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Fiscal Rules versus the Financial Condition of EU Local Government Units

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Abstract: The financial crisis and significant deterioration of public finances have led to the strengthening of instruments aimed at ensuring the financial stability of the state, including fiscal rules. The article[1] focuses on the fiscal rules binding the local self-government units (LGUs) of the European Union. An attempt was made to answer the question of how the design of fiscal rules in LGUs has changed, especially in crisis situations, and what was the effectiveness of these regulations. The results of statistical analyses covering the period 2001-2020 are shown. As the aggregated values with such a large variety of local financial systems are difficult to compare, the article presents the results of two case studies (Portugal and Poland), where no significant correlations were found between the number or strength of fiscal rules and the budget deficit indicators. Summarising the analysis of the financial situation of the Polish and Portuguese municipalities, it can be stated that the financial health of LGUs varies greatly depending on the size of the municipality, which makes it difficult to formulate general conclusions regarding the links between the fiscal rules and the financial condition of LGUs.

Keywords: local government finance, fiscal rules, financial condition.

1. Introduction

The financial crisis and the significant deterioration of public finances in the European Union have led to the strengthening of instruments aimed at ensuring the financial stability of the state, which include, among others fiscal rules which are most often defined as a permanent constraint on fiscal policy, reflected in terms of fiscal performance indicators (Kopits and Symanski, 1998). The instruments are classified depending on the value that a given rule is to limit, hence the distinction between budget

[1] This article is based on research financed by Warsaw School of Economics (grant no KZiF/S22:1:31).

balance, debt, expenditure and revenue rules. The latter, aimed at preventing excessive fiscal burdens, are used least frequently.

The financial crisis showed that the fiscal rules in force at that time did not to a large extent fulfill their role, hence after the crisis the so-called second-generation rules were introduced. The new rules contain mechanisms to adapt to the phases of the business cycle and are strengthened by monitoring carried out by independent fiscal institutions (Franek and Postuła, 2019). Eyraud et al. (2018) emphasise that effective rules are simple, flexible and enforceable, and these features are very difficult to achieve simultaneously. The second generation rules became more flexible, and the regulations introduced favoured the improvement of their enforcement, but at the same time they became more and more complicated and thus difficult to verify.

The subsequent challenges related to the pandemic crisis and the applied exit clauses, temporary suspensions or loosening of the rules, indicate the need to evaluate the effectiveness of fiscal rules. In the literature, such analyses mainly concern the rules applied to the entire public finance sector (general government sector), and to a much lesser extent refer to the rules binding individual subsectors. The aim of the article was to partially fill this gap, focusing on the rules aimed at local government units (LGUs).

The article explores how the arrangements of fiscal rules in LGUs have changed, especially in crisis situations, and how effective these regulations are. Since the aggregated fiscal indicators within European Union countries are difficult to compare due to the large variety of financial systems and the tasks performed by local government units, the article presents the results of two case studies. Poland and Portugal were selected for analysis, as the fiscal rules applied to LGUs in both countries are classified among those strongest.

2. LGUs fiscal rules in the EU

In the database of the European Commission (2021), there are 60 fiscal rules binding LGUs directly, i.e. those that apply either only to the local government subsector, or to the local government subsector and other subsectors individually, and not within the entire public finance sector (general government). The database includes rules introduced since 1983, some of which have been abolished or replaced with others.

In 2020 there were 28 rules in force, and 11 of them were applied for the first time before 2010; most of them aimed at reducing the budget deficit. The fiscal rules are highly diversified – some of them limit nominal values, others refer to their relation to GDP. There are also differences in triggering the corrective mechanisms in cases of deviation from the rule – sometimes they are activated automatically, sometimes they need some previous actions, at times such mechanisms are not even provided. The diversity of fiscal rules affects their strength, and thus their effectiveness.

The Fiscal Rule Strength Index developed by the European Commission takes into account five criteria:

1) the strength of the legal basis – the highest marks are assigned to the constitutional rules (higher than ordinary law);
2) the possibility of modifying the set goals – rules with targets that cannot be changed or suspended, except in strictly defined situations (the so-called escape clauses), are rated the highest;
3) monitoring bodies and the correction mechanisms – the assessment takes into account the independence of such bodies, the frequency of rule monitoring, the status of the bodies monitoring correction mechanisms, as well as the presence of independent bodies preparing/endorsing macroeconomic/budget forecasts;
4) method of triggering the correction mechanisms – mechanisms implemented automatically in a precisely defined scope are rated the highest;
5) resilience to shocks, where it is assessed, among others, compliance of the exit clause with the regulations of the Stability and Growth Pact.

The fiscal rule strength index (FRSI) applicable to LGUs appeared in the database of the European Commission relatively recently. In 2020, the Spanish expenditure was rated the highest, while the Polish debt rule and the Italian budget balance rule were rated slightly lower. The fiscal balance rules binding Finnish and Irish LGUs were considered the weakest (Figure 1).

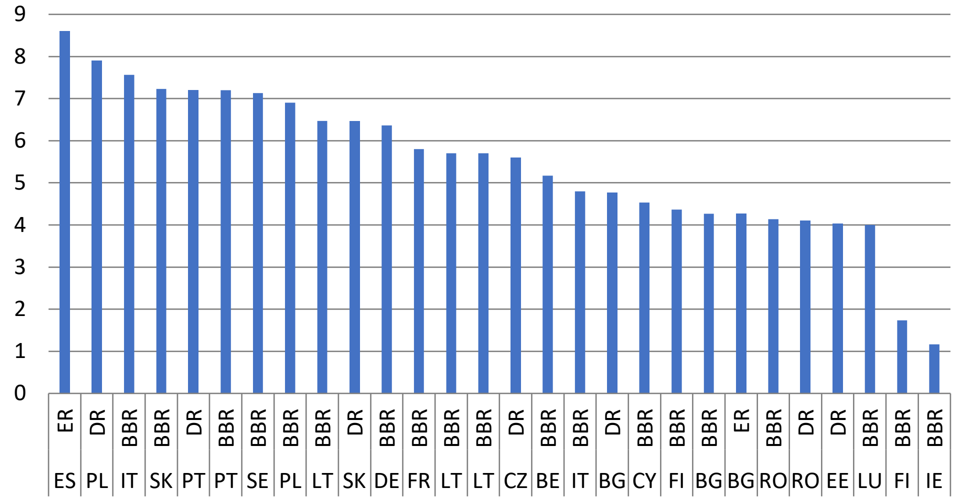

Fig. 1. The strength of LGUs fiscal rules* in 2020

* ER – expenditure rules, DR – debt rules, BBR – budget balance rules.

Source: own work based on (European Commission, 2021).

It should also be noted that in recent years many new fiscal rules have appeared, often with automatic correction mechanisms. However, the challenges faced by LGUs in connection with the outbreak of the pandemic resulted in the application of previously unforeseen 'loosening' solutions, or even suspending the rules.

The statistical analysis for the period 2001-2020 showed no significant correlations between the presence or number of fiscal rules binding LGUs and the LGUs deficit in relation to GDP. The analysis was based on information from the European Commission's database on local fiscal rules in 27 European Union countries, and data on the amount of the local government deficit published by Eurostat. The Pearson correlation coefficient between the number of rules and the deficit ratio in the analysed years was more often negative (from –0.24 in 2013 to –0.05 in 2005), but for eight years this relationship was positive (in 2009 it was the highest but only at 0.31). Very similar, although slightly higher, correlation ratios were also recorded between the presence of only the deficit rule and the amount of the LGUs deficit in relation to GDP (from –0.31 in 2013 to 0.41 in 2009). This is in line with previous research on national fiscal rules. According to Bandaogo (2020), it is not the mere presence of the rules that is important, but their strength and credibility. In the case of LGUs fiscal rules, however, no stronger correlation was noted between the strength of the budget balance rules and the budget deficit indicators. Due to the limited scope of information on the strength of local fiscal rules, the analysis covered only the years from 2015 to 2020, and only those EU countries for which such data were available (15 in total). The correlation between rule strength and deficit-to-GDP ratios was positive but weak (maximum 0.22). At the same time, it seems that due to the large diversity of LGUs in EU countries, the analysis of aggregated values does not fully reflect the complexity of the entire problem.

For this reason, in the further part of the article two cases were analysed: Portugal and Poland. In both countries the fiscal rules binding LGUs are considered by the European Commission as comparably strong. Focusing on two countries allowed for a broader analysis of their regulations and the use of more indicators reflecting their financial health.

3. LGUs fiscal rules in Portugal and Poland

In Portugal, new fiscal rules for LGUs were enacted in 2013. They replaced the previously applicable regulations limiting the total level of net debt to 125% of the previous year's income, and limiting increases in net debt to zero (European Commission, 2021).

Since 2014[2], Portuguese municipalities have been bound by the new budget balance rule and the debt rule. The early warning mechanisms also foresee some consequences related to the under-implementation of the revenue plan. If the revenue execution rate in two consecutive years is lower than 85%, the bodies designated by law have to be informed.

The budget balance rule imposes the obligation to ensure a balance or a positive balance between budget revenues and expenditures. In addition, LGUs in Portugal are required to maintain a positive (or zero) difference between current revenue and current expenditure plus the amount of the average loan repayments. A negative difference is allowed as long as it does not exceed 5% of current revenue and will be covered in the next budget year.

The debt rule assumes that the total debt at the end of December may not exceed 150% of the average net current revenue from the previous three financial years. Apart from financial debt, the total debt includes liabilities to suppliers, but excludes liabilities resulting from extrabudgetary operations. Certain operations are excluded by law from the limit, for example, loans to finance the reconstruction of the municipal infrastructure damaged by disasters. On the other hand, the debt limit also includes the debt of the entities in which the LGU participates. There are also rules for reducing the debt (if the debt limit is not met) and the possible increase of the debt (if the limit is respected).

In 2020, in connection with the activities of municipalities aimed at counteracting the effects of the pandemic, the fiscal rules imposed on LGUs were loosened. This concerned both the budget balance rule and the debt rule (Alessandrini et al. 2021). The balance rule was suspended with regard to the obligation to maintain a positive (or zero) difference between current revenue and current expenditure plus the amount of the average loan repayments (Modernização do Estado e da Administração Pública, Direção-Geral das Autarquias Locais, 2020). It was allowed to exceed the debt limit if it was related to taking measures to counteract the impact of COVID-19. The costs of financing the anti-pandemic measures were also not included in the calculation of the required debt reduction in situations where the LGU did not meet the debt limit. Moreover, for municipalities that respect the debt limit, in 2020 and 2021 the restriction of debt increase was suspended (Conselho das Finanças Públicas, 2022).

Polish legislation contains two fiscal rules which are directly aimed at LGUs. The first of them limits the level of debt, while the second relates to the budget balance. Regulations limiting the debt already appeared in the Public Finance Act of 1998 (Ustawa z dnia 26 listopada 1998 r.). The limit concerned both the amount of repayment of liabilities and the debt servicing costs in a given budget year (15% or 12% of planned revenues), and the total amount of debt (60% of revenues). Similar regulations were repeated in the Public Finance Act of 2005 (Ustawa z dnia 30 czerwca 2005 r.), while the validity of these regulations was extended until the end of 2013, so that LGUs had more time to prepare for the new debt limit, known as the individual debt ratio (IDR), adopted in the Public Finance Act of 2009 (Ustawa z dnia 27 sierpnia 2009 r.).

From 2014 the ratio of planned repayments of liabilities (due to credits, loans, sureties and guarantees as well as redemptions of securities), including interest, to total income could not exceed one-third of the sum of current surplus plus income from the sale of assets in relation to total income for the three years preceding the year for which the relation is established. Certain exemptions from the above limit were allowed, which concerned, among others, the repayment of loans taken for the so-called pre-financing of EU projects.

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[2] Description of the rules in force since 2014, based on: Conselho das Finanças Públicas. Box 2 – *Budgetary rules in local government*, https://www.cfp.pt/en/boxes/public-finance/budgetary-rules-in-local-government).

The introduction of the IDR was a response to the postulates of LGUs to abolish the earlier limit, which was excessively restrictive for entities with a high development capacity, while for weaker units – too liberal. However, the drawbacks of the new debt rule were noticed quickly. Numerous studies (see e.g. Jastrzębska, 2012, p. 197; Kornberger-Sokołowska, 2015; Marchewka-Bartkowiak and Wiśniewski, 2012; Wiśniewski, 2014; Wójtowicz, 2017) indicated, among others, the strong dependence of the IDR on the economic situation of the last three years, including one-off values in the formula (income from the sale of assets), or the sole design of the IDR, that could create an incentive to extend the period of repayment of liabilities and to transfer part of the debt outside the LGUs budget, for example to municipal companies.

At the end of 2018, an amendment to the IDR was adopted which gradually (using different methodologies for the years indicated by law) changes the structure of the rule, e.g. by extending to seven years the period taken into account for the calculation of the debt limit and by modifying the variables in the formula.

In 2020 additional pandemic exemptions from the debt limit were allowed, and the annual debt limit to 80% of income was added. This limitation did not apply to those LGUs that would not exceed the IDR without the new COVID-19 exemptions. Regulations loosening the debt rule were also in force in 2021.

The budget balance rule appeared for the first time in Poland in the Public Finance Act of 2009 (it came into force in 2011). Pursuant to Art. 242, it was not possible to pass the LGUs budget in which the planned current expenditures exceed the planned current income increased by the budget surplus from previous years and so called free funds[3]. A similar ban (with some reservations) also referred to the budget execution. In 2018, some changes were adopted regarding the sources that could be used to balance the budget.

Under the COVID-19 legislation, it was allowed to increase the allowable current deficit by the amount of current expenditure incurred on tasks related to counteracting the pandemic and by the amount of the loss in income caused by COVID-19. Such regulations were in force in 2020 and 2021, and some modifications to the rule were also introduced for 2022.

4. Financial condition of municipalities in Portugal and Poland

The financial condition of an LGU represents the ability to meet its financial obligations and obligations related to the services provided (Jacob and Hendrick, 2013, p. 11). The financial stress will therefore be related to the inability not only to settle municipal financial obligations on time, but also to provide services to residents of a standard no worse than those already established. The lack of, or the incomplete guidelines for such standards, and the lack of data on their fulfillment, mean that when analysing the financial condition of LGUs, one focuses on financial data. There are many indicators that can be used for such analyses (see: Brown, 1993; Dylewski, Filipiak, and Gorzałczyńska-Koczkodaj, 2010; Filipiak, 2009; Honadle, Costa, and Cigler, 2004; Jacob and Hendrick, 2013; Kloha, Weissert, and Kleine, 2005; Stone, Singla, Comeaux, and Kirschner, 2015; Zafra-Gomez, López-Hernández, and Hernández-Bastida, 2009), and several of them were selected for this article, mainly those related to the budget result and debt. As there are no established benchmarks for LGUs, the assessment of the financial condition is made on the basis of a comparison to other similar units.

Portugal is a unitary state, with two autonomous regions (Madeira and Azores), and 308 municipalities. According to the division proposed by Basílio and Borralho (2021), Portuguese municipalities were divided into three groups: small (up to 20,000 inhabitants), medium (from 20,000 to 100,000) and large

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[3] Free funds are understood as cash surpluses on the current account of the LGU budget, resulting from the settlement of issued securities and loans from previous years.

– over 100,000 inhabitants. Most Portuguese municipalities are small (61%), the share of medium-sized municipalities is 31%, while the remaining 8% are those inhabited by more than 100,000 people.

A similar division was used for Polish municipalities. However, taking into account the different financial conditions specific to towns with poviat (county) rights[4], these units have been presented separately. As in Portugal, the population of municipalities in Poland is dominated by the smallest units, which constitute 86% of the total; 11% are medium-sized municipalities other than towns with poviat status, and 1% towns with poviat status. Currently only towns with poviat status (2% of all municipalities) are units with a population of over 100,000.

Until 2015 the *per capita* budget position indicator in all Portuguese municipalities showed similar trends, but in 2012-2013 there was a clear discrepancy between the largest units (with the highest surpluses per person) and the medium-sized units, where these indicators were the lowest. From 2016 the index developed in a more diversified manner, but until 2019, medium-sized municipalities recorded the lowest values. In 2020 the situation changed – the largest deficit was recorded by municipalities with over 100,000 inhabitants (Figure 2).

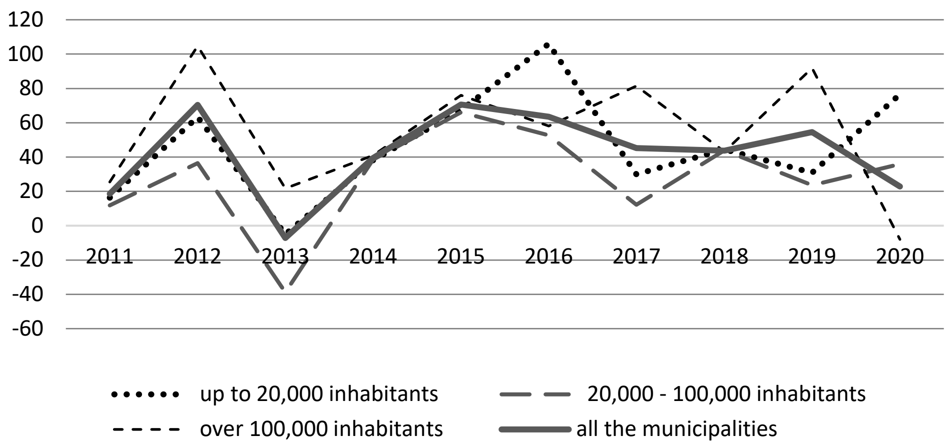

Fig. 2. Budget result per capita in Portuguese municipalities (in EUR)

Source: own work based on Instituto Nacional de Estatística data, http://www.ine.pt.

The average current result *per capita* increased in 2011-2017 from EUR 58 to EUR 162. Over the next years, the surplus systematically decreased, down to EUR 143 in 2020. The situation of the smallest municipalities clearly improved – it was the only group that recorded a current deficit during the analysed period (in 2011), but in the next few years its current surplus exceeded the surplus realised by other groups of municipalities.

In 2020 the current *per capita* result showed similar trends as the total *per capita* result, which confirms that the first year of the pandemic was the most severe for the largest units, while the smallest municipalities were then in a much better financial condition.

In 2011-2019 the debt *per capita* decreased significantly – on average from EUR 753 to EUR 357. This indicator was the highest in the smallest units (it decreased from EUR 1080 to EUR 581), and the lowest debt fell on the inhabitants of the largest municipalities (Figure 3). It should be noted that larger municipalities have a greater income capacity, while smaller units are highly dependent on transfers from central government.

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4 Polish self-government units at the local level are municipalities divided into rural, urban-rural, urban and towns with poviat (county) rights.

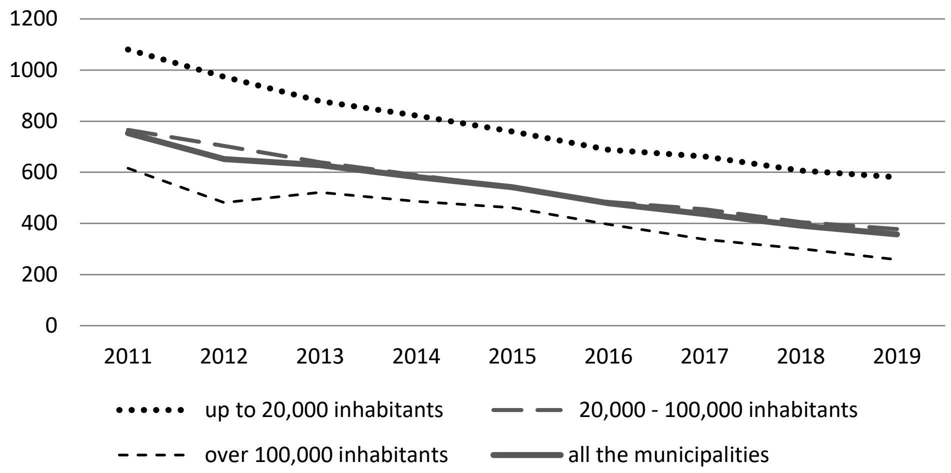

Fig. 3. Debt per capita in Portuguese municipalities (in EUR)

Source: own work based on Instituto Nacional de Estatística data (http://www.ine.pt).

The debt-to-limit ratio also improved notably – in 2014 it was 70%, in 2018 only 39%, with the same asymmetry of results between groups of municipalities of various sizes (Basílio, Borralho, 2021).

In the analysed period, the debt-to-income ratio decreased almost continuously (except for 2013) in all groups of Portuguese municipalities. In 2011 it was on average 109.4%, while in 2019 it was only 42.5%. Importantly, capital expenditure still constituted a significant part of all expenditure. In 2011, in municipalities with up to 20,000 residents, the share of capital expenditure was 34.7% (23.5% in the largest units). Since 2016 the share of capital expenditure in all groups of LGUs has almost completely levelled off, and in 2020 it amounted to an average of 26% of total expenditure.

In Poland, after the introduction of the budget balance rule, the total budget result *per capita* improved significantly, although until 2014 the average for all groups of municipalities remained negative. In 2016 all groups of LGUs recorded the highest surpluses, while two years later they all recorded deficits. From 2018 significant differences could also be seen between the largest municipalities (with the largest deficits *per capita*) and the smallest units, where the surplus *per capita* was the highest (Figure 4).

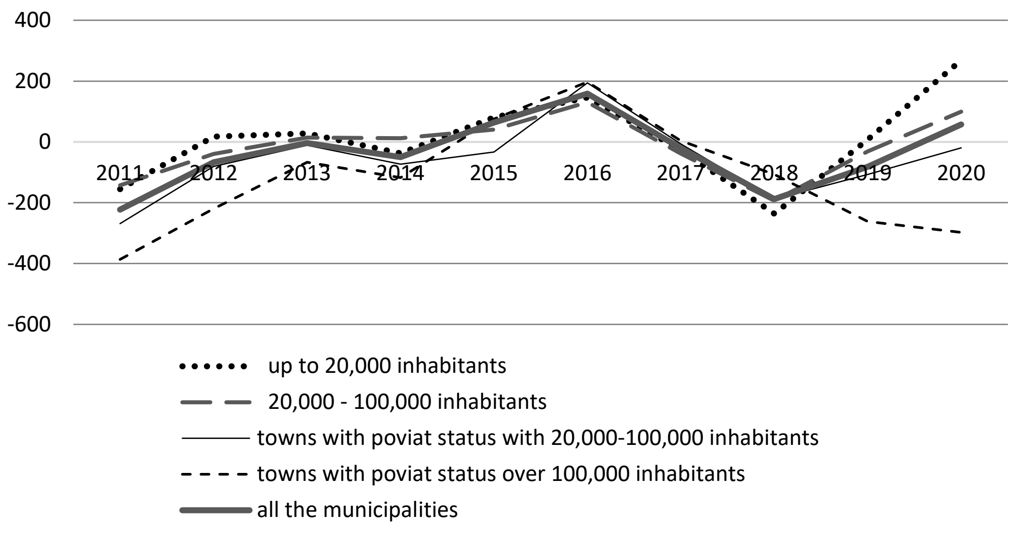

Fig. 4. Budget result per capita in Polish municipalities (in PLN)

Source: own work based on Ministry of Finance data (n.d.).

Much greater differences between the groups of Polish municipalities occurred in the case of the current budget result *per capita*. In 2011-2020 all groups of LGUs recorded surpluses, but for most of the period the highest indicators were recorded in the largest towns with poviat status, and the smallest indicators were in towns with poviat status with the number of inhabitants not exceeding 100,000. In 2020 the current surplus generated by the largest entities decreased significantly.

Fewer and fewer units did not comply with the budget balance rule. While in 2011 over 50 municipalities recorded a current deficit, which was not covered by surpluses or free funds, in the following years this number decreased significantly and since 2016, there were practically only singular such situations. The most important reason for the failure to comply with the rule was the lower than planned income execution, with the same as planned expenditure execution (Krajowa Rada Regionalnych Izb Obrachunkowych, 2019). In 2020, when the rule was loosened, no breach of the rule was recorded for the first time.

In 2011-2017 the average debt *per capita* of the Polish municipality was at a similar level and amounted to approximately PLN 1,480. Towns with poviat status, especially the largest ones, were characterised by clearly higher debt (Figure 5). After 2017, the debt *per capita* was growing in almost all groups of LGUs. In 2020 the debt of the inhabitants of the largest towns with poviat status was almost three times higher than for the inhabitants of the smallest units.

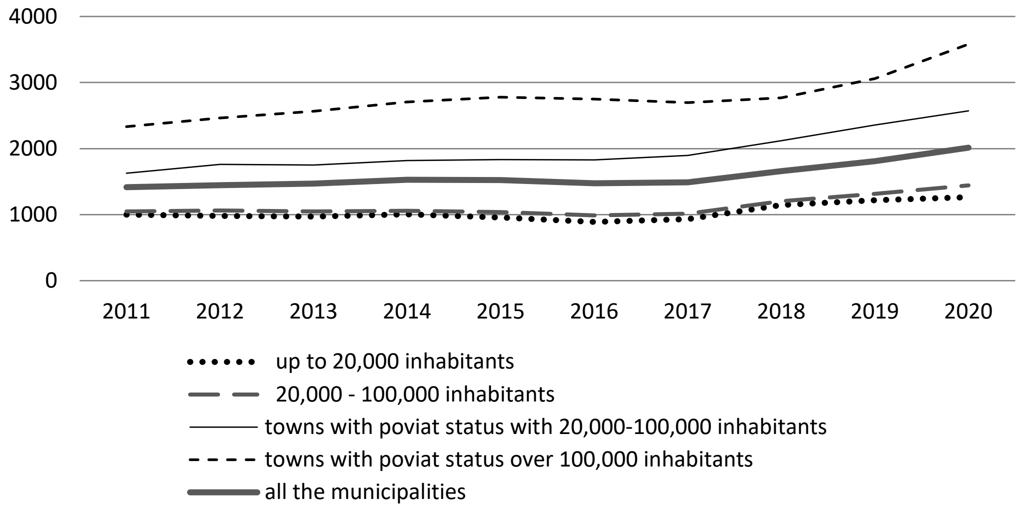

Fig. 5. Debt per capita in Polish municipalities (in PLN)

Source: own work based on Ministry of Finance data (n.d.).

The share of capital expenditure in the total expenditure of Polish LGUs was lower than in the Portuguese ones. In 2011 it averaged 22.2%, whereas the lowest value was noted in 2016 (11.5%), and in 2018 it increased to 19.1%. The lowest rates were recorded almost continuously in smaller towns with poviat status.

According to information provided by the Krajowa Rada Regionalnych Izb Obrachunkowych[5] (2021), a total of 49 LGUs (nine fewer than the year before) did not meet the debt rule in at least one year of the long-term financial forecast for 2021 and subsequent years. However, as emphasised, it is impossible to assess the fulfillment of debt limit requirements without knowledge of the realistic incomes of LGUs and the scope of public services provided. This comment is still relevant.

5 National Council of Regional Audit Chambers.

5. Conclusion

It is difficult to show unequivocally the relation between fiscal rules and the financial stability of LGUs. Such analyses are complicated by both the endogeneity of variables and other factors, such as the degree of fiscal decentralisation, the sensitivity of the main sources of income to economic fluctuations, and the volatility of legal regulations significantly affecting the financial management of LGUs. One should also not forget about actions, which – aimed at improving financial results and complying with the applicable fiscal rules – reduce the quality of public services provided.

In recent years, fiscal rules binding LGUs have undergone many modifications, and the changes introduced were aimed at, among others, the possibility of a flexible reaction in the case of an economic downturn. However, during the pandemic crisis, these solutions were rarely used as many countries decided to suspend or loosen the rules, sometimes in a way that is difficult to reliably verify. An example of this is Poland, where the new exemptions from the rules included current expenditure related to counteracting COVID-19 – the amount of which cannot be confronted with budget reporting in any way.

Summarising the analysis of the financial situation of Polish and Portuguese municipalities, it can be stated that the financial health of LGUs varies greatly depending on the size of the municipality, thus it is difficult to generalise the links between the fiscal rules and the financial condition of LGUs. Nevertheless, many important indicators have improved (although not in all the years) and fewer and fewer units have failed to meet the established limits. However, it is not known whether the improvement in financial results is related to the deterioration of the quality of services provided.

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Reguły fiskalne a sytuacja finansowa jednostek samorządu lokalnego UE

Streszczenie: Kryzys finansowy i znaczące pogorszenie stanu finansów publicznych doprowadziły do wzmocnienia instrumentów mających na celu zapewnienie stabilności finansowej państwa, w tym reguł fiskalnych. Przedmiotem artykułu są reguły fiskalne obejmujące jednostki samorządu terytorialnego (JST) Unii Europejskiej na poziomie lokalnym. W artykule podjęto próbę odpowiedzi na pytanie, jak zmieniała się konstrukcja reguł fiskalnych w JST, szczególnie w sytuacjach kryzysowych, i jaka była skuteczność tych regulacji. Przedstawiono wyniki analiz statystycznych, które objęły lata 2001-2020. Ponieważ wielkości zagregowane przy tak dużej różnorodności lokalnych systemów finansowych są trudno porównywalne, w artykule przedstawiono wyniki dwóch *case studies* (Portugalii i Polski). Podczas badania nie stwierdzono istotnych korelacji pomiędzy liczbą reguł fiskalnych czy siłą reguł a wielkością deficytu JST w relacji do PKB. Podsumowując analizę sytuacji finansowej gmin polskich i portugalskich, można stwierdzić, że kondycja finansowa JST jest mocno zróżnicowana w zależności od wielkości gminy, co utrudnia sformułowanie ogólnych wniosków dotyczących powiązań między regułami fiskalnymi a kondycją finansową JST.

Słowa kluczowe: finanse samorządowe, reguły fiskalne, kondycja finansowa.