

The process of fiscal consolidation in Europe in the aftermath of the global financial and Euro sovereign debt crises has brought to the forefront the challenges of enforcing fiscal discipline in federal or decentralized countries. The literature on enforcing fiscal discipline in federal or decentralized countries. The literature on fiscal federalism has attributed this challenge to the presence of soft budget constraints at the subnational level. That is, the inability of subnational governments (henceforth SNGs) to keep fiscal deficit outcomes within targets set as part of fiscal consolidation strategies at the general government level. Soft budget constraints have been shown to originate from the inability of central governments (hereafter CGs) to credibly commit to not bailing out SNGs and, as such, to constrain SNGs fiscal outcomes. Soft budgets have been shown to be driven by political motives, including re-election and stability. They are aggravated by flawed intergovernmental fiscal institutions, including large vertical fiscal imbalances, weak fiscal rules, and limited market discipline. Flawed institutions act by raising expectations among voters and creditors that CG must be accountable in the event SNGs are not able to fulfill their spending mandates or debt obligations. Soft budget constraints have been typically assessed by exploring the determinants of fiscal outturns using fiscal reaction functions.

A small but growing empirical literature on the implementation of fiscal consolidations offers a different perspective. Rather than searching for reasons for why fiscal outcomes cannot be constrained and targets enforced, it questions whether fiscal targets or the forecasts basing such targets are set appropriately in the first place. A number of papers have shown that official forecasts tend to be optimistic among advanced economies. Optimistic fiscal forecasts have been attributed to difficulties in forecasting downturns and booms in real time and strategic reasons. Another set of factors are related to strategic considerations, which have been shown to be salient in the EU among countries seeking to comply with the Maastricht convergence process and ex-ante deficit rules under the Stability and Growth Pact.

This paper contributes to both literatures by seeking to better understand the determinants of fiscal non-compliance at the subnational level [and] we define fiscal non-compliance as events when SNG budget balance outturns are below corresponding targets.

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