

Chapter 13:

Lessons and Conclusions

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I. Introduction

In chapter one, we pointed out a disturbing tension between optimistic theories of decentralization and a growing number of less promising case studies. Despite its intuitive appeal, decentralization does not necessarily lead to improvements in allocative efficiency, accountability and governance. In particular, this volume has demonstrated that decentralization may soften the budget constraints of subnational governments. One of the key goals of this study is to resolve that tension by establishing some of the conditions under which decentralization might be most helpful and harmful.

The problem of soft subnational budget constraints is rooted in a commitment problem at higher levels of government. Central government commitment to a firm framework comes easily if center can claim disinterest in local performance problems. However, vulnerability to bailout demands is more typical. Thus our focus is on the underlying causes of the central government's vulnerability, as well as steps that can be made to facilitate commitment. In this concluding chapter, we first revisit some basic themes and set up the analysis. In section II, we provide a brief overview of the case studies to place them in two dimensions-- the severity of the problem and the institutional framework for subnational finance. In section III, we discuss the mechanisms at work in a system with a "disengaged" higher level government that relies mostly on market

mechanisms, focusing on two cases from North America. We discuss the institutional, political, and historical conditions under which such a framework can be successful. In section IV, we discuss the hierarchical oversight and control mechanisms, examining both successful and unsuccessful attempts to impose fiscal discipline from above. Section five concludes by arguing that in many cases of decentralization, the path towards improved fiscal discipline involves a gradual process that is best achieved through a judicious mixture of market and hierarchical mechanisms.

Two Platforms for to Fiscal Discipline

Our analysis points out two rather different frameworks consistent with subnational fiscal discipline. A system might work well without hierarchical mechanisms if it is characterized by very low levels of external effects, or a central government that is either quite limited in its powers, unambitious in its goals, or in possession of strong commitment facilities. For instance, we argue below that the United States has good commitment in its constitution, its history, the high number of states, and low levels of externalities due to the low ambitions of the center and the large size of the states. For this reason, along the same lines, we emphasize important differences between a case such as the U.S., which was never centralized, and one that is attempting decentralization.

Such a limited and unambitious central government seems to be a rarity among decentralized systems. At the other end of a continuum, the German constitution reflects a higher level of ambition when it spells out a guarantee of “equivalent living conditions” in all of the federal states. Such ambition may easily result in bailouts if the hierarchical mechanisms do not sufficiently curtail opportunism. Most of the case studies

in this volume describe fiscal, political, and financial factors that make the central government vulnerable to manipulation by the subnational governments, and as a result unable to “just say no” and stand by it. When these factors are present, a prima facie case exists for hierarchical constraints. In fact, it is difficult to escape the conclusion that in many countries, the best way to harden budget constraints, at least in the short to intermediate term, is for the central government to get *more involved* in the regulation of subnational governments.

A Middle Road

These two platforms -- a disengaged center relying on incentives and market mechanisms and one more involved with hierarchical instruments -- can both lead to reasonably hard budget constraints. Thus it is tempting to conclude that countries should simply choose one or the other and stick with it. But in some contexts, as when jurisdictions are small and the center traditionally is strong, the center cannot commit to a no-bailout policy (recall the fire truck analogy). On the other hand, Norwegian-style hierarchy is simply not plausible in vast federations like China and India where subnational assertion of power comes about descriptively and makes sense normatively. However, for the majority of the cases under analysis, neither the American nor the Norwegian solution is practical.

We will argue that countries do not face a choice between dysfunctional markets and blunt hierarchy. The case studies indicate that hierarchical instruments can be honed and made to supplement developing market mechanisms, rather than to obstruct their growing role. Market discipline can grow, but only as a process of gradual central

government disengagement. The interaction between local and central governments described in chapter one is an iterative game, and in each round of play local officials and their constituents (voters, creditors, asset owners) learn about an evolving incentive framework, including about the evolving credibility of central government's institutions. In general, however the basic institutions that support or undermine this commitment cannot be changed overnight, and the learning process is likely to be gradual.

II. A Schematic Overview of the Case Studies

First of all, it is useful to ask which countries experienced the most severe and persistent manifestations of the soft budget constraint problem. Although it is by no means a perfect measure, it is helpful to compare the development of aggregate deficits for the subnational sectors under examination. These data are presented in figure one for the developing and transition country cases (excluding China and Ukraine, for whom appropriate data were not available), and in figure two for the OECD cases. Modest subnational deficits are certainly no cause for alarm, nor are large temporary deficits brought on by unexpected shocks. Figure one, however, shows that large aggregate deficits, ranging from fifteen to over thirty percent of total revenue, have been quite persistent from the mid-1980s to the present in the Brazilian and Indian states and Argentine provinces. These data reflect the discussions of persistent soft budget constraints in each of the corresponding case study chapters. Figure two shows that sizable and persistent subnational deficits are not limited to the developing world. Specifically, as discussed in chapter 6, the German *Laender*, particularly Bremen,

Saarland (and more recently some of the new Eastern *Laender*), have faced soft budget constraints in recent years as well.

Figure 1: Subnational Deficit as Percent of Revenue: Developing and Transition Country Cases

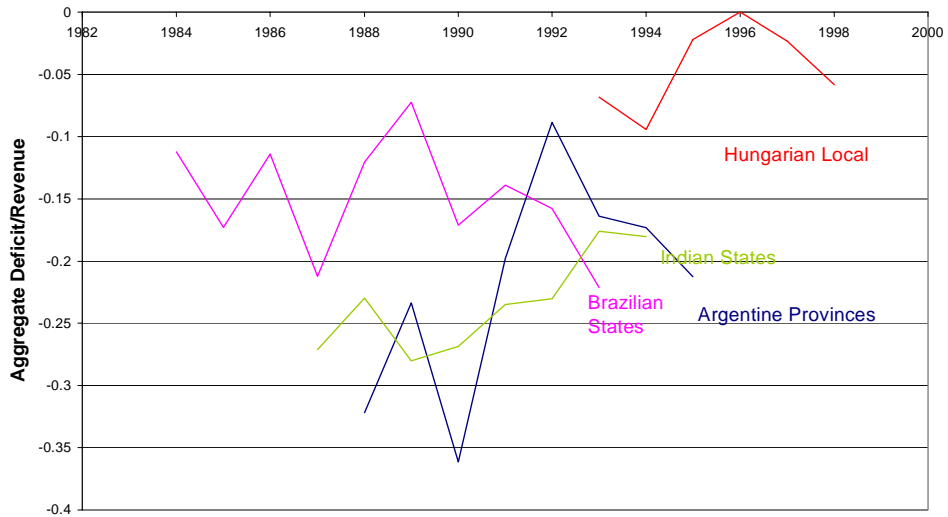
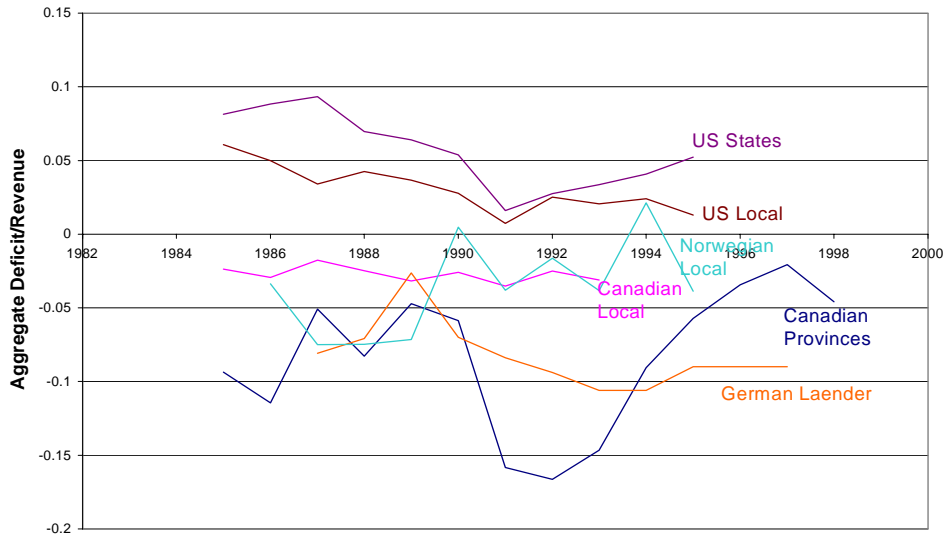


Figure 2: Subnational Deficit as Percent of Revenue: OECD Cases



Source: IMF Government Finance Statistics and World Bank staff estimates

Figures one and two also suggest that some of our cases demonstrated relatively balanced budgets. Among the developing and transition countries, the balanced budgets of the Hungarian local governments stand out. As discussed in Chapter 7, recent precipitous improvements in the fiscal balances, if sustained, may indicate a successful hardening of budget constraints there. Figure two shows that budgets have been balanced on average in the U.S. state sector, as well as in the local government sectors in the United States, Canada, and Norway. In each of these cases, aggregate subnational deficits have been very small as a percent of revenue, and in the United States, surpluses and contributions to “rainy day funds” are common.

Figure two also tells an interesting story about the Canadian provinces. At the beginning of the 1990s, a recession combined with declining intergovernmental transfers put serious pressure on provincial budgets. This led to large short-term increases in provincial deficits and debt burdens. As discussed in Chapter 4, the provincial governments eventually responded to pressure from creditors, voters, and asset owners by adjusting tax rates and expenditures. A similar story can be told, albeit on a smaller scale, in the United States. The U.S. states and local governments faced regional economic downturns, unexpected increases in health care costs, and cuts in federal grants in the late 1980s and early 1990s. Some states ran large deficits, and as shown in figure two, the aggregate surplus declined significantly. As with the Canadian provinces, the U.S. state and local governments adjusted to these shocks on their own, and aggregate surpluses are again increasing.

The U.S. states and Canadian provinces are the clearest examples of market discipline. The states and provinces have wide-ranging fiscal autonomy—most of their

revenues come from broad-based taxes for which the bases and rates are determined locally. Moreover, they borrow in competitive capital markets and their respective central governments place no constraints on their spending and borrowing . State and province politicians and their constituents have few reasons to expect bailouts-- there is no history of bailouts, no clear mechanism through which local obligations might be assumed by other jurisdictions and attempted bailouts by the federal government would risk being challenged on constitutional grounds. Persistent deficits are assumed to lower credit ratings and raise borrowing costs, resulting in political pressure to adjust when faced with adverse fiscal shocks.¹

Such reliance on market discipline is rare, however. In fact, the only other decentralized public sectors with relatively hard budget constraints and balanced budgets— the local/municipal sectors in Norway, Canada, and Hungary— achieve this primarily through strong hierarchical oversight. These case studies described strict rules and regulations governing local spending and borrowing decisions, imposed and enforced by the central government (in Canada, by the provincial governments). In each of these cases, hierarchical oversight appears to partially obviate the market mechanisms. In other words, credit markets, local voters, and asset owners play less of a role in disciplining local fiscal decisions.²

¹ Evidence of a link between deficits and the electoral success of incumbents is provided by Lowry, Alt, and Ferree (1998).

² In the case of Hungary, however, an important step has been taken towards less politicized mechanisms of the market place, with the passage of a bankruptcy procedure. It provides clarity and puts pressure on lenders to be prudent, and has worked in several instances of restructuring without bailouts.

Figure 3: Hard Budget Constraint Mechanisms, 1986-1999

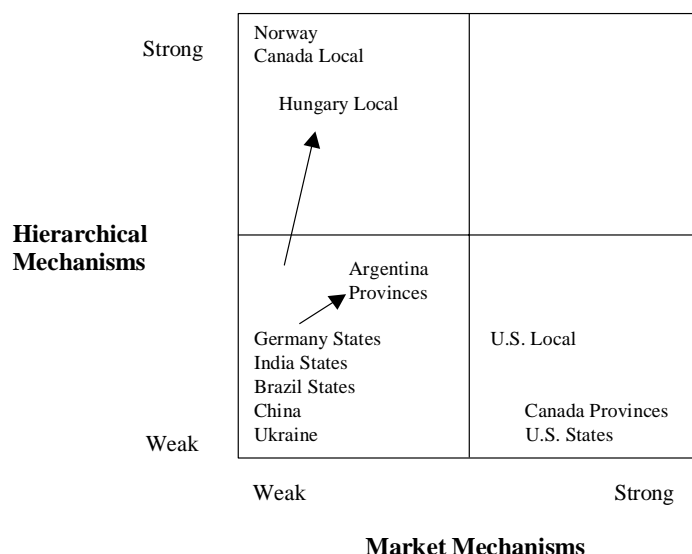


Figure three lays out the role of market and hierarchical mechanisms over the last decade in a two-by-two table. The horizontal axis represents the strength of market-type mechanisms, while the vertical axis represents the strength of hierarchical mechanisms. The table is divided into four quadrants, and the cases are displayed in the quadrant that best characterizes the strength of each type of mechanism during the last decade. The Canadian provinces and U.S. state and local governments fall into the southeast quadrant—they rely almost exclusively on markets for credit, votes, and capital, and use no hierarchical mechanisms (Many U.S. states apply debt limits to municipalities, but not all, and monitoring and enforcement is varied at best). The local government sectors in Norway, Canada, and Hungary in the northwestern quadrant rely primarily on hierarchical mechanisms. The remaining cases fall somewhere in the southwestern

quadrant-- a combination of hierarchical and market-type mechanisms that both are relatively weak. For these, the case study chapters describe significant manifestations of the soft budget constraint problem. Those cases for which deficit data were available—the federal states or provinces of Germany, India, Brazil, and Argentina—each displayed large and persistent deficits (figures one and two). The Chinese and Ukrainian case studies also described persistent soft budget constraint problems.

The arrangement of cases in figure three is not very precise; no doubt it masks some of the subtlety and complexity of the case studies, yet it teaches some valuable lessons. Three of the cases are located closer to the middle of Figure 3 than the others. Argentina is closer to the middle, with an arrow tentatively indicating movement. As described in greater detail below, the Argentina case may provide some lessons about the possibility of strengthening both mechanisms when the starting point is one with soft budget constraints. The local government sector in Hungary also has moved out of the southwest quadrant by combining markets and hierarchy, but this transition has been dominated by increased hierarchical oversight. The U.S. local government sector is placed slightly higher than the states and Canadian provinces, reflecting that many states use some hierarchical restrictions on local governments, though local electoral competition, land markets, and credit markets clearly are important as well. These two alternative mechanisms are placed in relief in Canada, where the provincial and local governments both face relatively hard budget constraints, are enforced by market and hierarchical mechanisms respectively.

The remainder of this chapter asks (1) why countries end up in the southwestern quadrant of figure three and (2) how they might move out of it, or avoid it altogether.

Sections three and four take a closer look at the institutional requirements for market and hierarchical hard budget constraint mechanisms. The emptiness of the northeastern quadrant in figure three reflects the inherent tension between the two ideal types; total central government dominance over local fiscal decisions is simply not compatible with strong market-type oversight. Nevertheless, we argue that it may be possible to move toward the middle of figure three by shoring up hierarchical mechanisms in the short run while gradually making a transition to market discipline. Since a country context may limit the scope for central government disengagement and commitment, the context also sets limits for sole reliance on market mechanisms, even in the long term.

III. Market Mechanisms

The cases of Canada and the United States demonstrate that hard budget constraints might be enforceable without central government oversight of subnational fiscal and borrowing decisions. In fact, we have argued that local fiscal discipline will only be enforced by market-like competition for capital and political support if creditors, citizens, and asset owners believe that the central government will *not* be responsible for local fiscal decisions. How do such beliefs develop? A brief look at Canadian and American history suggests that the process might be slow, incremental, and sometimes painful.

In both the Canadian provinces and U.S. states, voters learned “the hard way” that the costs of imprudent fiscal decisions would be borne locally—they endured painful fiscal crises without receiving bailouts. The most important events in the United States

took place in the 1830s and 1840s, when many of the states ran into serious debt servicing difficulties and defaulted (See English, 1996). Despite vigorous lobbying efforts on the part of the most indebted states, no federal bailout was granted. According to one historian, taxpayers “saw how the abuse of state credit increased tax burdens at the most inopportune time and led to over-expansion, waste, extravagance, and fraud” (Ratchford, 1941: 121). In chapter 4, Bird and Tassonyi describe a similar learning process in Canada, starting even in the pre-Confederation period. Like the American states, the provincial governments ran into difficulties with bond issues for railways and canals, and voters learned through a series of crises that they would ultimately pay the costs for provincial fiscal decisions. Even in the nineteenth century, voters and creditors alike learned to view the states and provinces as sovereign entities.

It is interesting to note that many of the U.S. states have self-imposed constitutional and statutory borrowing restrictions and balanced budget requirements. These are not imposed by higher-level governments (and thus we do not view them as hierarchical mechanisms), contrasting the restrictions imposed on local governments in Canada and the U.S. Rather, these restrictions were imposed by states and provinces on themselves, or perhaps more accurately by state and local voters on their representatives. The first state-level fiscal restriction in the U.S. were imposed by angry voters in the 1840s after a series of costly tax increases resulting from imprudent borrowing decisions. These restrictions were viewed favorably by credit markets, and quickly spread to other states. Much more recently, similar rules have been implemented in several Canadian provinces. Following the recent period of persistent provincial deficits and unprecedented indebtedness, pressure from voters combined with a desire to reassure creditors have led

many provinces to impose fiscal restrictions upon themselves. In both countries, such self-imposed restrictions demonstrate the strength of the markets for votes and credit.

What lessons for other countries can be drawn from the Canadian and American experiences? Importantly, the Canadian provinces and U.S. states had fiscal sovereignty prior to the formation of a federal union, and then formed federal unions with limited ambitions and powers. When the starting point for decentralization is a strong central government with wide-ranging commitments, the challenges are likely different, and greater. Moreover, reliance on market discipline depends either on weakness centrally or on restraint in the discretionary use of central government powers. Canada and the US originally came about as governments for huge, sparsely populated areas, with federal governments that were not only limited explicitly by constitutional construct, but which were also weak militarily and fiscally relative to those areas, and with small ambitions with respect to expenditures and redistribution.

A feature of the US federation that has gone almost unnoticed in the fiscal literature is that-- as affirmed by the 11th constitutional amendment-- states are sovereign and cannot be compelled to repay debts (English, 1996).³ Thus, in the event of a state default, the federal government is not bound in its judiciary capacity to enforce the claims of creditors. With the federal government being cleared of such responsibilities, expectations of bailouts may be reduced. First, by not being involved in enforcement actions, the federal government avoids direct implication in the state's situation. Second, as creditors have weaker powers, the state *and* the center are less vulnerable. Countering

³ Ratified February 7, 1795: "The Judicial power of the United States shall not be construed to extend to any suit in law or in equity against one of the United States by Citizens of another State, or by Citizens or Subjects of any Foreign State."

these advantages, however, since third party enforcement is not available, supply of credit may be more restrained.

A. Fiscal Institutions

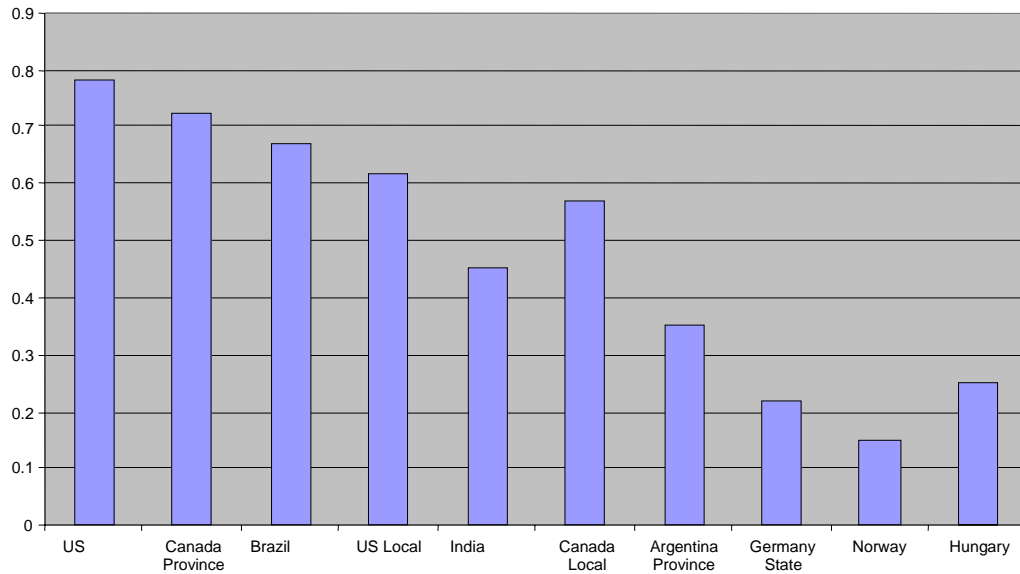
Subnational Revenue Autonomy and Vertical Fiscal Imbalances

In addition to their explicitly limited central governments, the Canadian provinces and U.S. states share a related unique feature—among subnational governments they are (along with the Swiss Cantons) probably the most fiscally autonomous in the world. They fund themselves primarily through broad-based taxes for which bases and rates are set without federal interference.⁴ Although equalization transfers do make up a significant portion of the revenue of some of the smaller Canadian provinces, on the whole the Canadian provinces and U.S. states are much less reliant on intergovernmental transfers than the other cases examined in this volume (See Figure 4).⁵

⁴ Provincial income taxes in Canada could for most provinces be characterized as shared revenues, but the arrangement is voluntary (and not agreed to by all). Some provinces have also initiated coordination on the sales taxes.

⁵ Figure 4 displays own-source subnational revenue as a percent of total subnational revenue. $1 - (\text{transfers} + \text{revenue-sharing}) / \text{total subnational revenue}$. It attempts to give a realistic comparative perspective on local fiscal autonomy by calculating the amount of revenue in each subnational sector that is raised locally. Thus for instance, shared revenue that is legislated, collected, and redistributed by the central government is excluded. Brazil is a difficult case because the vast majority of state own-source revenue comes from the value-added tax (ICMS), for which the base and rate are determined by the federal senate. The states do have considerable influence over this revenue source, however, derived from their ability to grant exemptions. If the ICMS is included as “own-source revenue,” as in Figure 4, the Brazilian states appear to be among the most fiscally autonomous subnational entities in the world. If not included, they would appear to be some of the least autonomous.

Figure 4: Own-Source Subnational Revenue as % of Total Subnational Revenue



Source: Rodden (1999)

As explained in chapter one, high vertical fiscal imbalances certainly can represent an obstacle for market discipline. If a state's fiscal difficulty could be seen as resulting from the discretionary acts of the central government, then market participants would likely look to the center for a resolution, not merely to the state. High vertical fiscal imbalances therefore can send signals to voters, creditors, and asset owners that the higher-level government is ultimately responsible for local fiscal outcomes and obligations.

However, high vertical fiscal imbalances do not automatically lead to soft budget constraints. The two cases with the highest levels of transfer-dependence in figure four—Hungary and Norway—were able to achieve relatively hard budget constraints through hierarchical mechanisms. In fact, Eichengreen and von Hagen (1996) use a large sample

of monetary unions to show that high levels of vertical fiscal imbalance typically *are* accompanied by more stringent borrowing restrictions. Rodden (1999) demonstrates that high levels of vertical fiscal imbalance, if accompanied by stringent hierarchical borrowing restrictions, are associated with balanced subnational budgets: the largest subnational deficits are found when high vertical imbalances combine with borrowing autonomy. The case studies of Ukraine, Brazil, India, and (pre-reform) Argentina provide further evidence that weak hierarchical mechanisms and transfer-dependence is a dangerous combination.

While *pure* market-type discipline requires significant fiscal autonomy, it is important to note that newly empowered state and local governments largely depend on transfers and revenue-sharing. This importance of the center's taxing powers is not surprising, given the challenges of devolving revenue-raising responsibilities in developing countries. First, there may be a strong normative case for central government redistribution. In poor countries with high levels of cross-region income inequality, this can be pursued through expenditure programs such as health, education, social protection, and infrastructure. These can be decentralized in their execution even if they are funded in part through intergovernmental transfers. Second, on efficiency grounds, jurisdictional tax coordination and other limitations in revenue autonomy has potential payoffs in reducing distortions to private behavior, excessive tax competition, and the costs of administration. As a descriptive prediction, vertical imbalances will be increasing as one decentralizes a broader domain of expenditures to small jurisdictions at low levels, unless one has either a very distorted or regulated system of subnational taxation. Thus, transfer

dependence may be a feature that is not easily disposed of, and market-type discipline is unlikely to emerge as the predominant mechanism for small jurisdictions.⁶

If there is a relationship between transfer-dependence and soft budget constraints, the root cause is the *discretion* of the central government, combined with expectations about how that discretion will be used. Even if provinces are quite self-reliant in revenue, *unused* taxing powers of the center may still be available and even expected to be used to provide bailouts in the future. Conversely, even when transfers are large, discretion in the disposition of these can conceivably be “locked up” by institutional features such as strict adherence to formulas (Argentina) or delegation to autonomous commissions.

The discretion that remains can be in principle used in two ways. The inclination to use it 'the wrong way'-- to bail out a troubled jurisdiction even when trouble is self-inflicted-- can be thought of as in the Samaritan's dilemma: the invitation to manipulate the center lies in the center's vulnerability (his redistributive heart, in the case of the Samaritan). Thus the relatively hard budget constraints of U.S. federalism might be attributed in part to the fact that the federation came about as a voluntary union with a limited mandate: to guarantee the right to 'the pursuit of happiness', without any guarantee or responsibility for what can be provided within each state.

That is not to say that a strong tendency towards redistribution cannot in principle be associated with hard budget constraints. The two may be compatible if the redistributive mechanism is expected not to work when problems are self-inflicted. But the principal agent model allows *some* redistribution to be consistent with incentives even when the center lacks information to distinguish luck from effort (fiscal effort, for

⁶ An additional reason for persistent high levels of vertical fiscal imbalance is provided by Daniel Triesman (1999), who argues that central governments use transfers to pay off would-be secessionist regions,

instance). The requirement is that the center can commit-- in the sense an insurer would be committed—not to give full coverage, so that incentives to effort remain. Information to distinguish thus does not ensure incentives unless there is commitment. Commitment is provided for in contract theory by assuming the information is verifiable and will be acted upon by an independent court.

Unfortunately in contests between governments, politicians could override the consequences of potential court decisions, so the commitment devices of law and contracts can be displaced in practice. And also in more general practice, even the best insurance schemes involve moral hazard, and political intervention can make things worse.

Clarity of Responsibilities

Market discipline requires not only that subnational governments have the fiscal autonomy necessary to respond to adverse shocks on their own, but also an intergovernmental system that makes this sufficiently clear to citizens, asset owners, and creditors. Thus, the distribution of revenue, expenditure, and regulatory authority between levels of government should be clear and stable. In many of the cases, market discipline was undermined by the fact that tax bases overlap, and major areas of government expenditure fall into the realm of “joint tasks” or “concurrent powers.” Overlapping tax bases, uncoordinated tax administration, and a muddy distribution of spending authority led to confusion and incentives for opportunistic behavior in Brazil. In Ukraine, the basic distribution of authority between governments is poorly defined and shifting, seriously undermining accountability. In India, *most* public sector activities fall

especially in ethnically divided federations.

into the realm of “concurrent powers” or “joint tasks” for three or two levels of government, harming accountability through cost-shifting.

Clarity in responsibilities may, however, be a distant goal to strive for. As mentioned above, national revenue may be an important funding source for redistribution (not only descriptively, but also normatively) and public expenditure programs such as education and health services. Decentralizing these services can be very helpful to make the services accountable to users and local citizens, but the national government is unlikely able to express indifference with respect to the services delivered. First, its role in providing funds along with its own accountability may prevent such indifference. Second, its hand in funding gives it an instrument in acting on service delivery which may be imprudent or impossible to lock up or give away. Thus users and citizens may not be confused but right when directing their anger for flawed services both towards the provincial and the national capital. Likewise, a provincial governor who thinks the national government will take part of the blame and pay part of the bill if she skimps on school quality may be right. Reflecting its own vulnerabilities, many national governments are unlikely to be credible if stating that reduced funding will be the mechanic response if the province should fail in reaching educational goals. These observations illustrate the challenges in establishing incentive compatibility under conditions of low development and high transfer dependence.

Local Provision of National Public Goods

In the above paragraphs, we described a situation where the center is vulnerable to manipulation not only because of its role in funding but also because it 'cares' about what

the subnational government is charged with providing. In public finance terms, pressures for central bailouts build if local governments are responsible for the provision of public goods that have national constituencies. More specifically, if subnational governments are responsible for expenditures like welfare, unemployment, and pensions during severe economic downturns, they may put pressure on central government to step in when revenues fall short. Creditors and their voters will join in, and pressure is likely to build at the national level. Some of the provincial fiscal crises in the 1930s described in the Canadian chapter unfolded in this way because the provinces were responsible for most “relief” expenditures. A similar dynamic led to pressure for bailouts of state and provincial pension programs in Brazil and Argentina.

Intergovernmental transfers that are deemed “insufficient” to cover mandated spending responsibilities have been a major part of the problem in India. The system of “gap filling” and occasional debt forgiveness employed by the Finance Commission can thus be seen as compensating for inadequacy of funding to fulfill the obligations set out for them by central planning directives. Similar problems were reported in the case studies of Argentina and Brazil, though once again, Ukraine seems to have demonstrated the most severe problems.

When nations are large, this perspective is particularly important under the rather compelling case for viewing poverty alleviation as a national public good (See Wane, 2000). Musgrave's recommendation that redistribution is a national responsibility in effect reflects this perspective. Similarly, Sen's observation that democratic nations prevent famines hints that poverty alleviation is a national public good as a descriptive matter. Thus, at least in democracies, national 'intervention' can be expected when core

dimensions of welfare are threatened locally, and this places limits to institutions of non-intervention.

Rules Versus Discretion in the Design of Intergovernmental Transfers

Clarity and predictability are also important in the design of intergovernmental transfers. A “no bailout” commitment from the federal government will be much more credible if intergovernmental transfers are legislated and distributed according to clearly defined rules. If one can remove the distribution of grants from the uncertainty and vote-trading of the legislative process, one may also have removed subnational expectations of bailouts and forgiveness.

Even if the rules governing intergovernmental transfers are clearly defined and adequately enforced, the rules themselves might undermine hard budget constraints. This is clearly the case in Germany. The constitutionally mandated equalization system, though very predictable and non-discretionary, sends a clear message to the smallest and poorest states that fiscal indiscipline will be rewarded with increased transfers. More generally, the intergovernmental fiscal system provides the states with few incentives to increase fiscal effort or counteract tax evasion. A related problem was described for the Indian system of intergovernmental transfers. While the process employed by the Finance Commission does include some clearly defined rules, perhaps its greatest weakness lies in the basic rules and procedures themselves. Above all, the Indian system features a systematic gap-filling approach that discourages fiscal effort and fiscal discipline in the states.

The problems with transfers based on bargaining were demonstrated most clearly in the case study of Ukraine, where the intergovernmental system has been overwhelmed with rent-seeking and opportunism. A history of discretionary transfers and political bargaining also clearly undermined fiscal discipline in Brazil. The ad hoc bilateral bargaining between the central government and localities under China's "fiscal contracting" system, as well as the new "dual track" system, also result in soft budget constraints for the localities. Although transfers in India appear to rely on clearly established rules, in practice the process leaves a great deal of room for discretion and bilateral negotiation.

The Argentine case, on the other hand, suggests that improvements in the clarity and predictability of the intergovernmental transfer system might help harden budget constraints. From the mid-1980s to the present, much of the discretion in the Argentine system of intergovernmental transfers has been replaced by rules that are hard to change, so provinces have less reason to expect bailouts.

The recommendation of limiting the center's discretion to avoid gamesmanship of large subnational jurisdictions goes directly to the heart of any decentralization reform. Ultimately, the first big question is whether, or in what areas, the center can let go of ambitions with respect to subnational entities and sever its channels of vulnerability to their acts. The second big question is whether it can lock up its discretionary powers in a credible way, or at least increase the costs to itself of subsequently deviating from the announced framework. Most likely, any decentralization is half-genuine at best, meaning that scenarios exist in which the center would consider deviating from its pre-announced

stance. Given such scenarios, the question is whether the key to discretion is buried sufficiently deeply. Often it is not.

B. Political Institutions

Political institutions are also critical to the beliefs and perceptions that undermine market-type fiscal discipline. The central government's vulnerability and commitment to "say no" when pressured for bailouts depends on its organization and incentive structure. In many situations the central government is an organization that by its very design has trouble "saying no" to bailout demands. Local officials and their constituents are aware of this, and are likely to exploit it.

Consider first the role of legislatures in democracies. When local governments are unable to pay workers, contractors, or bond-holders, these groups are likely to put strong pressure on the region's representatives in the central legislature. As described in chapter one, decision-making in legislatures is often characterized by log-rolling and vote-trading between representatives of regions. Not only might this lead to excessive spending on purely local public goods and "pork-barrel projects" as political scientists have demonstrated (e.g., Shepsle and Weingast, 1984), but it may afford the representatives of fiscally troubled local governments the opportunity to strike bailout deals. These bailouts may represent a politically rational outcome even if costs exceed benefits for the country as a whole. The decentralized, fragmented nature of the Brazilian legislature was clearly an important structural reason for soft state-level budget constraints. In particular, the state governors have been able to trade votes and push their

agendas through in the Senate. On more than one occasion, logrolling in the Senate made bailouts possible, and once negotiations started, they led directly to increases in the size and scope of bailouts.

Strong Presidents and Political Parties

Some of the other case studies demonstrate ways around the problem. First of all, this problem can be mitigated if the legislative process gives authority to individuals or groups who are held accountable by a national constituency for the overall fiscal and economic performance of the country. Strong presidents and political party leaders can play this role, as brief comparison of Brazil and Argentina demonstrates. Brazil featured weak and fragmented political parties, and a president who was unable to command the support of his partisan colleagues in the legislature. This led to a policy process characterized by complex regional log-rolling, even within the same party. This made it relatively easy for the states to push for bailouts and stand in the way of key intergovernmental reforms. In Argentina, on the other hand, the president presided over a relatively strong and disciplined party with links between the provincial and federal branches. The president had a strong mandate for macroeconomic stability. This made him able to mobilize partisan links to legislators and provincial politicians to minimize regional self-seeking, and push through important intergovernmental reforms to harden provincial budget constraints.⁷

Standing up to pressure from subnational officials, local workers, contractors, and bond-holders whose payments are threatened requires a great deal of political strength, cooperation, and far-sightedness at the center. Politicians are unlikely to have this

strength if their reelection chances are determined primarily by the provision of “pork” to their districts, as in Brazil. Nor are they likely to muster up this strength if the central government is a fragile coalition on the verge of collapse, as has sometimes been the case in India. In these situations, the central government’s “no bailout” commitment lacks “motivational” credibility (Shepsle, 1991). Local officials and their constituents know that the central government does not have incentives to be resolute. Strengthening party discipline, leadership, and enhancing the stability of political coalitions may be ways of improving motivational commitment.

Delegation: an independent central bank as an example

The case studies show that another kind of commitment is also important—the imperative. This kind of commitment was illustrated by Ulysses when binding himself to the mast (Shepsle, 1991). A commitment has imperative credibility if the actor can demonstrate that she is *unable* to break the commitment, even if the motivation should arise. The best way for the central government to make an imperative commitment not to provide bailouts is to remove much of the discretion over the relevant decisions from those actors who may have the strongest motivations to provide them-- the legislators. One such argument was made above about intergovernmental transfers—they should be determined by rules rather than legislative discretion. More generally, the delegation of authority from the legislature to other bodies that are more insulated from political pressure (especially pressure for bailouts from local governments, their voters, and bondholders) might help strengthen the government’s commitment.

⁷ See Dillinger and Webb (1999).

First of all, an independent central bank might be an important source of imperative commitment. Local governments, their constituents, and their creditors may believe that the central government will provide bailouts if it controls the money supply. In contrast, if monetary policy is formulated by an autonomous agency with an anti-inflation mandate, these actors know that the central government itself faces a harder budget constraint, making bailouts less likely. Chapter 2 argued that severance of political control over the central bank as an important part of reforms hardening budget constraints in Argentina. On the other hand, more discretionary, political monetary policy may have helped undermine central government commitment in Brazil.

The judiciary and the predicament of enforcing property rights

A contract such as a loan defines certain rights and obligations, and the capacity and willingness of government to adjudicate and enforce these rights in general are at the heart of the rule of law. Thus, the rare occasions when a government representative seizes debtor assets on behalf of creditors may be important in the general incentive structure.

When government is a contracting party, legal tradition may afford government assets immunity from seizure. Government entities thus may be poorly suited as contracting partners, since the other party may be deprived of the support ordinarily available to enforce contracts. Such immunity is of course rather compelling in settings with imperfect separation of powers (i.e. no independent judiciary). If the sheriff is not going to seize the king's car on behalf of a creditor, then declaring immunity of the king's assets is a useful clarification. In modern times, however, immunity can typically be and often is ruled out explicitly in the law and in the contract. This allows the

enforcement of contracts, helping government entities such as kings, countries, and municipalities to be more suitable contracting partners, at least in principle.

Nevertheless, if a contract dispute is sufficiently “political,” intervention from executives or legislators may help it escape or override the judicial process, so separation of powers will never be perfect. This can be done in an innocent fashion without compromising the courts themselves, for instance by paying off creditors who would otherwise go to court to have their claims serviced. Thus, bailout, whether of a defaulting state owned company, a private company or family, or a subnational government, can be seen as preventing a call on government, broadly defined, to enforce contracts under the law.

This call to enforce the property rights may indeed be a compelling cases for intervention; the law may have enforcement consequences that are unacceptable politically (think of Shakespeare's Merchant of Venice). If schools are to be closed, taxes to be raised, or policemen to be fired and lose their pension, pain is being distributed. More importantly, perhaps, higher level government is implicated - through adjudication and enforcement - in triggering the event. Actually, if the law does not set explicit limitations for the powers given to creditors, voters could in principle lose *all* control over taxation and service delivery, thus all control over their jurisdiction, including, in the limiting case, everything of value there (such as private property). For these reasons, unless the law delicately sets limits to creditor rights in actions against subnational government, the process cannot be contained within an unpoliticized judicial machinery. An important aspect of the bailout is that it allows the confrontation between creditors and debtor to escape the judicial process, and thus prevents what might otherwise be an

embarrassing and costly exposure of the limits to the rule of law. A bailout makes the situation go away, so the obligation to enforce property rights may no doubt in practice contribute to bailouts in practical life.

By the same logic, bailouts might be avoided if it is clear that creditors have few legal rights relative to a subnational government debtor in default. This is subject to an important caveat-- creditors must also lack political clout. As examples, both Inman (Chapter 12) and English (1996) find it important for the resistance to state bailouts in the US in the 1840s that many of the bondholders were foreigners and thus weak politically in a US context.

An observed arrangement with weak creditor rights that has both positive and negative aspects is seen among sovereign nations, but also among the states in the United States. Against sovereign nations, third party enforcement is either unavailable or limited and extremely costly. Similarly, in the US federation, the federal government and its institutions effectively are barred from enforcing obligations of the individual states. One consequence is that the debtor is protected from the consequences of certain sanctions, and another is that the federal government is freed from the bailout pressure that might result from being implicated in such consequences. Nevertheless, this institutional arrangement is more an inheritance than something that can be recommended for adoption in general, but aspects of it may convey lessons about the bailout problem in general.

For local governments in the US, weak creditor rights are an important part of the general framework, though in a very different arrangement. Both state law and federal law can be used in proceedings of defaulting local governments, often under a bankruptcy

law and often involving a trustee acting under the supervision of the courts (See McConnell and Picker, 1993). Bankruptcy proceedings can only be called by the municipality, not the creditors-- a first expression of weak creditor rights. Interestingly, in actual US practice, municipal assets are invariably left in the hands of the local government, as are important policy instruments such as expenditure programs and most taxes (a few new taxes may be authorized to service debt in an orderly way). Thus, effectively, creditors are left with very weak rights both at the municipal and the state level. While probably having other implications both positive and negative, one interesting aspect of such weak creditor rights is that this arrangement protects the judiciary from political intervention, not by building strong judiciaries (which may be difficult, particularly in a common law context), but by avoiding situations that would call for intervention. If giving creditors greater access to the tax base would violate an understanding of democracy, or if closing schools would seem as harming children rather than the responsible parties, then these qualms could command bailouts or other political interventions in a system with less restricted creditor rights. Importantly, weak creditor rights may have costs in terms of supporting a low quantity of credit, or in terms of costly signaling by those who want to borrow, but they do appear to provide clarity as well as uncompromised enforcement institutions.

IV. Hierarchical Mechanisms

This section proceeds by first examining some cases of successful hierarchical oversight. Next, it examines some cases in which hierarchical mechanisms failed to prevent serious manifestations of the moral hazard problem. Finally, it provides some specific lessons from the case studies about how to introduce and strengthen central government rules and oversight while sowing the seeds of market discipline in developing and transition countries.

A. Successful Hierarchical Oversight

Fiscal discipline in the local government sectors of Norway, Hungary, and Canada is enforced primarily by hierarchical mechanisms and this is to some extent also true for local government in the U.S. The contrast in Canada between provinces and local government provides a useful illustration. The fiscal crises affecting the Canadian provinces in the 1930s affected the municipal governments as well. In fact, the Canadian provincial governments were responsible for funding most of the municipal level public services, and the fiscal woes of one level therefore reflected those of the other. The provincial governments learned that they would be held responsible not only for their own debt and fiscal health, but for those of the municipalities as well. The provincial governments responded by imposing strong hierarchical controls on local spending and borrowing. The provinces now have control over the vast majority of local revenue, and local borrowing is very limited. Provincial governments regulate all aspects of local borrowing.

A similar development took place more recently in Hungary. During the early stages of the transition process, local governments began to run large and persistent deficits, some of which escalated into financial crises and demands for bailouts. Like the Canadian provinces in the 1930s, the Hungarian central government responded by implementing hierarchical control mechanisms over local spending and borrowing. The ministry of finance now oversees the budget process at all levels of government, controlling ex ante payments against budget appropriations. The central government regulates local government borrowing, requires balanced budgets, and enforces numerical debt service limits.

In both cases, the lower-level governments were extremely dependent on transfers, and no one could reasonably expect that local governments adjust to adverse fiscal shocks on their own. High levels of vertical fiscal imbalance clearly presented higher-level governments with a moral hazard problem. Since they knew they would ultimately be held responsible for local burdens, they implemented top-down fiscal restrictions.

The Norwegian case tells a similar story. Local governments are highly dependent on transfers, and the central government assuages the intergovernmental moral hazard problem with strong, binding hierarchical rules. Even though they are popularly elected, local governments are viewed essentially as agents of the central government. Norwegian local governments have some discretion in raising revenue, but local budgets are regulated by the central government (via the supercounty administrator), which requires operational budget balance. Loan financing for current expenditures is not

allowed, and all local government borrowing must be approved by the central government.⁸

In each of these cases, hierarchical restrictions do a reasonably good job of mitigating the problem of deficit-shifting. But this form of oversight is not without its costs. According to the case studies, a less severe problem of cost-shifting remains. In other words, while the worst forms of moral hazard may be under control by administrative fiat, the problem is not eliminated. No matter how complex or rule-based its criteria for intergovernmental transfers, it is difficult for the central government to distinguish between true local fiscal hardship and strategic information manipulation. Each of these case studies described strategic “grantsmanship” by local governments-- attempts to hide and distort true costs and benefits in order to receive extra resources funded by other jurisdictions. Chapter 9 suggests that this may be part of the explanation for the rapid growth of the public sector in Norway, so the scheme may have been less successful in containing government size than in containing fiscal deficits. This is particularly interesting in the Norwegian case since conditions may be termed extraordinarily positive for elimination of moral hazard. There are very many municipalities, an unusual homogeneity and consensus about goals, and both at the center and locally the belief exists that grants are used proactively to enhance discipline.

Moreover, each of these case studies expressed some concern that the dominance by the higher-level government is damaging to market oversight and more generally suppresses the advantages of decentralization. In Norway and Canada, lenders to local

⁸ In a recent development, when the mayor of Austevoll municipality “declared” bankruptcy, the minister of local governments declared “municipalities cannot go bankrupt”. Subsequently, the supercounty administrator not only indicated where the municipality make savings and revenue efforts, but also

governments view the central (provincial) government as ultimately responsible for the debt, and credit markets therefore have no incentives to screen or punish for poor fiscal performance. The Canadian and Norwegian cases suggested that domination by higher-level governments provides the local governments with few incentives to be innovative or energetic, and in Norway at least, provides “little scope for local democracy.” The authors of each of these case studies suggested that local governments did not have strong incentives to use even their existing borrowing authority to promote local investments in schools and infrastructure.

But the costs of hierarchical oversight should not be over-drawn. Though these cases clearly demonstrate the tension between hierarchical and market-type hard budget constraint mechanisms, they also show that the two can coexist in practice. The Canadian case suggests that in spite of blunt hierarchical oversight, local fiscal decisions do affect the well-being of voters, who do face some incentives to oversee local decisions. The Hungarian case displays a particularly encouraging mixture of market and hierarchical mechanisms. Much of the recent legislation strengthening central oversight is also aimed at building the elements for disengaged market mechanisms. For instance, new securities regulations introduce far-reaching information disclosure and audit requirements, which make it easier for local creditors and voters to assess local fiscal performance. The municipal bankruptcy law creates a prospect for default resolution without additional money and political intervention, though only time can tell whether the courts or political intervention will prevail. Moreover, the debt service limits themselves seem to take a clever form—local government borrowing limits are

explained that the municipality had been punished in grants allocation for its lacking revenue effort (Bergens Tidende, October 5 and 18, 2000).

determined by a formula that provides local governments with incentives to collect more revenue and control costs. Such rules are less redistributive and provide steeper incentives – conditional on the center’s ability to signal commitment not to deviate from them.

B. Failed Attempts at Hierarchical Oversight

In spite of some problems, hierarchical hard budget constraint mechanisms in Hungary, Canada, and Norway are deemed successful (at least in part) because they appear to have prevented persistent deficits and serious moral hazard problems. The same cannot be said for attempts at hierarchical oversight in India and Brazil. The failure of market mechanisms in these countries was described above. India has relied on a form of hierarchical oversight for some time, while Brazil has attempted more recently to introduce new hierarchical mechanisms in a context of a liberal federal regime. Each is discussed in turn.

Forms of fiscal discipline based on markets for credit and votes have played a very limited role in India because of the dominant role of the central government in allocating and approving state borrowing, in turn commanded by the limited depth of a nonpublic financial sector. The Planning Commission, the Finance Ministry, and the Central Bank are all involved in the regulation of state finances. The central government and its agencies are the primary source of credit for the states, and all of the states are in debt to the central government. The central government appears to have a wide range of constitutional and statutory hierarchical mechanisms at its disposal. States have several channels for circumventing controls, including the access to and the guaranteeing of the

borrowing by state-owned enterprises. More generally, political and administrative fragmentation at the center undermines the commitment to enforcing the hierarchical rules. Coordination between the various commissions and agencies responsible for overseeing state borrowing is also a major challenge. Perhaps even more important is the fact that in recent years, the political composition of the central government (weak, logrolling coalitions of state-based parties) is poorly suited to establish discipline and enforce limits on local borrowing. The center possesses neither the strength nor the incentives to implement new legislation aimed at closing loopholes in the existing framework for oversight.

The story in Brazil is quite similar. Through much of the 1980s and 1990s, the Brazilian states faced few effective hierarchical limitations on their spending or borrowing decisions. The only restrictions placed on the states actually had the opposite effect: by placing restrictions on states' ability to control their expenditures on public sector wages and pensions, the center bolstered the perception that states were unable to adjust. The central government has used the powers it gained as states had to negotiate with the center, however, to strengthen its authority to regulating state-level spending and borrowing. The central government now has tools that were not afforded it in the constitution, instruments that in theory at least can be used to limit borrowing by states, including numerical limits on debt, prohibitions of new bond issues and of borrowing from state-owned banks. The effectiveness of these instruments has been undermined in practice, however, by administrative and political fragmentation in the federal government (as in India). The most important problem with hierarchical oversight in Brazil is the fact that enforcement is left to the Senate, which is dominated by the

interests of the state governors. However, a new set of hierarchical mechanisms has been introduced in Brazil with the recent “fiscal responsibility” legislation, and these may indeed prove helpful, though the keys lie in the credibility of the center’s enforcement.

These cases of unsuccessful hierarchical oversight suggest three related lessons. First, hierarchical oversight is not simple when subnational governments have access to a wide variety of formal and informal sources of credit. Tools for hierarchical control may be particularly restricted in federations, where the center is constitutionally constrained, at least until the point where subnational crises lend the central government a stronger hand. No matter how committed the central government may be, it can be extremely difficult to design and enforce an adequate hierarchical regime. More specifically, any regime of hierarchical fiscal discipline must focus not only on direct government borrowing, but also on borrowing through state-owned enterprises and state-owned banks. In addition to India and Brazil, evidence from China, Argentina, and even Germany suggests that central government reform efforts should attempt to enforce clear separation between the budgets of subnational governments and their public enterprises. In each of these cases, borrowing activities of (or through) subnationally-owned enterprises introduced important off-budget sources of “soft” local government finance. More obviously, subnational governments simply should not own banks, or if they do the regulation of financial institutions and the framework for subnational governments becomes inter-related and all the more challenging. Fortunately, the Argentine provinces and Brazilian states have recently agreed to privatize their banks. As clearly demonstrated, an important building block in subnational government fiscal discipline is

that the regulatory and supervisory power of the country's financial sector institutions – irrespective of ownership – is vested in independent national institutions.

The second lesson is that hierarchical mechanisms are only as good as the strength and credibility of the central government's commitment to stand by them and enforce them. The central governments of Brazil and India are in many respects arenas for the consummation of regional logrolling deals. Legislation in Brazil requires cross-region coalition-building where national parties cannot be relied upon for party discipline, while legislation in India requires tricky bargains between state-based parties. Section two above suggested that such fragmented political institutions undermine the central government's commitment to "say no" when pressed for bailouts. Such conditions also undermines hierarchical discipline, so the implications for fiscal discipline translate into a cautionary note on the extent and shape of decentralization as well.

The third lesson follows from the second: blunt hierarchical mechanisms like central government credit allocation and borrowing restrictions do not seem to work well in large, diverse federations. Large jurisdictions will assert their own powers and will likely over time win some battles to govern their own affairs. Reflecting this, perhaps, political federalism is a form of government that limits the ability of central governments to intervene in the affairs of the federated units. Moreover, formal federal systems often feature constitutional provisions that protect the autonomy of the sub-units, or they directly include representatives of the sub-units in central government institutions—typically the upper house (examples are the Brazilian and U.S. senates). Then, the clout of the largest subnational jurisdictions can undermine the success of hierarchical control mechanisms. Although the size of our sample does not allow firm conclusions, it is

tempting to conclude that strong Norwegian-style hierarchical hard budget constraints are most likely to be effective in small, relatively homogeneous political entities such as within Norway, or within a Canadian province.

V. Designing a Hard Budget Constraint

In the previous sections, we used the case studies to explain how different systems of fiscal decentralization work and identify key problems that undermine hard budget constraints. But we have also emphasized that one solution will not work for all cases. In fact, some “solutions” may do more harm than good under the wrong conditions. This section builds on that theme, exploring what can be done in a process of decentralization in light of country conditions and characteristics. While a good deal of cross-national variation can be explained by historical and institutional legacies, institutions *can* be altered and incentives improved. In fact, fiscal crises and even large bailouts provide some of the best opportunities for institutional reform. This section concludes by bringing out some basic principals that might guide an intergovernmental reform agenda.

Can a federation be flawed?

Theory concludes that autonomy in some dimension (borrowing, say) usefully can be granted to the lower levels if incentives can be structured so as to internalize external effects. The other side of the coin, however, is that hierarchical controls can be helpful if the center is unable to commit to an incentive framework that internalizes

externalities, for instance if it cannot resist calls for bailouts.⁹ Thus the bailout problem arises when the central government is vulnerable to the effects of a subnational fiscal crises *and* fiscally strong enough to execute a bailout, while too weak in terms of other instruments (regulatory, say) that in advance could prevent subnational fiscal profligacy.

Consider jurisdictions ranging along a continuum from national governments to small municipalities. At one end of the continuum, no higher-level entity (or third party in general) exists which has the power to control the jurisdiction's acts *ex ante*, and no entity has the inclination (i.e. vulnerability) and fiscal powers to execute the bailout *ex post*. Importantly, *between* nations, several possible sources of external effects will typically be severed, so the extent of vulnerability is reduced simply as an institutional phenomenon: there is no or little codependence in access to credit or in the exchange rate, and the obligation of judiciary enforcement is cut off. We might refer to these conditions as characterizing fiscal "sovereignty." Moving along the continuum, consider a semi-autonomous province within a nation. In such cases, the higher level has the fiscal powers of the lower level and then some, for instance through its money creation powers, or simply because the power to tax originates in the central government's soldiers.¹⁰ Moving even further to small municipalities, it might be the case that the lower-level jurisdictions are highly dependent on higher levels for financing and serve primarily as conduits for the implementation of national government policies. In these latter cases,

⁹ For a parallel perspective from the firm, see Holmstrom and Milgrom (1994).

¹⁰ A general assumption that national government has the fiscal powers of lower levels and then some is straightforward from a perspective of physical powers, even as we see nations taken over, forming coalitions and breaking up. However, delegated tax authority must be recallable, and thus the assumption may not apply if constitutional constraints can be committing. But physical powers and time consistency may be tests more important than the commitment in a constitution. Assume for instance that a constitution states that the national government cannot levy taxes on property. National government might respect that provision; not changing it or circumventing it. But national government might also refrain from levying

the ambitions and the fiscal powers of higher-level governments should be matched by other powers, for instance to regulate the activities of lower-level governments. As the center's vulnerability increases, so should its ex ante regulatory powers.

In the abstract, this kind of symmetry of powers might be expected to evolve naturally, but this is not always the case. Institutions may be described as "staggered layers;" some "heavy" layers that are difficult to change constitute the rules of the game, while some "lighter" ones represent the actions in each period of play.¹¹ In some countries, basic "heavy" institutions create a troubling asymmetry: a center that is weak in its regulatory authority vis-à-vis subnational governments may be strong fiscally and thus vulnerable to their fiscal irresponsibility. This asymmetry appears often to be a side-effect of the bargains that create and maintain many large, diverse federations. Even if they start out with symmetric and quite limited powers, central governments in federations gain wide-ranging fiscal authority over time, especially in response to wars and other domestic crises. However, the constraints of federalism—whether formal and constitutional or informal and political—often prevent the central government from amassing symmetric powers to regulate the activities (including borrowing) of the states or provinces. Whether or not a country maintains an explicitly federal constitution, the central government might find it difficult to regulate local fiscal behavior if it is fragmented by frequent power struggles, short-term incentives, and difficult coalition-building.

property taxes because this is found to be a sensibly delegated revenue source, so the role of the provision itself may be hard to judge.

¹¹ Williamson (2000), to illustrate, mentions norms and religion as forming over a century to a millenium; bureaucracy and judiciary over decades to a century, etc. In our context of government design, the

The Challenge of Decentralization

Figure Five illustrates this problem by examining three key dimensions of relations between governments. First, it categorizes central government as fiscally strong or weak. Second, it asks whether the central government can credibly lock away its discretionary power to provide bailouts. Third, it examines the strength of the central government to regulate the activities of lower-tier governments. In the far northeastern cells, which we have merged, the central government is strong fiscally, but these fiscal powers are matched by strong regulatory powers. We refer to this arrangement as subordination. In this cell, the central government's deep pockets might make it vulnerable to manipulation, but it has the regulatory capacity to assuage the potential moral hazard problem by controlling or regulating local decisions *ex ante*. We have reviewed several "hierarchical" mechanisms that might be successful in this regard. In this environment, whether or not the central government has locked away its discretion is not important, since the subnational government does not have much power with which to manipulate the center.

As countries decentralize and move away from the subordination cells, the danger is that central governments will lose instruments of control over local governments without giving up or credibly locking away their fiscal powers. Our case studies show that decentralization falls rather easily into the "bailout" cell, where the central government has weak control over lower-level governments, while it retains the deep pockets that render it vulnerable to gamesmanship for bailouts. As we have seen, it can be extremely difficult to move quickly to the Northwestern-most cell where discretion

distinction would be between 'superlaws' such as constitutions, and laws, assuming that the former can be changed less frequently than the latter, thus changing the nature of the subsequent game.

has been credibly locked away. This corresponds with what we call “unconstrained decentralization.” A central government with strong fiscal powers at the beginning of a decentralization process will find it extremely difficult to make credible promises not to provide bailouts when emergencies arise. This might be particularly difficult in cases where the central government has, through a recent history of state socialism, come to be viewed as ultimately responsible for insuring basic services.

Figure 5: Dimensions of Intergovernmental Relations

		Has the center credibly locked away its discretion?	The central government's ability to regulate subnational government is:	
			weak	Strong
Central government is fiscally:	Strong	Yes	Unconstrained Decentralization	Subordination
		No	Bailouts and Soft Budget Constraints	
	Weak	Not relevant	Sovereignty	

In terms of the resulting incentives for subnational governments, the cell "unconstrained decentralization" has much in common with "sovereignty." Steps can indeed be taken to improve the center’s commitment, but we have argued that full commitment will not arrive instantly in response to some institutional tinkering. For this reason, realistic acknowledgement of the center's powers, ambitions and commitment problems is key to successful decentralization, and the framework will include regulation, involvement and oversight; quite different from what is experienced by a sovereign. Short of situations like Yugoslavia, it is also unlikely that countries will move directly to the lowest row of Figure Five by giving up significant fiscal power. In fact, we contend that true subnational “sovereignty” is quite rare, and an approximation is mostly likely to

evolve when independent entities like the American colonies cede authority to a (then) weak central government in an explicitly limited way.

Combining Markets and Hierarchy

We have argued that it is naïve to expect central governments to disengage or commit so quickly or completely as to make market mechanisms sufficient for fiscal discipline. Yet hierarchical mechanisms will often be both too inflexible and too bendable; they can stand in the way of good projects and then bend to unfortunate political pressures. Thus, subordination-- especially when it comes to borrowing and investment-- is not likely to provide a satisfactory answer to the problem of subnational fiscal discipline, especially in large, diverse federations. How is it possible for a country to move its subnational jurisdictions away from outright subordination without softening budget constraints?

Although the best strategy depends on the characteristics of the country in question and the starting point, the case studies seem to point to a general strategy resolving this dilemma. This strategy entails sustained, perhaps even increased central government oversight in the short term, using the rules and administrative procedures that create the strongest possible incentives for voters, creditors, and asset owners to oversee local fiscal decisions in the longer term. The case studies and section three show that practical steps can be taken to strengthen market discipline, even in the short run.

Consider once again the case of Hungary. As suggested above, the new rules regulating local borrowing in Hungary, while placing real constraints on the borrowing behavior of local governments, create incentives for local governments to increase revenue efforts and cut costs. The new regulations also invite oversight from voters and

creditors by forcing local governments to provide information, including by establishing accounting and auditing procedures. The most interesting innovation in Hungary, however, is the new legislation governing local bankruptcy. Instead of the center being pressured to respond to local fiscal crises on an ad hoc basis, this legislation points to a set of clear procedures. The most important aspect of the process is that it does not involve the central government legislators or executives—it relies on courts and arbitrators. This is as good an effort as any to signal to local governments, their voters, and their creditors that the central government will not use the public purse to resolve local fiscal crises. Such laws can help establish the precedent that the consequences of local fiscal decisions will be felt by local citizens and creditors. Political pressures for bailouts and other interventions will emerge, but a good defense lies establishing such a standard procedure. The record from other countries (see English, 1996, and chapters on U.S., Canada) indicates that the early tests are the important ones.

Can Bailouts Improve Incentives?

One should not exclude the possibility that central government oversight can be improved and market discipline encouraged, perhaps ironically, through a bailout. In some of the cases, subnational governments were highly dependent on transfers, and these transfers were simply inadequate in the face of exogenous shocks produced by fluctuations in interest rates, inflation, and other factors over which subnational governments had little control. In cases with high transfer dependence, central governments may in certain cases not be able to avoid some sort of unplanned, emergency transfers in a given subnational fiscal crisis. Also, the crisis and the bailout

may allow an opportunity for negotiations and improvements in institutions that otherwise would be impossible. The main problem with unplanned emergency transfers, especially at the early stages of democratization and decentralization, is the demonstration effect—they may undermine the learning process that can eventually lead to market discipline.

But all bailouts are not created equal, and our lesson is that bailouts differ by the institutional reforms accompanying them. The Argentine case demonstrates that bailouts need not teach local governments and their constituents that profligacy pays. The central government may be able to structure a package with reforms that staves off default and alleviates the most serious hardships without creating bad incentives for the future. The fiscal pacts that have been negotiated between the central government and the provinces have not absolved provincial governments of their responsibility to repay their debts. In fact, provincial governments have been forced to deal with significant political and fiscal hardships after the debt renegotiations. The central government has an important mechanism at its disposal—it offers to collateralize transfers and channel them to the creditors of each province. Thus facilitates enforcement, bringing willingness to pay closer to ability to pay if the former should be lower. The cost may be that the center puts itself in the middle: it would most likely have to deviate if it should be challenged to continue sending transfers directly to creditors under a severe provincial crisis, so the scheme would be threatened by a failure to prevent such crises.

The Argentine and the Brazilian cases show that bailout episodes can be important opportunities for major reform of the intergovernmental system. In federations in particular, the center's hand may need to be strengthened by concessions of

subnational governments, but these concessions often only come if the center has something to give. The Argentine central government insisted that the provinces agree to several far-reaching structural reforms aimed at improving long-term incentives. Above all, the provinces were forced to privatize their banks.

Concluding Reflections

As subnational governments gain new rights and responsibilities around the world, a number of things can go wrong. In many countries, decentralization is a political process that is driven by transitions to more democratic, participatory forms of government. Actual experiences with decentralization will depend critically on basic institutional and political incentive structures. While these are in some respects products of lengthy processes of evolution and learning, they are also fundamentally products of human design. Opportunities for serious, purposive institutional design are rare but not entirely lacking. When they present themselves—often as the result of failure and crisis—it is useful to have some basic guiding principles. Although this book has advanced several such principles along with more specific arguments about institutional design, one observation stands out—the importance of transparency and accountability to ordinary citizens. Perhaps the most important but vexing “hard budget constraint mechanism” is an active and informed public with incentives and tools to oversee government decision-making. In the long run, budget constraints are most likely to be hard, and decentralization deemed a success by scholars and citizens alike, if the decentralization process bolsters the accountability of governments at all levels to their citizens.

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