Preventing local government defaults: no-bailout policy and its alternatives

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Fiscal decentralization introduces the risk that subnational governments act fiscally irresponsible in the belief that a higher government will bail them out if they run into trouble. The economic literature therefore prescribes a strict no-bailout policy. We survey fiscal rules and fiscal policies concerning subnational governments in 20 European countries, and find wide discrepancies, both between theory and practice and between rules and actual policies. Countries with a no-bailout rule often do bail out subnational governments, sometimes on a large scale, while countries lacking such a rule sometimes do not, or only sparingly. Fiscally responsive behavior of subnational governments seems to depend on a balanced mix of policy measures, notably providing sufficient funding, adequate fiscal supervision, early intervention mechanisms and bailout rules that are sufficiently unattractive. A no-bailout rule is neither necessary nor sufficient.

1. Introduction

It is a cherished principle in the literature on fiscal federalism that tasks should be executed at the lowest suitable level of government. Fiscal decentralization enables public services to be tailored to local needs and preferences, and may reduce costs (Oates 1972, Boadway and Shah 2009).

However, fiscal decentralization comes with two complications. First, central governments may have made local governments legally responsible for the implementation of certain policies without providing sufficient funding (unfunded mandates; Eyraud and Gomez Sirera

2015). Subnational governments levy taxes and may have access to other own revenue sources, but these seldom suffice to finance all their activities. Local tax autonomy is limited in many countries, and municipalities in poor areas may have shallow tax bases. Such vertical fiscal imbalances require the use of intergovernmental transfers. However, if funding falls short, local governments may be forced to spend more money than they receive.

Secondly, intergovernmental transfers may weaken local governments' incentives to operate efficiently (Smith et al. 2019). After a higher level of government (from now 'central government') has indicated its interest in certain policy goals, a lower level of government (from now 'local government') may expect to be bailed out in case financial problems arise which preclude achieving these goals (Allers 2014, Goodspeed 2002).

Defining exactly what we mean with "bailout" is not easy. Following Petterson-Lidbom (2010), we define a local government bailout as a situation where a central government extends more resources ex post to a local government than it was prepared to provide ex ante. Often, this is an unexpectedly needed transfer of funds to a local government, or the assumption of local debt, in order to save a local government from financial problems. However, bailouts have been known to occur in situations where local governments did not seem to be in a fiscal crisis. Also, bailouts may be implicit, and be disguised as discretionary grants or the relaxing of accounting rules that give local authorities more fiscal leeway. Examples will be provided below.

Based on Kornai (1980), the economic literature stresses that, once it is clear that a central government is willing to bail out local governments, local authorities have an incentive to overspend or to take excessive risk (Garcia-Milà et al. 2001, Bordignon and Turati 2009, Pettersson-Lidbom 2010). Moreover, decentralization leads to an asymmetric information problem between higher and lower levels of government, because the local government has better knowledge of the costs of implementing policy. This means it can credibly pretend to have insufficient funding, as it is difficult for the central government to recognize bad fiscal policy. As soon as the credibility of a no-bailout policy is lost, the risk of fiscally imprudent behavior increases.

Therefore, another cherished principle in the literature on fiscal federalism holds that higher levels of government must maintain a credible no-bailout policy to avoid fiscal crises and bankruptcies among local governments. In the economic literature, this is often claimed to be the only reliable policy which can avoid local government profligacy in fiscal federations (Rodden 2006, Pettersson-Lidbom 2010, Dovis and Kirpalani 2020). A credible no-bailout

policy gives local governments a strong incentive to be fiscally prudent. Moreover, it gives potential lenders an incentive to assess the risk associated with lending to a local government. When financial profligacy makes this risk too large, the jurisdiction will face prohibitively high interest rates.

Within Europe, Switzerland is hailed as an example of such fiscal fortitude and success, as it sticks tightly to the no-bailout principle. However, it is not self-evident that a no-bailout policy is the only way central governments can maintain fiscal discipline among local governments. Despite the good academic pedigree of the no-bailout principle, the empirical and comparative research to support it is scarce. There seem to be two major discrepancies between what we think we know about bailouts in Europe, and what is actually going on.

First, there are large discrepancies between legal rules on the one hand and actual policies on the other. National governments with an official no-bailout policy often do implement bailouts (e.g. Hungary). Meanwhile, although Switzerland maintains a credible no-bailout policy in practice, Swiss law does not forbid bailouts. A credible no-bailout policy is difficult to maintain because central governments are often seen as responsible for policy that is implemented at lower levels of government. Therefore, both citizens and local governments can expect higher levels of governments to step in in case of fiscal crisis. For instance, cessation of public services in such areas as education and health care may be seen as unacceptable, and reflecting badly on the central government, even if local governments have failed. Central government often funds a significant share of local government expenditure. This may be seen as an admission that it takes an active interest in the pursuit of local policy (Rodden 2006).

Secondly, we will show that several European countries, e.g. Denmark, hardly ever need to implement bailouts even though they have a de jure or de facto bailout policy. Fiscally responsible behavior may be fostered by other means. Voters may punish politicians who mess up, formula-based equalization grant may ensure sufficient funding, fiscal rules may prevent risky behavior, and bailouts can be made unattractive by attaching conditions. Even in Switzerland these policy mechanisms seem vital. This is important, because soft budget constraints could actually be efficiency-improving. E.g., Besfamille and Lockwood (2008) argue that hard budget constraints may lead local governments to underinvest. Dietrichson and Ellegård (2015) suggest that conditional bailout grants may induce more fiscal discipline than a hard budget constraint.

This paper aims to further our understanding of how central governments incentivize fiscally responsible behavior among local governments. To do so, we first describe current policies concerning local government bankruptcies and bailouts in 20 European countries. Then we present a more detailed overview of the tools governments have at their disposal to induce fiscally responsible behavior besides a credible no-bailout policy, and give examples of their use in European countries. We use this overview to show the discrepancies between de jure and de facto bailout policy, and between the theory on bailouts and the empirics of successful fiscal federalism in the absence of a no-bailout policy. We draw lessons that may help central governments to successfully avoid local government fiscal crises and profligacy, without ruling out bailouts.

2. European bankruptcy and bailout policies

We now turn from theory to practice: how do countries handle fiscal distress among local jurisdictions? We surveyed 20 European countries, listed in Table 1. We studied the literature, and we asked country experts for information (see Appendix). In some countries, policies differ by state. E.g., German Bundesländer, Belgian regions and Swiss cantons have substantial autonomy to shape fiscal policies regarding local governments. Like local authorities, such states may also experience fiscal distress themselves, but we limit our analysis to local governments. Where for simplicity we refer to "central government", in federations this may actually apply to state government.

Only in five countries we surveyed are municipal bankruptcies legally possible: Austria, Bulgaria, Hungary, Italy and Switzerland. In Hungary, no less than 45 municipalities went bankrupt since 1996, but none since a nationwide bailout in 2011-2014. In Switzerland and Austria, however, municipal bankruptcies are very rare. Austria saw its last case in the 1930s, Switzerland in 1998.

In other countries, municipalities cannot technically go bankrupt, but there may exist similar mechanisms. In England, e.g., councils may issue a so-called section 114 notice. This is effectively an admission that a jurisdiction lacks resources to meet current expenditure, that its financial reserves are depleted and that it has little confidence that it can bring spending under control in the near future. This is quite exceptional; in 2018, Northamptonshire was the first local authority to issue a section 114 notice for two decades (The Guardian 2018).

Regardless of the legal possibility of bankruptcy, fiscal crises may occur, and without an adequate response municipalities can become insolvent. Table 1 provides a quick and simplified overview of bailout policies among European countries. Interestingly, some countries have a formal no-bailout policy, while in practice local governments have been bailed out. Moreover, countries in which bailouts are (*de facto*) possible do not necessarily suffer from endemic local government profligacy, contrary to what the economic literature predicts. Whether explicit bailout regulation exists or whether higher government tiers bear formal responsibility for lower governments in trouble does not seem to matter much for the frequency with which local governments are rescued.

Table 1: Bailouts and bailout policies in European countries and states

	A no-bailout clause is enshrined in law	**Neither bailout nor no-bailout clause in the law**	**Bailouts are formally regulated**
No bailouts in at least 25 years		Switzerland Flanders France Austria	
Rare bailouts	Portugal	Czechia England Ireland Poland	Denmark Estonia Greece The Netherlands
Many bailouts	Hungary Spain	Sweden Wallonia	Bulgaria Finland Germany Italy

Three countries officially rule out bailouts: Hungary, Portugal and Spain. They illustrate the difficulty of upholding such a rule. Portugal saw a few municipal bailouts during the crisis years around 2010; this was before it formally ruled out bailouts by the central government in 2013. Nevertheless, nowadays it maintains a fund to finance municipalities in fiscal trouble which is financed by other municipalities. No bailouts have occurred since 2013. This

paradox in Portuguese bailout policy makes it difficult to predict whether bailouts will occur often in the future. An extreme case is Hungary, which assumed all debt of all local governments in 2011-2014, even though there were no financial problems at the sector level (Vasvari 2018). Spain too saw widespread explicit bailouts, and also large-scale implicit bailouts through discretionary grants (Velasco 2019, Foremny and Solé-Ollé 2016). In other words, two out of three cases in our sample with a no-bailout policy show frequent bailouts.

Meanwhile, in four countries in our sample that allow bailouts, but lack formal rules regulating bailouts, bailouts do not occur. Of these, Switzerland is the best known case. Following the bankruptcy of the municipality of Leukerbad, the Swiss Supreme Court in 2003 decided that there was no obligation for the canton of Valais to bail out its highly indebted municipality. Prior to this court ruling, this had been unclear, as the law does not oblige cantons to bail out municipalities, but it does allow them to do so. Creditors seemed to believe that cantons would step in if needed, because after Leukerbad, which confirmed the no-bailout commitment, cantonal risk premia fell by about 26 basis points (Feld et al. 2017).

For Austria there is no record of explicit municipal bailouts, although provisions for this exist (see below) and municipalities can unconditionally obtain loans from the Federal Financing Agency (Vielhaber 2014). In Flanders, no bailouts have taken place in 25 years. It is true that the Flemish government recently offered to take on municipal debt in exchange for municipal consolidation. However, this was on a minor scale and part of a deliberate policy to encourage municipal scale enlargement, so according to our definition, this does not constitute a bailout. In France, departments facing a state of insolvency may be bailed out, but municipalities do not seem to receive any additional funding if they face a state of insolvency.

In four countries, bailouts are not formally regulated but occur rarely. In some cases these bailouts are implicit, e.g. in the form of discretionary intergovernmental grants. Implicit bailouts take, e.g., place in England, where government ministers have substantial discretionary freedom to adjust grant allocations (De Widt 2016). This may be used to prevent local fiscal crises. Moreover, in the 2018 Northamptonshire case referred to above, the central government allowed the county council to spend a large share of the cash received from the sale of its brand new headquarters on funding day-to-day services, in conflict with accounting rules (The Guardian 2018). Although technically not a bailout – no money flowed from the central government to the council – this prevented the council falling into insolvency.

In three other countries without formal bailout regulations, bailouts are similarly rare. In Czechia, the case of the bailout of the municipality of Rokytnice nad Jizerou is remarkable,

because normally this country solves local financial troubles by the involuntary sale of municipal property (Ponce 2019). Ireland bailed out one local government (Sligo County Council) since 2010. Poland maintains a fund for municipalities in fiscal crisis, and in 2004 several local governments received a loan to avoid insolvency (Kopanska 2011, p. 122), but in 2018 it rejected a request for help from the municipality of Ostrowice.

However, in two cases, bailouts are not formally regulated, but do occur regularly. In Sweden, 88 municipalities were bailed out between 1998 and 2005 through two different programs. These have always been conditional bailouts, with recovery plans attached to them. In the Belgian state of Wallonia bailouts are a regular phenomenon. In 2015, for instance, around 20% of municipalities were undergoing a financial recovery process in exchange for which they received financial support.

Of the countries in Table 1, eight have rules to regulate municipal bailouts. These rules may determine who pays for bailouts, and whether they are a grant or a loan (Table 3). Four countries in this group have seen only few bailouts. Denmark saw one bankruptcy in 2002 (Mau 2015). Estonia saw eight bailouts since 2005. In Greece there have been three bailouts in 2016. Twelve municipalities were bailed out in the Netherlands between 1998 and 2019. On the other hand, four other countries with specific bailout regulations have seen many bailouts: Bulgaria, Finland, Germany and Italy.

3. Tools to prevent fiscal difficulties

Why have many countries without a credible no-bailout policy not suffered from endemic fiscal crises among local governments, as theory predicts? This has received little attention in the literature (see, however, Allers 2014, Mau 2015). There are several policy options for countries to prevent local fiscal troubles.

3.1 Sufficient funding

The first way to limit the need for bailouts is to ensure local governments have sufficient funding to fulfill their regular tasks. In that case, bailouts are only needed in case of financial mismanagement or unforeseeable scenarios. Thus, local governments should be allowed a sufficiently large and stable tax base and sufficient tax autonomy. This enables local jurisdictions to cope with setbacks. A possible reason for the lack of bailouts in Flanders is

that Flemish municipalities possess great tax autonomy and source a major part of their revenues from local taxation. This means that adverse financial shocks are more easily absorbed than in, e.g., the neighboring Netherlands, where local taxation is too insignificant to save municipalities in grave trouble.

Furthermore, central governments can provide grants to local governments to supplement own revenues. At the macro level, the grant amount should be sufficient, together with tax revenue, for local governments to provide basic public services. Moreover, grant allocation should be formula-based and aimed at equalizing differences in spending need and revenue capacity. Jurisdictions with, e.g., many children, or adverse climate conditions, may need a grant that is relatively higher than other jurisdictions to fulfill their tasks. The same applies to jurisdictions with low tax capacities. A formula-based grant system may make a no-bailout clause more credible compared to other grant systems, as it provides funding based on relatively objective standards, thus enhancing transparency and accountability (Boadway and Shah 2009).

Of the countries listed in Table 2, only Greece does not seem to have a fiscal equalization system. It does have, however, several grants that take into account peculiarities of municipalities, such as location on an island or in the mountains. The extent to which differences in fiscal capacity are actually equalized differs greatly among countries. In Hungary, tax capacity is equalized and municipalities receive grants to cover deficits (Raffer 2019). The Netherlands, on the other hand, boasts a complicated and ambitious equalization system aimed at enabling all municipalities to provide similar service levels when opting for a standard tax rate (Allers and Vermeulen 2016). It is difficult (if not impossible) to quantify the 'quality' of fiscal equalization systems, and no such attempt has been made here.

3.2 Pressure from stakeholders

Central governments are not the only stakeholders in preventing local government fiscal crises. Perhaps voters or creditors may help induce responsible fiscal behavior. In case of a local government bankruptcy, citizens face a significant and painful disruption in service provision. Local politicians' fiscal imprudence can be checked by voters who punish such behavior. However, this requires voters to be able to pin the blame on the correct culprit. Moreover, voters should carry enough of the costs to care. Voters may consider a bailout a free gift from national tax payers to local voters, something hardly worthy of punishment. Indeed, in the Netherlands, this mechanism to ensure fiscal prudence does not seem to

function properly, as voters do not punish local politicians for fiscal irresponsibility or fiscal crises (Allers 2014).

Creditors are also hurt by a local government default. Therefore, they may put a brake on fiscal recklessness by charging interest rates that depend on credit risk. The last column of table 2 shows that in a number of countries, loans to municipalities are provided by public institutions. These may include publicly owned banks but, sometimes, also the national treasury. In such cases the market mechanism to control local government debt may not function. However, borrowing from private lenders is also widespread. In seven countries in our sample municipalities can *only* obtain loans from private sources. Still, this does not necessarily mean that, in these countries, private investors punish fiscal profligacy, as bailout expectations disrupt this market mechanism.

3.3 Fiscal rules

All countries employ fiscal rules to avoid fiscally reckless behavior of local governments (see also Turley et al. this volume). These can, e.g., require a balanced budget, allow debt only to be used for capital investments, set absolute or relative maximum levels of debt, or limit spending. In all countries in our sample bare two, municipalities are subject to some kind of balanced budget rule. However, what a 'balanced budget' actually means varies. In the Netherlands, e.g., the balanced budget requirement does not rule out borrowing, because municipalities use accrual accounting (Allers 2014). Therefore, expenditures to acquire assets does not appear on the budget in the year of acquisition, but are spread out over the economic life of the assets, in the form of interest and depreciation. In Spain, a balanced budget rule exists but does not seem to be enforced. In practice, borrowing by municipalities occurs in all countries in our sample.

Over half the countries in Table 2 have debt limits for municipalities, and so do several German and Swiss states. These limits may be absolute or relative, and sometimes apply to certain kinds of debt (e.g., only to short term debt). As with balanced budget rules, enforcement of debt limits differs greatly between countries. In The Netherlands, there is no upper limit to what a municipality can borrow, but a ceiling related to the term structure of its debt, which aims to prevent interest rate risks. In thirteen countries, a so-called "golden rule" applies, which restricts borrowing to funding capital expenditure.

Fiscal rules limit local autonomy, which comes at a cost. By limiting borrowing capacity, spending capacity or increases in tax levels, local governments can respond less freely to changing circumstances. Absolute limits to borrowing may make capital investments insufficient. Meanwhile, limits to increases in tax levels and spending, such as Denmark uses, restrict local democracy as they make it hard for a municipal council to set its own course.

3.4 Supervision

To be able to punish transgressions, adherence to fiscal regulation needs to be supervised. Indeed, supervision itself may already improve behavior if it makes local administrators more alert. All countries in our sample monitor whether local governments comply with fiscal rules. The literature on regulation distinguishes between four types of supervision: traditional oversight, competition, mutuality and contrived randomness (Lodge and Wegrich 2012).

In most countries, municipalities have to provide standardized fiscal information at regular intervals to higher government tiers. This falls under traditional oversight. In some cases the budgets that are monitored must span multiple years, in which medium-term threats to financial stability need to be addressed. Usually, financial supervision also entails regular deadlines to hand in financial documents. In roughly half the countries in our sample, loans, budgets and annual reports do not need ex ante approval by higher levels of government. In the other countries, at least one of these three requires approval from a higher level of government. In roughly one third of the countries, and some Swiss cantons, individual loans require approval by a higher level of government.

A more competitive approach to supervision may include, e.g., making municipal budgets accessible and easily understandable to the wider public, enabling it to make informed decisions in municipal elections (e.g. the Netherlands, via www.waarstaatjegemeente.nl). This could induce politicians to compete over prudent fiscal policies (yardstick competition). Alternatively, the central government can let public auditors compete over municipal auditing jobs, looking at their previous performance (e.g. Poland). This may lead auditors to be stricter towards municipalities.

It is also possible to foster close professional relationships between individuals at the municipal level and at the national level. These relationships can provide municipal agents with useful information, training and feedback and can induce close cooperation between different levels of government (e.g. Ireland). Alternatively, in some countries municipalities are collectively punished for fiscal malpractices amongst individual municipalities (e.g.

Denmark). This could lead them to monitor each other more closely, to share best practices and to discuss each other's policies. In the Netherlands, a bailout is in effect financed by all other municipalities, which makes administrators of the municipality receiving a bailout grant unpopular among their peers. These example are based on an approach called 'mutuality'.

In some countries, public auditors are selected randomly (e.g. Italy), so no-one knows in advance who will audit a specific municipality. This way corruption, which depends on close ties between individuals who trust each other, may be reduced. Similarly, it may not be known in advance which elements of a loan or budget will be particularly scrutinized (e.g. Ireland). Detailed regulation is often difficult to enforce, by randomly scrutinizing specific elements it is possible to induce municipalities to comply with all the details of the regulation.

3.5 Early intervention

To prevent major fiscal problems, central governments often try to intensify supervision or intervene before major problems occur. More than half the cases in our sample have had a policy for some form of preemptive intervention for more than 10 years, an additional four implemented such measures since the 2009 financial crisis (Finland, Hungary, Italy and Portugal).

In Denmark, the Ministry of Economic Affairs and the Interior requires no local fiscal crisis to force a local government into a fiscal consolidation program. Such a procedure starts automatically when a local government breaks the balanced budget rule. Contrary to the other countries, Bulgaria, Spain, Sweden and Wallonia have never implemented an early intervention procedure.

Italy knows three levels of increasingly burdensome obligations due to fiscal crisis: re-balancing, pre-default and bankruptcy. Under the re-balancing scheme, local governments come under increased scrutiny, retain their autonomy, and can decide themselves how to increase taxation and cut expenses. However, in the scenario of bankruptcy, the national government steps in and freezes debt and interest payments, liquidates assets, and increases taxes.

3.6 Costly bailout

The final tool to discourage the need for bailouts is to make them unattractive. Bailouts may be accompanied by forced fiscal consolidation, loss of local autonomy or personal (criminal) accountability for local politicians or administrators (Allers 2014, Boadway and Shah 2009). In all countries in the sample, breaking fiscal rules, causing a fiscal crisis or needing a bailout are to some extent punished.

Table 3 shows that all countries we surveyed restrict local autonomy in case of bailout. In practice, local politicians perceive a credible loss of autonomy as a grave threat. After all, they lose the ability to shape policy in accordance with the preferences and ideals of the local council. This may have sufficient repellent force to make bailouts very unattractive to local politicians (Allers 2014).

Another way to make bailouts and fiscal crises unattractive to local politicians is making politicians personally (criminally) accountable for their actions. In less than half the countries in our sample politicians or auditors may lose their job or be functionally replaced by central government officers in case of severe fiscal crisis or rule breaking. In theory this count should include Spain, but this regulation does not seem to be enforced in practice. Of course, in all countries financial fraud is punishable in court. The personal implications resulting from fiscal malpractices come in different forms. For instance, in Finland, local politicians may lose their position as the municipality may be forced to amalgamate. Specifically, in case of a local fiscal crisis, an expert group is instituted to guide the local government to fiscal stability. If the local government defies these financial recommendations, amalgamation may follow (Moisio 2015). In countries such as Austria, Estonia and Switzerland, legal sanctions may follow in case of gross negligence or breaking the law. In Flanders this also was possible, however, this has recently been abolished. In England, auditors can lose their license in case of rule breaking.

Table 2: Fiscal regulation in European countries

Country	Average population size[1]	Fiscal equal-ization	Balanced budget rule	Absolute or relative debt limit	Debt only for capital spending	Loan or budget or annual report requires approval	Borrowing from private banks or public sources?
Austria	4.166	Yes	Yes	Yes	Yes	Yes	Private
Belgium	19.177	Yes	Yes	Yes	Yes	Yes	Private
Bulgaria	26.702	Yes	Yes	Yes	No	No	Private and public
Czech Republic	1.688	Yes	Yes	Yes	No	Yes	Private
Denmark	58.459	Yes	Yes	Yes	Yes	Yes	Private and public
England	167.898	Yes	Yes	Yes	Yes	No	Private and public
Estonia	16.657	Yes	Yes	Yes	Yes	Yes	Private
Finland	17.670	Yes	Yes	No	No	No	Private and public
France	1.885	Yes	Yes	Yes	Yes	Yes	Private
Germany	7.449	Yes	Yes	In some states	Yes	Yes	Private and public
Greece	33.181	No	No	Yes	No	No	Private and public
Hungary	3.088	Yes	Yes	Yes	No	Yes	Private
Ireland	151.078	Yes	Yes	No	Yes	Yes	Private and public
Italy	7.617	Yes	Yes	No	Yes	No	Private and public
Netherlands	44.816	Yes	Yes	No	No	No	Private and public
Poland	15.507	Yes	Yes	Yes	Yes	n.a.	Private
Portugal	33.524	Yes	Yes	Yes	Yes	Yes	Private and public

Spain	5.720	Yes	Yes	Yes	Yes	Yes	Private and public
Sweden	34.218	Yes	Yes	No	Yes	No	Public
Switzerland	3.768	Yes	Yes	Depends on canton	No	Depends on canton	Private and public

[1] In 2016. Sources: OECD (2018) and SNGWOFI (2019).

Table 3: Bailout regulations

Country	**Who funds the bailout?**	**Is the bailout a loan or a grant?**	**Preventative intervention possible?**	**Forced fiscal consolidation?**	**(Preventative) loss of autonomy?**	**Personal liability?**[1]
Austria	National government and states	No bailout	Yes	Yes	Yes	Yes
Belgium	Region	Wallonia: Grant Brussels: Loan Flanders: No bailout	Flanders: Yes Wallona: No	Yes	Yes	Flanders: No Wallonia: No
Bulgaria	National government	Loan	No	Yes[2]	Yes[2]	No
Czech Republic	National government	Grant	Yes	Yes	Yes	No
Denmark	National government	Both	Yes	Yes	Yes	No
England	Depends (see text)	See text	Yes	Yes	Yes	Yes
Estonia	National government	Grant	Yes	Yes	Yes	No
Finland	National government	Grant	Not until 2015	Yes	Yes	Yes
France	National government	No bailout	Yes	Yes	Yes	No
Germany	States	Grant	Yes	Yes	Yes	Yes
Greece	Other municipalities	Loan	Yes	Yes	Yes	No
Hungary	National government	Both	Not until 2012/2014	Yes	Yes	No
Ireland	National government	Grant	Yes	Yes	Yes	No

Italy	National government	Both	Only implemented after 2011	Yes[2]	Yes[2]	Yes
Netherlands	Other municipalities	Grant	Yes	Yes	Yes	No
Poland	National government	Loan	Yes	Yes	Yes	Yes
Portugal	Local governments	Grant	Since 2013	Yes	Yes	No
Spain	National government	Both	Since 2012/2013	Yes[2]	Yes[2]	No
Sweden	National government	Grant	No	Yes	Yes	Yes
Switzerland	Canton	No bailout	Yes	Yes	Yes	Depends on the canton

1. Fraud is punishable by law in all countries. Here we refer to the possibility of losing one's job or position as a result of breaking fiscal regulation without fraudulence.
2. In some countries, it is not clear how strictly formal regulation is applied. This makes it difficult to assess whether fiscal consolidation and a loss of autonomy are in fact enforced.

4. Successful policy mixes

Although the economic literature stresses the importance of credible no-bailout rules to prevent local government fiscal crises, local government bailouts are quite rare in many countries lacking such rules. We have presented a range of tools available to countries that seek to limit fiscal irresponsible behavior of local governments. This section describes how the Netherlands, Austria, Denmark, Flanders and Switzerland succeed in preventing the need for frequent bailouts. From this overview, it appears that no single rule or approach can achieve success. Rather, there are different sets of policies which together can increase local fiscal responsibility. In line with what Eyraud and Gomez Sirera (2015) find, all successful countries ensure sufficient funding for regular tasks, be it through an extensive tax base or through sufficient fiscal transfers between levels of government. Other rules which can feature in a successful policy mix are strict fiscal discipline, making bailouts unattractive through attached requirements, and early intervention.

4.1 Bailouts in practice

In the Netherlands, a clear bailout rule exists, enshrined in law, commonly referred to as Artikel 12. Dutch municipalities know that they can expect a bailout if they have a structural budget deficit which they are unable to fix unaided, even if they brought this upon themselves, and bailouts do occur regularly. Yet the number and costs of these bailouts are a far cry from the deluge that is to be expected according to the economic literature. Between 1998–2014, ten different municipalities were bailed out, and received bailout grants for an average of three to four years per municipality. Typical bailout grants varied between 150 and 400 euro per inhabitant per year (Allers 2014). In 2015-2019, two more municipalities were bailed out. Currently, there is less than one bailout per year, on a total of 355 municipalities (in 2019).

In contrast to the Netherlands, Austria has no rules governing the bailing out of municipalities. However, municipalities may receive special grants, *Bedarfszuweisung II*, in order to help it balance its budget. These grants are conditional: they imply tighter fiscal supervision and a strict consolidation program. This means that Austria, in a way, does bail out municipalities after all. Unfortunately, there do not seem to be publicly available data on how often this happens, and how much is paid in such grants.

The Austrian and the Dutch approach, in turn, bear quite some resemblance to the Danish one. Since 1988, 30 Danish municipalities have been put under administration, with the last case occurring in 2011 (Mau, 2015). In roughly 80 percent of these cases, the municipalities received supplementary grants, for 1 to 3 years, of around 80 to 100 euro per capita per year. This is roughly a quarter to half as much as Dutch municipalities received as bailout grants (150 and 400 euro, see above).

A further interesting case is the Belgian state of Flanders. In contrast to the Walloon state, Flanders does not have explicit regulation governing bailouts of municipalities, nor did it bail out a single municipality in the last 25 years (Leroy 2018). However, as Belgian states are responsible for local government finance and supervision, the feeling is that Flanders would step in if needed.

We see that, differences in the legal framework concerning bailouts notwithstanding, actual differences in social costs due to bailouts and fiscal crises may be small. Austria, Denmark, Flanders and the Netherlands are four examples of countries in which higher levels of government are expected to bailout municipalities in trouble, yet in none of the countries do

we observe widespread fiscal problems among local governments. Outcomes do not differ very much from those in Switzerland with its celebrated no-bailout policy.

Even in Switzerland, a credible no-bailout policy may not be the main tool to induce local fiscal responsibility. After all, before the 1998 Leukerbad default, Switzerland's no-bailout policy had never been tested. Although the 1947 federal law absolves cantons of responsibility for local fiscal crises, it does allow cantons to bail out municipalities. Creditors in fact seemed to expect bailouts (Blankart and Klaiber, 2006). This may also be concluded from the fall, by 26 basis points, in cantonal risk premia after the Leukerbad debacle made the no-bailout commitment credible (Feld et al. 2017). Yet, between 1947 and 2019, only Leukerbad went bankrupt. This makes it doubtful that its no-bailout policy is *the* key to Switzerland's success. So what do Switzerland and other successful European countries have in common to limit local government profligacy?

4.2 How to avoid bailouts

The main reason bailouts are rare in the Netherlands seems to be that the requirements are sufficiently unattractive to prevent municipalities from abusing the system (Allers 2014). The bailout procedure temporarily robs Dutch municipalities of their fiscal autonomy. During the entire bailout period, on average 3–4 years, the municipality is under forced administration. It cannot decide to increase spending or reduce revenues, except when not doing so would lead to unacceptable problems. Such exceptions need prior approval from the central government. The municipality must cut back spending in order to regain structural budget balance in several years. The bailout grant amount is tailored to enable the municipality to do this without making cuts that would lead to unacceptably low service levels. An inspector from the central government oversees this process. Consequently, local politicians have very little leeway to put their political programs into practice.

Bailouts also carry a stigma. Fellow Dutch municipalities bear the burden, as bailout grants are paid out of the municipal fund that feeds the equalization grants to all municipalities. Administrators and civil servants are likely to feel peer pressure to avoid such a situation. Furthermore, municipal finances are monitored by Dutch provinces, which look at medium-term budget projections. Provinces intensify supervision if financial troubles loom. This makes it hard for municipalities to break the medium-term budget balance rule without any repercussions. Meanwhile, we can rule out several other potential explanations in the

Netherlands (Allers 2014). E.g., there are no binding rules that restrict municipal borrowing. Moreover, as a result of the bailout system, a local government does not need to behave fiscally responsibly in order to remain creditworthy. Also, fiscal mismanagement does not end Dutch political careers prematurely.

Austria, meanwhile, relies on restrictive regulation and tight supervision. Austrian municipalities are obliged to balance their budget. Austrian states generally restrict local borrowing to funding capital spending, and borrowing is subject to state approval. The states limit short-term credit through strict ceilings, and municipalities usually have to pay back such loans within the fiscal year. If a municipality is not able to do so, the budget is not balanced and the supervisory body can demand that balance is restored within the next fiscal year, through spending cuts or revenue increases. Ultimately, in case of severe fiscal crisis and rule breaking, a state may dissolve a municipal council.

Denmark also severely restricts the fiscal autonomy of its municipalities, including a balanced budget rule and expenditure and tax limits. Current revenues fund most of municipal investment. Borrowing is allowed for utilities which are fully financed by user fees. Apart from that, municipalities can only borrow to finance investments by special permission from the central government. In order to smooth temporary discrepancies between revenues and expenditures, Danish municipalities may use short term credit on the condition that the annual average of these deposits is positive over the last 365 days. Violation of this *Kassekreditreglen* triggers an automatic process aimed at preventing the need for a bailout. The national governments then puts the municipality under administration and monitors it closely as it carries out a fiscal consolidation plan. As fiscal autonomy is very limited, and tax rates cannot be raised at will, this implies spending cuts. However, the municipality may also receive discretionary grants to help its recovery. Although the Danish governments does not seem to consider this a bailout, by our definition, it is.

Flemish municipalities must adhere to a balanced budget rule. Borrowing is limited indirectly through the *autofinancieringsmarge*, which ensures that debt servicing can be financed out of current revenues. Municipalities have a large tax base, which includes property values and personal income, which are not strongly pro-cyclical, so in times of economic downturn Flemish municipalities are ensured sufficient funding. In case a local decision does not comply with fiscal regulation, the state can suspend or nullify it. Breaching the balanced budget rule leads to a suspension of local autonomy, regardless of whether this also immediately leads to a fiscal crisis.

The legal framework in Switzerland is not that dissimilar from the countries described above. Like Flemish municipalities, Swiss municipalities have a large tax base to tap from and do not dependent heavily on fiscal transfers. Nevertheless, all cantons reduce differences in fiscal capacity through fiscal equalization schemes. Like municipalities in the other successful European countries, Swiss municipalities, therefore, have sufficient funding. Moreover, municipalities are supervised by their cantons, they need to comply with a balanced budget rule (at least for the medium term), they often can only borrow for capital investment purposes or to cover short-term deficits, and they need to reduce their deficits at specified rates in many cantons. Cantons scrutinize annual reports to monitor whether municipalities comply with the rules. Moreover, in some cantons municipalities require dispensation for individual loans. Eighteen cantons can reject budget proposals if they do not comply with fiscal regulation.

Additionally, in all Swiss cantons, financial statistics are published for the wider public and the media, and in 22 cantons independent local auditing commissions scrutinize financial statements and budgets. All cantons can intervene and take over municipal government in case of rule violations, even in the absence of a fiscal crisis, with several levels of escalation, ranging from demanding specific behavior or changes in legislation to acting on behalf of the municipality. Lastly, bankruptcy is very unattractive to local governments: it leads to a major loss of autonomy. Courts may also punish individuals if they are found personally guilty of enacting illegal fiscal policies. For instance, in the case of Leukerbad, the municipal president was sentenced to prison for five yours for fraud leading to bankruptcy of the municipality (Neue Zürcher Zeitung 2004).

Again, the similarities between these countries are likely to explain their common success when it comes to limiting local government profligacy. The lack of a no-bailout rule in most of these successful countries is strong evidence that such a rule is not strictly necessary to maintain acceptable levels of local fiscal discipline. However, these countries do have other things in common. Firstly, they all ensure that municipalities can obtain or receive sufficient revenue to execute the tasks they have been assigned. This generally avoids fiscal crises caused by a lack of funding to provide basic public services (Eyraud and Gomez Sirera 2015). Secondly, their central or state governments aim to intervene well before major fiscal problems arise. They require municipalities to maintain a balanced budget, at least in the medium term. The importance of such rules in reducing debt levels is also found in studies of American states (Eyraud and Gomez Sirera 2015). Thirdly, these countries make bailouts or

bankruptcy unattractive, through loss of autonomy, forced fiscal consolidation, and even a loss of job or personal liberty. It appears that maintaining a no-bailout rule is harder than maintaining an unattractive bail-out rule.

4.3 How not to do it

So what causes widespread fiscal crises and bailouts in other European countries? To start, Bulgaria, Finland, Hungary, Italy, Portugal, Spain, Sweden and Wallonia lack (or lacked) early intervention systems. This means that these governments were unable to intervene in municipalities when problems were starting to arise, for instance mounting but still manageable deficits. In some cases early intervention systems were introduced, but enforcement of strict adherence to fiscal rules appears to be absent (e.g. Italy and Spain).

German states do have the option of early intervention, but still there are widespread fiscal problems among municipalities. However, it seems that German municipalities structurally received too little funding to execute their tasks (Heinelt and Stolzenberg 2014). While welfare spending went up, the financial crisis reduced tax income, which depends to an important extent on business profits. States were forced to step in to ensure municipalities had sufficient funding. Moreover, in some states the original oversight body, the Ministry of the Interior, was seen as being too close to local governments. In these states, the Ministry of Finance has taken over supervision of cutback programs. Also, politicians seemed reluctant to force municipalities to cut expenses in light of increasing health care and welfare costs. This is a problem more countries suffer from.

Besides formal rules, a more intangible characteristic is of equal importance, namely the political will to enforce fiscal regulation or to uphold a no-bailout clause. For instance, in Italy, fiscal regulation for local governments is constantly changing. Responses to fiscal crises differ a lot over time and per case, as do the consequences of receiving a bailout. In Spain, much of fiscal regulation does not seem to be enforced. Meanwhile, Hungary in 2011-2014 assumed all debt of all local governments, irrespective of any fiscal need, seemingly purely for political motives (Vasvari 2018). Without political commitment to maintain fiscal responsibility and to avoid bailouts and fiscal crises, any regulation, however good it looks on paper, is doomed to fail.

5. Conclusions and discussion

We have provided an overview of bailout rules and policies, and of the institutions governing local fiscal responsibility, in 20 European countries. Moreover, we have examined how institutions influence fiscal responsibility among local governments. Contrary to the common argument that only a credible no-bailout policy can prevent local government profligacy, we find that many European countries manage to do this through other means. Moreover, the one European country boasting a credible no-bailout policy, Switzerland, may in fact not enjoy a low level of local fiscal irresponsibility as a result of that policy. It seems likely that the Swiss success is due to fiscal rules and practices which are also employed in other countries that are similarly successful. Another conclusion is that formal bailout rules almost bear no resemblance to actual policies. Countries which legally rule out bailouts do in fact bail out local governments, while some countries without such legislation do not.

One of the main theoretical reasons to have multiple levels of government is to enable policy differentiation (Oates 1972). Ironically, we see that local fiscal autonomy has to be limited to some degree to prevent local profligacy. Fiscal decentralization turns a national government into a common pool resource which can be exploited. To prevent this from happening, local autonomy is circumscribed in combination with monitoring of local fiscal policy.

However, in some countries, local autonomy may be limited to an unnecessary degree. Compare for instance the cases of the Netherlands, Flanders and Denmark. In Flanders, municipalities have a broad tax base, but relatively strict debt limits. In the Netherlands municipalities have a relatively limited tax base, but they can borrow relatively freely. Meanwhile, in Denmark it is very difficult to increase tax levels, and borrowing is limited. The Netherlands, Flanders and Denmark could probably all increase local autonomy without imperiling local fiscal responsibility. Denmark and the Netherlands could allow their municipalities more tax autonomy, as Flanders does. Meanwhile, Flanders and Denmark could allow their municipalities to borrow more easily, as their Dutch peers can.

All in all, this is a positive message to countries in which local governments often have fiscal crises. For most countries it was never feasible to become like Switzerland. A credible no-bailout policy is difficult to maintain, and it is likely that Switzerland only manages this because of its long tradition and acceptance of local autonomy and responsibility. However, it is possible to design a system of fiscal regulation which prevents widespread, large-scale,

recurring problems. Becoming like Denmark, Austria, Flanders or the Netherlands is more feasible, by providing sufficient funding, timely supervising local budgets, limiting local budget autonomy, and making bailouts politically costly. However, without the political will to enact and enforce fiscal rules, all this will be futile.

Appendix

Much of the information used to write this chapter is derived from two sets of sources. Firstly, information is taken from *Local Public Finance in Europe: Country Reports* (Geissler R., Hammerschmid G. and Raffer C. 2019). Secondly, information has been gathered by the authors through correspondence with country experts. We would like to thank the following experts for their help: Falk Ebinger (Austria), Jan Leroy (Belgium), Koenraad de Ceuninck (Belgium), Juraj Nemec (Czechia), Michal Placek (Czechia), Niels Jørgen Mau Pedersen (Denmark), Dennis de Widt (England), Viktor Trasberg (Estonia), Celine Duboys (France), Nikos Hlepas (Greece), Izabella Barati (Hungary), Gerard Turley (Ireland), René Geissler (Portugal), Filipe Teles (Portugal), Dirk Foremny (Spain), Lars Feld (Switserland). Wherever we make a specific claim about a country, and do not provide a citation, we have based this claim on the country reports edited by Geissler, Hammerschmid and Raffer, or we base ourselves on the aforementioned correspondence. Of course, we are responsible for any mistakes we may have made.

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