

Chapter 2

Argentina: Hardening the Provincial Budget Constraint

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In setting hard budget constraints on subnational finances, Argentina has gone from being one of the worst countries in the 1980s to being one of the more promising in the 1990s among middle income countries that have democratically elected subnational governments. The constraints developed in the 1990s are relatively complete, leaving no major loopholes, although they are fragile in the sense of having only one institution or interest group sustaining them, and so they still appear vulnerable.

Argentine provinces in the mid 1980s faced exceptionally soft budget constraints and, as one would therefore expect, had high deficits that were about half of the overall public sector deficit. Then, in a series of steps over the next ten years, policy changes-- particularly at the federal level-- tightened the constraints and filled various gaps. This raises two questions: Why was there a soft budget constraint in the 1980s? How was it possible to harden it thereafter? As we shall see, the latter was a more difficult process and will receive the most attention.

¹ LCPSR, World Bank. The views here are those of the author and are not necessarily the position of the World Bank. This paper draws heavily on Dillinger and Webb (1999). It benefited from comments by Jonathan Rodden, Francisco Eggers, and Gunnar Eskeland, who bear no responsibility for any remaining shortcomings.

To understand the evolution of provincial budget constraints over time, it is important to know the macroeconomic and political-constitutional backdrops of the drama.

I. Macroeconomic background

In the 1980s, Argentina went through its worst hyperinflation, peaking in 1989 and bringing the economy and society to what was widely seen as the brink of collapse. The new administration of Carlos Menem then had a mandate to take drastic measures to stabilize the economy. After a few months of indecision and miscues, Menem brought in Domingo Cavallo as Minister of Finance, who engineered a successful stabilization and fiscal adjustment of the whole public sector. Provincial fiscal adjustment contributed to the overall public sector reform and Menem gained political support for being part of it. (See Table 1).

From the point of view of intergovernmental finances, the most important fiscal development associated with the stabilization was the rapid growth of tax revenues that were shared with the provinces. This was partly a direct result of new policies, particularly some improvements to tax collection and enforcement, and partly an endogenous result of the stabilization – without high inflation there was no longer the massive erosion of the real value of tax revenue resulting from the delays in payment. Such delays had been particularly costly to the provinces, because their own taxes and the taxes shared with the federal government were levied on domestic currency flows. (The exclusively federal taxes were on trade and therefore levied in foreign exchange.)

Without adequate tax revenues during hyperinflation, the provinces came to depend on the inflation tax, along with the federal government. They borrowed from their provincial banks, who then discounted the debt at the central bank, effectively giving the provinces a share in the seignorage from inflation.

Table 1. Growth, Inflation, and Fiscal Balances in Argentina, 1983–97

	(percent)			
<i>Country and indicator</i>	<i>1983–87</i>	<i>1988–90</i>	<i>1991–94</i>	<i>1995–97</i>
Real growth (annual average)	1.77	-3.43	8.89	2.69
Inflation (annual average)	370	1,910	53	1.3
Overall balance (% of GDP)				
Central	-5.11	-0.87	0.27	-1.32
Subnational	-4.90	-1.99	-1.33	-0.88
Primary balance (% of GDP)				
Central	-3.44	-0.07	1.40	0.28
Subnational	-4.84	-1.76	-1.16	-0.56
Public enterprises			0.73	0.02

Source: Ministry of Economy, Argentina; International Monetary Fund *GFS* and staff estimates, and authors' estimates.

II. Constitutional and Political Framework

Argentina has a long history as a federal country, now with 23 provinces plus the city of Buenos Aires. It is a presidential system, as everywhere in Latin America, with considerable power vested in the office of the president. Congress in normal times must approve his main fiscal policy initiatives, but he has substantial patronage and party discipline with which to convince them, and executive emergency powers are extensive and-- at least prior to the 1994 constitution-- were frequently used. Two additional features deserve special attention.

First, the executive or the military have suspended the normal constitutional process frequently. The military has taken over the national government twice since 1950, most recently in 1976-82. Under both civilian and military rule the national government has frequently taken over state governments, often dismissing elected governors. At least three provinces had such interventions in the 1990s, and Cordoba had federal interventions for 24 of the last 50 years (Nicolini, et al., 1999; Cordoba, 1997). So the constitutional and practical autonomy of provinces face limits that would not permit serious flaunting of the rules. In contrast, the Brazilian states have not faced such strong limits, and as a result, they have been able to ignore or circumvent central rules (See chapter 3).

Second, political geography makes the Argentine federation very asymmetric in practice, even though the constitution does not prescribe special treatment for any province. Buenos Aires province has 38 percent of the nation's population, 48 percent when combined with Buenos Aires city, and together they generate well over half of the national GDP. This gives them a strong position in the lower house of Congress and a dominant position in the economy and public finances. Indeed, as the main source of tax revenue and the locus of the majority of the cost of any macroeconomic instability, Buenos Aires's gains from prudent macro-fiscal policy make it worthwhile for them to pay a substantial part of the cost, in contrast to the usual pattern in federal systems pointed out in chapter 1, where every state has incentives to refuse to contribute to national fiscal prudence in hopes of free-riding. At the other end of the size spectrum of provinces, all of the smaller-than-average states get above-average representation per capita in the senate, and the minimum of 5 representatives per provinces gives ten of

them substantially more representation than a one-person-one-vote system. Consequently, if it costs a certain amount of resources per voter to win the support of any state, buying support of a low-population province will cost less than support of a high population province.

III. Historical evolution of fiscal federal relations

Although the 1853 constitution limited the federal government's taxing power to taxes on foreign trade, it granted the power to impose domestic direct taxes "for a determined time period" and subsequently allowed the federal government to impose domestic indirect taxes concurrently with the provinces (Murphy 1995). During the 1930s, in response to a drop in foreign trade taxes, the federal government introduced national income and sales taxes that replaced most existing provincial taxes. To compensate provinces for lost revenue, it established a system of revenue sharing (known as coparticipation). Revenue sharing has become more complex but remains the backbone of provincial revenues. Despite the historical origins that give provinces rights to share in the revenues, the national government makes all the decisions on the tax rates for the shared taxes.

Because of its historic origins, the allocation of *coparticipaciones* is made by a *ley de convenio*, a type of super law that requires the approval not only of both houses of Congress and the president but also of each of the governors. While the military government (1976-83) used intervention and coercion to by-pass these rules, they brought about deadlock in the mid 1980s after democracy was restored. The Radicals had the

Presidency and had weak control of the lower chamber of Congress, while Justialistas (Peronists) controlled a slim majority of provincial governments and thereby also the indirectly-elected Senate. The divided government could not reach an agreement on distribution of participaciones, so they were all distributed by executive discretion, as *Aportes del Tersouro Nacional* (ATNs) (World Bank 1990; Garman, Haggard and Willis, 1996). The latter had existed for years, and continue to exist, but they became the main channel for transfers to provinces from the federal budget. While there was presumably some capriciousness by the executive in the distribution of these funds, the main problem seems to have been provinces getting additional funds as conditions for political support needed by the weak president. In tandem with central bank funding, discussed below, this situation in the mid 1980s represented the epitome of a soft budget constraints for provinces.

In 1987 the Justialistas took control of the lower chamber of Congress and expanded their control of states and the Senate. This broke the deadlock and led to the 1988 *Ley de Coparticipaciones*. This law remains in effect, although it was substantially altered by two fiscal pacts in the early 1990s and is overdue for a complete revision. As one would expect, the Justialistas wanted to shift resources to the provinces as a group and passed a relatively generous formula for allocation of transfers to provinces, higher than in the early 1980s and equal in real terms to the formula transfers of the late 1970s. The law specifies that allocation by formula of 99% of the revenues from shared taxes, leaving 1% to be distributed by ATNs.² Most of the ATNs have gone to small provinces

² The pool of taxes subject to coparticipation consists of the federal income tax, valued added tax, excise and asset taxes-- all the major federal domestic taxes except those on fuel and social security. Before the transfer, several deductions are made from the provinces' share and are given to the national social security system and to several special funds for the provinces. Of those destined for special provincial funds, the

since 1988, which has softened the budget constraints of these provinces. By the same token, the executive has effectively no discretion in distributing meaningful resources to the large states. The law does set a firm limit on transfers to the large states and thus to the majority of provincial spending, so it has been a success for improving fiscal stability. The formula does not, however, return to a province most of any extra revenues generated there, meaning that it provides very weak incentives for provincial fiscal effort, and is ultimately fiscally inefficient (World Bank 1999). Also it is weak in improving equity, for the distribution is only weakly correlated with poverty indicators or (negatively) with per capita income.

The most important determinants of the per capita distribution of transfers are the per capita representation in congress, the inverse of population density (which also translates into more political clout per capita) and being the home province of the president (Porto and Sanguinetti, 1998; Sanguinetti and Tommasi, 1997; Kraemer 1997). Although almost everyone agrees that current transfer formulas have serious problems, the multiplicity of veto gates has made it difficult to get a revision in the democratic setting of Argentina with the 1994 constitution (Saiegh and Tommasi, 1999).

In the late 1980s and 1990, poor tax collection and high inflation eroded considerably the real value of resources that provinces got from the *coparticipaciones* and other tax sources. Indeed, inflation hurt provincial revenue more than federal,

largest deduction is to compensate for the costs of education and health services transferred to provinces (introduced in 1992) and for the Fondo Conurbano, which ostensibly assists Buenos Aires province in providing basic services in the suburbs of Buenos Aires city. Deductions from the pool before coparticipation are also made to finance transfers to provinces in financial difficulty, but such transfers are limited to a small percentage of the pool. In addition to coparticipation, the federal government also shares its fuel tax revenues, allocating fixed shares to finance housing (FONAVI) and provincial road and infrastructure projects. Oil-producing provinces also receive directly a share of the royalties from oil companies.

because the shared taxes were domestic and collected with longer lags, while the exclusively federal trade taxes were denominated in foreign exchange. The provincial as well as federal governments thus came to depend on seigniorage and the inflation tax. The availability of discretionary transfers to states, the softness of the federal government's own budget constraint, and the access that provinces had to monetary financing (given in part because the federal government could not deliver regular budgetary resources reliably) contributed significantly to the softness of the provinces' budget constraints.

In the end, the hyperinflation provided a bailout (at the expense of money holders) to the provincial as well as national governments, eliminating most of the real value of their domestic debt on the eve of stabilization. This made subsequent steps for fiscal adjustment more attractive and easier.

In Argentina prior to 1991 provinces borrowed a lot, much of it from their own provincial banks, which then discounted the loans to the central bank, effectively giving provinces a share in the seigniorage and inflation tax. There were over 20 provincial banks, including two each in Mendoza and Córdoba. In 1990 they provided more than 60 percent of the credit needs of provincial governments at low or zero interest rates, and the central bank lent massive amounts through rediscounts, to prevent the collapse of several provincial banks, due to poor loan recovery and overstaffing. By 1989, subsidies to subnational governments and others were estimated at about \$8 billion—more than 5 percent of GDP and close to half of the overall public sector deficit. This was the worst

kind of hole in the budget constraint, for it encouraged provinces to overspend their budgets and it hid the cost, mixing it in with the cost of inflation from other sources.

In the late 1980s macroeconomic instability reached the point of hyperinflation, following a long series of failed economic stabilization programs. Their main failure was the inability to reduce the public sector's deficit. On the eve of elections in 1989, real wages dropped precipitously. Inflation in one week reached 17 percent, and a banking crisis was imminent. The government was virtually bankrupt due to its inability to collect taxes (Peralta-Ramos 1992).

Macroeconomic instability had become closely, and correctly, associated in people's minds with the overall decline of the economy since the first half of the century. When hyperinflation in 1989–90 threatened to push the country further into underdevelopment, people grew desperate and were ready for strong policy medicine. President Menem and his new economics minister, Domingo Cavallo, were able to muster political support for radical solutions. The keystone was the Convertibility Plan, introduced in April 1991. This fixed the exchange rate of the Argentine currency (renamed the peso) to the dollar and required that the monetary base not exceed the dollar value of international reserves. This in effect transformed the central bank into a currency board by mandating a 100 percent reserve requirement for the issue of high-power money (later, the law allowed up to one-third backing by federal government bonds). It also removed the power to devalue from the Ministry of Economy and placed it with congress, where the need to obtain majorities made changing the law relatively difficult, especially in a federal presidential system. This helped harden budget constraint on the overall public sector, which gave the national government a strong incentive to set a hard

budget constraint in its relations with the provinces. Other national governments, lacking such a hard budget constraint on themselves, have been less likely to enforce it on the other levels of government (Dillinger, Perry, and Webb 1999).

With the imposition of peso convertibility, inflation slowed to 3 percent in 1992, 0 percent in 1993, and 6 percent in 1994. Due to strong collection efforts, reverse-Tanzi-Oliveira effects, and economic growth, tax revenues increased dramatically, especially from shared taxes. This was reflected at the provincial level, where revenue jumped over 25 percent in real terms between 1991 and 1992, and over a percentage point in GDP, which was itself recovering strongly. See table 2.

Table 2. Trends in Provincial Revenues and Expenditures in Argentina, 1991–97

(In percent of GDP)

<i>Type of revenue</i>	<i>1991</i>	<i>1994</i>	<i>1997</i>
Current Revenues	8.19	9.45	9.52
Provincial taxes	2.59	3.42	3.21
Provincial nontax revenue	0.40	0.62	0.77
National transfers (<i>aportes</i>)	5.20	5.42	5.55
Current Expenditures	7.77	9.10	8.25
Capital Expenditures	1.21	1.40	1.55
Primary Surplus (deficit)	(1.34)	(1.34)	0.11
Overall Surplus (deficit)	(1.48)	(1.55)	(0.29)

Source: For 1991–94, World Bank 1996c; for 1997, Republic of Argentina, *Informe Económico regional*

Difficult fiscal adjustment was necessary at the federal level, especially reducing public employment and privatizing state-owned enterprises (World Bank 1997). Extensive public relations explained how structural adjustment was necessary to prevent a revival of inflation, and in backroom political deals the executive took advantage of the federal system of representation. A winning set of provinces in both houses could consist

of Buenos Aires province for its weight in the chamber of deputies and the low-population provinces for their weight in the senate. The *Fondo Conurbano*³ helped to obtain the support of Buenos Aires province, which in turn ran a surplus the first couple of years after the stabilization and then kept spending from outstripping the growth of revenues. For the small provinces, the flow of per capita *coparticipation* revenue, plus discretionary transfers in a few cases, was very high relative to their size, but not in the aggregate (Sanguinetti, et al. 1999). Because of their low population and high representation per capita, small provinces were inexpensive places to buy support in the house and especially the senate (Gibson 1997).

By the time of stabilization in 1991, hyperinflation had greatly eroded the real value of domestic debt, giving governments at all levels almost a clean slate on that side, although external debts remained substantial. In 1991-92, the federal government renegotiated its outstanding debts with the provinces. Each side had claims against the other. Provincial governments were in default on long-standing loans from the federal government. The federal government, in turn, was in default on payments owed to the provinces. The exact value of these mutual obligations was subject to dispute, particularly since the hyperinflation of 1989 had distorted their value in real terms. The federal government emerged from the negotiations as the net debtor; the provinces emerged with virtually no debt to the federal government. This outcome proved advantageous not only for the states, but also for the federal government in the future. Because the states had virtually no debt to the federal government on which they might default– the states were

³ This was a special fund targeted to Buenos Aires. Although it is an ad hoc fund, outside the regular coparticipation system, its funding is legislated as a fixed transfer, not at executive discretion.

just getting transfers – the center had a stronger hand in pressuring states to adjust in response to subsequent fiscal shocks. Since then, the total provincial debt has grown little in pesos (or dollars) and has declined as a share of gross domestic product (GDP) and of provincial revenues. A large share of the debt is owed to the private sector – domestic and foreign – and is being serviced.

Since 1993 a Ministry of Economy resolution explicitly has prohibited any federal agency from using its resources to pay a creditor on behalf of a province. *The Banco de la Nacion* has also, without hesitation, deducted debt service from the coparticipation transfers in cases where those transfers were used as collateral for provincial borrowing. This has discouraged provinces from excessive borrowing in this way (eventually, after 1995), although it has made creditors more willing to lend.

To reinforce its autonomy, the central bank's charter was revised in September 1992, establishing an independent board of directors ratified by congress, with fixed terms of tenure. Two provisions in the charter had important implications for provinces. First, the charter dictated that the central bank could not take any new domestic assets. This meant that provinces could no longer go to the central bank to rediscount loans by provincial banks to provincial governments, ending their access to seigniorage and the inflation tax. Second, the charter prohibited the central bank from guaranteeing bank deposits. Then provincial banks had to rely on depositor confidence to maintain liquidity. Both measures reduced the central bank's role as lender of last resort and hardened the financial budget constraint on provinces, limiting their ability to borrow from state banks and eliminating access to central bank financing. At first these constraints were not binding on provincial finances, because of the rapid growth of tax revenues. However, it

proved to be important that the limits were entrenched in the midst of the post-convertibility boom, because they were firmly in place when the boom came to an end and pressure for deficit financing increased.

Taking advantage of the provinces' rapid and unexpected increase in revenues, the federal government negotiated a series of fiscal agreements in 1992–94. *Pacto Fiscal I* (August 1992) diverted coparticipation funds to the national social security system, which was poorly funded and required large subsidies. Under the agreement, provinces allowed 15 percent of the total taxes subject to coparticipation to be diverted to finance the transition costs of national social security reform. To close the pact, the federal government guaranteed a floor of \$8.7 billion annually in coparticipation payments, expressed in terms of fixed amounts of pesos per month. In expressing the guarantee in terms of pesos, the federal government bet that revenues would grow (and that transfers would exceed the guaranteed amount). Over the next three years, the government won the bet, and the provinces did not collect on their insurance. Although they did collect in 1995 and early 1996, the national executive paid a modest price in exchange for important structural reforms.

As additional quid pro quo, the government established a *Fondo de Desequilibrio Fiscal* for small poor provinces. Because political power of the small provinces is disproportionate to their population, due to their overrepresentation in both houses of congress, the fund bought political support at relatively low cost. Government also called in political obligations from the delegation of Buenos Aires province, demanding support for the fiscal pact as reward for the recently enacted *Fondo Conurbano*.⁴

⁴ Based on an interview with Luis Antonio Zapata.

Pacto Fiscal I followed soon after the transfer of federal health and secondary school programs, including 284,000 federal employees, to the provinces. In the *Pacto*, the federal government guaranteed payment equal to its expenditures in each province in 1992. The payment was financed not from central government revenues but from the provinces' share of coparticipation taxes. This allowed the federal government to exit from a major area of expenditure without any increase in transfers to the provinces.⁵

In August 1993, the federal government negotiated *Pacto Fiscal II*, which reformed provincial pension funds. Prior to the reforms, each province maintained a separate pension fund for its employees. Benefit payments were funded out of current revenues. These included, in addition to earmarked salary deductions, subsidies from general treasury revenues. The scale of treasury subsidies were under 0.5 percent of GDP for the 16 provinces expected to transfer their pensions to the federal government. Actuarial projections indicated that most provincial pensions were financially unsustainable. Although the pensions were legally a concern of individual provinces, the Ministry of Economy feared that a major collapse would ultimately redound on the federal government itself, especially since some of the personnel had been inherited from the federal level.

Under the second fiscal pact, the federal government agreed to take over the pension system of any province that passed a law authorizing it to do so. Once transferred, the federal pension system would eventually confer on federal and provincial

⁵ Provinces later claimed to have been blindsided by this agreement. In the 1994 revisions to the constitution, they insisted on added a clause prohibiting the transfer of federal programs without adequate compensation.

civil servants the same retirement eligibility conditions, contributions, and benefits that were available to the private sector. Provinces were slow to implement the reforms, however. Because the transfer would reduce the benefits of active employees, it was opposed by public employee unions. Not all provinces would benefit from the transfer in any case. Although federalizing a provincial pension plan would eliminate the need to subsidize pensions from the general treasury, it would also increase employer contributions in some cases. The small provinces and Córdoba would be the primary beneficiaries (World Bank 1996b and 1996c). The provinces of Buenos Aires and Santa Fe would not benefit, because savings from the elimination of subsidies would be more than offset by increases in direct payments (from employers) into the national system.⁶ In return for signing the second fiscal pact, the federal government offered to raise the guaranteed minimum of coparticipation funds. During the same period, the government also offered to finance the privatization of provincial banks, but prior to 1995 only four small provinces (Corrientes, La Rioja, Chaco, and Entre Ríos) had done so. While the take-over of the pension funds could be considered a bailout in that they reduced the obligations of the provinces (Sanguinetti et al 1999) it was a fixed value offer related to obligations usually predating the current governors, and the terms removed any

⁶ Absorbing the net losers would cost the federal government, however. The federal government would have to not only pick up the provincial subsidy, but also pay more. This is because the contribution rate to the federal pension system is lower than in provincial plans. Thus the amount of contributions coming in will fall. Because benefits paid to existing retirees will remain unchanged, the gap between contributions and pension payments will widen. Over time, the net cost to the federal government is likely to fall, however. This is partly because pensioners retiring after the transfer will receive the national benefit regime, which is less generous than the provincial plans. In addition, the number of retirees will fall, because the minimum retirement age is higher in the national system than in the provinces. Finally, once transferred to the federal scheme, pensions will be subject to the Solidarity Law of 1995, which eliminated automatic wage indexation for pensioners and imposed ceilings on the size of the monthly pension.

possibility for provinces to get the transfer again in the future. Thus it can be considered part of the process of hardening the budget constraint.

While provincial revenues increased rapidly in the 1991–94 period, expenditures increased at the same rate or faster in some provinces. Between 1991 and 1994, revenues increased by 1.4 percentage points of GDP and expenditures by 1.5 points. Personnel costs accounted for about half the increase in expenditure. Growth in transfers to social security, private schools, and municipalities accounted for another 16 percent, and growth in capital spending, for 13 percent. Interest costs remained small, about 2 percent of total outlays. Provinces with precarious finances at the start of the post-convertibility boom continued to have precarious finances despite dramatic increases in revenue. Smaller provinces, along with Córdoba and Buenos Aires city, were in greatest jeopardy. In other words, many provinces were behaving as though they had a soft budget constraint, although the rules on the books implied a hard one. Clearly the rules lacked credibility, due to the long history in Argentina of circumventing budget constraints.

In December 1994, events in Mexico (the Tequila crisis) ended the post-convertibility revenue boom. Argentina was particularly vulnerable to a financial crisis, due to its heavy reliance on foreign capital inflows, the inflexibility of its exchange rate regime, and the need for a strong financial system under the Convertibility Plan. GDP fell 4 percent in real terms in 1995, and provincial revenues dropped 8 percent. The Tequila crisis also prompted a run on most provincial banks, except the Bank of the Province of Buenos Aires. With the prospect of central bank assistance closed off by the convertibility law and the central bank's new charter, provinces were forced to use their own resources to prevent provincial banks from failing and to recapitalize them. Through

a project financed by the World Bank and the Inter-American Development Bank, the federal government refinanced the liabilities of the provincial banks taken over by provincial governments, but it made the assistance conditional on privatization of the banks.

The Tequila crisis tested the nascent hard budget constraint implied by the convertibility law and the new central bank charter. Initially the provinces responded to the fall in revenues by borrowing—either directly from the treasury or from their provincial banks—or by obtaining emergency grants from the federal government. As a result, provincial debt expanded dramatically, totaling \$17.3 billion by mid-1996, more than two-thirds of which had been run up since 1991. See table 3. They used mainly three sources. First, they ran up arrears to suppliers and personnel. Second, after exhausting the tolerance for delayed payment, they resorted to forced lending, paying staff and suppliers with bonds. These bonds could be converted to cash at a discount at provincial banks and then used to pay taxes. These two kinds of forced lending accounted for more than half of the debt incurred in the first year and a half of the crisis. Third, despite their financial difficulties, the provinces were able to continue borrowing from private banks, pledging their coparticipation transfers as guarantee. The federal government was a party to this arrangement in that *Banco de la Nación* would deduct the debt service from federal tax receipts and transfer only the remainder to the provinces. Even after the Tequila crisis, the government adhered to this practice. This sharply reduced net transfers to provinces with high levels of bank debt, taking as much as one-third of coparticipation to pay creditors. This experience increased the credibility of the rules. Even though the rules were occasionally bent, these partial exceptions still

required painful fiscal adjustment on the part of the provinces and indeed made it sustainable.

Table 3. Provincial Debt in Argentina, 1996–97

(as of November 1998)

	1995	1996	1997
Total Provincial Debt	15,393	17,292	16,249
of which:			
Banks (1)		5,771	4,382
National government (2)		768	473
International organizations		1,525	1,997
Provincial Bonds	1,124	2,248	3,640
“Consolidated debt” (3)		5,142	5,582

(1) Including private and provincial banks. Bank debt and thus total declined from 1996 to 1997 largely because BA Province renegotiated some of its debt with its provincial bank.

(2) Loans to provinces under BOTE 10 and BOCEP.

(3) Debt contracted with federal fiduciary fund to finance privatization of commercial banks and bonds issued to suppliers and other debtors in lieu of payment and bonds issued to refinance such debt.

Source: For 1996, Ministerio de Economía IEFE; For 1997, Republic of Argentina, *Informe económico regional*, December 1997. November 1998

The timing of adjustment differed among provinces. Buenos Aires province adjusted substantially in the early 1990s and therefore had less need to adjust in the economic crisis. While the province began the post-convertibility period with an overall deficit of 10 percent of revenues, subsequent increases in expenditures, although large, were less than the increase in revenues between 1991 and 1994. With the help of the *Fondo Conurbano*, created in 1992, the province achieved an overall surplus in 1992. When the Tequila crisis caused a 3 percent drop in real revenues, the province responded by reducing capital expenditures, which sufficed to maintain the overall deficit at its 1994

level, 4 percent of current revenue. Total debt was still less than one-third of revenues in 1997, and more than half of this was a long-term zero-coupon bond.

The city of Buenos Aires was an administrative arm of the national government until 1996. When the convertibility law went into effect, the city's overall deficit was 12 percent of revenue. Partial adjustment in the early 1990s and in the Tequila crisis brought the deficit down to 8 percent of revenue in 1994 and thereafter, mostly financed by arrears that were later converted to bonds. Real adjustment did not occur the city got self government and the first elected mayor in 1996. The new administration (Radical) took major adjustment measures, which attained a surplus in 1997, and refinanced its debt with long-term bonds.

Córdoba is the classic case of post-Tequila adjustment. In 1991 it had an overall deficit of 16 percent of revenue, which widened further in the boom years, largely due to higher spending on personnel. A new administration in 1995 implemented drastic measures. It reduced work-hours and salaries 30 percent temporarily, cut capital spending 40 percent, dismissed more than 6,000 nonstatutory staff, and transferred 1,500 health workers to the municipalities without compensation. In the next two years, the province's overall balance improved – a deficit of only 3 percent of revenues in 1996 and a surplus of 2 percent in 1997. Arrears were converted to short term debt and then refinanced with longer term debt to private banks. The *Banco de la Provincia* has been restructured and the government has agreed to privatize it.

Other provinces followed a pattern of fiscal restraint where the provincial government was of the same party as the national president. Indeed this pattern seems to go back to the 1980s as well (Jones, Sanguinetti, and Tommasi 1997). Next to the

province of Buenos Aires, Santa Fe was the most important case of a Justicialista province adjusting promptly after the start of stabilization. Getting those two to adjust before the crisis provided a critical mass of fiscally sound provinces and allowed the central government to take a hard line in forcing the other provinces to adjust.

The success of the Menem-Cavallo team in forcing the provinces to go along with the national adjustment program resulted from an unusual conjuncture of historical opportunities, and the capital markets and political circumstances may again test the firmness of the anti-inflation, anti-deficit position. Nevertheless, the establishment of sound rules and institutions and the precedent of upholding them in the face of political pressure have improved the likelihood that good policies will withstand future tests.

IV. Status of budget constraints in the late 1990s

As one can see from the historical overview, the budget constraints of the provinces must operate in several dimensions in order to assure a sustainable fiscal posture, one that does not result in bankruptcy or otherwise require a federal bailout. Table 4 show the three main fiscal policy dimensions -- Revenue, Expenditure, and Borrowing. To the extent that the political control from the center is weakened, the fiscal conditions must hold more strongly. A review of Argentine intergovernmental fiscal relations in 1999 and the changes from 1980 along the three dimensions indicates how far the country has come in the last decade and shows where further progress is needed.

<i>Table 4: Dimensions of hard budget constraints on provinces</i>	
1. Revenue and transfers	
<ul style="list-style-type: none"> • - Rule based transfers from the center • - Ability of provinces to increase revenues 	
2. Expenditure	
<ul style="list-style-type: none"> • - Firm allocation of spending responsibilities • - Ability of provinces to control spending and costs 	
3. Borrowing	
<ul style="list-style-type: none"> • Ex ante constraints <ul style="list-style-type: none"> • From the center • self imposed • Ex post consequences and resulting incentives <ul style="list-style-type: none"> • -- Enforcing payment by SNG • -- Enforcing losses on banks with bad loans to uncreditworthy SNGs – bank regulation • Autonomous central bank to enforce budget constraints on overall public sector 	

Revenues and transfers

Most transfers from the center to the provinces are based on rules, in contrast to the 1984-87 situation. The remaining problem is that the transfers are so preponderant in financing the province. In 1994, shared revenues accounted for 64 percent of total provincial revenues. General revenue sharing (coparticipation) is the largest single transfer, accounting for the bulk of transfers: 72 percent in 1991 and 57 percent in 1997. The importance of revenue sharing varies among provinces, but it has at least some importance to all of them. In Buenos Aires city, it is only 9 percent of total revenue; in large provinces it accounts for about half: Buenos Aires, 46 percent; Córdoba, 51 percent; Santa Fe, 57 percent; and Mendoza, 58 percent. In small provinces, the transfers typically

account for more than 75 percent of revenues, reaching 95 percent in La Rioja and Tierra del Fuego.

Dependence on federal revenue sharing per se has not weakened provincial power. The provincial share of revenues is theirs by law, and there is little explicit federal discretion in determining the amount or distribution of transferred funds. In the vast majority of transfers, the volume of funds subject to sharing is determined either as a fixed share of specified taxes or as a fixed amount in pesos. The distribution of funds among provinces is determined largely by formula, with coefficients fixed in the 1988 coparticipation law. Nevertheless, the dependence on intergovernmental transfers gives the federal government some leverage over the provinces. Because transfers can be created or altered through legislation, new transfers can be offered as a quid pro quo for provincial compliance with federal initiatives. This technique was employed extensively to achieve a series of fiscal agreements in 1991–94, discussed below. Transfers also provide private banks with instruments to ensure that debt service is paid, because debt service can be deducted from transfers at the source.

The provinces generate about 40 percent of revenue from self-administered taxes. Four taxes—on gross receipts, property, automobiles, and stamps—account for the majority of tax revenue. Of this total, the tax on gross receipts accounts for about 60 percent. Provincial taxes are largely the purview of large provinces. In 1996, the city and province of Buenos Aires accounted for two-thirds of total provincial tax collection, and the five large provinces (including Buenos Aires city) accounted for 87 percent of the total. So Argentina does not meet the condition of revenue independence of provinces, but it does meet the condition of an aggregate limit on transfers.

Expenditure and service delivery responsibilities

The decentralization law and the fiscal pacts with the provinces in the early 1990s clarified which functions, such as primary and secondary education, the states and municipalities had to take on. They also clarified which responsibilities could not be pushed back onto the federal level. The provinces also had authority to cut their costs, although the usual politics and rules governing public employment did not make it easy. Also, in 1998 teacher protests at the national level led the federal government to intervene, putting a special tax on autos to pay for teacher wage increases.

Borrowing

At present, as in the pre-1990 situation, there are no ex ante limitations on the ability of provinces to borrow from commercial banks. The effective limits in the 1990s all come from market forces and self restraint by the provinces. The critical steps from the federal government were a variety of measures that largely eliminated the provincial banks as sources of credit to the provinces. The 1991 convertibility law ended the ability of provincial banks to rely on the central government as a lender of last resort, forcing them to pursue delinquent loans vigorously (including loans to provinces), or to go out of business or to get capital infusions from the provincial government. Provincial governments that still own banks have to pay in additional capital if needed to meet the required ratios. The central bank can no longer discount any loans from provincial banks, and there is only limited deposit insurance, fully funded by the banks themselves. Since 1996, banks actually monitor each other through the requirement for each bank to issue subordinated debt that other banks will be willing to hold. Tight regulations limit the

lending of a bank to any one borrower, including a province, and require banks to implement provisions against loans not being serviced.

Provincial bonds and some provincial loans are subject to ex ante federal government controls. Bonds have to be reviewed and registered by the Ministry of Economy, which reportedly exercises this role with a light touch. There have even some bond issues on the international market without prior review by the Ministry of Economy, as by the Province of Buenos Aires (Eggers 1999). Although this hands-off attitude seems at first like a serious gap in the hard budget constraint facing the provinces, it has the important advantage of forestalling the expectation that the federal government will take responsibility for the quality of provincial debt and might provide an eventual bailout.

The borrowing control mechanisms now center on the arrangements that the provinces make to collateralize their debt. Usually this is done with a pledge of coparticipaciones as collateral. These are generally handled by the *Banco de la Nación*, which is a semi-autonomous federal agency that, among other functions, handles the distribution of coparticipaciones to the provinces. The provinces have an interest in keeping the agency free from political interference in order to keep the federal government from trying to delay distribution of the provinces' share in national tax collection. From the creditors' viewpoint, the same autonomy makes collateralization with *Banco de la Nación* an attractive enhancement of creditworthiness. Provinces with a weak credit position have to give an irrevocable instruction for *Banco de la Nación* to deduct the debt-service payments up-front from their coparticipaciones. Provinces with a stronger credit rating are able to satisfy their creditors with a less onerous pledge, namely

that the creditor can collect from *Banco de la Nación* only if there is a default in payment. In either case, for each loan or bond issue the province and creditor negotiate a percentage limit – the *cupo* – on the share of the daily flow of coparticipaciones that can be taken for service of that loan. The *cupo* is typically set at a level sufficient to pay the regular debt service even with coparticipaciones flowing at the low end of the expected range. The *cupos* sum to much less than 100 percent, of course, so that the province knows that it will have at least a minimum flow of coparticipaciones left for other uses. In case of a default and a subsequent acceleration of claims, not all creditors get their money on schedule, and the length of delay for each creditor depends on its place in the queue and the size of its *cupo*. The sum and seniority of the *cupos* is known to all creditors, and they calculate how long it will take to get their money back under various scenarios, and negotiate the price and other terms of the loans accordingly. Entities with the strongest creditworthiness, including the province and the city Buenos Aires, are able to borrow without pledging their coparticipaciones and do not do it.

V. Lessons from the 1990s

There seems no doubt that Argentine provinces faced a harder budget constraint at the end of the 1990s than at the beginning, but many additional challenges remain. Evaluating the hardness of the regime since the stabilization requires a clear definition of bailout. Provinces in the early 1990s were coming out of a very soft budget constraint regime and obviously pushing the limits, often spending and borrowing unsustainably, or carrying obligations for debt and pensions that were unsustainable in a stable price

setting, while inflation might have saved them before. The mere fact of a financial resolution, which had to come somehow at some time, does not indicate a bailout and soft budget constraint. What matters is whether the resolution occur in a way that allows or encourages a repetition, by making the over-spenders better off than they would have been with prudent behavior. By this standard, described earlier, bailouts of provinces have become smaller and more rare in Argentina since the stabilization.

First, the requirement for restructuring often eliminated future opportunities for imprudence – privatizing provincial banks and turning over pension systems to the federal government. In both of these cases, the provinces had been building up liabilities that could eventually threaten the nation’s financial and fiscal systems, and it was prudent of the federal government to intervene.

Second, there were political costs to the extravagant provinces, most obviously in the cases of political intervention, when the governor lost office. Paying the debt service out of participaciones was also politically painful when provinces had to cut pay to their workers.

Third, the adjustment process seems to have been politically unpleasant, because the provinces typically delayed accepting the programs until forced to do so by dire fiscal pressure and because few have repeated the adjustment process. Those that did were low population provinces, which received softer treatment for political reasons discussed above.

For most of provincial spending, the federal government succeeded in hardening budget constraints. Since provinces still depend heavily on transfers, however, the resource allocation is more rigid than in countries where local governments self-finance

more. This rigidity and the accompanying inefficiency and inequity could undermine the system in the long-term, but the government is working to design politically feasible reforms that will put the system on a better path. If there is simply a revision of the formula, with all the transition and payoffs necessary to get every province to accept it, then the problem of excess rigidity will remain, dooming the solution to be temporary at best. A longer lasting solution will probably require somehow giving some of the tax bases back to the provinces in exchange for a reduction of coparticipaciones. This will have the added benefit of allowing provinces to enhance their creditworthiness in ways other than pledging their coparticipaciones.

The various measures to harden the provincial budget constraints succeeded in part because they were set in the context of a broader adjustment program that was perceived, correctly, to be essential for the rescue of the overall economy. As this motive for imposing and accepting budget constraints wanes, the institutional structure becomes more important. The institutional reforms of the 1990s appear to have improved incentives and closed some of the most important loopholes, and in most dimensions – notably the convertibility law and the prohibition against federal lending to the provinces – it would take congressional action to relax the constraint. The logic of federal systems makes this unlikely. It should be relatively easy for blocking coalitions to prevent relaxation of the constraints. Getting a critical mass of political support the establishment and initial enforcement of hard budget constraints in the early 1990s was politically much more difficult.

But it was possible. The presidency (including the cabinet ministers) is the only office with a national constituency and as such is more likely to take into account the

interests of the overall economy, while the members of congress represent regional constituencies as well as their parties. In the effort to impose hard budget constraints, the Argentine president needed to have a critical mass of provinces to support the adjustment at both the federal and provincial levels. To get this he used both the uneven congressional representation of the provinces and his role as leader of a relatively unified, disciplined party system. The low population per senator and representative of the low-population states allowed him to buy their support cheaply, even when they were not in his party. At the same time cohesion of the party allowed the president to get important provincial governors to support the program of fiscal adjustment required by the Convertibility Plan, starting with the two largest Justicialista provinces, Buenos Aires and Santa Fe. The Argentine governors acted as players on their national party teams. In contrast, the Brazilian governors often act primarily as leaders of their provincial teams--party affiliation is only a flag of convenience. In Argentina the primacy of national over provincial laws is spelled out in the constitution and has been demonstrated in repeated interventions by the federal government throughout this century and the last, by civilian as well as military governments. Although interventions have been rare since 1983 and absent under the 1994 constitution, there was no doubt of the federal government's legal and military capacity to intervene, and this power seems to have been a latent factor in the ability of the national government to enforce the states' debt obligations (Dillinger and Webb 1999; Haggard 1999).

The Argentine president's authority to adjust was enhanced by the trauma of hyperinflation. The economic collapse and civil unrest that accompanied the hyperinflation of the late 1980s prepared the political ground for radical measures. By

invoking Justicialista party discipline and raising the specter of a return to hyperinflation, Menem was able to marshal broad support for his program. The two fit well together, for it was the Justicialistas' first return to power since the military coup ousted and then persecuted them. Getting reelected and avoiding another takeover from the right required the Justicialistas to demonstrate that they could end hyperinflation. Thus the stabilization and the hardening of public sector budget constraints have been maintained by a combination of the interest of the Menem administration, the general commitment of the society, and the set-up of institutions, such as the Convertibility Law.

VI. Prospects for the Future

Although Argentina's federal system entered the 1990s with a serious soft budget constraint problem, seeds for market discipline have been planted in the 1990s. Voters now have much stronger incentives to examine, punish, and reward the fiscal decisions of the provinces, and creditors have new incentives and tools to assess risk before lending to individual provinces. The independence of the central bank vastly strengthens the central government's credibility when pledging to refuse future bailout demands. Moreover, debt renegotiations have actually strengthened the central government's hand in overseeing subnational reform in fiscal management.

Nevertheless, important challenges remain. Basic reform of Argentina's complex system of intergovernmental transfers remains a pressing though politically challenging necessity. Long-term market discipline will require increased revenue autonomy for the provinces, and decreased involvement of the central government in the relationship between banks and subnational governments. The recent reforms came about during a

rare period of political unity on the issue of fiscal reform, during which the central government had a unique opportunity to impose constraints on the provinces.

Since 1998 Argentina has suffered a severe recession because of international shocks like the decline of commodities prices, the rise of interest rates, and the real depreciation of its major trading partners relative to the dollar and the peso and because of domestic developments like bad weather and electoral uncertainties. Provincial finances everywhere have suffered; their over fiscal balances worsened from zero in 1997 to -11% of total revenues in 1999. Debt stocks burdens jumped from an average of 61 % of revenue in 1997 to 75 % at the end of 1999.

The new federal government, taking office in December 10th, 1999, responded with a program of debt relief or rescheduling, conditional on fiscal adjustment. For the smaller provinces, the federal government has created a new agency, the Provincial Development Fiduciary Fund, that will offer longer terms and lower rate financing to those that adopt qualified fiscal adjustment programs. As of March 2000, nine provinces had already signed onto the program and others are expected to join soon. The larger provinces are expected to approach the international financial institutions for assistance. For both groups the financing will be available only in tranches, contingent on continuation of the agreed reform programs. And for both, the federal government explicitly guarantees the provincial debt.

To the extent that the federal government is thus taking over the provincial debt, it appears similar to the initial pattern in Brazil, which ended with states repeatedly defaulting on their debt that the federal government and central bank had taken over (Dillinger and Webb 1999). Also the politically divided government system in Argentina

of 2000 – a coalition government at the national level and the opposition party having most governorships – is a move away from the dominance by a single party (*Justicialista*) in the 1990s, although it is still a long way from the chaos of Brazil's party (non-)system.

There are also important institutional and policy differences from the Brazilian experience, however. First, the Argentine federal government faces a hard budget constraint and cannot access central bank financing, because of the convertibility law. Second, the deduction of debt service from revenue-sharing transfers is firmly institutionalized through Banco de la Nacion and established in people's expectations. Thus any resources for a bailout would require explicit and difficult legislative decisions at the national level. It remains to be seen whether Argentina's federal government will insist that the provinces service their debt and avoid repeating the bailouts and following the whole path of Brazil. Only time can tell whether the recent reforms will be sufficiently robust if confronted with continued fiscal crisis-- especially under divided government-- or if the political obstacles to further reform can be overcome.

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