PEMNA Center

Fiscal rules for subnational governments: The menu and implications from the cross-country comparison

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Contents

List of Table

List of Figures

I. Introduction

- Since the 2008 global financial crisis, the influence of national finance on the markets has become a prominent issue, while the principle of fiscal soundness has been attracting increasing attention across the world.
  - As the trend of greater global economic integration has brought the entire world together as a de facto single market, the macroeconomic shocks in an individual country may influence the global market. In such cases, the role of public finance as an institutional device to minimize such an influence is becoming more highlighted.

- Each country operates a system of budget management with the aim of securing fiscal soundness, while legislating and ensuring the permanence of such systemic policies is central to instituting fiscal rules.

- However, ensuring adequate fiscal health may not be possible through the central government's budget management alone.
  - The scale of transferable funds available to the general government sector is on the increase, and debt levels in the public sector including local public corporations are also expected to rise steadily.
  - Along with the general account of the central government, national public enterprises, sub-national governments and local government corporations also identified as posing a threat to fiscal soundness, and the trend of fiscal expansion in the public sector requires close examination.

- In particular, intergovernmental fiscal relations and the scale of fiscal transfers are deemed to have absolute influence on a country's fiscal health.
  - In Korea, fiscal transfers to local governments account for the biggest portion of

mandatory spending, and increasing welfare expenditures also fall into the category of national treasury subsidies granted to local governments.

- This applies not only to Korea but also to all advanced countries and Asian nations, and the analysis of fiscal soundness requires the careful examination of the fiscal relations between central and local governments and the scale of intergovernmental fiscal transfers.
  - Even if the scale of intergovernmental fiscal transfers is small, in cases where these transfers correspond to mandatory transfer payments, increases in local government spending may significantly impact fiscal soundness, considering the future demographic structure and sector-specific spending.
  - By contrast, even if the size of fiscal transfers to local governments is large, when these transfers can be mainly adjusted by mutual agreement between the central and local governments, there is a possibility of flexible fiscal operations. In such cases, it is possible for the national and sub-national governments to cooperate with each other in ensuring a sound fiscal stance.

□ Reflecting this trend, the need for intergovernmental budgetary management has been actively debated in international organizations.

- Previous discussions have examined works of research on fiscal rules in developed countries and examples of sub-national fiscal rules in several Asian nations.

□ The contents of fiscal rules for sub-national governments, however, depend on country-specific circumstances, which require considerations towards varying elements including the degree of decentralization, political independence, intergovernmental fiscal relations and governance as well as macroeconomic factors. Therefore fiscal rules do not easily lend themselves to straightforward comparisons between companies.

- In addition, given the nature of analyses by international organizations, it is essential to compile a number of examples from different countries to be categorized according to their characteristics in order to draw relevant implications, but the generalization of case studies on fiscal rules at the local level can be an exceptionally difficult task.

- In particular, determining the applicability of examples from developed countries onto other countries, especially developing nations, requires a cautious approach.
  - Countries that have already entered the phase of population aging and face considerable fiscal rigidity from high welfare spending are in stark contrast from the emerging economies of Asia with higher economic growth rates.
  - Accordingly, taking into account changes in discussions among international organizations and examples in advanced countries and Latin America, this paper intends to suggest the need for and limits of sub-national fiscal rules and fiscal rules that are self-imposed by local governments.
  - Subsequently, this paper intends to present the applicability of examples in developed countries to developing nations including member countries of the Public Expenditure Management Network in Asia (PEMNA), as well as the expected effects and disadvantages of such application.

II. General Status of Fiscal Rules and the Present State of the Introduction of Fiscal Rules for Sub-national Governments

1. Definitions and Types of Fiscal Rules

A. Background of Discussions on Fiscal Rules for Sub-national Governments

☐ The debate on sub-national fiscal rules has primarily revolved around international agencies, the motives behind which do not differ significantly from the background of discussions on fiscal rules for the general government.

- The need for public financial management systems including fiscal rules stems from sharp rises in public sector spending.[1)]

☐ Crivelli and Shah (2009) give a brief overview of discussions on fiscal rules for sub-national governments preceding the recent global financial crisis.

- Fiscal rules for lower levels of government must be distinguished from those at the national level, and the initial reason for the discussion on fiscal rules at the local level was that local governments in federal countries wanted to minimize the so-called "common pool problem."
- Fiscal rules between central and local governments have undergone three major changes. First, fiscal rules were introduced in the United States since the mid-19th century in order to prevent expansion in capital spending at different tiers of government (the federal government and state governments) in a federal system, similarly with their adoption by several cantons in Switzerland during the 1920s. The second trend, starting with New Zealand's Fiscal Responsibility Act of 1994, gave particular importance to "rules-based"

1) OECD (2014), pp.38; Escolano et al.(2012), pp.3

principles for fiscal responsibility by expanding fiscal management for sub-national governments into medium-term fiscal plans, with strong emphasis on fiscal rules. In recent years, fiscal rules have once again come into the spotlight with the enactment of Brazil's Fiscal Responsibility Law of 2000.

- Fiscal rules aim to ensure fiscal soundness by establishing quantitative (statistical) and compulsory standards for fiscal management systems.
  - The institutional frameworks for central, sub-national and local governments remain the same across the general government sector.

□ The background of discussions on sub-national fiscal rules can be divided into before and after the 2008 global financial crisis.

- In discussions prior to 2008, the emphasis was on the need for such rules as a means of curbing a sharp rise in fiscal spending, while after the international financial crisis, striving for long-term sustainability in consideration of potential financial burdens (e.g., population aging) became regarded as the main rationale for fiscal rules.

- At the 2002 IMF-World Bank Conference on "Rules-based Macroeconomics Policies in Emerging Market Economies," discussions examined the need for and limits of sub-national fiscal rules in member countries of the European Economic and Monetary Union (EMU) and Latin American countries.[2)]
  - The said discussion can be summarized as the attempt to link fiscal rules adopted in EU member states since the 1990s to decentralization, which identified three key issues.
  - First, the understanding of sub-national fiscal conditions necessary for the application of fiscal rules is asymmetrical over that of national fiscal conditions. Second, fiscal rules may limit the budgetary autonomy sub-national governments, and may also raise the problem of unduly reduced capital outlays in particular. Third, fiscal rules may restrict local governments' flexibility in conducting fiscal operations to execute budgetary activities with respect to the business cycle.

2) Balassone et al.(2002), Braun and Tommasi (2002)

- Recent discussions have featured OECD analysis data gathered over the period since the 2008 global economic crisis, and the present conditions of sub-national fiscal rules in EU member countries have been detailed through near-annual surveys.

- In short, the tone of discussions about fiscal rules may differ depending on the countries concerned and their economic conditions.
  - (World Bank and IMF) Reservations were put forward about fiscal rules for emerging economies in 2002 due to the concern that the applicability of such rules can be quite limited in the course of local governments' fiscal expansion.
  - (OECD, EU and IMF) On the other hand, following the 2008 global financial crisis, there were discussions on the need to expand the applicability of fiscal rules in OECD countries and EU member states and to complement these rules with fiscal management schemes like the intergovernmental transfer system, which shows the trend of debate on moving towards boosting the effectiveness of fiscal rules.

B. Definitions of Fiscal Rules

- The most commonly cited definition of fiscal rules derives from Kopits and Symansky (1998).
  - Kopits and Symansky explain that a fiscal policy rule is a permanent constraint on fiscal policy, defined in terms of an indicator of overall fiscal performance and expressed as a numerical ceiling or target.[3)]
  - Definitions of fiscal rules are summarized by Hong Seung-hyun as follows:
    - The IMF (2009) defines fiscal rules are numerical targets on fiscal aggregates that are expected to be in place over a long period.

3) "… a permanent constraint on fiscal policy, typically defined in terms of an indicator of overall fiscal performance… such as the government budget deficit, borrowing, debt or a major component thereof-often expressed as a numerical ceiling or target…"

- Tapp (2010) defines fiscal rules as "legislated fiscal targets."
- The World Bank (2011) defines fiscal rules as "specific quantitative numerical ceilings or targets."
- Schaechter et al. (2012) define fiscal rules using the concepts of "permanence" and "numerical targets."
- Many other domestic studies (Park Hyung-soo and Ryu Deock-hyun, 2006; Ryu Deock-hyun, 2011; Choi Kwang and Lee Sung-kyu, 2010; Samsung Economic Research Institute, 2011; Seoul Institute, 2010) use the definition of Kopits and Symansky (1998). The National Assembly Budget Office (2013) defines fiscal rules as a "fiscal policy measure adopted by each country in order to ensure fiscal discipline with a view to making specific and legally-binding fiscal operations of fiscal aggregates such as revenue, expenditure, the budget balance and public debt."

☐ The above definitions also apply to fiscal rules for sub-national governments. Provided, however, that the "principal agent" of fiscal policy and the "subjects of fiscal rules" are respectively the central government and sub-national governments.

C. Types of Sub-national Fiscal Rules

☐ First, fiscal rules for the central government are classified into four types: debt rules, budget balance rules, expenditure rules and revenue rules, and the advantages and disadvantages of these rules and applicable countries are described in the following table.

☐ As the definition of fiscal rules does not vary across levels of government, types of fiscal rules at the local level are identical with those of fiscal rules at the central level.

▪ According to the OECD (2013), types of fiscal rules and key issues are summarized and categorized as follows:

<Table II-1> Pros and Cons by Type of National Fiscal Rules and Applicable Countries

Type	Pros	Cons	Applicable Countries (as of 2012)
Debt rule	• Directly linked to debt sustainability • Easy to monitor and communicate	• Insufficient economic stabilization feature (pro-cyclical) • No clear operational guidance in the short run • Rule could become a temporary measure • Debt could worsen due to uncontrollable factors	Israel, Serbia, Poland, Slovakia, the United Kingdom, etc.
Budget balance rule	• Clear operational guidance • Directly linked to debt sustainability • Easy to monitor and communicate	• Insufficient economic stabilization feature (pro-cyclical) • Primary budget deficits could widen due to uncontrollable factors	Israel, Indonesia, etc.
Structural budget balance rule	• Economic stabilization function (counter-cyclical) • Relatively clear operational guidance • Directly linked to debt sustainability	• Difficulty in adjusting rules, particularly during structural economic changes • Difficult to monitor and communicate	Colombia, Portugal, Serbia, Spain, the United Kingdom, etc.
Expenditure rule	• Clear operational guidance • Counter-cyclical • Easy to control the size of government • Relatively easy to monitor and communicate	• Not directly linked to debt sustainability since there are no revenue constraints • Could lead to unnecessary changes in the distribution of spending when meeting expenditure limitations	Ecuador, Israel, Japan, Namibia, Poland, Romania, Spain, the United States, etc.
Revenue rule	• Easy to control the size of government • Can improve revenue policy	• Pro-cyclical • directly linked to debt sustainability since there are no expenditure constraints	The Netherlands, France, Kenya, Australia, etc.

Source: Schaechter et al.(2012) and IMF fiscal rules dataset via Hong Seung-hyun (2012)

- Budget balance rules (BBRs): This type of rule refers to the principle of establishing a balanced budget in order to preserve a "balance between the revenues and expenditures of the government." Rules may cover the current budget and capital account and even "off-budget items."
  - However, a more common rule is the "golden rule," which requires "current account spending" to remain within tax revenue, but allows a certain level of borrowing for "expenditure on public capital investments."[4)]
- Borrowing and debt rules: In most OECD countries, "constraints on borrowing and debt levels" are typically imposed and stringently enforced by a higher tier of government.
  - Although borrowing is not allowed by principle, exceptional cases allow borrowing for such purposes as capital spending or to borrowing in domestic currency only.
- Tax limits: Tax limits restrict sub-national discretion over the tax base and rates.
  - Tax limits aim to prevent local governments from exercising authority over their tax base and rates, which may result in the temporary erosion of tax revenues. These restrictions have a negative impact on local autonomy.
- Spending limits: Spending limits refer to ceilings prohibiting the sharp growth of expenditure.
  - Explicit spending limits are rare in OECD countries. They are linked to income levels, inflation, population growth rates, other criteria based on fiscal needs or a combination of a number of factors.

4) The "golden rule" has been adopted by most states in the United States since the mid-19th century and several cantons in Switzerland since the 1920s (Crivelli and Shah, 2009).

2. Status of the Adoption of Sub-national Fiscal Rules and Problems Thereof

A. Countries that Adopted Sub-national Fiscal Rules and the Status Thereof

- Based on the IMF fiscal rules database, a review of the adoption of fiscal rules at the national level over the last two decades shows that the number of countries with fiscal rules has surged from five in 1990 to 76 in 2012.[5)]
  - The reason behind the increase in the total number of countries with fiscal rules corresponds with the dramatic increase in the number of fiscal rules at both the national and supranational levels.

- Fiscal rules for sub-national levels of government 1) may be self-imposed by sub-national governments by defining their position in relation to the legislature, and 2) may be imposed by the central government as part of its efforts to control their finances.
  - The two approaches to establishing sub-national fiscal rules correspond in their common efforts to improve the aggregate budget balance of the general government by securing fiscal soundness at the sub-national level. But the first notion refers to fiscal rules self-established by sub-national governments under the control of local residents, whereas the second notion connotes the central government's intervention and control over sub-national fiscal activities and implementation of sub-national fiscal rules. Such patterns may differ according to political or fiscal relationships between the central and sub-national governments.

5) Hong Seung-hyun (2012), p.19

<Table II-2> > Sub-central Fiscal Rules in Countries Self-imposed or Imposed by Upper-level Government, 2011

Sub-central government	Budget balance rule	Expenditure limit	Taxation limit	Borrowing constraint
Australia state	×	×	×	×
Australia local			×	×
Austria state	×			
Austria local	×			
Belgium state	×		×	
Belgium local	×		×	×
Canada state	×			
Canada local	×		×	×
Chile			×	×
Czech Republic	×		×	
Denmark	×	×	×	×
Estonia	×			×
Finland	×		×	
Germany state	×			×
Germany local	×			×
Ireland	×			×
Italy state		×	×	×
Italy local	×		×	×
Korea	×			×
Mexico state				×
Mexico local				×
New Zealand	×		×	×
Norway	×		×	×
Poland	×			×
Slovak Republic	×			×
Slovenia	×		×	×
Spain state	×			×
Spain local	×	×		×
Sweden	×			
Switzerland state	×		×	
Switzerland local	×		×	
Turkey		×		×

Source: Kaja Fredriksen(2013, OECD), p. 11, Table 1.
OECD Secretariat calculations based on Network questionnaire responses.

- The OECD (2013) compiled case studies of sub-national fiscal rules (including fiscal rules self-imposed by sub-national governments) based on survey materials of fiscal networks among OECD member states.
  - Fiscal rules currently in use by most OECD countries are budget balance and debt rules.
    - The least frequently used type is that of expenditure rules.
  - The detailed examination of each country showed that state governments in Australia and municipalities in Denmark had instituted all types of fiscal rules.
    - In terms of the different levels of government, the establishment and usage of fiscal rules showed a disparity between state and municipal governments in most countries, while only Switzerland maintains consistent fiscal rules across the state and municipal levels.
    - Although the United States did not participate in the OECD survey, it has maintained fiscal rules for the longest period and is therefore expected to have similar fiscal rules as those in Switzerland. However, the extreme number of sub-central governments and variations in sub-national fiscal rules across the country would impose limitations to compiling a coherent database.

B. Problems (Trade-offs and Side-effects) of Strengthened Fiscal Management Systems between the Central and Local Governments

- Regarding BBR and debt rules, the extent of implementation towards the relevant systems may vary depending on a given country's financial conditions.
  - It is difficult to conceptually define the optimum levels of debt, and the two types of rules may make it difficult for local governments to formulate their budgets due to the gap between cyclical fluctuations of local revenues and the fiscal year.

- **(BBRs)** The trade-offs between the above-mentioned systems can eventually lead to the inefficient allocation of resources.

  - Compliance with a BBR is made easier through a decrease in capital account spending because such a reduction is less politically sensitive than a drop in current account spending. Reducing financial resources with less political resistance is inevitably preferable to strictly ensuring the long-term sustainability of financial resources.
  - At the same time, stringent regulation of borrowing may inevitably lead to severe curtailments in necessary capital projects. On the other hand, since debt rules prohibit borrowing for current spending and only permit borrowing for capital spending, this may result in the inefficiency that capital spending is only financed through borrowing.
  - As a result, when operating fiscal rules specified as numerical standards, municipal governments are required to set their own targets and establish appropriate systems in order to adapt to them[6].

- **(Debt restrictions)** Debt limits restrict government expenditure by nature, and can therefore impose constraints on local investment through capital spending.

  - Although there is the positive effect that local governments' ineffective budget expenditure is limited in the short run, there is also the negative impact that long-term investment may be hindered.

- **(Tax and expenditure limitations)** It should be noted that these limits may distort the composition of local government expenditures.

  - Limiting local governments' expenditure levels affects the pattern of providing public services for local residents, and may thus give rise to distortions in the supply of local public goods

6) OECD (2013), pp. 45

☐ Consequently, excessive emphasis on fiscal rules may create the following side-effects:

- **(Fiscal gimmickry)** Local governments measures to bypass these stringent fiscal rules. For example, Sharp and Elkins (1987) cite the creation of special districts exempt from fiscal discipline, and the fact that when the Spanish government imposed strict regulations on public officials' wage levels, there was a sudden spike in the number of non-regular workers and a variety of strategies to circumvent the regulation.
- In the case of tax limits, the share of non-tax revenue through sources such as fees and user charges tends to increase.
- The widening scope of off-budget items raises the dilemma of accountability among local governments, since the conceptual complexity of public debt might be exploited by a local government to request intergovernmental fiscal transfers from a mid-level sub-national government, which is not constrained by the same fiscal rules.

C. Countermeasures to Problems and Side-effects of Fiscal Rules

☐ Ways to enhance the effectiveness of fiscal rules and mitigate their side-effects can be found in examples of fiscal rules in major countries.

- For example, if only one type of fiscal rule is used, its side-effects could be more substantial than its effectiveness. Hence most cases stipulate the implementation of three types of fiscal rules in concert.

☐ In designing fiscal rules, the consideration of "structural fiscal rules" rather than the application of individual rules can ease the side-effects of each individual rule.

- Substantial degree of autonomy held by a local government may raise the concern that fiscal stability could be vulnerable to cyclical fluctuations.

- There is a need for efforts to adjust the severity of enforcement towards fiscal rules, in accordance with the priority between the objectives of "short-term fiscal stability" and "long-term fiscal sustainability" generated by the execution of fiscal rules.
- In the aftermath of the economic crisis, Germany, Italy and Spain greatly upgraded their fiscal rules in order to help improve structural fiscal operations rather than the implementation of nominal fiscal rules.

▪ In this regard, the OECD recently noted that "structural balances" for Italian municipalities are feasible.

□ In addition, side-effects of fiscal rules should be mitigated through their even application across all budgets. The use of "escape clauses" could intensify these side-effects.

▪ As for the golden rule, the capital spending sector remains unconstrained by budget balance rules and debt rules.

- This is undesirable due to the potential risk for budget appropriations made not according to local residents' needs or national policy but instead by fiscal rules, which may only be conducive to further side-effects.
- Thus thorough efforts are required for compliance with fiscal rules to ensure universal coverage across all available budgets.

□ It is recommended that the enforcement of fiscal rules must be parallel to the pace of adaptation by local governments and therefore requires "flexible fiscal rules," which may appear somewhat contradictory to the initial purpose of the rules.

▪ For example, since "budget cuts" implemented as a follow-up measure could have devastating consequences for the economy, such a measure must consider the priorities in local government expenditure and coordination with other fiscal rules.

- The measures suggested by the OECD to mitigate the problems and side-effects created by fiscal rules can be interpreted to emphasize the need for mature fiscal conditions and harmony with existing fiscal management systems, rather than the applicability of fiscal rules.

D. Importance of Institutional Infrastructure other than Fiscal Rules

- According to the findings of previous studies, no clear conclusion has been drawn from the existing discussion on the potential correlation between compliance with fiscal rules and fiscal performance.
  - Escolano (2012) shows the effects of fiscal rules in European countries through an empirical study, which found the impacts to be almost negligible.
    - Poterba (1994), however, finds that in the United States, compliance with self-imposed fiscal rules has reduced debt levels and has clearly improved the performance of fiscal management through tight constraints.
    - Zycher (2013) notes that the phenomenon of reduced government spending occurs soon after the initial stage of the introduction of fiscal rules. Evidently, it is shown that the introduction of fiscal rules does not lead to long-term fiscal stability or a decrease in total public sector expenditure. In other words, the utility of fiscal rules is in their potency for short-term budget cuts.
    - Argimon and Hernandez de Cos (2012) show that the enforcement of fiscal rules in Spain appears to have failed in significantly improving the fiscal balances of regional governments.

- Correlation between different political systems and fiscal spending
  - Feld and Matsusaka (2003) show, in their empirical study of Swiss cantons from 1980 to 1998, that spending was reduced by approximately 19 percent in cantons that held a fiscal referendum on the matter, in comparison to other cantons, which saw no such effect.

☐ Determinants of fiscal performance encompass a wide variety of factors other than fiscal rules.

- Even if empirical research findings indicate that fiscal rules substantially affect fiscal outcomes, problems such as similarities between several determinant factors and omitted variables will persistently continue to arise.
- As a result, it is reasonable to view a given country's fiscal institutional infrastructure serves as the vital foundation for stronger fiscal performance, and it is subsequently necessary to observe the limited effects exerted by "fiscal rules" that were instituted in the process of achieving budgetary goals.

3. Present Status of Discussions on Sub-national Fiscal Rules

A. IMF[7)]

☐ The IMF analysis (2005) of the developments since the 2000s delineates the need for sub-national fiscal rules as follows:

- Local governments in major countries face fiscal crises due to the inclination to overspend through intergovernmental transfers and the expansion of debt levels.
- The tendency for overspending may arise from soft budget constraints, the common pool problem, interregional competition or short municipal election cycles.
  - In this regard, the IMF introduced four types of fiscal controls: administrative constraints (e.g., Korea), market discipline (e.g., the United States) and cooperative arrangements (e.g., Spain and Australia).
  - In particular, it is recommended to use rules-based controls setting out procedural and numerical targets.

7) Singh and Plekhanov (2005)

- In the case of similar fiscal capacities and spending burdens between the central and local governments, fiscal management on the part of local governments alone may prove sufficiently effective.
  - If vertical fiscal imbalances are substantial, however, local governments' fiscal capacity is weak and thus borrowing financial resources from the central government or external institutions becomes indispensible in order to bear the burden of public spending. The IMF emphasized that in these cases, it is necessary to strengthen fiscal management through the central government.

- The IMF expounded the need for fiscal rules at the regional level soon after the 2008 global economic crisis.
  - The need for fiscal rules at the local level arose as an issue from the expansionary fiscal policy undertaken by local governments in response to the global financial crisis and the subsequent decrease in tax revenue triggered by the economic downturn.
    - In terms of fiscal controls at the general government level, determining the proper scope for the levels of government covered by fiscal rules emerged as an important issue.
    - In turn, it was deemed necessary to include local governments as subjects of fiscal crisis management, as a result of their tendency towards frivolous expenditure.[8)]
    - The specific rationale for this is as follows: first, local authority for revenue generation or taxation is weak;
    - Second, local governments' reliance on central government transfers could create a moral hazard;
    - Third, local governments with high spending levels could create spill-over effects;
    - Fourth, conflicts could occur in the implementation of pro-cyclical policy due to the differences in the timeframes and scales of business cycle fluctuations between local governments.

8) the IMF (2009) via Hong Seung-hyun (2012)

□ In this respect, the IMF highlighted that it is possible to introduce fiscal rules for sub-national governments after setting national fiscal rules, and that it is essential to maintain policy consistency across different levels of government.

- Countries under supranational fiscal rules apply them across the entire general government sector, while national fiscal rules are applied only to the central government budget and separate provisions are set on local government budgets.
- Although the optimal option is to simultaneously introduce fiscal rules appropriate for different tiers of governments, this is rarely found in practice.
- If local governments bear the responsibility for implementing fiscal policy, it is possible to adopt fiscal rules at the local level.
  - The greater the share of public expenditure assigned to sub-national levels of government, the stronger the importance of fiscal discipline. If large-scale fiscal coordination is required, the burden of maintaining a sound fiscal stance must be shared across all levels of government.[9)]

□ Escolano et al. (2012) examined the impact of decentralization and institutional design on fiscal performance with regards to inter-governmental fiscal relations in EU countries after the global financial crisis.

- The IMF interest in fiscal discipline at the sub-national level stems from its focus on the notion that factors related to local governments may contribute to the deterioration of general government finances.
- This is because the IMF wished to examine whether fiscal rules are useful countermeasures against 1) the concern that the continual rise in the share of transfers to local governments in total national public expenditure may eventually undermine fiscal health at the general government level, and 2) a possibility that loose constraints on local government borrowing might

9) Ter-Minassian (1997)

damage budgetary discipline due to the nature of soft budget constraints.

- Rodden (2002) points out that high reliance of local governments on transfers reduces the overall balance across the general government. In particular, he argues that lax controls on sub-national borrowing, this could have a bad impact on the fiscal balance.

- The IMF took note of the deepening trend of fiscal decentralization and the fact that failure to establish mature institutional arrangements would result in the deterioration of fiscal discipline at the sub-national level. In this regard, the IMF assessed whether fiscal rules have a positive impact on budgetary outcomes.
  - The existing literature (Sutherland et al., 2005; Ter-Minassian, 1997a, 1997b, 2007) reports that fiscal rules may have a positive impact on fiscal performance.
  - However, as a more recent study on the performance of fiscal rules, Debrun et al. (2008) report that there is no conclusive evidence on this matter. The empirical analysis conducted by Debrun (2008) found fiscal rules to be effective pertaining to the fiscal performance of the general and central governments, while fiscal rules applying to sub-national governments were found to have no significant effect on fiscal outcomes.[10]

☐ Fiscal rules are being used as a means of diminishing sub-national fiscal deficits, and in particular, debt constraints and the balanced budget principle are representative methods for enforcing the rules.

- Most EU countries are using fiscal rules customized for the central and local levels.

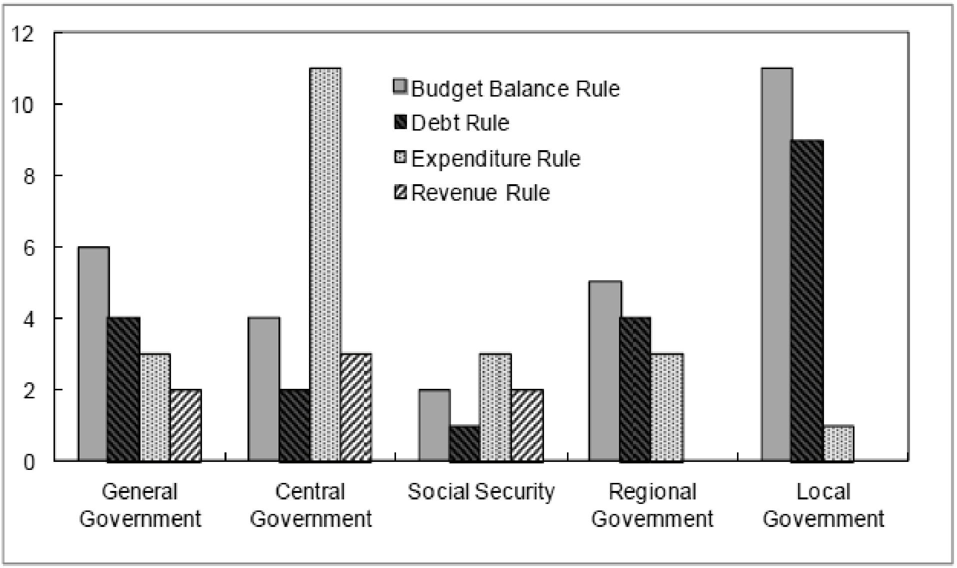
- The active application of fiscal rules does not necessarily connote a high degree of effectiveness.

10) Afonso and Hauptmeier (2009) also found a robust link between fiscal rules at the central government level and fiscal performance.

□ The IMF's panel survey data analyses show that fiscal rules are more actively adopted in countries with a higher level of decentralization, and this trend applies to cases where local taxation autonomy is great.[11)]

- This trend is applicable to both the central and local governments, and a degree of public spending decentralization at the national level is likely to result in a high utilization rate in relation to fiscal rules for the central government.
- The IMF assumes that there are two ways of central government control over lower-level governments in a decentralized environment: 1) to grant spending obligations without providing financial aid through unfunded mandates and 2) to adopt fiscal rules.

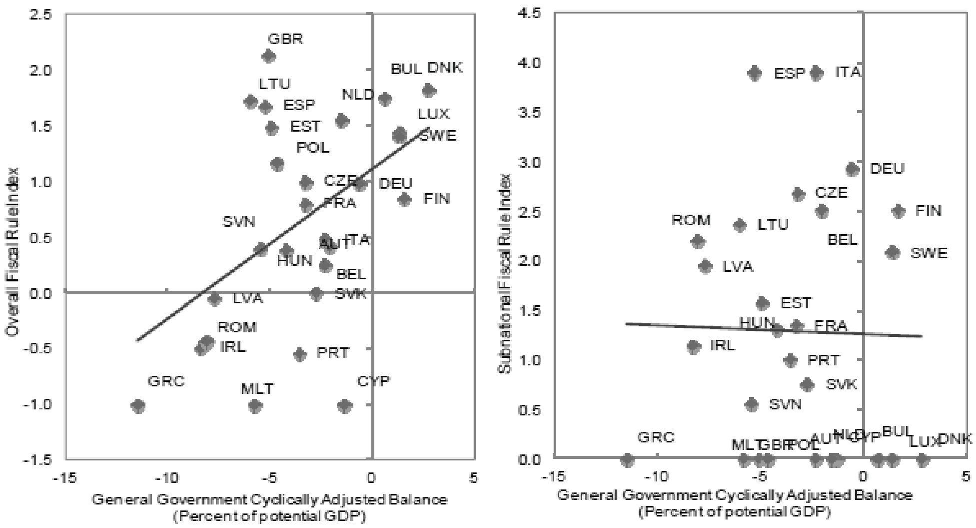
[Figure II-1] Fiscal Rules in the EU Member States by Type of Rule and Level of Government, 2008



Source: European Commission Services

11) The panel survey data analyzed by the IMF is an unbalanced panel data set of EU member states for 1990-2007 from the EU's statistical agency, Eurostat.

[Figure II-2] Fiscal Rules Indices and Fiscal Performance, 2008



Source: Eurostat, European Commission, and authors' calculations via Escolano et al. (2012), p.12, Figure 6

☐ Both the simple correlation analysis and the empirical analysis of the panel survey data find that there is no close link between compliance with fiscal rules and fiscal performance.

☐ In addition, the IMF assessed whether local expenditure decisions are affected by fiscal rules, but found no statistically significant correlation to confirm it.

☐ Finally, the IMF examined whether "formal coordination" between the central and local governments affects local spending levels, but did not discover a statistically meaningful result in this case either.

☐ In conclusion, the IMF analysis results did not find conclusive evidence regarding the institutional utility of fiscal rules in affecting budgetary outcomes.

- Fiscal rules in EU countries appear to be somewhat lax in stringency, which may stem from the fact that European central governments maintain relatively strong fiscal authority.
- Intuitively speaking, it is difficult to reduce expenditure on areas in which spending increases are publicly visible, such as healthcare or local education and welfare, due to the political sensitivity surrounding such aspects. Such areas are naturally more susceptible to political influence rather than principles of fiscal rules, and in this regard, the national government supports the fiscal status of sub-national governments by providing financial aid, which actually undermines fiscal rules.
  - It has also been pointed out that it is unreasonable for the central government to apply fiscal rules unfavorable to local governments while encouraging local government spending through unfunded mandates.
- Furthermore, the IMF explains several common features of intergovernmental fiscal relations, which also correspond with the relevant details of existing literature:
- First, countries with a high level of decentralization tend to show excellent fiscal performance. Second, in the same vein, it is confirmed that the merits of expenditure decentralization are offset in countries with a high dependency on central government transfers. Third, it is also found that greater local autonomy on revenue generation generally results in weaker fiscal performance.

B. World Bank

□ Discussions about sub-national fiscal rules at the World Bank were summarized by Crivelli and Shah (2009).

- The aforementioned analysis used the panel data of Wetzel and Dunn (2001) and Dabla-Norris and Wade (2002) to arrange examples from relevant countries on the subject of fiscal rules.

- The existing debate highlighted the difficulty in actualizing the following key points at the level of local governments: harmonizing local fiscal activities with market discipline, the revitalization of financial markets to strengthen the competitiveness of sub-national governments, emphasizing the aspect of revenue generation by local governments, and curbing the frequency of central government bail-outs.[12)]

□ The pros and cons of sub-national fiscal rules were examined by summarizing the examples of countries with fiscal rules by each subject.

- (Examples of market discipline) In Finland, almost no restraints apply to national and sub-national borrowing. The provincial governments in Canada have no constitutional or legal limits on their borrowing and are practically exempt from central government controls. Nevertheless, the balanced budget principle is observed in most provinces and local government debt is closely monitored by financial markets, while public debt is maintained at certain levels. Naturally, there are strict limits on borrowing by lower-level municipal governments that require prior approval by higher levels of government. Among developing countries, Mexico has been preemptive in its reforms to establish a harmonious relationship between fiscal activities and market discipline.
- (Performance and implication of fiscal rules) Empirical analyses using panel data in the existing literature (Rodden, 2002; Webb and Zou, 2002; Singh and Plekhanov, 2005) indicate that the impact of fiscal rules remains unclear. Examples of individual countries in terms of the broader topic of fiscal policy reform show variations in fiscal outcomes for each country.
  - In Norway, municipalities faced serious debt during the period of 1980-1998, but showed improvements such as compliance with the balanced budget requirement following the implementation of corrective administrative measures. In Sweden and Finland, roughly two-thirds and three-quarters of the municipalities, respectively, achieved a balanced

12) Ter-Minnssian (1997), Lane (1993)

budget in 2001. In Spain, despite the introduction of the Domestic Stability Pact, 11 out of 17 regional governments failed to abide by the requirement of balanced budget in 2003.

- (Examples of fiscal rules evasion and fiscal gimmickry) Imposing fiscal rules on local governments provides another motive to circumvent the rules.
  - In Italy, fiscal rules have been avoided in some cases by creative accounting techniques. In China, the occurrence of irregularities has followed the phase in which sub-national governments collaborate with financial institutions to serve as the financial platform for the continuous expansion of fiscal spending.
- Also, the World Bank reviewed the status of fiscal rules by offering a detailed introduction to each fiscal rule with examples of applicable countries.
  - The World Bank paper is particularly noteworthy for its extensive coverage on not only the fiscal rules themselves, but also examples of fiscal reform, including fiscal responsibility legislation required for the enforcement of fiscal rules and the procedural rules that must be adhered to during the enforcement of fiscal rules, with particular attention on the fact that fiscal performance can be ultimately improved through the reform of fiscal institutions.
- Moreover, IMF, OECD and EU analyses are mainly focused on advanced countries in Europe, while the World Bank paper includes examples from Latin America and Southeast Asia, thereby presenting relevant implications to developing economies.

□ In addition, the World Bank emphasized the importance of inter-governmental fiscal coordination in its analysis of early-warning indicators including the so-called “traffic light system” in Latin American countries for example. It also outlined the need to create a database for scientific debt management and that excessive intrusion by the central government inevitably entails a decline in local autonomy.[13)]

13) Kim Hyun-a (2007)

- At the 2011 World Bank Conference in Brasilia, there was a debate on "Fiscal Rules at Sub-national Level."
  - Countries discussed at the conference include Argentina, Brazil and Mexico.
  - It is true that there are political and legal difficulties in the application of fiscal rules. Therefore, at the very least, the formulation of fiscal plans requires the prioritization of "debt rescheduling" by local governments.
    - In this process, the discussion suggested that the central and local governments must present a scenario through the contractual approach, and further described methods of fiscal management and adjustment from Step 1 (debt crisis) to the Step 5, followed by the proposition that the desirable outcome would be for the national and sub-national governments to reach an agreement on a target during the final stage of Step 5.[14)]

C. Details of Sub-national Fiscal Rules in EMU Countries

- The two pillars of fiscal rules at the European level are the frameworks of the "Stability and Growth Pact (SGP)" and "medium-term fiscal plans."
  - Until the early 2000s, EMU Fiscal rules underscored flexible fiscal operations to ensure that public finances can be managed more flexibly during downturns. In this regard, the rules emphasized two elements; the need to ensure "fiscal sustainability" under financial and fiscal stability, and flexible budgetary management to secure stability.[15)]
    - EMU members have adopted the approach that fiscal stability following macroeconomic impacts must be maintained not just in financial policy but also in the fiscal sector.
- In European countries, fiscal rules defined in the Treaty of Maastricht

14) "Step 1: Debt crisis, Step 2: Pressure mounts → Fiscal adjustment, Step 3: Debt rescheduling becomes an option, Step 4: Conditionality and fiscal adjustment program, Step 5: Agreement (contract) is signed..."

15) "Budget flexibility is needed for stabilization policy: It has become more important in EMU as member states can no longer rely either on a monetary policy tailored to national needs or on exchange rate" (Balassone et al., 2002, pp.4)

and the SGP outline a basic framework for the application of fiscal rules for sub-national governments, which is described as an area requiring a link to fiscal federalism.

☐ Another central pillar of European fiscal rules emphasizes fiscal rules under medium-term targets.

- The European Parliament requires the budgetary policy of EMU member states to set medium-term fiscal objectives in consideration of cyclical fluctuations, and as a result, budgetary policy by EMU member states are formulated with automatic stabilizers and discretionary power under medium-term fiscal targets.
- The selection of medium-term fiscal targets requires consideration of three factors: severity of expected recessions; budget elasticity with respect to the business cycle; and extent of discretionary power in setting automatic stabilizers.

☐ An EMU analysis summarizes the details of fiscal rules as below, and showcases the absolute impact of institutional support on the effectiveness of fiscal rules:

- First, fiscal rules must be predetermined in terms of numerical criteria;
- Second, ex post compliance with the rules must be allowed;
- Third, the invocation of escape clauses must be allowed only in exceptional events such as a recession, and must remain outside of the jurisdiction of the relevant member state.
- Fourth, it is not desirable to apply escape clauses to borrowing for investment projects;
- Fifth, every member state must be subject to monitoring procedures, and it is desirable to ensure the operational dynamics of “peer pressure” within the European Parliament;
- In addition, bail-outs undermine the effectiveness of fiscal rules, and

institutional arrangements are a determinant of the success of fiscal rules.

- In addition to the above-mentioned details of national fiscal rules, sub-national fiscal rules stipulate more important restrictive conditions:
  - First, the existence of information asymmetry among different government tiers may incur the free-rider problem in governmental actors other than those with the final fiscal responsibility, which may offset the positive effects of compliance with fiscal rules. Hence, the European Parliament proposes that any violation of EMU fiscal rules must be dealt with as the responsibility of the central government in the country concerned.
  - Second, the EMU suggests that fiscal rules at the sub-national level must be more stringent than those introduced at the national level with respect to the funding of capital outlays.[16)]

- Solutions to problems of sub-national fiscal rules suggested by EMU are as follows:
  - First, making it mandatory for fiscal rules at the central government level to be adapted at the local level as well.
    - However, nominal debt ceilings for local governments must be determined as appropriate for each country, and must also allow margins for budget flexibility with respect to economic fluctuations.
    - Changes in sub-national tax bases resulting from cyclical downturns in intergovernmental transfers require a cautious approach, while raising taxes to overcome a decrease in fiscal transfers during economic downturns also requires careful consideration since it would essentially signify fiscal expansion.
    - On the other hand, it is not desirable to rely on outright bail-outs such as

16) "Perhaps, reflecting the lack of a federal authority with the power to enforce fiscal discipline, EMU fiscal rules are tighter than those generally introduced at the national level with respect to the funding of capital outlays and the effects of the economic cycle on the budget"(Balassone et al., 2002, pp.8)

rainy day funds, and such reliance may weaken the effectiveness of fiscal rules in other countries as well.

- Second, extending the SGP from the EMU level to the national level.
  - This means that the central government would exercise authority over sub-national governments as the EMU would over its member states, whereby local governments would develop macro-fiscal consolidation policies.
  - Each country, however, has different tiers of lower-level governments and a wide variety of fiscal expenditures, which would make it more difficult to obtain and manage information.
  - The application of European rules could be extended from the larger decentralized regional governments to relatively smaller governments.
  - Otherwise, the administrative costs and the political burden of adjustment would merely be shifted from the central government to upper-level sub-national governments, and unlikely to result in the success of the solution.
- Third, introducing a system of deficit permits for sub-national governments.
  - This system, however, is difficult to be adopted even at the central level. At the local level where various tiers of sub-national government face individually distinct financial conditions, it is in fact difficult to suggest fiscal deficit caps in accurate reflection of financial conditions.

☐ (Summary) In light of the above points, the EMU presents the characteristics and limitations facing countries of varying sizes that are equipped with relatively secure decentralized systems and governments at federal or regional levels.

- (For larger sub-national governments) It could be effective for the central and sub-national governments to enter an agreement for macroeconomic fiscal stability, similar to the SGP. Such an agreement has the merit of minimizing fiscal information asymmetry between the central and local governments.
- (For smaller governments) In the application of the SGP, cyclical changes in

the tax base should be minimized and the budget balance should be kept in nominal terms, in order to enhance the feasibility of the SGP.

- The principle in which a local government gains a higher deficit cap in relation to fiscal transfers following the application of the deficit cap of the central government during a budget surplus is referred to as the "compensated golden rule." The introduction of this rule must be carefully considered since it may be exploited by local governments in attempting to expand their capital expenditure.
- The significance of institutional characteristics in each country is also highlighted, and given the differences in the degree of decentralization and political influence, it would not be easy for the EMU to suggest its own fiscal rules to local governments.

☐ The "Report on Public Finances in EMU 2012" presented by the EMU in 2012 shows examples and the current status of sub-national fiscal rules adopted after the 2008 global financial crisis.

- It is possible to apply the golden rule, and for example, borrowing is allowed for temporary revenue shortfalls and debt reductions at the sub-national level.
- Meanwhile, statutory limits on sub-national expenditures are mostly nonexistent across the EU. Therefore lack of control over the growth of sub-national expenditures is in some cases pointed out, but such ceilings are rarely introduced.
- Instead of setting statutory thresholds on fiscal aggregates, most EU countries have instituted some form of budgetary coordination across different government tiers.
- The existence of a system of internal budgetary coordination represents the solid foundation of fiscal discipline at the general government level.
- (Penalties for non-compliance with fiscal rules and discipline) Punitive measures imposed for violations of fiscal rules are described as below:
  - Corrective measures need to be introduced within a timeframe specified

under the enhanced supervision of the ministry of finance.

- Cuts in shared taxes or central government grants are possible. For example, In Denmark, the central government has recently made its block grant to sub-national governments on the conditions that they will meet their expenditure targets and will not increase their own taxes.

▪ It is difficult to establish generalizations towards sub-national debt details and rules.

▪ When evaluating fiscal risks at the sub-national level, the central government must exercise stringent surveillance over local governments and negotiate a stabilization plan to restore fiscal sustainability through special joint committees or boards.

▪ The application of sub-national fiscal rules may connote limitations in the provision of certain services through public enterprises owned by sub-national governments.

D. Details of Sub-national Fiscal Rules Discussed at the 2005 Meeting of the OECD Network on Intergovernmental Fiscal Relations

□ **(Necessity for fiscal rules)** The need for fiscal rules is concerned with ensuring fiscal accountability and sustainability.

□ The OECD analysis (2005) emphasizes that facing a significant scale of vertical fiscal imbalances between the central and sub-central governments, the national government must exercise control over sub-national governments through fiscal rules.

□ At the 2005 meeting, the concern was raised that public sector expansion is complicating decisions on and channels for resource allocation.

▪ It was underscored that in case improvements such as the simplification of fiscal flows and market functions fail to operate properly, even predetermined spending requires the option to suspend the flow of resources.

- It was highlighted that there is a growing demand for performance management to enhance the effectiveness of fiscal rules, which requires the actual implementation of accounting transparency, monitoring and reporting and availability of punitive options.

☐ For reference, budget balance rules are strictly observed in Korea. Compared with other OECD members, Korea is deemed to exercise strong control in terms of constraints on intergovernmental fiscal relations or debt, despite becoming somewhat more relaxed since 2006.

- In most OECD countries, debt ceilings are explicitly imposed on local governments. Denmark and Korea prohibit borrowing for current expenditure at the municipal level.

☐ **(Procedural rules for the establishment of fiscal rules)** Prerequisites for the substantive implementation of fiscal rules include principles of accounting transparency, monitoring and reporting, and sanctions."[17)]

- (Accounting transparency and consistency) Since accrual basis accounting has its own pros and cons, the OECD does not recommend it in all cases.
- (Monitoring and reporting) An effective monitoring system is particularly important in the face of widespread information asymmetry across all tiers of government or horizontally between local jurisdictions.
- (Sanctions) Punitive measures are essential for the effective implementation of fiscal rules, and their severity varies depending on each country's administrative and fiscal infrastructure.

☐ The above-described procedural rules facilitate the effective execution of fiscal rules, and their effective enforcement may allow the alleviation of some fiscal rules.

17) OECD (2013), pp. 42

<Table II-3 > Borrowing Constraints (Borrowing and Debt Rules)

	Prohibited	Prior approval is required	Restricted to certain purposes	No restriction on access to borrowing
Imposed	Denmark local Korea local (current)	Canada local Japan (capital) Korea (capital, ~2005) Spain local (capital) Turkey local Greece local Ireland local Luxembourg local Mexico local United Kingdom local	Germany local Norway local Spain local (capital) Portugal local Canada local France local Hungary local Italy state and local Slovak Republic	Canada state Czech Republic local France local Netherlands local (current)* Poland local
Negotiable binding	Spain region (current)	Spain region (capital)		
Self-imposed			Switzerland state	Canada state

Source: OECD (2005), p.17

- **(Fiscal rules and intergovernmental fiscal relationships)** The enforcement of fiscal rules is closely linked to existing intergovernmental fiscal frameworks.
  - (Spending assignment) For example, if local expenditure autonomy or tax authority is relatively strong, it may be difficult to use fiscal rules at the local level. In these cases, it may be more effective for sub-national governments to exercise self-discipline in relation to fiscal matters.
    - It is therefore pointed out that the enforcement of sub-national fiscal rules must aim to complement existing intergovernmental fiscal frameworks, and the use of fiscal rules as a corrective alternative for the limits and problems of existing policies faces limitations.[18)]

18) "The experience across OECD countries suggests that fiscal rules can only go so far to make up for malfunctioning intergovernmental fiscal frameworks, and that they work best if they act as a complement rather than a substitute for a well-designed institutional set up"

- In addition, strong sub-national autonomy in terms of taxation and expenditure may incur the so-called "ratchet effect," which poses difficulties for local governments to exercise self-control over expanded spending caused by economic upturns.

☐ (Bail-outs and insolvency) Rescuing sub-national governments from financial distress is also an important functions of fiscal rules.

- Although several countries stipulate clear "no bail-out" clauses to prevent moral hazard by local authorities, most countries allow a higher tier of government to assist lower levels of government to overcome a financial crisis.
- Insolvency legislation can be a mechanism for restructuring the overall fiscal policies of a sub-national government, which may enhance the credibility and effectiveness of fiscal rules.

☐ **(Financial markets)** The evaluation of a sub-national government's credit rating by the financial market may be much more effective than the arduous implementation of monitoring by the central government, but assessment by the financial market alone may face its own limitations.

- Therefore, if local governments are actively open to financial markets and regularly volunteer to update information for their own credit assessments, there would be less need for tight fiscal rules.
- However, this is not to suggest that active relations between sub-national governments and the financial market would necessarily result in lower debt dependency.
- In consequence, even if local governments are well adapted to financial markets, the effects of filtering through financial markets could be significant only when the following conditions are met:
  - First, the most important precondition is that a higher level of government's bail-outs and guarantees are prohibited;

- Second, when the development of the financial market is at an inadequate stage, entrusting local government risks to financial markets may constitute a significant risk;
- Third, the flexible operation of fiscal rules according to financial market circumstances requires politicians in sub-national governments to have the capacity to respond flexibly to economic signals in market conditions.

E. Domestic Research on Sub-national Fiscal Rules

☐ While a number of domestic studies examine intergovernmental fiscal management, not many are based on the concept of fiscal rules.

☐ Kim Hyun-a (2007) presented findings on intergovernmental fiscal management and its direction in Korea, and underlined the need for strengthened fiscal management systems rather than explicit fiscal rules.

- The degree of fiscal risks at the local level in Korea was not considered to be high until 2008.
  - Municipal finance structurally depends on fiscal transfers from the central government. In view of institutional arrangements, including local authority over the tax base and tax rates; preliminary project controls such as tax exemption and reduction clauses and assessment of local investment and borrowing; and constraints on issuance of local government bonds through limits on the total issuance amount, Korea is seen to have stronger fiscal institutions compared to other major countries.
- The effects of the financial crisis have increased the debts of municipal urban development corporations since 2008, and the total debt of local governments has reached approximately 100 trillion won as of 2014.

<Table II-4> Cluster Analysis

Cluster					
Strong spending control and high efficiency	High allocative efficiency but low spending control	Strong spending control but lower efficiency	Strong deficit control but often less shock absorption	Good efficiency and sustainability	Overall weak rules
Korea	Austria State Austria Local Belgium State Canada State Czech Republic Finland Ireland Mexico State Mexico Local Switzerland Local	Italy State New Zealand Turkey Belgium State Canada State Czech Republic Finland Ireland Mexico Local Mexico State Sweden Switzerland State	Australia State Canada Local Germany State Germany Local Italy Local Norway Spain State	Chile Denmark Estonia Poland Slovak Republic Slovenia Spain Local	Australia Local Belgium Local

Source: OECD Secretariat calculations based on Network questionnaire responses via Fredriksen (2013), p.15, Table 2

- The ramifications of the economic crisis indicate that unlike in the past, domestic macroeconomic circumstances can become very uncertain in the future. In response to these uncertainties, the introduction of strict fiscal management schemes equivalent to fiscal rules is fully under way.[19]

□ Other relevant studies have analyzed sub-national fiscal rules with a focus on discussing self-imposed fiscal rules.

19) See the Local Finance Act revised in 2014.

III. Examples for the Adoption of Sub-national Fiscal Rules in Major Countries

1. Austria

- In 1999, the Austrian government introduced the Domestic Stability Act, which carries legal binding force on budgetary rules for sub-national governments.
  - The main objective of the Pact was to keep general government deficit below 3 percent of GDP.
    - The amendment of the Pact in 2000 specifies penalty clauses in case of non-compliance.
  - The main details of the Pact are as follows:
    1) A budget balance for general government should be achieved by 2002.
    2) The central government has to cut its deficit in 2001 and 2002.
    3) The fiscal surplus of regions must reach approximately 0.75 percent of GDP.
    - Municipalities have to balance their budget over the period 2001-2004.
  - The debate on the assessment method of budgetary outcomes resulted in the agreement to ensure consistent assessment through the establishment of common accounting standards for all levels of government.

- At the end of 2011, the Austrian government revised the Austrian Internal Stability Pact (AISP).[20]
  - The main details of the revised AISP are described as below:
    1) More stringent deficit targets have been set.
    2) A new structural balance rule, which will be applied from 2017 onwards, sets a lower limit of general government structural deficit at -0.35 percent of GDP for the central government and -0.1 percent of GDP for lower tiers of government.

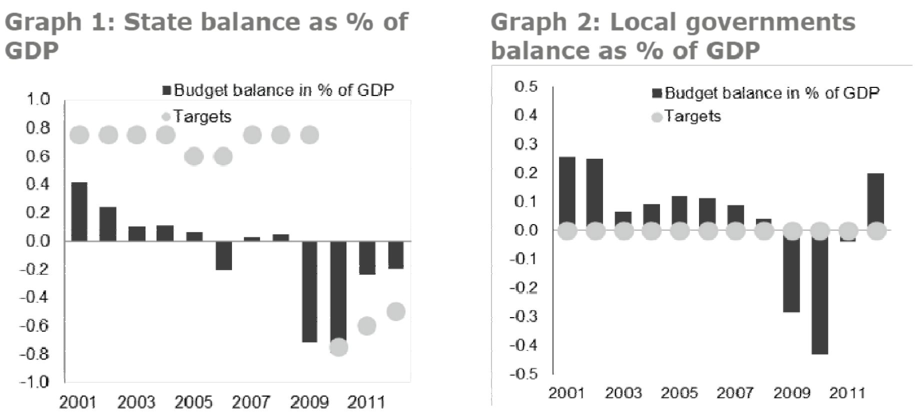
20) Fargnoli (2014)

3) Expenditure growth in all government levels must not exceed average potential growth.
4) The existing rule for new debt has been also revised. Considering past cases where sub-national deficit targets were improperly set or renegotiated, the new rules will require stricter implementation.

☐ The status of compliance with sub-national fiscal rules is as follows[21]:

- State governments failed to meet their budgetary targets from 2001 to 2009.
  - The state government budget balance posted a surplus of 0.6 percent of GDP on average in the period 1988-2000, while it fell to a deficit of roughly 0.1 percent of GDP in the period 2001-2009.
  - On the contrary, lower-level governments below the state level successfully achieved their targets in most years.
  - Since the onset of the fiscal crisis in 2009, both states and local governments have recorded budget deficits.
  - As fiscal consolidation started in 2011, state governments achieved their targets in 2011 and 2012, while lower levels of government met their targets in 2012.

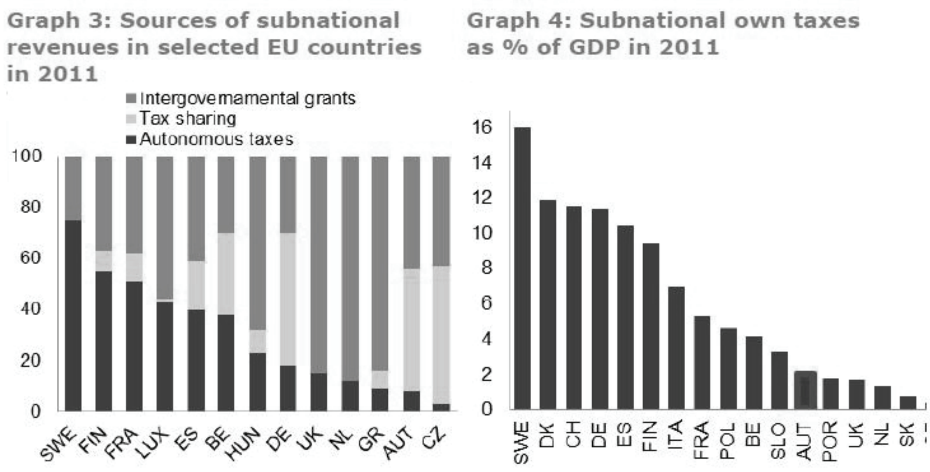
[Figure III-1] Status of State and Local Government Budget Balances in Austria



Source: Commission Services based on OECD, Eurostat data

21) Fargnoli (2014)

[Figure III-2] Sub-national Fiscal Conditions in Major EU Countries



Source: OECD

□ The OECD reports that, in Austria, the share of self-imposed sub-national taxes is particularly low compared to other countries, and that states and local authorities are given relatively low levels of discretion over their tax base and rates.

□ As stipulated in legislation, any penalties are to be paid to the Austrian central bank. If the AISP is observed within one year, the fine is refunded.

- Non-compliance with the AISP is not subject to punishment if a balanced general government budget is achieved or if the non-compliance results from a change in the interpretation of ESA95 accounting rules.

2. Belgium

- In the early 1980s, Belgium's public finances began to deteriorate, and soon after the budget deficit reached 15 percent of GDP in 1981, a recession set in and the debt ratio began to surge.[22]
  - As a result, the Belgian government drew up fiscal consolidation programs from 1981 to 1987, and the economy recovered.

- Since then, the Belgian government has produced a new SGP on an annual basis to define medium-term budget targets.
  - The first stability program in 1998 aimed to gradually reduce deficits every year.

[Figure III-3] Changes in Belgium's Mid-term Budget Targets

TABLE 1 TARGETS FOR THE FISCAL BALANCE UNDER BELGIUM'S SUCCESSIVE STABILITY PROGRAMMES
(percentages of GDP)

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
December 1998	**–1.3**	–1.0	–0.7	–0.3									
December 1999		**–1.1**	–0.5	0.0	0.2								
December 2000			**0.2**	0.3	0.5	0.6	0.7						
December 2001				**0.0**	0.5	0.6	0.7						
December 2002					**0.0**	0.3	0.5						
December 2003						**0.0**	0.0	0.0	0.3				
December 2004							**0.0**	0.0	0.3	0.6			
December 2005								**0.0**	0.3	0.5	0.7		
December 2006									**0.3**	0.5	0.7	0.9	
April 2008										**0.0**	0.3	0.7	1.0
p.m. Actual figures (1)	*–0.5*	*0.1*	*0.6*	*0.0*	*0.0*	*0.0*	*–2.3*	*0.3*	*–0.2*				

Sources: FPS Budget and Administrative Control, FPS Finance, NAI.
(1) Fiscal balance of general government according to the methodology used in the excessive deficit procedure.

22) Van Meensel and Dury (2008)

- As the 1999 stability program's stated objective of gradually dismantling deficits every year became somewhat ambiguous, a new target of achieving a balanced budget by 2002 was set.
- As the economic recovery in 2000 allowed the achievement of a balanced budget, the subsequent program, therefore, adjusted its objective into posting budget surpluses.
- As described in the figure below, Belgium's budget targets were successfully met across the board.

☐ The Belgian authorities adjust yearly targets on a consensual basis, rather than complying with predetermined rules such as the "balanced budget rule" or the "golden rule."[23)]

- As such, the supervisory council (Conseil Superieur des Finances: CSF) was established in 1989.
- There are no formal provisions on fiscal outlays, budgetary balances and debt rules in Belgium.
  - However, the CSF provides yearly guidelines on expenditure growth and the deficit level for each of the central government, regions, communities and social security authorities.
  - A regional government can levy supplements on national taxes, but has to consult with the central government and other regional governments in advance.
  - Regions and communities are authorized to issue bonds, which nonetheless require the approval of the central government.
- Fiscal rules have no legally binding force.
  - However, in 1989, the parliament authorized the central government to limit regional borrowing for a period of two years.
  - The restriction is to recommend regions to follow CSF guidelines, considering regional impacts on other municipalities.

23) Balassone et al. (2002)

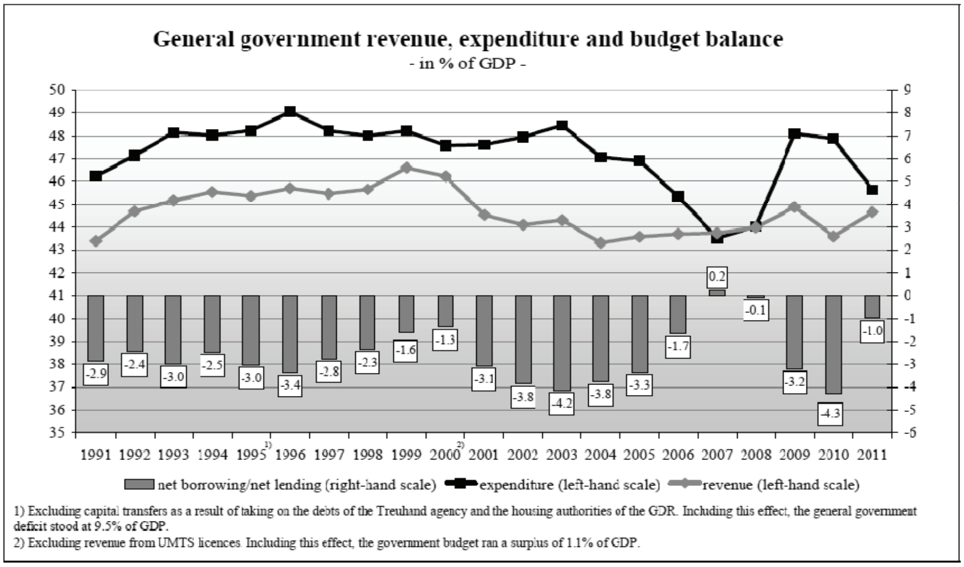
- In 1990, the CSF aimed to reduce the overall deficit across the general government.
  - Since the overall deficit persisted through to 2000, the CSF set the objectives of balancing the budget and gradually reducing debt levels by 2010.

- In conclusion, fiscal imbalances and growing public debt caused a period of confusion at the early stage of the decentralization process. But in the 1990s, fiscal consolidation was improved and the ratio of public debt to GDP also declined.
  - All regions and communities satisfied the provisions of the CSF deficit guidelines.

3. Germany

- Although the German government manages the levels of fiscal deficit and debt, there are no statutory provisions stipulating punitive measures for non-compliance with laws or failure to achieve targets regarding fiscal rules.
  - This is because the cooperative nature of intergovernmental relations in Germany does not allow the central government to introduce the Domestic Stability Pact without permission from local governments, while the local governments have no reason to agree on a binding agreement that does not offer direct benefits.
  - However, the importance of the Domestic Stability Pact began to be appreciated in 2001, when the fiscal deficit increased across the general government.

[Figure III-4] Changes in the Revenue, Expenditure and Budget Balance of the German General Government



☐ Despite achieving budget balance in 2007 and 2008, the fiscal deficit worsened in 2009 and 2010, whereby in 2010 the debt was estimated at 83 percent of GDP.

- Consequently a new policy called the "debt brake" was introduced in 2011 for the purposes of reducing debt and easing fiscal deficit.
- As a result, the fiscal deficit decreased by almost 3 percent in 2011 and the ratio of debt to GDP fell to 81.2 percent, indicating that the debt brake policy was effective to an extent.
  - The enforcement of the debt brake policy was extended to include regional governments.
- However, German law does not stipulate separate penalty clauses for local governments that fail to apply the fiscal rules.

4. Italy[24)]

- As the central government needed to strengthen budget discipline at local level to join the EMU, mandatory limits were adopted for fiscal transfers from the central to local governments in 1996 and 1997, and the Domestic Stability Pact was passed in 1999, as a law for the central government to impose a debt ceiling on sub-national governments.
  - However, the pact failed to be effective since estimation of the debt ceiling excluded healthcare, capital and interest outlays and because the amount in excess of the ceiling could be compensated afterwards.

- The Domestic Pact was supplemented by provisions regarding resources for public health through an agreement between the central and sub-national governments, but the unwillingness of the sub-national governments rendered the pact ineffective.
  - Decentralization in Italy has a relatively short history, since it was phased in according to the Maastricht Treaty to draw level with the EMU countries.

- In Italy, fiscal rules are currently set by the central government, and the "golden rule" for sub-national governments are is defined by the constitution.
  - The Italian system allows flexibility for borrowing in emergencies.

- Details of the Domestic Stability Pact (DSP), which stipulates adherence to fiscal rules by local governments,[25)] are as follows:
  - The Pact was introduced in 1999 to regulate spending of local governments.
  - The target and coverage of the DSP are on a three-year basis and are

24) Balassone et al. (2002)
25) European Commission (2012)

annually revised.

- The DSP aims at decreasing local expenditure by 11, 14 and 14 percent in 2011, 2012 and 2013, respectively, using the expenditure levels from 2006 to 2008 as reference.
- The DSP applies to regional and provincial governments and to municipalities at all levels, and regional and local governments non-compliant with the Pact should increase regional/local surtax rates.
- If a local government commits a serious breach of the DSP, the central government can replace its local officials by central appointment.
- Although the DSP was respected by the majority of local governments in the early stages of its introduction, sub-national expenditure growth has recently exceeded the target prescribed in the DSP.
- The weakness of the DSP is the frequent change in its targets and coverage, while healthcare spending is separately defined by the Health Pact.

☐ As a policy to encourage sound spending on healthcare as a key fiscal spending area, the Health Pact stipulates plans on expenditure limitation as follows:

- The Pact was introduced in 2000 to regulate sub-national government spending on public health.
- The upper limit of healthcare expenditure was determined at 107 billion euros for 2011 and may increase by 2.8 percent in 2012.
- Sub-national governments non-compliant with the HP should devise new restructuring plans, which may adopt a lower ceiling and additional sanctions with regard to local expenditure.
- Adherence to the Pact by local governments was low in its early stages, which led the central government to end up shouldering their debt. However, monitoring has been tightened since the second half of 2000 to impose more sanctions.

5. Spain[26)]

□ In 2001, the Sub-national Government Financing Law and the Budgetary Stability Law were introduced to define fiscal rules on local finances.

- The Budgetary Stability Law replaced the existing bilateral agreement between central and local governments. If a local administration violates the law, thereby breaching EMU fiscal rules, the administration would face punitive sanctions.
- The "golden rule" for sub-national governments and contingency plans were also instituted, and the clarity of the fiscal rules prevented instability resulting from the potential to negotiate any changes.

□ Details of fiscal rules for Spain's regional governments are as follows[27)]:

(Budget balance rule)

- Introduced in 2002, this rule allows the government to recommend an upper and a lower limit (currently 3 and 2 percent, respectively) to set budget balance targets based on the General Act on Budgetary Stability.
- The rule applies to the entire general government (local, regional and central governments and social security).
- Central, local and regional governments, in principle, share the responsibility for enforcement, although the ultimate responsibility is assumed by the central government.
- When a sub-national government is expected to fail the budgetary stability objective, the central government may issue an advance warning to it and may reject the debt issuance of regional and local governments.

26) Balassone et al. (2002)
27) European Commission (2012)

(Expenditure rule)

- The rule was introduced in 2011 to limit expenditure growth in accordance with economic growth.
- Economic growth was estimated by adding an inflation rate of 1.75 percent to the average growth rate estimated over nine years (the preceding five years, the current year, and the coming three years).
- The rule applies to central and local governments.
- Monitoring is conducted by the Ministry of Economy and Finance, and the relevant report is published on October 1 every year.

(Debt rule: regional government)

- The rule was adopted in 2009, and 17 autonomous communities are subject to the following rules:
  - Long-term debt is permitted only for capital expenses, and short-term debt (less than one year) for transitory cash needs.
  - The sum of capital and interest payments should not exceed 25 percent of current regional revenues.
  - The stock of debt at the end of the year should not exceed the sum of the stock at the end of the previous year and the debt issued to meet the deficit target.
  - Public debt issuance requires approval from central government.
- Monitoring is conducted by the Ministry of Economy and Finance.
- The 1980 Organic Act on Financing stipulated that autonomous communities can issue public debt with central government approval. If an autonomous community exceeds its limit for the year, its debt issue allowance for the next year is reduced by the amount of the excess.

(Debt rule: local government)

- The rule was introduced in 1997 and stipulates a debt ceiling for each local government as a certain percentage of its current revenue.

- The rule requires approval on long-term debt, when the debt exceeds 110 percent of current revenues or in case a public deficit exists.
- The Ministry of Economy and Finance conducts monitoring for Castilla-La Mancha, Madrid, Extremadura, Murcia, Canarias, Baleares and Cantabria, while regional governments do so for other autonomous communities.

6. Latin America

☐ Latin American countries characteristically possess a large population and economy, a relatively long history of fiscal decentralization, and the potential rapid growth despite economic fluctuations.

- Due to their excessive sensitivity to macroeconomic indicators and unstable political circumstances, however, consistent policy performance is difficult to secure.
  - Latin American nations, whether unitary or federal, generally show large state expenditure and high debt levels.
  - Latin American nations have seen relatively rapid changes in fiscal policies, which reflect a dynamic society through frequent reforms and experiments in their fiscal systems.
  - Fiscal rules exist at central and local levels.

☐ Previous studies indicate that the relationship between fiscal rules and fiscal performance drawn from panel data of other countries do not yield any clear implications for Latin American nations.

- empirical analysis on the finance of Latin American nations, using the presence of fiscal rules as an institutional parameter to examine its relationship with fiscal performance, and the result surprisingly showed that fiscal deficits and the fiscal system have a negative correlation with statistic significance.
  - In summary, the observance of fiscal rules has a positive effect on reducing the fiscal deficit of a country.

<Table III-1> Some Evidence on Fiscal Rules in Latin America

Country	Columbia	Mexico	Brazil	Argentina
Year	1997		1998	1999
Kind of restriction	Borrowing Constraint- Traffic Light Law		Ex-ante control over subnational debt	Fiscal Responsibility Law
Level of government	Subnational governments		Subnational governments	National government, and later subnational governments
Tested	Yes		Yes	Yes
Main Characteristics	Demand side restriction on borrowing and supply side regulation (fully provisioned for red light territories)		Senate approval is required for all subnational government borrowing operations, prohibiting the issue of bonds and borrowing from state-owned banks	- Deficit target and fiscal balance convergence path - Pluriannual budget formation - Limits on current expenditure growth - Transparency
Non-compliance event	According to MoF, out of 21 depts that required permission for new credit, approximately 10 got new credit without permission		The states observed the prohibitions on new bond issues only in the narrow legal sense: they did not halt the capitalization of interest on existing bond debt. Nor did these regulations stop new "emergency lending" by Central govt intermediaries	National government: No year since 1999 the deficit target were fulfilled. Subnational: 6 out of 11 did not comply with deficit limits,3 out of 8 did not comply with spending limits
Enforcement	Judicial		Judicial	Judicial

<Table III-1> Continued

Country	Columbia	Mexico	Brazil	Argentina
Year	2000	2000	2000	
Kind of restriction	Fiscal Responsibility Law	Market discipline for subnational borrowing	Fiscal Responsibility Law	
Level of governments	All Subnational governments	Subnational governments	All levels of government	
Tested	No	No	No	
Main Features	Limits and restriction on: - Current expenditure - Municipality creation - Transparency	- No discretional transfers to states - No securing debt with payments from the revenue sharing agreement - Subnational debt subjected to normal credit exposure celings - Bank's capital risk weighting linked to the international rating of the SNG	It applies to the three levels of government and encompasses all branches. This Law contains explicit numerical hard budget and intra-budget constraints, public dissemination of information, and institutional and individual sanctions. The law goes into full effect in 2002.	
Enforce- ment	Judicial	Market	Legislative-own state legislature	

- Due to the endogeneity of parameters and limitation of data subjects in the above case, the study would seem to require continuous in-depth analysis to support it.

☐ Unfortunately, the IMF analysis does not confirm whether Latin American nations have since maintained compliance with their fiscal rules.

- Therefore, it was pointed out that it might not be desirable to evaluate the effectiveness of fiscal rules at this stage.
  - Hence, the next chapter will cover cases of fiscal rules applied to a number of countries.

A. Argentina[28]

□ The Fiscal Solvency Law was passed in 1999 to solve the problem of deteriorating budget balance and growing debt.

- The law aimed to achieve budget balance at the national level by 2003.
- It set numerical limits for fiscal deficit and limited the growth of government expenditures.
- It adopted pluriannual budgeting, a Countercyclical Fiscal Fund and measures to increase the transparency of public finances.

<Table III-2> Compliance with the Fiscal Solvency Law

Year	Limits (as % of GDP)		Observed
	1999 Law	2001 Modification	
1999	1.9%		3.1%
2000	1.1%		2.5%
2001	0.5%	2.5%	4.0%
2002	0.3%	2%	
2003	0%	1.3%	
2004	0%	0.9%	
2005	0%	0%	

Source: Fiscal Solvency Law and Ministry of Economy

28) Braun and Tommasi (2002)

- Since the law did not prescribe separate rules for sub-national governments, it was instead expected for sub-national governments to voluntarily institute similar laws. Consequently, the exclusion of sub-national governments has become a fundamental weakness of the law.

<Table III-3> Degree of Accomplishment of Provincial Solvency and Fiscal Responsibility Laws Deficit and Expenditure Goals (Argentina, year 2000)

Province	Explicit Limit on Deficit	Actual deficit	Accomplishment	Explicit Limit on Expenditure	Observed	Accomplishment
Catamarca	For year 2000: 2% of the average of total expenditure of years 1998 and 1999.	1.9%	Yes	No		
Cordoba	The current deficit must be zero	158 millions	Yes	The Current Expenditure cannot grow more than Regional Demestic Product (RDP). If RDP decrease, the Current Expenditure must be held constant.	The Current expenditure grew 2% and the PBG held constant	No
Chaco	For year 2000: the deficit must be less than 100 millions. Them it must decrease at 20% yearly	-171 millions	No	No		
Chubut	For year 2000: the primary surplus must be equal to the 50% of public debt interest of that year	The surplus was 70% of public debt interest of that year	Yes	The Current Expenditure cannot grow more than RDP. If RDP decrease, the Current Expenditure must be held constant.	The first semester 2001 Current expenditure decrease 2% compared with first semester 2000.	Yes
Formosa	For Year 2000: the deficit must be less than the debt amortization of this year.	99 millions of budgetary deficit and 234 millions of public debt amortization	Yes	The Primary Expenditure cannot grow more than National Resources. If National Resources decrease, the Primary Expenditure must be held constant.	The Primary Expenditure decrease 15%	Yes
Mendoza	No explicit, Fiscal Equilibrium for year 2003.			No		

<Table III-3> Continued

Province	Explicit Limit on Deficit	Actual deficit	Accomplishment	Explicit Limit on Expenditure	Observed	Accomplishment
Misiones	For Year 2000: the deficit must be less than the debt amortization of this year.	134 millions of budgetary deficit and 76 millions of public debt amortization	No	The Primary Expenditure cannot grow more than National Resources. If National Resources decrease, the Primary Expenditure must be held constant.	The Primary Expenditure decrease 15%	Yes
Neuquén	Primary surplus must be 3% of total revenue at year 2001	At the first semester of 2001 the primary surplus was 20 millions.	Yes	The Current expenditure must be lower than 833 millions in year 2000.	The Current Expenditure were 1025 millions in year 2000	No
Río Negro	For 2001, the primary result must be zero	At the first semester of 2001 the primary deficit was 14 millions	No	No		
Salta	Fiscal equilibrium	The fiscal deficit was 69 millions (7% of total revenue)	No	Personnel Expenditure must be lower than 65% of Current Revenue.	The personnel Expenditure were 53% of Current Revenue (MM condic)	Yes
San Juan	Fiscal equilibrium	At the first semester of 2001 the primary deficit was 46 millions	No	Personnel Expenditure must be lower than 65% of Current Revenue.	The Personnel Expenditure were 85% of Current Revenue	No
Tucuman	The current deficit must be zero	52 millions	Yes	The Current Expenditure grow must be lower than the Current revenue growth. If Current revenue decreases, the Current Expenditure must be held constant	The Current Expenditure decreased 2%	Yes
Tierra del Fuego	The fiscal deficit must be equal to the budgeted.	9 millions of surplus vs. 16 millions.	Yes	No		

Source: Braun and Tommasi (2002)

<Table III-4> Main Characteristics of Sub-national Fiscal Rules in Argentina

Province	Law?	Date	Explicit Limits on			Pluriannual Budget Formulation	Stabilization Fund	Fiscal transparency
			Deficit	Public Debt	Current Expenditure			
GCBA	NO							
Buenos Aires	NO							
Catamarca	YES	12/00	Yes					Yes
Cordoba	YES	03/00	Yes	Yes	Yes		Yes	
Corrientes	NO							
Chaco	YES	05/00	Yes	Yes		Yes		
Chubut	YES	-	Yes	Yes	Yes	Yes		
Entre Rios	NO							
Formosa	YES	12/99	Yes	Yes	Yes	Yes	Yes	Yes
Jujuy	NO							
La Pampa	NO							
La Rioja	NO							
Mendoza	YES	01/00	Yes				Yes	
Misiones	YES	05/00	Yes	Yes	Yes		Yes	Yes
Neuquen	YES	-	Yes		Yes			
Río Negro	YES	01/01	Yes	Yes		Yes	Yes	Yes
Salta	YES	05/99	Yes	Yes	Yes			
San Juan	YES	01/01	Yes	Yes	Yes			
San Luis	YES	08/99		Yes	Yes	Yes		Yes
Santa Cruz	NO							
Santa Fe	NO							
Santiago Del Estero	NO							
Tucuman	YES	09/99	Yes		Yes	Yes		
Tierra del Fuego	YES	08/00	Yes	Yes				
National Govt.	YES	09/99	Yes	Yes	Yes	Yes	Yes	Yes

<Table III-5> Compliance of Constitutional Debt-Service Rule (Argentine Provinces)

Jurisdiction	Constitutional Limits	Debt service/Total Revenue Year 2000
G.C.B.A.	No limit	3%
Buenos Aires	No limit	3%
Catamarca (a)	20%	24%
Córdoba (b)	20%	13%
Corrientes	25%	41%
Chaco	25%	14%
Chubut	No limit	12%
Entre Ríos	25%	27%
Formosa	25%	39%
Jujuy	20%	31%
La Pampa	25%	1%
La Rioja (b)	25%	6%
Mendoza	No limit	14%
Misiones	25%	10%
Neuquén	No limit	14%
Río Negro	25%	26%
Salta	25%	13%
San Juan	No limit	12%
San Luis (b)	25%	0%
Santa Cruz	No limit	2%
Santa Fe	25%	5%
Sgo del Estero	25%	6%
Tucumán	No limit	22%
Tierra del Fuego	25%	19%

Source: own elaboration based in Sanguinetti(2001) and Ministry of Economy
(a) It should not be higher that 20% of five-year average
(b) Based on the lowest revenue within the past three years

- Although the law stipulated a higher ceiling of fiscal deficits to achieve budget balance by 2003, this stipulation was not followed. Although the ceilings were further heightened through the amendment in 2001, the law was still not obeyed.

- In the case of provincial governments, only five out of 11 provinces that adopted hard constraints actually adhered to the constraints, and only two of the five, Cordoba and Tucuman, met the objectives defined in the law for several years.
    - Another case is that 16 out of 24 provinces limited the ratio of debt service to total revenue to 20-25 percent of the total revenue through the provincial constitution, but only ten of them complied with the limit as of 2000, which further worsened in 2001.
    - As shown in the above cases, a law with inadequate institutional design does not guarantee fiscal sustainability.

B. Brazil[29)]

- In 1998, as a means of tightening sub-national budget constraints, borrowing by sub-national governments became subject to prior approval, and the issuance of new bonds and the borrowing from state-owned banks were prohibited.

- After the balance of payments crisis in 1998/1999, Brazil introduced the Fiscal Responsibility Law in 2000.
    - The law includes rules on government debt, wage bill and other fiscal indicators for all levels of government.

29) Braun and Tommasi (2002)

- In addition, it strengthened restrictions on the final year of office for politicians in order to curb undue political exploitation of the economic cycle.
- Sanctions are imposed both at the institutional and individual levels. A sub-national government that does not comply with the law is subject to limits on new credit operations, transfers and guarantees imposed by the central government.
- At the individual level, penalties could result in the termination of the responsible government official, who would then be prohibited from working in the public sector for five years and perhaps made to face criminal charges or fines.
- The law also includes provisions regarding the transparency of fiscal information.

□ According to the preceding evaluation, municipalities have seen an increase in revenue and a decrease in expenditure since the introduction of the law, which indicates a significant accomplishment.

7. United States

A. Applications of Fiscal Rules for Sub-national Governments

□ The application of strict fiscal rules during the re-establishment of fiscal relations among sub-national governments in the United States during the late 1980s and the subsequent institution of fiscal austerity through the measure are largely considered to have been effective.

- The United States federal government was able to achieve a fiscal surplus by the 1980s, but the financial situation of state governments worsened due to the economic slowdown following the late 1980s; cuts in federal grants; the transfer of redistribution programs to local governments resulting from the growth in the elderly population and the cost of healthcare insurance; and the transition from general grants into specific ones.

- As a result, most states adopted an expenditure reduction strategy in accordance with the budget balance rule.

☐ The background and current state of the BBR system for state governments are as follows:

- All state governments except Vermont's stipulate a balanced budget rule defined by law.[30]
  - Sanctions are outlined in the state constitution or written into law by the state legislature.
  - In some cases, the BBR is based on the debt limit prescribed in the jurisdictional constitution.
- In 1991, 22 states raised revenues below expectations, and 20 states reported expenditures surpassing their budget.[31] In the United States, however, state governments are constitutionally prohibited from deficit finance.
- Therefore, politicians had to choose between increasing tax and reducing expenditure, and a survey at that time showed that revenue increase was preferred.
  - Regardless, the approach of reducing expenditure was adopted by most states. Poterba (1994) explained that states with a clear political inclination may spend more aggressively and consequently are more likely to generate budget deficits.

☐ The following are three approaches to establishing a balanced budget for state governments:

- First, the budget proposed by the governor must be balanced.
- Second, the budget passed by the state legislature must be balanced.

30) National Conference of State Legislatures 1999

31) Poterba (1994)

- Third, the budget must be balanced at the end of the fiscal year.
- The principle of balanced budget applies to operating budgets and excludes capital budgets.

☐ The following are the measures taken by states to comply with the budget balance rule:

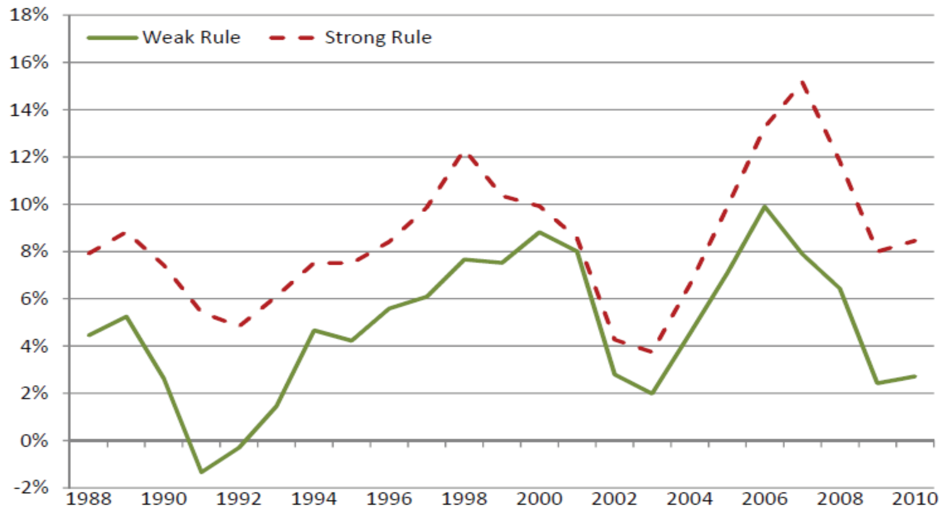
- All state legislatures reduced expenditures, while the governor or an appointed board decreased spending in case of a budget shortfall.
- Most state legislatures increased revenues and occasionally appropriated from the general fund of previous fiscal years or rainy day funds.
- Some states used short-term borrowing to cover a budget gap.
- It is highly rare for states to acquire long-term loans to cover an operating deficit.
  - The California government borrowed 11 billion dollars in 2004 to cover a shortfall in its operating budget.
  - Many states require a referendum for new long-term debt issuance.
- States defer payments to sellers, local governments or employees, or change the timing of tax payments, as a short-term maneuver to meet balanced budget requirements by the end of the fiscal year.

☐ Fiscal performance after the enforcement of the BBR (strong rule) shows that the rule made a difference in the budget balance between states that adopted the rule and others that did not.

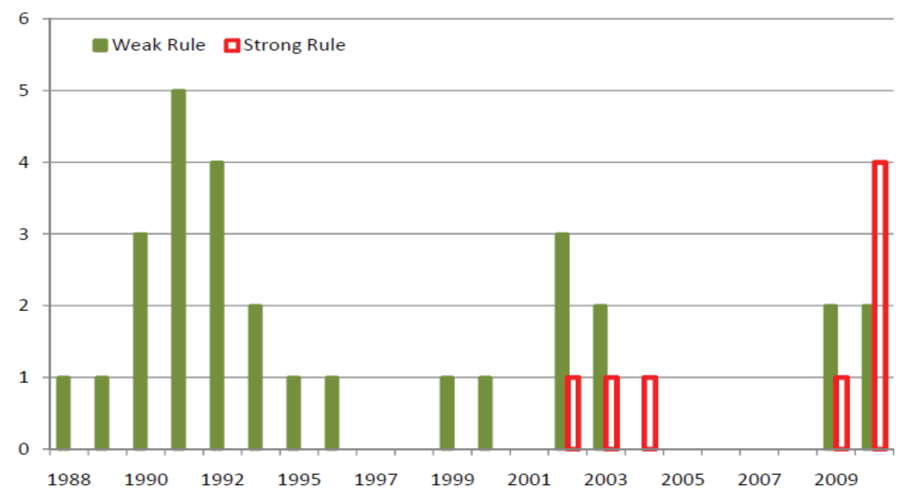
- Year-end balances were much improved, and the likelihood of a fiscal deficit decreased.
  - Strong budget rule is conducive to strong finances.
  - Large year-end balances resulting from fiscal stability allow the capacity for the state to absorb negative shocks.
- The high balances at the end of 2006, however, proved insufficient to buffer an economic downturn.

- Year-end balances, as a percentage of the average year-end balance in general fund expenditures, rise during economic booms and fall during downturns.

[Figure III-5] Year-End Balances as a Percent of Expenditure



[Figure III-6] Number of States with Negative Budget Balance since the Introduction of BBR



☐ Strong fiscal rules were enforced to complement institutional reforms.

- (Reform of grant system) For the system of grant transfers to lower-level governments, the need for a change in the direction of the transfers was raised to reduce general grants and instead provide conditional or comprehensive grants.
- (Intergovernmental sharing of spending authority) In the process, the function of government expenditure became shared between state and local governments, and the system experienced a change in which a state government directly manages expenditure only when local governments are unable.

☐ It has been demonstrated that fiscal crisis management systems (BBR, TEL, etc.) clearly influenced fiscal operations in the United States, and in particular, the sharing of fiscal responsibilities among central, state and local governments during the studied period offers significant insight.

- The cases of state governments in the United States demonstrate that the fiscal operation patterns of state governments are affected by political environment, constitutions or statutes, or systems.
- Another noteworthy matter is the way in which state governments have operated their finances within the confines of intergovernmental relationships and the given political landscape.

B. Budget System of the United States Federal Government[32)]

☐ Gramm-Rudman-Hollings (1985)

- Official title: The Balanced Budget and Emergency Deficit Control Act of 1985
- The law established annual deficit targets.
- It introduced a sequestration mechanism to meet deficit targets, which had little effect.

32) Lutz and Follette (2012)

- The targets were revised in 1987 in the Balanced Budget and Emergency Deficit Control Reaffirmation Act, but the failure in reducing the fiscal deficit led to the abolishment of the law and the passing of the Budget Enforcement Act in 1990.

☐ Budget Enforcement Act (1990)

- The law was enacted in 1990 as a part of the Omnibus Budget and Reconciliation Act.
- It aimed at achieving budget balance by 1995 through tax increases and spending cuts for the following five years.
- Limits for discretionary spending were set for the period of 1991-1995.
- The PAYGO principle was adopted for mandatory spending.
  - Budgets in excess of expenditure caps or non-compliant with the PAYGO principle were subject to parliamentary approval.
  - Excesses in discretionary spending would trigger sequesters.
  - If a change in tax revenue or mandatory spending worsened the deficit, thereby breaching the PAYGO principle, a sequester was triggered for mandatory spending.
  - Exemptions existed for emergencies.
- Although the Act was more realistic than Gramm-Rudman-Hollings, it did not result in a sufficient reduction of the fiscal deficit.

☐ Omnibus Budget and Reconciliation Act (1993)

- As the Budget Enforcement Act did not succeed in deficit cuts, President Clinton proposed this law to increase tax revenues and cut mandatory spending.

☐ Tax Reduction and Balanced Budget Act (1997)

- The Act extended discretionary caps to 2002 and set objectives to achieve budget balance by 2002.

- From 1998 to 2002, budget surpluses became common, but it is not certain that the Budget Enforcement Act contributed to this result.

- As discretionary spending limits were breached in 1999 and 2000, the positive influence of the Budget Enforcement Act began to diminish and the budgetary framework began to disintegrate as greater tax cuts led to widespread disregard for the PAYGO principle.

- The PAYGO rule on tax revenue and mandatory spending was reinstated in 2010 but had little effect.

IV. Operation of Fiscal Management Systems among PEMNA Nations

1. Thailand

☐ Current state of major fiscal rules in Thailand

- According to the Budget Procedure Act B.E. 2502 (1959)[33], regulations and statutes regarding budget balance, fiscal balance and foreign debt serve as automatic stabilizers.
  - The Act prevents unnecessary spending and ensures that actual state expenditure is less than the estimated amount.
  - Budget balance rule: The Act of 1959 stipulates that fiscal deficit should not exceed 20 percent of the estimated expenditure.
  - Initially stating in 1969 that fiscal deficit should not exceed 20 percent of the planned spending, the regulations were amended in 1973 to increase the limit to 20 percent of the expenditure, plus 8 percent of the principal of public debt.

☐ Fiscal Debt Management Act (2005)[34]

- The Ministry of Finance allowed a loan increase to cover budget deficits caused by expenditure exceeding revenue.
  - However, the loan amount was prohibited from exceeding the sum of 20 percent of the annual budget combined with the additional budget of the year, or 80 percent of the budget set in that year to repay the principal of the existing debt.
- Fiscal sustainability conditions
  - The ratio of public debt to GDP must not exceed 60 percent.
  - Debt financing must not exceed 15 percent of the budget.

33) ESCAP (1997)

34) Sangubban and Wangcharoenrung (2011)

- Investment budget must be at least 25 percent of the budget.

▪ Public Debt Decree

- Annual foreign debt must not exceed 9 percent of annual export receipts.

▪ Ministerial Decree (Cabinet's resolution)

- Public debt must not exceed 50 percent of GDP.
- Debt service must not exceed 15 percent of total government spending.
- Capital expenditure must not exceed 25 percent of total government spending.

☐ Public Debt Management Office of Thailand

▪ The office manages public debt in order to prevent interest rates from rising to an excessively high level.

▪ It evaluates and circulates funds to cover the cost of infrastructure development by vitalizing the domestic bond market.

▪ The Public Debt Management Office is operated by the Thai government.

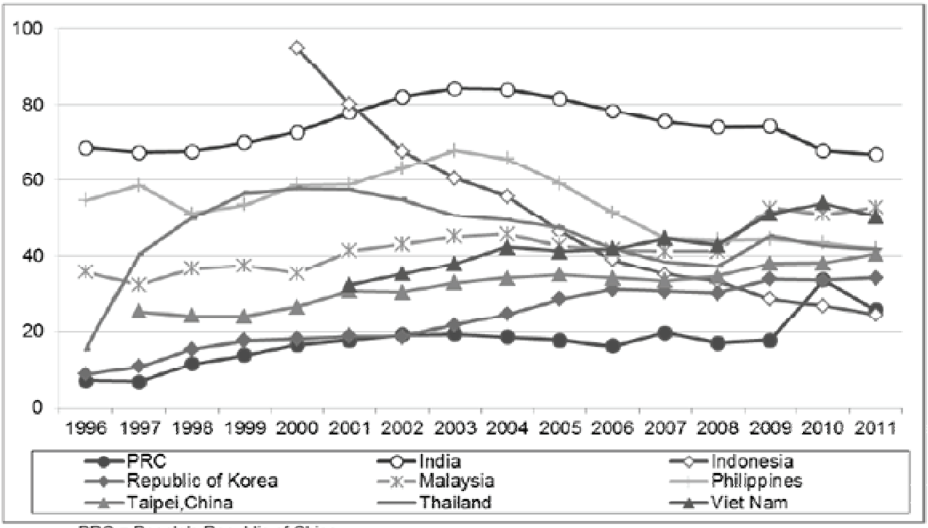
[Figure IV-1] Fiscal Sustainability Framework

(Million Baht)

Fiscal Sustainability Framework (60-15-0-25)	2010F	2011 F	2012 F	2013 F	2014 F
Public debt to GDP ratio (%)	48.42	51.21	53.24	55.42	56.91
Debt service ratio (%)	12.61	13.24	13.33	13.44	13.79
Budget balance (Budget basis) (billion baht)	-350.0	-420.0	-420.8	-420.2	-418.1
Capital expenditure to budget ratio (%)	12.60	16.50	25.00	25.00	25.00
Government Balance (Budget Basis)	**2010 F**	**2011 F**	**2012 F**	**2013 F**	**2014 F**
Revenue (billion baht)	1,350.0	1,650.0	1,758.9	1,875.0	1,998.8
Expenditure (billion baht)	1,700.0	2,070.0	2,179.7	2,295.2	2,416.9
Budgetary Balance (billion baht)	- 350.0	- 420.0	- 420.8	- 420.2	- 418.1
Budget Balance / GDP (FY)	- 3.68	- 4.15	- 3.92	- 3.69	- 3.47
Primary Balance	- 135.7	- 145.9	- 130.2	- 111.8	- 84.8
Assumptions	**2010 F**	**2011 F**	**2012 F**	**2013 F**	**2014 F**
GDP Growth (Real) (FY)	4.5	4.0	4.0	4.0	4.0
Inflation (FY)	3.0	2.5	2.0	2.0	2.0
Exchange Rate	33.5	33.5	33.5	33.5	33.5

Source: Fiscal Policy Bureau, Fiscal Policy Office

[Figure Ⅳ-2] General Government Debt (% of GDP) in Emerging Asia, 1996-2011



PRC = People's Republic of China.

Source: IMF, *World Economic Outlook* Database.

Limitation of Thailand's fiscal rules

- Although the fiscal rules are established by law, they lack the necessary legal binding force, since the government itself issues emergency decrees or special laws to permit additional borrowing.
  - In fact, the Thai government has in the past disregarded fiscal rules by exercising its discretionary power and enacting emergency decrees. For example, the decrees authorized the government to borrow 400 million baht (approx. 12.3 million US dollars) in 2009 amidst the global financial crisis to stimulate the economy, and to borrow 350 million baht (approx. 10.8 million US dollars) for flood rehabilitation and disaster relief.
  - In addition, the government is planning to establish a special law to authorize the borrowing of 1.6 trillion baht (approx. 490 billion US dollars) in order to fulfill the requirement of 2.27 trillion baht (approx. 699 billion US dollars) for a public investment program in 2011.

2. Indonesia

- As prescribed in the State Finance Law and Government Regulation 23/2003, fiscal deficit is limited to 3 percent of GDP according to the budget balance rule established in 1967, and debt is prohibited from exceeding 60 percent of GDP according to the debt rule set in 2004.[35)]
  - Although fiscal rules apply to sub-national governments, sub-national governments face limitations in fiscal resources due to their high dependence on transfers from the central government, which is over 90 percent of their budgets. The authority of taxation also mostly belongs to the central government.[36)]
  - Budgets and borrowings by sub-national governments require prior authorization from the central government, and foreign borrowing is completely prohibited.

- Aside from budgetary authorities, Indonesia maintains a strong and effective ministry for planning (BAPPENAS), which allows a smooth functional coordination between the planning ministry in charge of capital outlays and the budget authorities in charge of current expenditure.[37)]
  - Indonesian local governments have recently made efforts to abide by fiscal management systems in a realistic and timely manner (with the exception of affluent regions such as those engaged in oil production).
  - The main task of future budget management for sub-national governments is to devise a detailed medium- or long-term fiscal roadmap and specific plans with regard to the Indonesian central government's method of operating basic policies on the fiscal management of local governments.

35) IMF (2013)

36) Blöndal et al. (2009)

37) Kim John M. and Hong Seung-hyun (2013)

- Lewis and Oosterman (2009) found that Indonesia's fiscal rules were relatively well observed in recent times for the following possible reasons:
  - Balanced budget rule: Since lower level governments generally limit expenditure to within the amount that they are guaranteed to receive, their debt levels are not high in reality. In particular, fiscal rules are better obeyed in affluent regions, such as oil-rich areas.
  - Passive revenue estimation: An excessively conservative estimation of revenue due to poor budget forecasting may result in substantially large budget surpluses.[38)]

3. Malaysia[39)]

- As prescribed in the Loan (Local) Act of 1959 and the Government Funding Act of 1983, the government is obligated to follow the budget balance rule (golden rule), which permits borrowing only for development / capital spending.
  - The Loan (Local) Act and the Government Funding Act limited the central government debt to 55 percent of GDP, and the provisions on external debt and treasury bill issuance were reinforced by other laws.
  - The External Loans Act 1963 stipulated that external debt should be limited to 35 billion rupiah.

- The government aims to maintain the fiscal deficit at about 3 percent of GDP by 2015, but since this target is not considered a fiscal rule in itself, there are no sanctions in case of breaches.

38) Seifert (2012)
39) IMF (2013)

- Aside from legislations, efforts to strengthen and adhere to fiscal rules include guidelines set by the treasury department to prohibit allocated budgets from exceeding the yearly revenue.
- Article 111 (2)[40] of the Malaysian constitution states that sub-national governments are prohibited from borrowing without the central government's approval.[41]

☐ Even if state governments are approved to acquire loans, they remain highly dependent on the central government, as most (about 95 percent) of the loans are granted by the central government.

- This is both because most state governments are too small to participate in the capital market and because the capital market is insufficiently developed.
- The remaining 5 percent of the finance is mainly sourced from local financial institutions.

☐ The above-mentioned constraints lead local governments to mainly request finances from the central government for development projects, for which approval is relatively easy to obtain.[42]

4. China

☐ Since the Tax Division System Reform in 1993, the central government has seen an increase in revenue, whereas local governments have lost a significant part of their source of tax revenue.

40) "A State shall not borrow except under the authority of State law, and State law shall not authorize a State to borrow except from the Federation or, for a period not exceeding five years, from a bank or other financial source approved for that purpose by the Federal Government, and subject to such conditions as may be specified by the Federal Government".

41) Abdul Jalil and Abdul Karim (2008)

42) Abdul Jalil et al. (2011)

- The 2001 Tax for Fee Reform allowed local governments to collect tax, which replaced various kinds of fees as an income source for local governments.
  - Nonetheless, fees and non-tax revenues still account for a significant part of revenue for sub-national governments.

□ As part of the Tax Division System Reform, a de facto zero-deficit law was introduced for sub-national governments in 1994, which stipulated that lower level governments are prohibited from borrowing or issuing bonds.

□ In contrast, the BBR is considered to have been ineffective in its implementation (Wang 2008, Liu 2008).

- Despite the legislation, sub-national governments attempted to fulfill their expenditure obligations by operating finances through off-budget items, which subsequently began to accumulate as debt. The numerous causes behind this trend include an inadequate system of monitoring, lack of transparency, and hidden debt.
- Based on official government statistics, Hussain and Stem (2008) found that off-budget revenue accounted for 42.3 percent of overall revenue and off-budget expenditure comprised 22.2 percent of overall expenditure in 2003.
  - Since these figures do not include the income generated by state-owned enterprises (SOE), the actual off-budget revenue is likely to be larger.
- Proceeds from land leasing and sales account for 80-90 percent of infrastructure expenditure (Liu 2008, pp. 171).

□ In China, revenue is shared by the central and local governments, while the responsibility and burden of expenditure is mostly borne by local governments.

- Therefore, it should be noted that local governments are prone to fiscal deficits and if local borrowing is not properly controlled, the central government may bail out a struggling region.[43)]

- Anderlini (2011) estimated that local government debt alone equated to around 35 percent of GDP in 2011.
  - Wang (2008) and Liu (2008) both suggested that the above policy of limiting the borrowing of local governments has not been successful for the following reasons:
    - As an emerging country, China's rapid economic growth has led to much greater public demand for expenditure, which limited the government's ability to provide citizens with the satisfactory level of infrastructure and public services.
    - Although a larger proportion of tax revenue is transferred to sub-national governments in China compared to other countries, their expenditure responsibilities are correspondingly heavy and thereby pose financial difficulties.
    - The responsibility to provide public services is largely on the part of lower-level governments; in cases where tax revenues do not match the planned expenditure, the burden of financing the expenditure is placed on the lower-level government concerned.
    - Lower levels of government have no option but to rely on off-budget sources to finance their activities.

- In the early 1990s, policy makers instituted the ban on sub-national borrowing in order to prevent debt accumulation, but the policy led to the undesired side-effect of off-budget operations.
  - Since there is no available data on the fiscal situation at lower levels of government in China, it is difficult to evaluate whether the situation had deteriorated more rapidly before or after the ban on local borrowing.

43) Seifert (2012)

- Liu (2008) suggested that instead of prohibiting borrowing, a regulatory framework should be established to allow sub-national governments to self-finance their activities.
  - This would allow sub-national governments greater access to financial resources and to finance long-term infrastructure projects more efficiently and equitably.
    - In addition, governments would be exposed to market discipline and disclosure requirements, which would result in greater convenience for management.
  - Another benefit of the policy would be the stimulated growth of the financial market.
  - According to Anderlini (2011), the Chinese ministry of finance has recently chosen a select number of local governments to conduct a pilot program of allowing them to issue bonds.

- Debt management of the central government
  - In 2010, the central government began to make a variety of efforts towards managing local government debts, enhancing caution towards expanding expenditure, and reconsidering the distribution of tax revenue between the central and local governments, which have been argued to mitigate debt risks by enhancing response capabilities.
  - First of all, the central government needs to share expenditure responsibilities for its revenue with local governments, strengthen the budget management for debt and tighten the monitoring and assessment towards the use of local government debt.

V. Conclusion and Policy Implications

1. Summary and Implications

- In most cases, fiscal rules act as an effective means of fiscal management in which the central government encourages local governments to reduce deficits, borrowings and expenditures, and to consider their tax revenue conditions.
  - However, each country differs in terms of fiscal conditions and other institutional aspects required for fiscal rule compliance, and various factors of influence can emerge over time.
  - In addition, different objectives of fiscal rules may have trade-off effects in relation to each other.
  - Moreover, countries with a rapid economic growth often require increased local spending, the process of which may show inadequate adherence to fiscal rules.
    - Therefore, each country needs to flexibly adjust the enforcement and procedure of the rules under their own institutional conditions.

- In summary, due to the contradictions and limitations of this study in presenting a model of fiscal rules for different countries, there is a need to present the guidelines of fiscal rules and fiscal management and the implications drawn from case studies of fiscal rules through a “menu of applicability.”
  - Changes in fiscal activities of sub-national governments in major countries over the previous 20 years show that the progress of decentralization is generally accompanied by an increase in the scale of local finances under the influence of economic cycles.

- The fundamental limitation is that there are trade-off effects in securing both sustainable and stable finance.
  - The central government has no option but to intervene in the operations of local governments to keep budget balanced in the short term, which may nonetheless serve as an obstacle to the long-term fiscal activities of local governments.
  - Moreover, simple fiscal rules are expected to be more effective, but their application may not be feasible for all autonomous communities whereas complex fiscal rules may not be enforceable in the application stage.
  - Bail-outs may end up encouraging moral hazard among local governments.

□ Nonetheless, in most countries, fiscal rules are required to be followed at all levels of government. In particular, fiscal rules for sub-national governments may be referred to as "fiscal management" depending on their characteristics, but there may be a need to retain the title of "fiscal rules."

- First, as macroeconomic instability deepens, the application of the rules to the central government level alone may prove ineffective and, in principle, local governments require a framework of fiscal operations within the boundary of fiscal rules.
- Second, the key point of fiscal management is/lies essentially in limiting expenditure. The reason for maintaining fiscal rules despite the presence of existing rules is to ensure that countries or local governments subject to the rules recognize their binding force and are forced to aim for fiscal consolidation.
- Third, fiscal rules for sub-national governments can curtail local governments' demand for extra spending or political demand from other interested parties.
- Fourth, fiscal rules for sub-national governments can, as a result of peer pressure effects, serve to encourage other municipalities to follow the rules.

- The following is a summary of implications drawn from analyses of major international organizations and case studies of various countries:
  - As key recommendations from OECD analyses, the following covers the details of fiscal rules for sub-national governments in developed countries and aims at systematically limiting local government spending.[44)]
  - First, intergovernmental fiscal relations can affect the utility and effectiveness of fiscal rules.
    - In the United States, a country with self-imposed fiscal rules, the rules work relatively well, which suggests that when transfers between central and local governments are well-established and conducted on a large scale, fiscal management may be conducted through means other than fiscal rules.
    - If fiscal rules are not established out of a country's self-identified necessity and instead introduced by the demand of a higher-level government or regulations of a supranational body, such as the EU, it is desirable to negotiate and encourage compliance by each tier of government rather than unilaterally mandating adherence.
  - Second, fiscal rules may become more effective with medium- and long-term fiscal targets.
    - If necessary, long-term plans must be devised through various means such as the formulation of scenarios.
    - On occasion, it needs to be demonstrated that fiscal rules take precedence over existing policies in terms of the binding force.
  - Third, fiscal targets must be designed with consideration for the business cycle.
    - In addition, if set targets are being met through the observance of existing rules alone, fiscal rules may not be respected.
    - Trust between sub-national governments is the key to sustaining the effectiveness of fiscal rules, which requires decision-making in consideration of reconciling the rules and other fiscal measures.

44) OECD (2013), pp.53

- Fourth, it is recommended that fiscal rules are made applicable for all sub-national governments and include the budget of sub-national public enterprises.
  - In particular among expenditure accounts, current and capital expenditures are recommended to be compliant with fiscal rules. Since the golden rule loosens borrowing conditions for capital expenditure, it may distort budget allocation. This is because sub-national governments may attempt to continue spending increases through capital outlays, if perceived as a possible course of action.
- Fifth, procedural rules must be followed to ensure adherence to fiscal rules.
  - This requires intergovernmental cooperation, perhaps in addition to the adjustment of priorities with regards to existing policies and collaboration with the legislature.
  - Rules must present precise figures in order to avoid any ambiguity.
  - Monitoring compliance with the rules must be easy and it is recommended that the monitoring system be made available not only to external auditors, but also to the central government and the general public.

□ On the other hand, in the case of Latin American countries and emerging nations, the acceptance of fiscal rules requires the establishment of overarching fiscal systems, including the settlement of decentralization, development of fiscal systems and expansion of local tax bases, which may accelerate the building of fiscal system infrastructure through discussions on the introduction of fiscal rules.

- Problems that must be solved ahead of others include: (1) large vertical fiscal imbalances, (2) a tax-sharing scheme with little incentive to raise taxes locally, (3) a variety of bail-out measures, (4) opaque political motives and (5) lack of willpower to build intergovernmental consensus.[45)]

45) Braun and Tommasi (2002), pp.28

- Such countries must first establish the necessary infrastructure as follows:
  - First, local electoral systems must allow local governments to self-generate the basis for fiscal autonomy rather than follow guidelines from the central government or centrally appointed officials.
  - Second, tools must be secured to allow for legislative interaction among local governments, the legislature and politicians.
  - Third, budget processes must undergo reforms to curtail the influence of upper-level governments or uninvolved politicians (e.g., Mexico).
  - Fourth, institutional reforms must be made to improve intergovernmental relations.
  - Fifth, the Wicksellian connection should be considered first when improving fiscal systems, including the tax-sharing scheme.
  - Sixth, the scope of fiscal rules must remain consistently negotiable in line with the macroeconomic stage in order to maintain the rules.
- In particular, China, India and Indonesia, as with other emerging countries in Asia, must expand fiscal functions first rather than tighten fiscal rules, and therefore need to flexibly manage balanced budget rules and expenditure limits.
  - Such countries often witness creative accounting methods to evade fiscal rules, which may even be made powerless through superseding statutes.

☐ Based on the above implications, this analysis offers a summary of matters for consideration by sub-national governments in developing and transition economies when adopting and revising fiscal rules.

- This paper presents the three criteria of macroeconomic and market circumstances, fiscal and institutional conditions, and political maturity, each of which entails considerations and forecast indicators for each criterion.
  - The problem lies in the stringency of balanced budget rules and expenditure limits and the design of procedural rules.
  - For example, if a country shows rapid economic growth, small government debt and a low level of decentralization, fiscal rules may not be as effective as building a system for consultation with higher level governments or offering incentives, such as grants for fiscal system infrastructure.

<Table V-1> Institutional Considerations and Forecast Indicators regarding Fiscal Rules for Sub-national Governments

	Considerations	Forecast Indicators
Macroeconomic and market environments	① Economic conditions ② Debt levels and their increase trend ③ Size of the country	① GDP level, economic growth, interest rate, inflation rate, etc. ② Government debt levels (including central, local and general governments and public enterprises) and their increase rate ③ Population and land mass
Fiscal and institutional maturity	① Intergovernmental fiscal relations ② Rigidity of fiscal expenditure ③ Vitality of financial markets ④ Reforms in fiscal consolidation law ⑤ Degree of autonomy ⑥ Effect of elections and availability of elections of municipality leadership ⑦ Scale and growth rate of capital expenditure	① Scale of transfers, scale and proportion of revenue and expenditure of sub-national governments, power of sub-national governments to levy tax and set taxation standards ② Scale of statutory expenditure (welfare expenditure and elderly population) ③ Scale of local bond market ④ Number and cycle of amendment of fiscal consolidation law (GSP and Fiscal Responsibility Act) ⑤ Degree of autonomy represented by constitutions and laws, period of the existence of laws, local electoral systems, etc. ⑥ Increase in local government expenditure after elections ⑦ Scale of capital expenditure and its increase
Political maturity	① State form ② Political sensitivity ③ Corruption levels	① Federal or unitary state ② Regional gap, number of political parties ③ Relevant corruption indexes

2. Need for Additional Analysis

- Most prior studies on fiscal rules for sub-national governments are focused on the results obtained by analyzing their own surveys.
  - The IMF, EU and OECD have conducted data analyses or empirical studies through their own panel data and multiannual analysis data.
  - Analysis using macroeconomic indicators such as the above may help to determine whether the rules should be adopted, but the coverage, details and follow-up measures of fiscal rules should be based on the analysis of the specific data for each country.
    - Surveys and in-depth interviews may be required to consider various aspects of fiscal rules, including the background and economic and political maturity of each nation, as well as the details and application cases of fiscal rules in other countries.

- Therefore, a study on fiscal rules for sub-national governments of developing and PEMNA countries must also be conducted through the analysis of the KIPF survey.
  - The details of fiscal rules for PEMNA countries, once supplemented by KIPF survey data, may offer a myriad of suggestions in terms of fiscal management, rules and consolidation for sub-national governments through comparison with existing data from developed countries.

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