

# THE DUTCH LOCAL GOVERNMENT BAILOUT PUZZLE

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MAARTEN A. ALLERS

The fiscal federalism and public choice literatures stress that government bailouts should be ruled out as they increase the probability that jurisdictions will incur unsustainable debt levels or take excessive risk (moral hazard problem). The recent problems in the euro area seem to confirm this view. However, in the Netherlands, the law explicitly stipulates that local governments which are unable to balance their books will receive a bailout grant. Surprisingly, this does not seem to create problems. Few local governments apply for bailout, and the amounts they receive are modest. We analyse the Dutch case and investigate possible explanations for this apparent anomaly. Our results challenge the dominant view in the literature. It is possible to avoid fiscal irresponsibility by means other than a no-bailout policy.

## INTRODUCTION

In many countries, government has become more decentralized in recent decades. Decentralization has been promoted based on different arguments: democracy and good governance; preservation of cultural and ethnic identity; and economic rationales (Rodríguez-Pose and Sandall 2008; Kwon 2013). However, the realization has grown that decentralization may create a common pool problem. In some cases, local or regional governments succeed in shifting part of the burden of their public services onto the national taxpayer because they operate under a soft budget constraint.

The concept of soft budget constraints goes back to the seminal work of Kornai (1980). When a subnational government faces a soft budget constraint, it expects a higher level of government to support it in the case of financial distress. This expectation may be based on formal institutions or regulations, or on informal practices. A soft budget constraint weakens a subnational government's incentive to avoid excessive borrowing or risk taking. This results in an inefficient allocation of resources.

Regulation aimed at preventing subnational governments from getting into trouble, such as constraints on deficits or on borrowing, may be useful but often comes with loopholes. The recent European sovereign debt crisis illustrates that this is true for national governments as well. Studies of the effectiveness of borrowing constraints provide mixed results (e.g. Ter-Minassian and Craig 1997; Jin and Zou 2002; Rodden 2002; Singh and Plekhanov 2005; Broyles *et al.* 2009). The literature stresses the difficulty for potential rescuers to credibly commit themselves to a no-bailout policy *ex ante* (e.g. Dewatripont and Maskin 1995; Goodspeed 2002; Kornai *et al.* 2003; Rodden 2006). Even if subnational governments are themselves to blame for getting into financial difficulties, bailouts sometimes happen. That is because there is a lot of pressure to prevent public services such as healthcare or education from disappearing as a result of local government bankruptcy.

With the literature in mind, the Dutch policy regarding local government fiscal distress seems rather surprising. Dutch law explicitly states that local governments which are no longer able to balance their books may apply for a bailout. This bailout takes the form of a gift, not a loan. Bailouts occur even in cases of local fiscal irresponsibility.

Contrary to what the theory would predict, however, this system seems to be perfectly sustainable. Few Dutch municipalities need to be bailed out, and the total amount spent on

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Maarten A. Allers is in the Faculty of Economics and Business, and Center for Research on Local Government Economics (COELO), University of Groningen, The Netherlands.

bailouts is modest. After being bailed out, municipalities tend to improve their financial situation fairly rapidly, without the need for new bailouts later on. The bailout system does not appear to give municipalities a strong incentive to misbehave.

Bailouts may be beneficial if financial distress is caused by factors truly outside the control of subnational administrators. In that case, timely bailouts may be cost-effective and avoid unacceptable damage to public service provision. Moreover, the explicit bailout guarantee enables Dutch municipalities to borrow cheaply. Indeed, the two Dutch banks specializing in loans to local governments, BNG Bank and NWB Bank, enjoy triple-A ratings. Feld *et al.* (2013) show that lower risk premiums for jurisdictions which are potentially bailed out imply higher risk premiums for jurisdictions that potentially bail out. In the Dutch case, however, it is the collectivity of municipalities that pays for bailouts. The Dutch bailout system operates as a mutual insurance, lowering risk premiums overall. Finally, a strict no-bailout policy may provide excessive incentives for a high degree of effort, or discourage investment that is socially efficient (Besfamille and Lockwood 2008). Maskin (1999) shows that *ex post* bailouts may be a part of an optimal fee schedule designed to incentivize agents to put more effort into *ex ante* project screening.

Thus, if a bailout system without perverse incentives for local administrators exists, it is important to know what it consists of. The purpose of this article is twofold. First, we investigate the Dutch bailout system and its institutional context. Second, we intend to explain why the bailout system has not proven to be unsustainable, that is, why it is not over-exploited as the literature would suggest.

The following section discusses the literature and derives hypotheses. The third section describes the relevant fiscal institutions, and the Dutch experience with bailouts. The fourth section sets out our research strategy, which relies on process tracing, combining qualitative and quantitative research. The fifth section tests the hypotheses. The final section concludes.

## DECENTRALIZATION AND FISCAL DISCIPLINE

In the traditional fiscal federalism literature, subnational governments are portrayed as autonomous decision making units, responsible for their own set of tasks, and operating under a hard budget constraint (Musgrave 1959; Oates 1972). Revenues are provided mainly by subnational taxes and user charges, supplemented by modest intergovernmental transfers to account for externalities. Administrators are accountable to local voters. As a result, they have an incentive to operate efficiently.

Few countries are organized like this. In practice, task assignment is murky, with many tasks effectively shared between different levels of government (Rodden 2006), which reduces transparency and accountability (Geys and Vermeir 2012). In many, especially European, countries, national law requires subnational governments to provide nationally uniform levels of essential public services as part of an attempt to guarantee equal standards of living to all citizens. To enable subnational governments to finance this, grants are provided. Subnational governments' ability to raise taxes or their freedom to borrow or spend is often limited, which weakens fiscal accountability. Brueckner (2009) calls this partial fiscal decentralization.

Under such circumstances, it is only natural that voters, creditors, and local administrators expect the central government to solve any subnational insolvency problems. As Rodden (2006) states, 'when the center dominates the power to tax and takes on heavy obligations to fund subnational governments, it cannot credibly commit to withhold bailouts

TABLE 1 *Ways to avoid fiscally irresponsible behaviour of governments*

Actor	Action	Mechanism
Higher level of government	No-bailout policy	Bailout made impossible
	Bailout conditions	Bailout made unattractive
	Fiscal rules	Influence on fiscal behaviour
	Financial supervision	Influence on fiscal behaviour
Creditors	Lending conditional on fiscal position	Influence on fiscal behaviour
Voters	Political costs	Influence on fiscal behaviour

in the event of a local fiscal crisis'. This creates a moral hazard problem. If some of the costs of local services can be shifted to other jurisdictions, why be frugal and responsible? In such a setting, public funds form a common pool which is easily over-exploited (Tullock 1959).

Analytically, several solutions to this problem are conceivable (table 1). In the first place, one might rule out bailout altogether (no-bailout policy). Alternatively, bailout may be made so unattractive (i.e. costly to the relevant decision makers) that it will only be used in cases of exogenous crises. If either policy is effective, subnational jurisdictions will not try to exploit the system. If both fail, the relevant stakeholders can try to influence subnational fiscal behaviour directly, for example by limiting their freedom to get into financial trouble. Here, we consider three stakeholders: higher levels of government; creditors; and voters. Higher levels of government can introduce fiscal rules such as borrowing restrictions or financial supervision. Creditors can demand sound fiscal policy from would-be borrowers. And voters can remove fiscally irresponsible politicians at the polls. Here, we describe each of these mechanisms in turn.

### No-bailout policy

According to Rodden (2006), only Switzerland, Canada, and the United States have credibly committed themselves to a no-bailout policy. Although such a policy might be optimal in the long run, it is difficult to maintain. Any exception to this rule would immediately revise upwards existing bailout expectations of creditors and subnational governments. Several empirical studies confirm that bailout expectations weaken fiscal discipline (Garcia-Milà *et al.* 2001; Bordignon and Turati 2009; Pettersson-Lidbom 2010).

A local default can be painful, involving closing down schools, hospitals, and other essential facilities (Singh and Plekhanov 2005). This makes refusing bailout politically costly. Von Hagen *et al.* (2000) show that bailouts are more likely if refusing these would put at risk the orderly provision of public services which are regarded as especially sensitive.

Fiscal externalities may also result in pressure to bail out subnational jurisdictions. A default by one jurisdiction may raise the cost of borrowing for others in the same country, or even threaten the creditworthiness of the entire country.

A credible no-bailout policy requires that a sufficiently large share of subnational government spending is financed by own-revenues – that is, taxation. Then, subnational governments are able to increase revenues if necessary to cope with fiscal setbacks. Otherwise, seeking bailout is often the only alternative, as spending usually cannot be reduced drastically in the short run. Subnational tax autonomy is often limited (Blöchliger and King 2006), reducing the scope for a credible no-bailout policy.

Many countries have a formal no-bailout policy, while in practice bailing out subnational governments when needed. Sometimes, local governments look for bailouts from a regional, not the central, government. According to Seitz (2000), German regions (*Länder*) formally rule out bailouts of local governments, but have secretly stashed away funds in case such a bailout is needed.

As we have seen, the Netherlands has the opposite of a non-bailout policy. We now derive a number of hypotheses that may explain why this does not lead to problems.

### Hypotheses

By seeking bailout, politicians can shift part of the burden of what they spend on outsiders. Whether this is attractive or not depends on the consequences – or costs – of a bailout. Bailouts are normally accompanied by conditions aiming to improve fiscal health as soon as possible (e.g. Von Hagen *et al.* 2000). Such conditions restrict subnational politicians' policy options. For example, bailouts can be made conditional on tax increases or reductions in the subnational government's fiscal autonomy. This makes bailout unattractive.

Under a no-bailout policy, the costs attached to a bailout are unknown, as there can be no rules covering this case. Thus, a non-credible non-bailout policy might lead politicians to believe that these costs will be bearable. An explicit bailout policy, on the other hand, may improve transparency and create sufficiently high costs to subnational politicians to prevent abuse.

Thus, if few bailouts are sought, that might be due to the high costs associated with them.

*Hypothesis 1:* Bailout requirements are sufficiently unattractive to prevent municipalities from abusing the system.

If bailouts cannot be ruled out or made sufficiently unattractive, fiscal rules may seem an attractive alternative. Spending ceilings, balanced-budget rules, or borrowing restrictions may reduce the risk that subnational governments get into trouble. Empirical evidence suggests that countries where subnational governments rely heavily on intergovernmental grants tend to restrict those governments' borrowing autonomy (Von Hagen and Eichengreen 1996; Rodden 2006).

*Hypothesis 2:* Fiscal rules prevent municipalities from accumulating unsustainable levels of debt.

The flip side is that such rules limit the options open to subnational governments faced with unexpected economic downturns (Milesi-Ferretti 2003; Singh and Plekhanov 2005). Thus, rules cannot be too strict, as a result of which they tend to be easy to circumvent by creative accounting. Moreover, the much-touted benefits of decentralization are only likely to materialize if subnational government is given sufficient autonomy. Apart from that, many studies document that fiscal rules are often dodged in practice (e.g. Granof 1984; Craig 1997; Ter-Minassian 1997; Von Hagen *et al.* 2000; Jørgen and Pedersen 2002; Ahmad *et al.* 2004).

Apart from enforcing fiscal rules, financial supervision by a higher tier of government may also ensure that fiscal practices which are not exactly illegal, but may nevertheless lead to problems, are detected early enough to prevent mishaps. This will be especially helpful in cases where subnational governments have limited financial expertise. Of course, in such cases, higher tiers of government can do little more than advise the supervised jurisdiction to mend its ways. They cannot impose reforms. However, financial supervisors can also help by publishing warnings that may alert the public or the local

council to fiscal risks. This would help them in disciplining the local government. In the Netherlands, financial supervision of municipalities is carried out by the provinces.

*Hypothesis 3:* Provincial financial oversight prevents municipal fiscal problems.

The eurozone sovereign debt crisis has again highlighted the importance of creditworthiness. Access to credit is vital to governments at all levels. Countries sometimes reduce deficits even in cases where this clearly harms economic growth, just in order to defend their credit ratings. This points to another mechanism, found in the literature, which could possibly help to restrain irresponsible fiscal behaviour: pressure from creditors (e.g. Rodden *et al.* 2003). Even if jurisdictions do not go bankrupt (as seems to be the case with countries), credit may be restricted or expensive if lenders fear being bailed-in.

*Hypothesis 4:* In order to preserve creditworthiness, municipalities must behave in a fiscally prudent manner.

Finally, voters may punish subnational politicians for being bailed out. This requires that voters place the blame at the correct level of government, and that they are unwilling to shift part of the burden onto other jurisdictions. In practice, local voters might in fact reward their politicians for receiving bailout grants, because this shifts part of the burden of local finance onto outsiders. On the other hand, bailouts may also be seen as a sign of incompetency, and be punished by voters.

*Hypothesis 5:* The political costs of fiscal mismanagement are prohibitive.

The empirical evidence is limited. According to Von Hagen *et al.* (2000), even if they were successful in obtaining bailouts, Australian state governments paid a high political price for what voters obviously perceived to be fiscal profligacy. Brender (2003) found that Israeli local politicians were punished for running deficits and incurring debt during the 1998 elections, but not in the elections of 1989 and 1993. This may be the result of a hardening of the local government budget constraint after 1993.

## INSTITUTIONAL SETTING

### Local government finance

Although it started life in 1588 as a federal state, the Netherlands nowadays is a unitary country. Subnational government consists of 12 provinces and (in 2014) 403 municipalities. Formally, municipalities have considerable autonomy regarding public service provision. In practice, however, there exists a lot of public and political pressure to provide an implicit 'minimum level' of public services. Municipalities falling behind may be singled out in press coverage fuelled by pressure groups, or they may be the subject of questions in the national Parliament. Such pressure could easily result in financial problems for cash-strapped municipalities. However, in the Netherlands, fiscal disparities are to a large extent equalized through an elaborate grant system. Thus, municipalities are able to provide similar service levels at similar tax rates. The equalization grant is formula-based and does not contain discretionary components. The variables in the allocation formula were chosen with an eye to preventing municipalities from influencing the amount of grant they receive.

Dutch municipalities depend heavily on funds provided by the central government, with little power to raise taxes (Allers and Elhorst 2011). This vertical fiscal imbalance makes it difficult for subnational governments to handle substantial financial setbacks. As we have seen, countries with a high degree of vertical imbalance often impose borrowing restrictions on subnational governments, in order to protect the central

government against bailouts. In the Netherlands, there are two legal restrictions with respect to subnational government borrowing. Both apply to the term structure of government debt, not to total debt levels. There are no spending ceilings.

Municipal administrators are supervised by the municipal council (horizontal supervision), which is elected through proportional representation every four years. The Municipality Law states that the council must ensure that a municipality's budget is balanced. An exception may be made if the local budget is expected to balance in one of the subsequent years, but this seldom happened in the period under study.

Municipal councils are not normally composed of persons with much financial expertise. Therefore, provinces are assigned the task of supervising municipal finances (vertical supervision). If needed, provinces can supply signals enabling the council to take measures to rein in administrators. Provinces themselves cannot force municipalities to take certain measures.

### **Legal framework bailouts**

As far back as 1933 a law was introduced which stipulated that municipalities in need may receive bailout grants. The current system was introduced in the Financial Relations Act (*Financiële-verhoudingswet*) of 1960. Bailout arrangements have not changed fundamentally since then. Article 12 of the Financial Relations Act stipulates that a municipality may receive a supplementary grant if revenues are significantly and structurally insufficient to cover necessary outlays, while local tax rates are sufficiently high. The grant money is taken from the Municipality Fund, from which general (unconditional) grants to all municipalities are paid. Thus, grants to other municipalities, not the budget of the central government, suffer when a municipality is bailed out.

Whether or not a municipality is bailed out is decided by the central government. The municipality must apply for bailout itself. The central government is guided by advice from the relevant province, specialists from the Ministry of the Interior, and the independent Advisory Council on Financial Relations (Rfv).

### **Local government bailouts in practice**

In 1967, the first year in which bailout grants under Article 12 of the Financial Relations Act were provided, 15 per cent of all municipalities were bailed out. As the number of small municipalities was reduced steadily, and the fiscal equalization system was refined, bailout became less frequent, as shown in figure 1. In 1998–2014, just ten different municipalities were bailed out, and received bailout grants for an average of three to four years per municipality. In a single year, an average of less than four municipalities (0.7 per cent) received a bailout grant in this period.

Since the gradual introduction of an elaborate new grant equalization system in 1997–2005 (Allers and Vermeulen 2013), bailout has become a rare event. Recall that this equalization grant is formula-based. Implicit bailouts through this grant do not happen (unlike, e.g. in Germany; see Fink and Stratmann 2011).

Before the new equalization scheme was in place, bailouts were often believed, rightly or wrongly, to result from insufficient means, combined with nationwide minimum standards for local public services. Thus, there was no strong stigma attached to bailout. Since then, each municipality is supposed to be able to finance the standard package of local services while levying a standard tax rate. Thus, municipalities bailed out after 1997 are much more likely to bear responsibility.



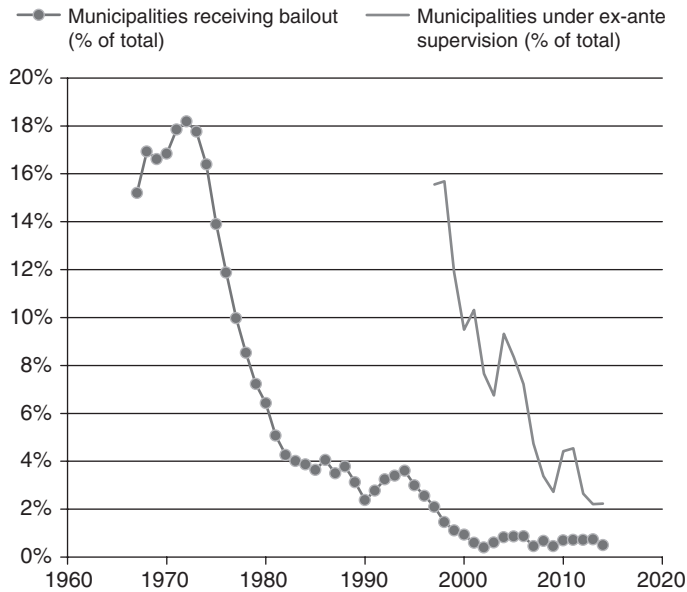


FIGURE 1 *Municipalities with bailout grants or under ex ante provincial supervision*

Typical bailout grants vary between 150 and 400 euro per inhabitant per year (figure 2; euros of 2013). Over the entire bailout period, this amount can get as high as 2,800 euro per inhabitant (Boskoop). Although bailout amounts are sometimes large in local per capita terms, as a percentage of the municipal fund, from which they are financed, they are not (0.1 per cent on average in 1998–2013).

If the central government believes that the fundamental reason for the troubled financial position of a municipality is local mismanagement, bailout is still granted. In such cases, however, it may require tax rates above the normal minimum rates. We identify four such cases in 1998–2014 (out of a total of ten, see above).

## METHODOLOGY

Now that the Dutch bailout system has been described, we turn to possible explanations for the fact that, in spite of what the theory predicts, it seems to be quite sustainable. From the above, it should be clear that, on theoretical grounds, the risk of fiscal irresponsibility on the part of Dutch municipalities, and of frequent bailouts, is substantial. Municipalities provide many public services that are important in people's daily life. The national government is widely considered to be ultimately responsible for the (continued) provision of local public services. Municipalities depend heavily on intergovernmental grants, and have little leeway to increase tax revenue. Bailouts are guaranteed provided financial problems are big enough, even in cases of obvious mismanagement. In the next sections, we test the hypotheses introduced in the second section.

Before we do so, we describe our methodology. In the social sciences, providing absolute proof that a hypothesis is true is usually not feasible. That goes for qualitative and quantitative research alike. Ultimately, acceptance depends on the plausibility of the evidence that supports the hypothesis, and on elimination of alternative hypotheses. This study relies

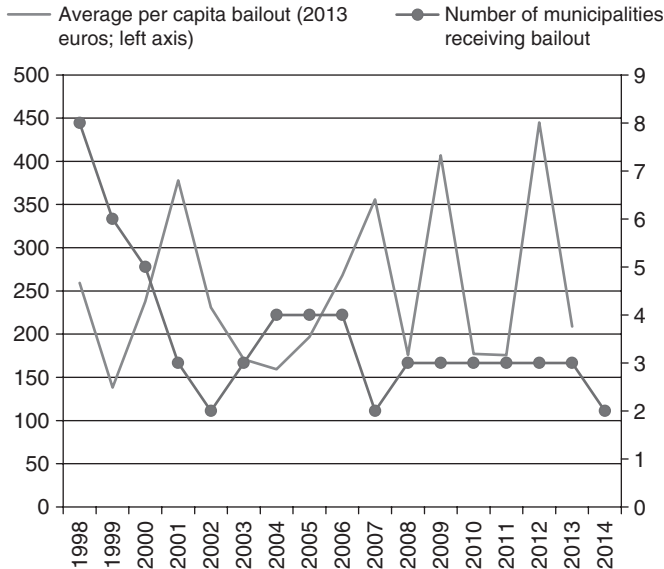


FIGURE 2 Number of bailouts and per capita amount

on process tracing (Collier 2011), which is suitable for small-n studies or case studies and aims to establish the causal mechanisms underlying the observation to be explained. By examining facts and the sequence of events, hypotheses can be strengthened or rejected. To test, for example, whether political costs are effective in preventing bailouts, a first step would be to establish what mechanisms are needed to make that work. In the next step, each mechanism would be put to the test. Even though process tracing will not always be able to eliminate all but one hypothesis, it can be useful by narrowing the range of possible explanations. It is important not just to test the preferred or most likely hypothesis, but to consider alternatives as well (Lorentzen *et al.* 2014).

The most satisfying kind of test at once confirms a hypothesis and eliminates others. A single test that can do this is not normally available. Then, a case must be built based on a number of weaker tests. Collier (2011) identifies three types: the smoking gun (confirms the hypothesis if passed, otherwise the hypothesis is weakened but not rejected), the hoop (eliminates the hypothesis if the test has failed, otherwise it affirms its relevance), and the straw-in-the-wind (adds support if passed, otherwise weakens it).

In the next section, we examine the hypotheses derived above, which are not mutually exclusive.

## HYPOTHESES TESTING

### Hypothesis 1: Bailout requirements are sufficiently unattractive to prevent municipalities from abusing the system

#### *High tax rate*

Two conditions for getting a bailout may be unattractive for local politicians. The first is that the local property tax rate must be at least a certain percentage above the average rate in the preceding year, for the entire period covered by the bailout procedure. This



percentage was 40 per cent in 1994–2001 and has been 20 per cent since 2002. However, this minimum tax rate requirement is unlikely to be an effective deterrent. That is because, until 2012, the average tax rate used to evaluate this requirement was not the actual average, but a nominal tax rate (*rekentarief*) used in the allocation formula of the grants supplied from the municipal fund. This nominal ‘average’ tax rate is in fact significantly lower than the true average. In 2010, for example, the minimum tax rate required to qualify for bailout was 1 per cent *below* the true average tax rate.

Since 2012, the true tax rate has been used to evaluate this requirement. Still, for this to make bailout sufficiently unattractive, local taxes need to be sufficiently high. In the Netherlands, local taxation is relatively unimportant. In 2012, the average home-owning household paid only 239 euro (other households, 40 per cent of total, do not pay property tax). That is about 110 euro per capita. Bailout grants are usually higher (figure 2).

The hypothesis that the minimum tax rate requirement makes bailout sufficiently unattractive is rejected, at least for the period before 2012.

### *Loss of autonomy*

A second feature making bailout unattractive is that it greatly reduces local autonomy. During the entire bailout period, on average 3–4 years, the municipality is under forced administration. It cannot take decisions that lead, directly or indirectly, to higher spending or lower revenues, except when not doing so would lead to unacceptable problems. Exceptions must be approved by the central government. The municipality must cut back spending. An inspector from the Ministry of the Interior oversees this process.

Consequently, local politicians have very little leeway to put their political programmes into practice. This may give them an incentive for prudent fiscal policy. There are two necessary conditions for this. The first is that politicians’ time horizon is long enough. The second is that they are more than just office-seekers: they must value autonomy – that is, they must care what policy is carried out by their jurisdiction.

To start with the first condition: the time lag between excessive risk taking or borrowing and a possible bailout is at least several years. Municipal councils are elected every four years. If aldermen or members of the council do not expect to keep office after the next elections, they might not care that the municipality’s budgetary freedom is endangered. This allows us to design a hoop test for hypothesis 1: can local politicians reasonably expect to be in office long enough to be confronted with the effects of fiscal mismanagement?

Dutch municipalities are governed by coalitions. After the elections, one or more of the old coalition parties are usually included in the new government. We investigated how often this happened in the elections of 1998, the first year of our research period. As it turns out, no less than 74 per cent of the parties that were part of the former coalition also became part of the new coalition after these elections. In only 3 per cent of the municipalities were all coalition parties excluded from the new local government. Indeed, in many municipalities (42 per cent), *all* coalition parties kept their seats in the government. In the elections of 2002, 2006, and 2010, a majority of coalition parties survived the elections as well. This means that, in general, the time horizon of local politicians should be long enough to care about the effects of bailout on budgetary autonomy.

We conclude that hypothesis 1 passes this hoop test.

If hypothesis 1 is true, we would expect that bailouts occur more often in municipalities where local politicians’ time horizon is relatively short. We put this to the test. In order to rule out reverse causality, we introduce a time lag. In municipalities that were bailed out in 2001–14, coalition parties did less well at the polls in 1998. Here, not 74

TABLE 2 *Descriptive statistics of variables used in table 3*

	N	Mean	S.D.	Min	Max
Percentage of coalition parties that remained in power after 1998 local elections	338	74.1	24.4	0	100
Inhabitants (,000)	338	36.5	62.3	1.0	718
Average number of addresses per square kilometre	338	0.09	0.09	0.01	1.42
Share of inhabitants older than 64	338	0.13	0.03	0.06	0.28
Share of inhabitants younger than 20	338	0.25	0.03	0.18	0.44
Share of ethnic minorities	338	0.04	0.04	0.003	0.23
Share of benefit recipients	338	0.09	0.03	0.04	0.17

but 50 per cent of all coalition parties remained in local government after the elections of 1998. We ran a logit regression where the dependent variable was a dummy that took the value one if the municipality was bailed out, or put under *ex ante* financial supervision, in 2001–14. The independent variable of interest is the percentage of coalition parties that remained in power after the local elections of 1998. We use this variable as an indicator of how confident politicians could be that they would keep office, and thus, of the length of their time horizon. As control variables we use some characteristics linked to local governments' spending, also applying to 1998 (Statistics Netherlands). Descriptive statistics are presented in table 2. Table 3 shows that a one percentage point increase in the percentage of coalition parties that remained in power after the local elections of 1998 results in a decrease of the bailout probability of 2.8 per cent ( $(1 - e^{-0.0285}) * 100\%$ ). This effect is quite strong and statistically significant. There is no effect on the probability of stricter (*ex ante*, see below) financial supervision by the province, however.

Of course, table 3 does not provide decisive evidence that hypothesis 1 is correct. An alternative explanation could be that in municipalities where a higher share of coalition politicians is re-elected, politicians are more experienced, and therefore less prone to financially irresponsible behaviour. However, we consider the result in table 3 to be a straw-in-the-wind test that supports hypothesis 1.

A second necessary condition for our hypothesis that fear of loss of autonomy prevents fiscal irresponsibility is that politicians value autonomy. That is not self-evident. Politicians might be satisfied with office itself, not caring about policy. Previous research in the Dutch setting concludes that local governments in their tax policy deviate to some extent from the preferences of the electorate, as reflected in the composition of the council. Allers *et al.* (2001) conclude from this that aldermen are 25 per cent policy-seekers and 75 per cent office-seekers. Keeping in mind that some extent of office-seeking (getting re-elected) is essential in order to pursue policy in the future, it seems that Dutch politicians are sufficiently ideologically motivated to care about loss of autonomy.

We consider this as a straw-in-the-wind test that supports hypothesis 1.

### **Hypothesis 2: Fiscal rules prevent municipalities from accumulating unsustainable levels of debt**

Dutch municipalities must balance their budgets, and there exist two legal restrictions with respect to borrowing. International comparisons usually list the Netherlands with countries where subnational borrowing is restricted (e.g. Rodden 2006). If debt financing is effectively ruled out, the need for bailouts may not arise. This section presents a hoop test for hypothesis 2.

TABLE 3 *Effect of time horizon on probability of ex ante financial supervision and bailout in 2001–14*

	<i>Ex ante supervision</i>	<i>Bailout</i>
Percentage of coalition parties that remained in power after 1998 local elections	–0.00214 (–0.35)	–0.0285** (–2.33)
Inhabitants (,000)	–0.00197 (–0.04)	–0.032 (–0.46)
Average number of addresses per square kilometre	–0.938 (–0.80)	1.002 (0.36)
Share of inhabitants older than 64	8.634 (1.18)	–16.12 (–0.68)
Share of inhabitants younger than 20	8.115 (0.94)	–8.935 (–0.46)
Share of ethnic minorities	–7.411 (–1.10)	–103.4** (–2.26)
Share of benefit recipients	5.163 (0.71)	2.291 (0.22)
Constant	–4.831 (–1.51)	4.672 (0.59)
Observations	338	338

Notes: Logit regression; 338 observations; robust z-statistics in parentheses. Municipalities amalgamated in 1998 or later left out of the analysis.

\*\*\*p < 0.01, \*\*p < 0.05, \*p < 0.1.

First, consider the balanced-budget requirement. There are two reasons why this does not rule out deficit financing. In the first place, municipalities use accrual accounting. Expenditures to acquire assets do 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, as in business. Thus, a municipality may borrow heavily while at the same time presenting a balanced budget. In the second place, budgeted spending and budgeted revenues are not necessarily realized. In the final accounts, an initial deficit (or surplus) is simply balanced by a corresponding change in the municipality's general reserve. By definition, this makes total revenues (including funds taken from the general reserve) equal to total spending. In 2010, for example, 32 per cent of municipalities ran an initial deficit (Statistics Netherlands).

Two legal rules directly apply to subnational borrowing. The short-term debt ceiling (*kasgeldlimiet*) holds that, for municipalities, the average net short-term debt (i.e. due within one year) is limited to 8.5 per cent of budgeted spending for each quarter of a fiscal year. The long-term debt ceiling (*renterisiconorm*) limits the amount of long-term debt (with a maturity of one year or more) for which the interest rate is subject to change in a given year (because it reaches maturity, or because the interest rate is not fixed) to 20 per cent of budgeted spending.

Both rules apply to the term structure, not to debt levels. However, they might limit the amounts municipalities can borrow in practice. For a sample of 100 municipalities, we checked whether the short-term debt ceiling or the long-term debt ceiling was binding in 2010. We find that the short-term debt ceiling was broken by 38 per cent of all municipalities in the sample in at least one quarter of 2010 (table 4). It seems that some municipalities benefited from the fact that, in this period, short-term debt was considerably cheaper than long-term debt. Apparently, breaking this rule does not immediately

TABLE 4 *Percentage of municipalities that broke the short-term debt ceiling in one or more quarters of 2010*

Number of quarters in which ceiling was broken	Percentage of municipalities
0	61
1	14
2	8
3	9
4	7

TABLE 5 *Room below the long-term debt ceiling, 2010*

Room below the long-term debt ceiling	Percentage
Average room to increase debt (% of budgeted spending)	13
Percentage of municipalities with debt at 0–50% of ceiling	73
Percentage of municipalities with debt at 50–75% of ceiling	14
Percentage of municipalities with debt at 75–100% of ceiling	8
Percentage of municipalities with debt above ceiling	5

result in sanctions from the province, which acts as supervisor. Most municipalities in our sample could increase their short-term debt considerably before hitting the legal ceiling.

With regard to long-term debt subject to interest rate changes, municipalities on average had used up only 7 percentage points of the available 20 per cent of budgeted spending (table 5). Thus, they could increase such debt by 13 per cent of budgeted spending and still be within legal borrowing restrictions. Most municipalities (73 per cent) could more than double their debt before hitting the legal ceiling.

Clearly, Dutch law does not put restrictions on municipal debt that are effectively binding. This is not just a theoretical nicety. In 2010, total municipal debt varied from 4 per cent of total spending in Leusden to a staggering 252 per cent in Bernisse (Statistics Netherlands). The average is 73 per cent. The only limit on borrowing is the need to finance interest and depreciation through the budget. If the budget can no longer be balanced, bailout may be granted.

We conclude that hypothesis 2 is eliminated.

### **Hypothesis 3: Provincial financial oversight prevents municipal fiscal problems**

Provinces are assigned the task of overseeing municipal finances. Normally, provincial supervision is *ex post*. Municipalities must send the budget for the coming fiscal year to the province. The budget must include forecasts for the three years after the relevant fiscal year. If the province is not convinced that a municipality's budget is structurally balanced, or if it foresees financial problems in the future, it may impose *ex ante* financial supervision (*preventief toezicht*). *Ex ante* supervision may also be imposed if a municipality fails to submit its annual budget in time, which is often a sign of financial difficulty.

The criteria for imposing *ex ante* financial supervision are not clear and differ between provinces. The decision to impose *ex ante* financial supervision is made public, and is often reported in the local press. Municipalities under *ex ante* supervision must submit their annual budget, and every supplementary budget, *ex ante* to the province for approval. The province will not accept proposals that it deems insufficient to ensure a

timely return to a healthy financial position. It will try to coax the municipality to take the budgetary measures it deems necessary. It has no power to impose such measures, however.

There has been some discussion on whether provincial oversight is unnecessarily strict. Recently, two provinces experimented with looser forms of financial supervision: Noord-Brabant (2007–10) and Limburg (2005–10). Both experiments were evaluated (Provincie Limburg 2010; Vink and Karamat Ali 2010). During the experiment in Noord-Brabant, no municipality was placed under *ex ante* supervision. The province continued to monitor the municipalities' budgets, but in a less detailed manner than before. Moreover, it did not publish its judgment on the soundness of local budgets. During the experiment in Limburg, every municipality's finances were investigated in depth once. If no problems were found, a light form of *ex post* supervision was implemented for the next four years.

During or after the experiments, no participating municipality asked to be bailed out. The financial position of participating municipalities does not appear to differ from that in the rest of the country. Both experiments lasted a relatively short period. We cannot conclusively answer the question whether provincial oversight prevents bailouts. It seems, however, that local politicians have not taken the opportunity to let fiscal policy get out of hand during the four consecutive years in which they were monitored only lightly.

This weakens hypothesis 3.

#### **Hypothesis 4: In order to preserve creditworthiness, municipalities must behave in a fiscally prudent manner**

Here, we present a hoop test by investigating whether a municipality's creditworthiness depends on its fiscal policy. If that is not the case, the hypothesis is eliminated.

Dutch municipalities borrow from banks. Because of the bailout system, credit is cheap and easily available. Thus, there is no reason to issue bonds. We interviewed an official of BNG Bank, one of the two publicly owned banks that specialize in loans to the public sector. BNG Bank has a market share of over 50 per cent.

We asked whether the fiscal condition of a municipality affects its ability to secure a loan, and whether it affects the interest rate. The answer was crystal clear: fiscal condition is irrelevant. Because of the bailout system, default risk is zero. Since BNG Bank was founded in 1914, every loan to a Dutch municipality has been fully serviced. A credit request will go directly from the client to the money dealer who arranges the loan. The interest rate does not contain a risk premium.

This eliminates hypothesis 4.

#### **Hypothesis 5: The political costs of fiscal mismanagement are prohibitive**

Financial mismanagement may weaken electoral support, but that is not necessarily true. Many voters will be aware that, if things get out of hand, bailout grants will prevent local services from collapsing, passing on the bill to the rest of the country. Still, voters could read bailouts or increased provincial oversight as a sign of incompetence on the part of the local government. First, we investigate whether local administrators have stepped down relatively often after bailouts. Then, we test whether re-election of local politicians has been affected by bailouts or the imposition of *ex ante* provincial supervision.

#### ***Administrators stepping down***

In the Netherlands, a single party seldom collects enough votes to be able to form a local government on its own. Coalition governments are the norm. Coalition parties choose the

local administrators (aldermen), who, since 2002, have no seat in the council. Together with the mayor, the aldermen form the local government. The mayor is not elected but appointed by the national government, and has limited executive powers.

If the municipal council no longer supports the local government, it can force one or more aldermen to step down. Political crises do not result in elections; the local election calendar is set nationally. In 1998–2010, 28 per cent of aldermen stepped down (Castenmiller *et al.* 2010). Most of them seem to have stepped down for political reasons, but the exact share is unknown.

First, we counted the number of aldermen who stepped down in municipalities which were bailed out in 1998–2011 (VNG).<sup>1</sup> For each municipality, we limit our count to the year the bailout grant was received, plus the three preceding years. That is because it usually takes some time for a financial crisis to result in bailout. In municipalities receiving bailout, 30.8 per cent of aldermen stepped down in non-election years. Next, we used the national percentage (28.1 per cent) to calculate the percentage in municipalities that were not bailed out, using data available on [www.decentraalbestuur.nl](http://www.decentraalbestuur.nl). This is 28.0 per cent. This percentage is lower than the percentage in bailout municipalities (30.8 per cent), but the difference is small.

So far, we find no evidence that supports hypothesis 5.

### *Re-election of local governments*

Even if local administrators are seldom forced to step down after a bailout, it is possible that voters punish them at the polls. Note, however, that the road from fiscal irresponsibility to bailout takes at least a number of years. Voters may have difficulty identifying who was responsible, or the culprits may already have left office after previous elections. This may make it difficult for voters to use bailout information to punish irresponsible politicians. Therefore, we include financial supervision in the analysis. This instrument can be applied as soon as problems are apparent, and it provides voters with information they may use at the polls. We test empirically whether re-election of coalition parties has been affected by bailouts, or by the imposition of *ex ante* provincial supervision, using data from the local elections in 2002, 2006, and 2010.

As the dependent variable we use the (relative) change in the vote share of the parties that form the local government (Center for Research on Local Government Economics (COELO)). Minority governments are quite common, because the fragmentation of the municipal council sometimes means that the minimum number of parties needed for a majority coalition exceeds the number of seats available in the local government. Thus, using a dummy variable indicating re-election of the previous coalition government is not practical.

As the independent variables of interest, we use dummies for bailout and *ex ante* financial supervision in the election year and the three preceding years. It seems likely that it is not the status regarding bailout or *ex ante* supervision as such that signals incompetence to voters, but a change in this status for which the current administration is responsible. After all, mismanagement by a previous government cannot be blamed on the current one. Therefore, we defined dummy variables with value one if the municipality is involved in bailout or *ex ante* supervision in the election year or one or two years before the election, but not three years before the election.

Among our control variables is the share of the coalition parties in the local council before each election. A high vote share in the previous elections makes it more difficult to win extra votes, and vice versa. Thus, we would expect a regression towards the mean,



TABLE 6 *Descriptive statistics of variables used in tables 7–9*

	N	Mean	S.D.	Min	Max
Change of vote share coalition parties	1272	-0.066	0.112	-0.538	0.385
Relative change of vote share coalition parties	1272	-0.102	0.183	-0.875	0.740
Bailout in election year, or one or two years before election	1272	0.010	0.101	0	1
Bailout in election year	1272	0.009	0.097	0	1
Bailout one year before elections	1272	0.009	0.093	0	1
Bailout two years before elections	1272	0.011	0.104	0	1
Supervision in election year, or one or two years before election	1272	0.083	0.275	0	1
Supervision in election year	1204	0.033	0.179	0	1
Supervision one year before elections	1142	0.047	0.212	0	1
Supervision two years before elections	1074	0.061	0.240	0	1
Change in tax burden	1272	0.040	0.047	-0.138	0.402
Vote share coalition in previous elections	1272	0.632	0.104	0.259	0.968

resulting in a negative sign. A second control variable is the relative increase in the local tax burden in the election year (COELO). Presumably, tax hikes are unpopular with voters. The literature on political business cycles has produced some empirical evidence that, for this reason, tax rates are sometimes reduced in election years (see, e.g. Aidt *et al.* 2011 and the literature cited therein).

In addition, we use year dummies to control for nationwide sentiments that may influence the urge to punish local governments. We also introduce dummy variables which take the value of one if a certain party is part of the local coalition government, and interact these with year dummies. Thus, for example, the dummy 'cda2002' takes the value of one if the Christian Democrat party (CDA) was part of the local coalition in 2002. These dummies are designed to pick up national trends in party popularity. We use such dummies for the three main parties: CDA, VVD (Conservatives), and PvdA (Social Democrats). Table 6 presents descriptive statistics.

Table 7 presents results of the full model, both with the absolute change in the vote share of the coalition and the relative change of this vote share as the dependent variable. As the dependent variables are proportions, OLS is not an appropriate method here. Instead, we ran logistic regressions (Papke and Wooldridge 1996). This means that the coefficients should be interpreted as log-odds ratios. Because vote shares can both increase and decrease, dependent variables are in the range  $[-1, 1]$ . In order to be able to run logistic regressions, we transformed the dependent variables to be in the range  $[0, 1]$ . This was done by dividing each value by 2 and adding 0.5.

Variables reflecting national trends seem most important to explain the vote share of local coalitions. This is consistent with the previous research finding that local elections are often decided on the basis of national party preferences (Dunleavy 1980; Boyne 1996; Boogers *et al.* 2011). The local characteristics included in our regression play a minor role. Year dummies turn out to be quite significant, suggesting that in both 2002 and 2006, coalitions not including CDA, VVD, or PvdA were more likely to lose votes than in 2010. Coalitions with Christian Democrats did well in 2002 and 2006; coalitions with Conservatives did well in 2010; and coalitions with Social Democrats did well in 2006 and badly in 2010.

The share of the coalition in the previous council has a significant coefficient, which is negative, as expected. The change in the local tax burden has no effect on the vote share of the local coalition. Previous research suggests that local governments are reluctant, for

TABLE 7 *Effect of bailout and ex ante supervision on change in vote share of coalition parties*

	Absolute change in vote share coalition	Relative change in vote share coalition
Bailout in election year, or one or two years before election	-0.012 (-0.19)	-0.027 (-0.28)
Supervision in election year, or one or two years before election	-0.020 (-0.92)	-0.048 (-1.32)
Change in tax burden	-0.021 (-0.16)	-0.015 (-0.07)
Vote share coalition in previous elections	-0.476*** (-7.20)	-0.502*** (-4.31)
year2002	-0.133*** (-2.82)	-0.227*** (-2.82)
year2006	-0.126** (-2.55)	-0.210** (-2.39)
cda2002	0.146*** (5.20)	0.250*** (5.20)
cda2006	0.123*** (3.97)	0.196*** (3.44)
cda2010	0.023 (0.97)	0.044 (1.11)
vvd2002	0.018 (0.82)	0.033 (0.92)
vvd2006	-0.007 (-0.32)	-0.010 (-0.27)
vvd2010	0.052*** (2.61)	0.096*** (2.84)
pvda2002	0.033 (1.44)	0.055 (1.50)
pvda2006	0.193*** (8.40)	0.322*** (8.3)
pvda2010	-0.100*** (-3.79)	-0.176*** (-3.88)

Notes: Logistic regression estimates; 1,152 observations; robust z-statistics in parentheses.

\*\*\* $p < 0.01$ , \*\* $p < 0.05$ , \* $p < 0.1$ .

political reasons, to let their tax rate deviate much from tax rates in neighbouring municipalities (Allers and Elhorst 2005). In our dataset, the local tax burden for households rose 4 per cent (20 euro) on average in election years (table 6). That may be too little to be noticed by voters.

Surprisingly, *ex ante* supervision or bailout in the election year or the two years before do not seem to affect the coalition's vote share (table 7). In order to distinguish between different periods of supervision or bailout on the one hand and elections on the other, we ran some additional regressions. Table 8 shows the results for bailouts, and table 9 for *ex ante* supervision. These regressions include the same control variables as those in table 8, but their coefficients are not reported because they are similar to those in table 8 (results are available from the author upon request). In just one case we find a coefficient that differs significantly from zero: *ex ante* supervision in the year before the elections seems to reduce electoral success of the coalition. This coefficient is only significant at the 10% confidence level, however (table 9). *Ex ante* supervision in the election year or two years before an election does not significantly diminish the coalition's vote share.

TABLE 8 *Effect of bailout on relative change of vote share of coalition parties*

	(1)	(2)	(3)	(4)
Bailout in election year, or one or two years before election	-0.066 (-0.07)			
Bailout in election year		-0.019 (-0.18)		
Bailout one year before elections			0.041 (0.42)	
Bailout two years before elections				0.043 (0.55)

Notes: Logistic regression estimates; 986 observations; robust z-statistics in parentheses.  
\*\*\*p < 0.01, \*\*p < 0.05, \*p < 0.1. Control variables not shown.

TABLE 9 *Effect of ex ante supervision on relative change of vote share of coalition parties*

	(1)	(2)	(3)	(4)
Supervision in election year, or one or two years before election	-0.042 (-1.14)			
Supervision in election year		-0.081 (-1.18)		
Supervision one year before elections			-0.095* (-1.82)	
Supervision two years before elections				-0.012 (-0.27)
Observations	1152	1114	1052	986

Notes: Logistic regression estimates; robust z-statistics in parentheses.  
\*\*\*p < 0.01, \*\*p < 0.05, \*p < 0.1. Control variables not shown.

We conclude that no evidence is found that voters punish financial misbehaviour. We reject hypothesis 5.

## CONCLUSIONS

We analyse the Dutch system of bailing out local governments in cases of fiscal difficulties. This system is rather unusual, explicitly guaranteeing bailout even in cases of obvious financial mismanagement. Nevertheless, we show that bailouts are rare and the amounts needed insubstantial. This article aimed to explain this apparent anomaly. We formulated five hypotheses and conducted a number of tests. These are summarized in table 10.

We have been able to eliminate three hypotheses. In the Netherlands, there are no binding rules that restrict municipal borrowing. Moreover, a local government does not need to behave fiscally responsibly in order to remain creditworthy. Third, fiscal mismanagement does not end political careers prematurely. Thus, it is possible to have an explicit bailout policy even without safeguards such as these.

This goes against the literature, especially because, on theoretical grounds, the risk of fiscal irresponsibility on the part of Dutch municipalities is substantial. Dutch municipalities provide many public services that are important in people's daily life. The national government is widely considered to be ultimately responsible for the continued provision of local public services. Municipalities depend to a very large extent on intergovernmental

TABLE 10 *Summary of hypotheses testing*

No.	Short description	Test	Test type	Result
1	Costly bailout: tax increase	Bailout leads to substantial tax increase	Hoop	Eliminated
1	Costly bailout: autonomy loss	Local politicians have long time horizon	Hoop	Passed
		Negative effect of time horizon on bailout probability	Straw-in-the-wind	Strengthened
		Policy matters to politicians	Straw-in-the-wind	Strengthened
2	Fiscal rules	Existence of binding borrowing restrictions	Hoop	Eliminated
3	Provincial oversight	Effect of less strict oversight	Straw-in-the-wind	Weakened
4	Creditworthiness	Relevance of fiscal policy for creditworthiness	Hoop	Eliminated
5	Political costs	Existence of political costs	Hoop	Eliminated

grants, and have little leeway to increase tax revenue. Historically, bailouts do not carry a strong stigma in the Netherlands, as these used to be quite common in the 1970s and 1980s.

Provincial financial oversight might keep local fiscal policy in check, but experiments with looser oversight have not resulted in noticeably weakened fiscal positions, let alone bailouts. Thus, although this hypothesis cannot be eliminated, it has been somewhat weakened.

This leaves hypothesis 1: bailout requirements are sufficiently unattractive to prevent municipalities from abusing the system. We can rule out the minimum tax rate requirement: insofar as this actually results in tax increases, these are completely insubstantial. However, bailout temporarily robs Dutch municipalities of their fiscal autonomy. We offer evidence that Dutch local politicians are more than office-seekers: it matters to them what policy is adopted. Thus, loss of autonomy may hurt local politicians – if their time horizon is sufficiently long. We provide evidence that shows that, in the Netherlands, coalition parties may realistically hope to be part of a new coalition after elections. Thus, local politicians are likely to be sufficiently forward-looking to have an incentive to avoid financial crises. We also find that the probability of bailout is higher in municipalities where local politicians are less sure of keeping office after the elections and thus may have shorter time horizons. This further strengthens hypothesis 1.

Of course, other explanations can never be fully ruled out. One might surmise, for example, that Dutch culture or ideology prevents abuse. The literature provides no testable hypotheses underlying such assertions, nor could we think of any. In fact, we do not think the Dutch differ fundamentally from people in surrounding countries. Indeed, customs in Dutch municipalities close to the Belgian or German borders may resemble those on the other side of the border more closely than those in Dutch municipalities on the other side of the country. Although this does not imply that Dutch-style bailout policies can be applied safely anywhere, the current no-bailout doctrine in the literature should be reconsidered. There are other countries where subnational politicians can be expected to have a long time horizon (e.g. Belgium, Germany). Attaching enough strings to bailouts might work there as well. Our conclusions might also be relevant for supranational organizations such as the European Union. There, a no-bailout policy clearly has not worked.

A no-bailout policy that lacks credibility may invite fiscally irresponsible behaviour because the costs to the perpetrators are unclear and thus easily underestimated. It might be preferable to have an explicit bailout policy instead, with clear rules making bailout sufficiently unattractive, with it being plausible that they will be actually implemented. This might prevent governments from speculating that the repercussions will be mild, as seems to have been the case in the eurozone bailouts.

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## NOTE

<sup>1</sup> VNG. *Gids Gemeentebesturen*. Den Haag: Sdu; Editions 1999–2011.

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