



## Decentralization and the challenge of hard budget constraints

*Reaping the benefits of decentralization requires mitigating its potential costs.*

Since the early 1980s fiscal and political decentralization have spread around the world. But do the benefits of decentralization—increased public sector efficiency and accountability—outweigh the potential costs? Decentralization can encourage dangerous opportunistic behavior by state and local officials. Left unrestricted, such opportunism can undermine macroeconomic stability and other objectives.

The most pressing manifestation of this problem is the softening of subnational budget constraints. The impact of decentralization on public sector efficiency and macroeconomic stability depends on a country's ability to prevent lower-level governments from passing on their liabilities to higher-level governments. Brazil's recent financial crisis was triggered by state-level defaults on debt payments—demonstrating the urgent need for institutional mechanisms that discipline borrowing by state and local governments.

This note draws on case studies of 11 countries—7 developing and transition economies and 4 OECD countries—to identify institutional factors associated with hard and soft budget constraints and extract policy lessons for other countries (see Rodden, Eskeland, and Litvack forthcoming and <http://www.worldbank.org/publicsector/decentralization/>). Fiscal, political, and financial institutions can facilitate hard budget constraints by strengthening competition at the local level—especially for capital—and by strengthening the central government's ability to regulate local borrowing and other activities. But such institutions can also promote soft budget constraints, inspiring subnational gov-

ernments to overborrow, overspend, or undertax on the assumption that the central government will cover their liabilities.

### Market discipline takes time to develop

Institutions can foster market-based fiscal discipline by encouraging voters, creditors, and asset owners to monitor local fiscal decisions and punish local leaders for making imprudent fiscal decisions. This role can also be assumed directly by the central government, which might enforce local fiscal discipline through rules, regulations, and administrative oversight.

Although well-functioning markets allocate credit better than hierarchies, and local oversight is generally preferable to central oversight, the Bank's client countries generally require a combination of market and central government mechanisms. Fiscal, political, and financial institutions often undermine pure market discipline, especially in developing and transition economies. Thus strong, centrally imposed fiscal restrictions may be needed, especially at the early stages of decentralization. The most prudent strategy seeks to strengthen market and rule-based mechanisms at the same time.

### Local creditors and constituents can enforce fiscal discipline...

The first and most basic mechanism for enforcing a hard budget constraint is a set of institutions that clearly conveys that local governments will bear the costs and benefits of their fiscal decisions. When this mes-

Effective decentralization requires hard budget constraints for local governments

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sage is also conveyed to creditors, voters, and asset owners, three additional mechanisms come into play. First, capital markets will constrain local fiscal decisions, and local governments will face limited access to credit if they do not make sound fiscal decisions. Second, profligate local officials will be voted out of office. Third, markets for land and other assets will supplement the market for votes—knowing that local fiscal decisions directly affect their property values and rents, land owners will likely lobby against imprudent debt, and owners of mobile assets might threaten to move.

### **. . . but only if institutions provide incentives to do so**

The problem with these market-like mechanisms is that they work well only when subnational governments have considerable fiscal autonomy, when voters and creditors have good information about local fiscal performance and risk, and when the central government is able to make a credible commitment that it will not provide bailouts. In the 11 countries surveyed, only U.S. states and Canadian provinces meet these conditions.

### **Three features are essential for fiscal institutions**

By reforming basic fiscal institutions, it may be possible to enhance accountability and strengthen incentives for market discipline. Three features stand out.

#### *Clear division of responsibilities*

Many of the Bank's client countries could stand to clarify revenue, spending, and regulatory powers. If there is much overlap and confusion in the assignment of authority between central and subnational governments—as in Ukraine—citizens and creditors may not have the ability or the incentive to distinguish between central and local obligations.

#### *Powers and revenues that match responsibilities*

Subnational governments must have enough revenue to implement their spending responsibilities. In many developing countries (South Africa, Ukraine) central governments

have mandated that subnational governments provide key public goods but have not devolved sufficient revenue for them to do so. In addition, local governments are more likely to credibly shift blame for local fiscal crises if the central government controls local spending decisions. For instance, public employment regulations in Brazilian states enable governors to claim that they have little room to maneuver when facing adverse fiscal shocks. If creditors and citizens are to perceive local obligations as truly local, central regulations must allow subnational officials to adjust to adverse shocks on their own.

#### *Well-designed transfers*

Subnational governments typically rely on revenue raised or regulated by higher levels of government. This setup can weaken local accountability and undermine the credibility of the central government's commitment to withhold bailouts (Rodden 2000). While a vertical fiscal imbalance is often unavoidable in developing countries, local budget constraints can be hardened by strengthening the local tax base, improving local tax administration, and encouraging local fiscal effort.

More important than the amount of intergovernmental transfers is how they are distributed. Transfers are often distributed through highly discretionary, political, and unpredictable processes, as in Brazil and Ukraine. But even rule-based transfers can create perverse incentives by rewarding poor fiscal performance, as in Germany and India.

The most important objective is to create predictable intergovernmental transfers that favor rules over discretion, encourage local effort, and give local politicians, their constituents, and their creditors few reasons to expect bailouts. Transfers should not be subject to yearly bargaining among politicians. Expert commissions and independent agencies may be helpful in reducing discretionary bargaining.

### **Political institutions are critical in hardening budget constraints**

Local politicians and their constituents are much more likely to expect bailouts in systems with decentralized, fragmented legis-

latures and weak party discipline. In such systems legislative coalitions may be hard to form, and vote trading is common. Such logrolling helps explain why a central government would provide bailouts to certain states even though bailouts are inefficient for the federation as a whole. Bailout expectations may be particularly strong if subnational officials are well represented in the central legislature, as in many federal systems.

Still, few countries are likely to pursue far-reaching reform of basic political structures. More realistically, central governments can enhance their no-bailout commitments by delegating authority to independent agencies, autonomous central banks, and (perhaps most important) independent arbitrators and courts. Reforms that increase the access of voters and creditors to information about local government performance will also enhance market discipline. More generally, reforms should fortify local democracy and strengthen links between local politicians' performance and their tenure in office.

### **Financial institutions also have an important role to play**

Public and private financial institutions can undermine or strengthen both market- and rule-based forms of fiscal discipline. In particular, the central government's role in the allocation of credit deserves careful scrutiny.

#### *Government transactions that undermine budget discipline*

In some countries the lending activities of the central government and its agencies have undermined hard budget constraints. India's central government has occasionally forgiven state debts. In Argentina, Brazil, and Germany states borrow from banks owned or controlled by subnational governments, undermining lender independence.

Privatization of such banks in Argentina and Brazil, and reform of the state-owned Landesbanks in Germany, may strengthen lender independence. Budget constraints can also be hardened by privatizing locally owned state enterprises, since these can also serve as conduits for excessive local borrowing.

#### *Local credit markets as a source of discipline*

A central government that allocates credit by administrative fiat may be unable to credibly commit to not provide bailouts. Thus it is important to reduce the central government's role in credit allocation and to strengthen local capital markets. Links between credit ratings and fiscal outcomes are growing stronger in several countries, including Germany, India, and South Africa. As borrowing from government intermediaries is replaced by borrowing from capital markets, fiscal discipline is expected to improve.

But it is not enough to simply set local governments free in domestic and international capital markets and hope for the best. Like asset owners and voters, creditors will discipline local fiscal decisions only if they are convinced that local borrowing is not explicitly or implicitly backed by the central government. They will take cues about the likelihood of bailouts from the fiscal and political institutions described above. If these cues suggest that the central government will provide bailouts if pressed, market incentives will do little to constrain local spending and borrowing decisions.

#### *The role of rule-based mechanisms*

While market mechanisms can and should be strengthened, they are often insufficient—especially in developing countries embarking on decentralization. In most of the Bank's client countries, local governments have little autonomy to set and raise taxes, creditors and voters have poor information and incentives, and the central government cannot fully commit to a no-bailout policy. In such cases additional hierarchical mechanisms might be needed to achieve hard budget constraints.

This does not mean that central governments must prohibit local access to credit markets. Rather, the central government might limit local deficits and debts, require that all or some borrowing be centrally approved, or not allow local governments to borrow to cover current spending (see Ter-Minassian and Craig 1997 and *PREMnote 15*).

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Central regulations might also seek to increase transparency and accountability in local budget processes. Following New Zealand's example, Argentina has passed a wide-ranging Fiscal Responsibility Law. Brazil is considering similar legislation. The proposed Brazilian legislation not only limits debt issues and personnel spending, it also introduces new budget rules and accounting principles to increase transparency at every level of government.

#### *Who will guard the guardians?*

One problem with central controls on local spending and borrowing is that they may make voters and creditors even less likely to view local governments as responsible for their obligations. Nor are such restrictions necessarily compatible with most of the efficiency and accountability advantages of decentralization. Moreover, central restrictions are only as strong as central enforcement.

Some of the case studies, however, show that it is possible to implement rules that simultaneously:

- Limit local autonomy and discourage opportunistic behavior.
- Clearly state that the costs and benefits of local fiscal decisions will be borne locally.
- Foster market-based discipline.

As noted, enforcement can be made more credible by delegating it to autonomous courts and agencies. For example, Hungary and South Africa recently implemented local bankruptcy laws that largely depoliticize the process, relying on courts and independent arbitrators.

### **Conclusion**

Central regulations need not undermine market discipline. Indeed, they can facilitate it by promoting local revenue collection, improving information, accounting,

and auditing, implementing and enforcing limits on borrowing to cover current spending, and clarifying bankruptcy procedures. Above all, reforms can improve the information and incentives of voters and creditors.

In many developing and transition economies that are rapidly decentralizing, hard budget constraints may require rules that restrain local borrowing in the short term. But in the long term such rules should let local voters and creditors know that local obligations are indeed local. As experience with decentralization evolves, subnational governments can gain revenue autonomy and establish credible track records of no bailouts—allowing them to move from rule-based to market-based enforcement mechanisms.

### **Further reading**

Rodden, Jonathan. 2000. "The Dilemma of Fiscal Federalism: Hard and Soft Budget Constraints around the World." Massachusetts Institute of Technology, Cambridge, Mass.

Rodden, Jonathan, Gunnar Eskeland, and Jennie Litvack, eds. Forthcoming. *Decentralization and Hard Budget Constraints*.

Ter-Minassian, Teresa, and John Craig. 1997. "Control of Subnational Government Borrowing." In Teresa Ter-Minassian, ed., *Fiscal Federalism in Theory and Practice*. Washington, D.C.: International Monetary Fund.

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*If you are interested in similar topics, consider joining the Decentralization Thematic Group. Contact Jennie Litvack (x80519), send an email to decentralization\_mail@worldbank.org, or click on Thematic Groups on PREMnet.*



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