$			-0.332* (0.174)
<b>Fiscal rules</b>			
$rules * unitary$	-0.043*** (0.014)	-0.048*** (0.016)	-0.044*** (0.014)
$rules * federal$	0.002 (0.014)	0.029 (0.023)	
$rules * regional$			0.016 (0.017)
$rules * local$			-0.019 (0.017)
<b>Controls</b>			
$def\_cg\_rev$	0.076** (0.036)	0.120*** (0.039)	0.074** (0.037)
$edec$	0.214** (0.087)	0.232** (0.114)	0.200** (0.090)
$intexp\_rev$	-0.001 (0.007)	0.001 (0.010)	-0.001 (0.007)
$outgap$	-0.000 (0.002)	-0.002 (0.002)	-0.000 (0.002)
$unempl$	-0.047 (0.209)	-0.215 (0.242)	-0.059 (0.210)
$trend$	0.005 (0.007)	0.002 (0.009)	0.006 (0.007)
$ln\_pop\_tot$	0.520*** (0.167)	0.526** (0.223)	0.514*** (0.168)
$depratio$	-0.603* (0.331)	-0.668* (0.392)	-0.615* (0.340)
Observations	247	195	247
R-squared	0.270	0.289	0.177
Number of code	19	15	19
Number of Groups	19	15	19
Number of Observations	247	195	247
Robust standard errors in parentheses *** p<0.01, ** p<0.05, * p<0.1			

Notes: Model (a): repetition of the estimation of model (d) in table 5 for comparison; Model (b): the local and regional level in federal countries are merged; Model (c): individual coefficients for the regional and local level in federal countries. All standard errors are robust to heteroskedasticity and autocorrelation (Newey-West).

Table 12: Regression: Deficits under different specifications

## C. Addiditional tables

Dependent Variable Deficit/Revenues	Interaction Terms
<b>Unitary countries</b>	
$tax_{(t-1)} * unitary$	0.380** (0.156)
$rules * unitary$	-0.107** (0.039)
$rules * tax_{(t-1)} * unitary$	0.040 (0.075)
<b>Federal countries</b>	
$tax_{(t-1)} * federal$	-0.087 (0.092)
$rules * federal$	0.006 (0.021)
$rules * tax_{(t-1)} * federal$	-0.172** (0.075)

Notes: Results for a regression allwong for interactions between *rules* and  $tax_{(t-1)}$ . Only main coefficients reported.

Table 13: Regression: Interaction model

## D. Construction of the Rules Index

The construction of the rules index follows the [European Commission \(2009\)](#). I adopt their dataset and calculate the rules index for the sub-national sectors. All balanced budget rules and debt rules applying to the sub-national sector are taken into account. All information about the included rules are available on the webpage of the European Commission. Rules applying to the general government sector are weighted by the respective sub-national expenditure share in it. The indicator is the sum of each criterion, divided by the total number of criteria. Each criteria itself is divided by the maximum score, i.e. all variables are forced to be between zero and one.

- *Criterion 1: statutory base of the rule*

The score of this criterion index is constructed as a simple average of the two elements below:

- *Criterion 1a: Statutory or legal base of the rule*

4 is assigned for a constitutional base

3 if the rule is based on a legal act (e.g. Public finance Act, Fiscal Responsibility Law)

2 if the rule is based on a coalition agreement or an agreement reached by different general government tiers (and not enshrined in a legal act)

1 for political commitment by a given authority (central or local government, Minister of Finance)

- *Criterion 1b: Room for setting or revising objectives*

3 if there is no margin for adjusting objectives (they are encapsulated in the document underpinning the rule)

2 there is some but constrained margin in setting or adjusting objectives

1 there is complete freedom in setting objectives (the statutory base of the rule merely contains broad principles or the obligation for the government or the relevant authority to set targets)

- *Criterion 2: Nature of the body in charge of monitoring respect of the rule*

The score of this variable is augmented by one point in case there is a real time monitoring of compliance with the rule (e.g. existence of alert mechanisms in case there is a risk of non-respect of the rule).

3 if there is a monitoring by an independent authority (Fiscal Council, Court of Auditors or any other Court) or the national Parliament

2 monitoring by the Ministry of Finance or any other government body

1 no regular public monitoring of the rule (there is no report systematically assessing compliance)

- *Criterion 3: Nature of the body in charge of enforcement of the rule*

3 enforcement by an independent authority (Fiscal Council or any Court) or the National Parliament

2 enforcement by the Ministry of Finance or any other government body

1 no specific body in charge of enforcement

- *Criterion 4: Enforcement mechanisms of the rule*

The score of this variable is augmented by 1 point in case escape clauses are foreseen and clearly specified.

4 there are automatic correction and sanction mechanisms in case of non-compliance

3 there is an automatic correction mechanism in case of non-compliance and the possibility of imposing sanctions

2 the authority responsible is obliged to take corrective measures in case of non-compliance or is obliged to present corrective proposals to Parliament or the relevant authority

1 there is no ex-ante defined actions in case of non-compliance

- *Criterion 5: Media visibility of the rule*

3 is assigned if the rule observance is closely monitored by the media, and if non-compliance is likely to trigger a public debate

- 2 for high media interest in rule-compliance, but non-compliance is unlikely to invoke a public debate
- 1 for no or modest interest of the media