

## *Chapter 1:*

### *Introduction and Overview*

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#### **I. The Context of Decentralization**

The basic structure of government is undergoing a major transformation around the world— central authorities are rapidly transferring responsibilities to lower levels of government. This has engendered a debate about the costs and benefits of decentralization. On the one hand, decentralization can introduce a sense of popular ownership of government and bring about direct benefits like improved efficiency and accountability in the public sector. On the other hand, it is becoming increasingly clear that decentralization may also introduce new costs that can easily undermine the benefits in practice (For example, see Prud'homme, 1995). In particular, the decentralization of fiscal and political authority creates incentives for opportunistic behavior among state and local officials. If the incentive framework is not well structured, the scope for microeconomic efficiency gains and even such goals as macroeconomic stability might be undermined.

Perhaps the most serious challenge to macroeconomic stability and efficiency in decentralizing systems is the subject of this study-- the maintenance of fiscal discipline. When budget constraints are soft-- meaning that an entity can expand its expenditures

without eventually facing the full cost-- expenditure programs involve negatives externalities and will therefore be overextended. This book uses case studies from OECD and less developed countries to explore the sources of hard and soft subnational budget constraints. In doing so, it transcends more abstract debates about the merits of decentralization, showing how the relationship between decentralization, efficiency, and ultimately accountability to citizens depends critically on a country's background and institutions.

Decentralization may be defined in many ways, but it will typically involve increased responsibilities and autonomy for lower level entities in one dimension or another. For a country, as for a firm or other organization, autonomy for a member entity raises the potential for opportunistic behavior, possibly with undesirable as well as desirable effects.

With the appropriate assignment of taxing and spending powers, provincial and local governments can be important conduits for the efficient provision of government services, whether they are seen as subordinate creations of the higher level governments or as entities accountable mostly to local constituencies. Moreover, when sub-national governments have real fiscal and political responsibilities, decentralization might enhance political participation and democratic accountability. Since some economists associate potential efficiency gains with decentralization, it is not surprising that some scholars even suggest that under the right conditions, fiscal decentralization can facilitate economic growth.<sup>1</sup>

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<sup>1</sup> For a review of the literatures linking decentralization to enhanced efficiency, democratic accountability, and growth, see Rodden (1999a, chapter 2).

While the potential benefits of decentralization have been addressed by a rich theoretical tradition ranging from Montesquieu to modern welfare economics and public choice, the costs have more often been addressed in post-hoc descriptive case studies. Recently, however, several empirical studies using pooled cross section and time-series techniques suggest that fiscal decentralization, as seen in practice, has not been associated with faster economic growth.<sup>2</sup> Evidence from these and other studies have resulted in warnings that the costs of decentralization can be high, especially at early stages of economic development, and in countries in transition to a market economy.

Above all, decentralization can undermine efficiency when each jurisdiction faces incentives encouraging costly sub-optimal behavior, leading to uncorrected externalities between jurisdictions. The soft budget constraint problem is but one example of such externalities.<sup>3</sup> While traditionally many analysts have assumed such problems to be unimportant under government decentralization, more recent literature has been aware of these practical challenges, and thus more balanced in terms of the costs and benefits of decentralization.<sup>4</sup> These studies focus on characterizing the conditions under which decentralization enhances or undermines the efficiency and accountability of the public sector, and emphasize the incentives resulting from political and other institutions.

This analytical approach is particularly pragmatic as it acknowledges that decentralization is usually driven by political and not economic concerns. Institutional designers and policy analysts need to know which institutions have worked, where, and

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<sup>2</sup> See, for instance, Zhang and Zou (1989). The indicators of fiscal decentralization in these studies come from finance statistics. An important question is whether it is right to interpret the subnational share of total public spending as an indicator of decentralization.

<sup>3</sup> Other examples include excessive vertical or horizontal tax competition, and the “local protectionism” that arises when subnational politicians gain opportunities and incentives to obstruct the free flow of labor, goods, and services across jurisdictional boundaries.

under what conditions? One of the most troubling outcomes of decentralization is the potential threat to fiscal discipline that arises from soft budget constraints. By developing a more comprehensive, interdisciplinary framework for assessing state and local budget constraints and applying it to 11 OECD and developing countries, this book sets out to develop a better understanding of what causes subnational fiscal indiscipline.

The analysis starts with a general discussion of the soft budget constraint problem. A goal in this discussion is to gain an understanding of soft budget constraints that goes beyond describing them as unfortunate policy errors. This study examines the forces driving the center to share costs in the aftermath of excessive subnational expenditures. While the underlying problem of soft budget constraints is similar in all decentralized public sectors, we argue that its severity and the proper mechanisms to handle it depend on each country's institutions.

Thus the goal of this introductory chapter is to set up an analytical framework to explore the problem and its potential solutions in a wide variety of settings around the world. It introduces the goals and the architecture of the case studies, and foreshadows some of the arguments and conclusions to be made in the final chapter. The following section explains the nature of the soft budget constraint problem in general terms. The third section then explores how incentives can be inadequate in some institutional settings. The fourth section lays out several specific mechanisms that might harden the budget constraints for provincial and municipal governments. The final section introduces the case studies to follow. In chapter 13, we build on this foundation, drawing out the lessons of the case studies in greater detail.

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<sup>4</sup> See, e.g., Inman and Rubinfeld (1997), Litvack, Ahmad, and Bird (1998), Rodden (1999a), Tanzi (1995), Qian and Weingast (1997), Ter-Minassian (1997).

## **II. Soft Budget Constraints and Bailouts: Exploring the Commitment Problem**

### *Defining Terms: Soft Budget Constraints and Bailouts*

The term *soft budget constraint* describes the situation when an entity (say, a province) can manipulate its access to funds in undesirable ways. Janos Kornai introduced the term to describe how state-owned enterprises could rely on increased subsidies if they increased their losses. *Bailouts* -- the kind of ad hoc additional funding that is provided when an entity would otherwise be unable to service its obligations -- do not necessarily represent soft budget constraints, but *expectations* of bailouts often do.

Softness of budget constraints comes about in various ways, but often there is a time lag and something that can be interpreted as an implicit contractual relationship. The most obvious problem arises when a provincial government incurs liabilities which later may be passed on to (and accepted by) the national government. For example, the recent financial crisis in Brazil was triggered if not caused by provinces de facto defaulting on their debt. The transfer of debt is only one of the many ways in which subnational liabilities eventually become national liabilities. Others include the under-funding of public sector pensions, the under-provision of public goods, and debts and arrears to public and private enterprises. These manifestations of soft budget constraints have been particularly important in formerly socialist countries. In any of these forms, the soft budget constraint problem can undermine macroeconomic stability, creditworthiness, accountability, and key public functions as we shall see.

In recent literature, the problem of soft budget constraints has been addressed in the context of the relationship between firms and creditors (Dewatripont and Maskin, 1995; Maskin, 1996). This literature provides an appropriate definition: “A soft budget constraint arises whenever a funding source finds it impossible to keep an enterprise to a fixed budget, i.e., whenever the enterprise can extract ex post a bigger subsidy or loan than would have been considered efficient ex ante” (Maskin, 1996: 125). The enterprise predicts it can position itself for the subsidy by taking certain actions (such as not having money to pay workers), and it then undertakes those actions, even if wasteful in themselves.

J. M. Keynes is credited with the statement “there is no such thing as an unfunded deficit.” When subnational budget constraints are soft, the national government eventually funds more of subnational expenditures than it intended. With subnational governments as well as with firms, soft budget constraints harm efficiency by introducing negative externalities. Autonomy is in general good for efficiency if a body faces the full costs of its choices, but if a body faces soft budget constraints, others will pick up part of the tab. As a consequence, softness implies that incentives are tilted towards excessive spending (or too little tax effort), and in many cases the open window is called borrowing.

### *The Sequential Bailout Game*

The problem of bailout expectations boils down to a simple sequential game. The first move is made by a self-serving local government, which borrows to adopt an unaffordable policy that provides local benefits. Or more passively, it may decide *not* to

undertake painful expenditure reductions (or tax increases) in response to a permanent negative revenue shock. It then finds itself in fiscal difficulties, and requests a special deficit-reduction grant or asks that the central government take over its obligations. The central government has the second move, and at that point the costs to the central government of *not* providing additional funds may exceed those of providing one. In some situations, the subnational government may have understood this all along, which is why it spent too much or refused to adjust in the first place.<sup>5</sup>

The key questions of this study emerge directly from this simple strategic scenario. First, if bailouts are costly and unproductive for the system as a whole, why would subnational politicians expect that central government have an interest in providing them? Second, can such expectations be altered once they have evolved? Third, if they cannot be altered, how can the costs of the resulting moral hazard problem be mitigated? In order to address these questions, it is important to understand a basic commitment problem facing higher-level governments. We introduce this problem with a simple analogy.

*The Commitment Problem: If you own a fire truck...*

Consider the problem of a voluntary fire protection cooperative. Incentives to contribute voluntarily to a fire department would appear to be adequate if it established a policy of extinguishing fires for contributing members only. But a policy of refusing to put out the fires of non-members might not be *credible*. With a firetruck around, to put

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<sup>5</sup> This problem is called the time-consistency problem in the economics literature. An appropriate example in public finance may be that a bridge project is found worthwhile and funded under a certain cost estimate. A stated policy not to increase funding if the cost estimate is exceeded is not time consistent (i.e. not credible), given that it is still worthwhile to *complete* a half-built bridge when the new estimate arrives.

out *any* fire may be rather compelling, either because there is an externality (fires can spread), or simply because wasting fortunes and lives is senseless. But if people expect all fires to be put out, incentives to contribute voluntarily will be inadequate.

It could be, of course, that letting a house burn down despite the ability to stop it would be an excellent way to make people contribute voluntarily. However, to make such sacrifices to earn a reputation may be a costly way to improve incentives. It may even be infeasible due to commitment problems, so voluntary fire services might be non-viable, even when there is a compelling economic case for them. The combined effect of the externality and the commitment problem can explain why governments provide fire protection through coercive taxation and enforce fire codes, even if these policy instruments are clumsy and bureaucratic relative to an idealized, incentive compatible world.

*Why do subnational governments expect bailouts?*

Now consider subnational fiscal problems as something less dramatic than burning houses. Teachers cannot be paid and children are about to be sent home after a municipality spends its money on an extravagant project, and the mayor throws up his hands. If the central government's standard policy is that jurisdictions must face the consequences of their decisions, is the policy still credible? The extension of extraordinary transfers to keep children in school may look like a policy blunder if they destroy incentives for municipalities. But the lack of credibility might have been evident in advance. The municipality may have had a variety of reasons to surmise that the center would not be able to resist using its "fire truck."

First, as with houses on fire, externalities are an important part of the bailout story. Wildasin (1997) shows how the center may choose a bailout ex post if otherwise the failing entity would cause negative spillovers to other jurisdictions. This argument is important when large financial institutions fail or when there are currency crises--innocent bystanders might be harmed. It also applies if financial markets fail to distinguish the promises of one province from another. More directly, spillovers exist when the national government is viewed as having implicitly guaranteed the liabilities (See, for instance Bai et al, 1999), and where its own reputation would be hurt by failing on those guarantees.

Spillovers are not the only cause of commitment problems, however, and contrary to Wildasin's argument, in many countries bailouts have gone to some of the smallest jurisdictions.<sup>6</sup> It is important to distinguish between an entity that is the subordinate part of a larger organization, and one that is the creation of its citizens. If a local government is merely a branch of the central government, then punishing its citizens is useless at best. It is only as the municipality becomes a body on its own, a creature of its own citizens with powers to match its responsibilities, that the central government might credibly commit to let it face the consequences of 'its' actions.

An additional commitment problem is related to the fact that the government generally is charged with enforcing property rights, typically through the judiciary. A task springing out of this obligation is to help creditors receive payment, or to adjudicate and enforce who gets how much when a contract is in dispute. However, the national government and its institutions might be weak-- lacking instruments, guts, or both-- in its

ability to enforce loan contracts against defaulting subnational governments. Approached by creditors and facing the prospect of failing in its obligation to enforce property rights, a weak national government may prefer a bailout. The case studies examined in this volume will show that a challenge is to have institutions that match responsibilities. A serious problem arises if the center has few enforcement options-- or a faint heart-- but is not absolved from heavy enforcement obligations.

*Can expectations change?*

Most of the case studies demonstrate that basic commitment problems allow bailout expectations in some context. Since many of these problems are rooted in history and the organization of institutions, we also wish to ask whether changes in behavior and institutions can lead to changes in expectations. Can commitment develop over time? Can the center earn a reputation for resisting bailout demands? Some of the case studies discuss historical episodes in which subnational governments learned through painful defaults that the central government would not provide bailouts. These same studies also emphasize institutional and situational factors that bolstered the central government's commitment. Other case studies examine recent institutional reforms that have explicitly aimed to increase the central government's ability to commit.

*What if the center cannot commit?*

While the case studies provide some encouraging examples of institutional reforms that improve the central government's commitment, we will argue in the

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<sup>6</sup> For example, bailouts in Germany have been concentrated in two of the smallest states—Bremen and Saarland. In Brazil, bailouts have gone not only to large, externality-producing states like Sao Paulo, but

concluding chapter that completely credible commitments are quite rare. In the vast majority of multi-tiered fiscal systems, the central government is a bit like the fire department that promises not to use its truck. A key proposition of this book is that *if* for national government, the fiscal problems of subnational governments are like letting houses burn, then this should be acknowledged up front. Under decentralized government, the center's vulnerability to fiscal crises of subnational governments can have causes ranging from concern for the national financial system to an interest in keeping provincial schools open or teachers calm.

If the central government is sufficiently disinterested in local performance or committed not to get involved (it can sell the fire truck or lock away the keys), it makes sense to grant wide-ranging fiscal autonomy to the lower-level governments. But if such a distance or commitment cannot be established (or it is too costly not to have a fire truck available), then an expectation of assistance *ex post* will exist even without a history of such assistance. In such a setting, borrowing restrictions and other higher-level intervention in lower level-fiscal affairs, like fire codes, may very well serve a useful purpose. This argument will be developed in greater detail in the final chapter.

### *The importance of institutions*

The case studies will demonstrate that these commitment problems are built into the basic governance structure of many decentralized systems. Soft budget constraints need not follow from a history of bailouts, but rather from an understanding of the nature of the center, its powers, and its commitments. A consistent and sad history of bailouts may reflect stable but unfortunately structured institutions, rather than a game in which

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also to some of the smallest, most isolated states, like Tocantins.

past play determines future play.<sup>7</sup> Similarly, in a newly decentralizing country, even if a central government with no history of bailouts makes verbal and parchment commitments not to help troubled subnational governments, the basic institutional structure might undermine their credibility. Consequently, normative policy prescriptions require an understanding of what drives expectations, what drives the bailout when it is given, and how this unfortunate equilibrium can be changed. The next section pursues this goal with a focus on fiscal and political institutions. Section four then builds on this analysis by identifying several “mechanisms” through which hard sub-national budget constraints might be achieved.

### **III. Basic Fiscal and Political Institutions**

The basic rules for the sequential game are given by fiscal and political institutions, and since these are different in each country, the game is also played differently. This section first discusses the vertical architecture of the intergovernmental fiscal system and the resulting incentives for voters and politicians. Second, it discusses the organization of the central government.

#### *Intergovernmental Fiscal Institutions*

The traditional understanding of intergovernmental grants and tax sharing comes from welfare economics. It assumes that a benevolent, omniscient central government

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<sup>7</sup> Game theoretic treatments (e.g. Bulow and Rogoff, 1989) show that if economic agents try to calculate their opponents' best responses, in important settings there is no scope for changing expectations by playing

assigns expenditure and revenue authority according to efficiency criteria, and that grants serve purposes of efficiency and redistribution (Oates, 1972; Musgrave, 1959). Indeed, the ability of the central government to use grants to overcome problems of externalities and inequality is central to any normative conception of a multi-tiered public sector. In practice, central governments may be vulnerable to tendencies of political economy and rent-seeking well-known elsewhere, and centrally enforced systems of transfers and revenue-sharing may thus cause inefficient responses that are not foreseen in the textbook version.

Unless funding between governments is completely independent of the recipient jurisdiction's choices, it is likely to create moral hazard problems between the central and sub-central governments, just as it does between a dominant funding source and a large firm or between a wealthy family head and a child in college. Sub-national officials-- and perhaps the whole jurisdiction-- face inadequate incentives since citizens of other jurisdictions will pay part of their programs. Local officials are thereby led to expand programs and to raise or exaggerate their costs (for empirical evidence, see Inman, 1988; Borge & Rattso, 1999).

The textbook solution is to let revenue-sharing and transfer programs depend on local choices only when this explicitly is the intention (as when a matching grant supports activities with positive externalities). As an example, transfers to make poor jurisdictions afford a certain provision of schooling would be based on the number of children, or need, rather than paying for actual educational expenditures. This goal may be important to strive for, but not fully attainable in practice. Subnational jurisdictions will try to play

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in a certain way (there simply is no reputation effect).

games to exploit the center (and thereby each other), and a key institutional design challenge is to contain the costs of these games.

Consider a public sector in which sub-national governments are almost completely dependent on transfers and loans from the central government. When faced with an unexpected adverse fiscal shock, local governments will likely not have the flexibility to raise additional revenue, and they will be forced either to cut services, run deficits, or rely on arrears to employees and contractors. If the situation escalates into a fiscal crisis in which the sub-national government is unable to pay workers or may default on loans, it can claim with some justification that it is not responsible for its fiscal woes. If successful in this strategy, pressure from voters and creditors will likely be directed at the central government, which quite likely *can* resolve the current crisis. Knowing this, transfer-dependent governments face weak incentives to be fiscally responsible. Even if such subnational governments could take simple but politically costly steps to avoid an impending fiscal crisis, it may be more rewarding to position themselves for a bailout.

Since it serves little purpose, sub-national politicians will not be held responsible by voters or creditors unless they have some autonomy in matters of revenue and expenditures. Thus an important consideration in the case studies is the level of “vertical fiscal imbalance” for subnational governments, or intergovernmental transfers as a percent of their revenue. However, attention is given also to the structure of intergovernmental grants and regulations in the fiscal system. We expect to see that if poorly defined criteria or political bargains determine the distribution of grants and revenue sharing, the resulting flexibility at the center harms the credibility of any “no

bailout” policy. In contrast, local voters and politicians are less likely to expect discretionary bailouts if intergovernmental transfers are tied to rules and criteria that are not easily manipulated. A separate difficulty is that the rules themselves might create soft budget constraints. More specifically, we shall see that some transfer systems designed to combat inter-jurisdictional inequality and absorb regional shocks create poor incentives for performance.

Each case study also examines the incentive effects of attempts to regulate the fiscal activities of local governments. Like transfer-dependence, central regulation of local fiscal affairs can send a strong signal to local politicians, voters, and creditors that the central government is ultimately responsible for local fiscal outcomes. In some countries the tax bases and/or maximum tax rates of subnational governments are limited by regulations. In others public sector employment and wages are regulated by the center.

Another consideration is the distribution and regulation of expenditure responsibilities. The central government might be unable to resist bailout demands if local governments are failing in their responsibility to provide certain key services that have national constituencies, like welfare or pensions. This problem is exacerbated if national policies -- such as minimum service standards -- limit local autonomy. By the same token, cost-shifting and deficit-shifting should be less likely if the central government is not involved in the provision of purely local public goods.

Finally, the case studies examine the clarity of the distribution of expenditure and revenue authority. This is an area in which the theory and practice of fiscal federalism diverge most visibly. Constitutions in multi-tiered systems do not divide up the

responsibilities of central and sub-national governments into well-defined, mutually exclusive categories. In some cases this may reflect that the public goods in question in their nature belong ‘between levels,’ as when a metropolitan area faces infrastructure challenges comprising several municipalities or even provinces. However, the case studies will show that unclear or shared responsibilities have a cost in terms of accountability and incentives.

### *Central Government Political Institutions*

The beliefs and payoffs of subnational governments are also shaped by the political institutions supporting central government behavior. Sub-national governments examine those incentives to take cues about likely behavior, including the prospects of bailouts. The case studies will show that a number of political factors might undermine the credibility of a policy not to bail out. The *horizontal* organization of the central government plays an important role, and it is necessary to examine the incentives and constraints facing legislators, premiers, and presidents. For instance, the central government might choose to provide a bailout if it faces strong electoral incentives to favor bondholders or local taxpayers over national taxpayers. It is important to know whom holds local debt, and how they are represented in the political process at the center (see Inman, this volume).

In addition, local governments might have strong reasons to believe that bailouts will be forthcoming if their interests are well represented in the central legislature, or if decisions in the legislature are made through regional log-rolling. In several of the cases examined in this volume, fiscally irresponsible governments were able to obtain bailouts

by using their influence in the national legislature, trading votes with other legislators, or by threatening to veto unrelated policy proposals. Some problems of horizontal bargaining are exacerbated if a few provinces are dominant in size. In many countries, a two-chambered legislature gives each region representation proportional to population in the lower chamber, with small regions relatively over-represented in the upper chamber. In such systems, small states have disproportionate power and their votes may be shifted cheaply in political bargaining.

In one particularly troubling scenario, the central government might appear to be little more than a loose coalition of log-rolling regional interest groups. This danger is most pronounced in formally federal systems, which usually include direct representation and constitutional protections for the states. Among our case studies, this kind of regional log-rolling has been a fact of life in Brazil, and is becoming one in India. This problem might be mitigated, however, in presidential systems if the president has a national constituency and the ability to mobilize majorities in the legislature (Fitts and Inman, 1992). This has sometimes been the case in Argentina (Dillinger and Webb, 1999; Webb, this volume). At the other end of the spectrum, consider a legislature in which party leaders have little control over backbenchers, and in order to manufacture a legislative majority, it is necessary to make side payments to each individual legislator. It is easy to envision how representatives of fiscally troubled regions might be able to insist on bailouts in the latter kind of legislature. In contrast, when parties are important in determining the political future of individual legislators, and parties are evaluated by

voters according to their ability to provide national (rather than purely local) public goods, there are fewer incentives for opportunistic cost-shifting (Rodden, 1999a).<sup>8</sup>

In short, the case studies often describe central government politics as a bargaining scenario that results in bailouts that are costly for the country as a whole. By the same token, some of the case studies also lay out conditions under which such self-interested politicians might throw their support behind positive reform efforts.

#### IV. Hard Budget Constraint Mechanisms

The groundwork has now been laid for a discussion of the various mechanisms that can *harden* budget constraints. In fact, section three already discussed one very general mechanism-- the basic fiscal and political institutions and the incentives they create for central and sub-national politicians. But politicians are only part of the story. Fiscal behavior is also constrained by actors such as creditors, voters, and owners of land and mobile factors. Under the right conditions, these actors can contribute to hard budget constraints. In the following, we discuss three “market-like” mechanisms that may under the right conditions support hard budget constraints. First, we discuss the possibility that subnational governments will be disciplined by *credit markets*. Second, we examine the role of *competition for votes* and other forms of political support. Third, we discuss *land markets* and fourth, the role of workers and investors who own *mobile factors*.

We refer to each of these as a distinct hard budget constraint mechanism. The proper functioning of each depends, in large part, on the basic structure of the political

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<sup>8</sup> Strong, disciplined political parties may also have some disadvantages if they weaken the incentives of individual representatives to respond to the preferences of their constituents.

and fiscal systems, but also on what other mechanisms are in place. In important realistic settings, local spending and borrowing decisions will not be disciplined by competition for capital, votes, and mobile factors. Thus a key task of this volume is to establish some of the conditions under which hierarchical intervention in subnational finance is warranted.

### *Capital Markets*

Even in theory, capital markets perform the allocative function well only if capital owners and institutions have the right incentives to select good credit objects. When borrowers are subnational governments, it is not necessarily the case that lenders bear the consequences if a borrower cannot or will not service her loans. If the mechanism works, subnational fiscal decisions are disciplined by the competition for credit, and poor fiscal performance will then lead to higher borrowing costs or constrained access. Such market responses, moreover, which are summarized in credit ratings, can provide important signals to voters about their government's performance. The functionality of the credit market depends on the quality of information, and thus on regulations covering disclosure, accounting principles, auditing, and the like.<sup>9</sup>

A variety of preconditions must be present for capital markets to perform this function of constraining or guiding sub-national fiscal activities (See Lane, 1993). Most obviously, the capital markets themselves and the general supportive institutions must be sufficiently developed. In countries with limited capital markets, access to capital funds is often through the central government-- e.g. a development bank, housing bank, or on-

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<sup>9</sup> Hopes and ambitions should be modest however. Most governments, high and low, rich and poor, if they can produce a list of explicit liabilities, cannot produce a list of assets, let alone a balance sheet.

lending mechanisms-- rather than competitive capital markets. Among our case studies, such institutions have played the most prominent roles in Argentina, Brazil, India, and Ukraine. In such financial intermediaries, lending as well as the servicing of loans often becomes embroiled in politics, resulting directly in soft budget constraints or other dysfunctional characteristics (as when these intermediaries themselves expect to be bailed out).

Even if local governments borrow in competitive international capital markets, the capital market mechanism may fail nonetheless. If *lenders* perceive bailouts to be likely (or provokable) they may continue to lend to sub-national governments in spite of poor fiscal and economic performance. Simply put, creditors will not worry about the borrower's fiscal performance if the loans are backed by central government guarantees, or if the constitution explicitly stipulates that sub-national governments will not be allowed to default. Even without such explicit guarantees, creditors are likely to take additional cues from more implicit aspects of the constitution, the organization of the central government, and the structure of the fiscal system about the likelihood of bailouts. Credit ratings-- and the price and availability of loans-- will then reflect the creditworthiness of the central government, or the public sector as a whole, rather than that of the sub-national government.

When a subnational government's liabilities are not explicitly or implicitly backed by central government institutions, its effects may in the ultimate extreme be parallel to the construct of a limited liability company. Creditors know that they have nowhere else to go if the entity has borrowed too much (or otherwise fails), so they will watch solvency (fiscal performance) carefully. But the resemblance of a limited liability

corporation will be slight: only if creditor rights are very weak can creditors be given adjusted payments for business to resume without higher level political intervention. Importantly, if the impression exists that some third party with deep pockets will keep the entity afloat, the monitoring function of credit markets is eliminated, effectively leaving all responsibilities with the third party. We shall see, quite generally, that the ability-- or willingness-- of higher level governments to distance themselves completely from the predicaments of lower level jurisdictions has its limits. These limits, and how they are reflected in other institutions (such as municipal bankruptcy procedures), determine what role the credit market mechanism can play.<sup>10</sup>

A task of each case study is to describe the nature of sub-national borrowing and assess whether the credit market mechanism is allowed to operate. When public intermediaries are used, the case studies describe and assess the regulatory regimes under which they operate. In several of the cases, a good deal of attention is given to the issue of why the credit market does not serve this function of discipline, or why it is an insufficient constraint on sub-national borrowing.

These are not all cases of rampant fiscal profligacy and bailouts, however. If the central government cannot fully commit to a no-bailout policy, the moral hazard problem can be mitigated by properly designed hierarchical controls on sub-national borrowing (see below). Hierarchical mechanisms are distinct from the credit market mechanism, however, and will to some extent undermine certain functions of the credit market mechanism. First, of course, they may constrain subnational borrowing to levels where

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<sup>10</sup> To give an example, municipal bankruptcy law in the US protects the assets of the municipality from creditors to the extent that they are critical to government functions. In actual cases, this has shielded practically all assets (McConnell et al, 199x). Thus, actual institutions do not allow citizens to lose their

debt-servicing capacity is not even questioned. Second, strong hierarchical constraints might signal to creditors that the central government is ultimately responsible for subnational obligations, breaking the link between the subnational's fiscal performance and its access to credit. These aspects of the hierarchical mechanism are discussed in further detail under a separate heading below.

A final note on credit markets is that the feasibility of financial contracting depends to some extent on a government that can protect property rights and enforce contracts. Part of this role is to arbitrate and enforce a sharing of the burden when it happens that lenders are not getting what they are owed. In that capacity, government institutions act on behalf of creditors against the borrower, but also gives the borrower a limited protection against creditors. Limits in these functions arise in hierarchical government in two ways. First, and particularly in a federal context, the central government may have limited powers relative to member states, even in the enforcement of contracts (see McConnell et al., 1993, and English, 1996, for the US). Second, the central government may be unable (or weak) in acting against a body that is seen as part of itself, as opposed to a separate entity.

These two are at the extremes of a line from sovereign to subservient, commanding different institutional approaches and giving different potential roles to the capital market mechanism. In the case of a subnational sovereign (or a weak central government), credit markets can function, but only to the extent that credit can be sustained without or with very little collective enforcement.<sup>11</sup> In the case of a subservient

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school, for instance, rather distributing all the pain ex post on the creditors. This, in the absence of higher level guarantees, constrains credit by limiting the harm to jurisdictions borrowing too much.

<sup>11</sup> Bulow and Rogoff (1989) provide a good discussion of what sustains and does not sustain credit in the case of sovereigns.

government, the borrower will to a great extent be protected through burden sharing in the case of default. For this reason, in the latter case, supplementary interventions and institutions (such as hierarchical controls) typically play a role.

### *Political Competition*

The political realm also provides a potential form of market discipline for sub-national officials-- the competition for political power. Ideally, voters in democratic systems face incentives to punish fiscally irresponsible representatives - local as well as national - by voting them out of office. The key question is whether voters have the authority, incentives, and information necessary to do so. Free, fair elections with vigorous opposition and autonomous media might play an important role in constraining sub-national fiscal decisions. But voters will prefer large deficits and unsustainable debt levels if they believe the costs will eventually fall on future residents of other jurisdictions. Also, the political mechanism is weakened if it is difficult for voters to obtain information about local performance. For instance, local politicians might be able to claim credit or shift blame for local performance when they are highly dependent on intergovernmental transfers, when they are subject to certain kinds of central regulations, or when the distribution of authority is not clear. Similarly, budget constraints are soft if politicians can fund popular programs in part by running up liabilities that are less visible to voters, such as unfunded pension liabilities or by providing infrastructure with substandard durability.

The case studies assess the strength of the political mechanism in hardening sub-national budget constraints. This involves examinations of the mechanisms through

which power is allocated, and the career incentives facing public officials. In some of the cases, these provide important incentives for fiscal discipline. Like the credit market, however, most of the case studies point out serious deficiencies in the structure of political incentives.

### *Land Markets*

Tiebout (1956) showed how competition between local jurisdiction run by land-owners under certain theoretical conditions can support efficient provision of local public goods and corresponding taxation. But also in a more practical context, the market for land plays an important role, in particular for intertemporal incentives.<sup>12</sup> To the extent that residents are typically owners of tradable land (or housing), markets provide future residents a voice in present fiscal decisions. If a debt stock is not matched by public assets whose benefits offset the future tax implications, new residents will demand a reduction in land prices from current owners. This gives current residents incentives to handle their affairs well, including the longer term consequences of subnational government borrowing. When the land market works well and the value of expected services and future tax payments are fully capitalized into current land prices, then residents who first approve the local debt will directly face the consequences -- either when repayment first falls due, or as land values appreciate in well-run jurisdictions.

The important assumption here is that those affected by the capitalization of local debts (and of public services) into land prices control the local political process. In a democracy, this works intuitively and directly to the extent voters are land-owners and vice versa, as ownership gives people a long-term stake in the community. But the mechanisms

can also work in other ways, well or not. To give an example of the potential problems, undeveloped land is often held by a very few (it is by definition not occupied by residents). Its value can thus be under threat in the political process. Nevertheless, interests can be represented in politics in many ways, depending on the institutions for policy making. If many residents are renters rather than owners, they may have insufficient financial stake in the future of the community, biasing politics towards borrowing and consumption, against investments.<sup>13</sup> Landowners might try to address this in part by buying influence directly, or if interests are concentrated they may subsidize larger policy packages. The incentive problems when a large share of voters are not owners are not well studied, but for all that we know they may be important.

Land is potentially related to governance in several ways, and land values and demand for land may also give local politicians important incentives directly as a revenue source. If the revenue base of local government in large part is property and land taxes (directly or indirectly), then this may give local politicians positive incentives to pursue policies that maximize property values, including sound fiscal policies.

### *Mobile Factors*

Mobile factors (workers, financial capital, entrepreneurs) also play a role in determining the prices for immobile assets (above) by putting pressure on local officials directly through their mobility. Workers and residents thus exert pressure not only directly through “voice” but also by “exit” (Hirschman, 1970). Rather than “voicing” their interests in the political process, they threaten to “exit” the jurisdiction if it does not

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<sup>12</sup> See Oates (1969) generally and Sprunger and Wilson (1998) for an application to local borrowing.

<sup>13</sup> For an analysis of differing incentives facing owners and renters, see Epple and Romer (1991).

provide a desired bundle of taxes and services (Tiebout, 1956). If these exit threats are credible, local politicians are likely to respond to such demands in order to protect their tax base (Brennan & Buchanan, 1981).

The effectiveness of this mechanism requires a number of strong assumptions. Most obviously, citizens and firms must be highly mobile. This is often not the case in developing and transition countries, especially those with large jurisdictions, heavy dependence on agriculture and large state-owned enterprises, or in fragmented settings with important ethnic and linguistic cleavages across jurisdictions. Secondly, of course, competition has to be real. This requires that jurisdictions are of a relevant size and have relevant powers (not over-regulated by the center), and that collusion is not too pervasive. Furthermore, the power of the land market mechanism and the competition for mobile assets can be limited by intergovernmental transfers or revenue sharing arrangements. For these reasons, the land market and mobile asset mechanisms receive scant attention in many of the case studies in this volume.

### *Hierarchical Mechanisms*

As we have laid out, an institutional setting can be envisaged in which creditors, home-owners, other asset holders and the local electorate provide a good incentive framework for subnational fiscal decisions. The no-bailout policy is then credible to all of these actors, and sub-national officials would face few incentives to seek bailouts. Above all, the costs and benefits of local spending and borrowing decisions would be borne locally. Should a jurisdiction borrow too much, the pain would fall on the jurisdiction, with some burden sharing by creditors in the more extreme cases, but no

funds would come from the higher level government. In this institutional setting, hierarchical restrictions on sub-national spending and borrowing would be unnecessary, and indeed difficult to rationalize. They could clumsily and unnecessarily constrain credit, and even signal that the central government assumes responsibility.

Most of our case studies, however, are very different from such a setting. Central government cannot firmly commit to a no-bailout policy, and local politicians, along with local voters, creditors, and asset-holders, have reasons to push cost-shifting and deficit-shifting strategies. Thus in many situations, an additional line of defense is necessary-- hierarchical oversight and regulation by the central government. In fact, the case studies display a wide range of mechanisms aimed at imposing hard budget constraints from the center. The most direct and blunt way to do this is to simply prohibit sub-national governments from borrowing, or to allocate all credit through the central government.

But central allocation of credit is often politicized or for other reasons end up being quite inefficient. It also makes it even more challenging to commit to an apolitical, no-bailout policy. The case studies demonstrate that difficulties abound in practice, but some mechanisms work better than others, and one goal of the case studies is to bring this out. There are also less blunt forms of regulation. In some cases, borrowing prohibitions are limited only to foreign borrowing. In others, sub-national governments can make their own decisions about borrowing initially, but with final approval subject to review by a central government agency.

In addition to direct central administrative oversight, a variety of mechanisms based on rules are also used around the world.<sup>14</sup> A common strategy is to place limitations on the use of debt at the local level, for instance, limiting long-term borrowing to capital projects only. Another strategy is to place numerical limits on the use of debt. For example, in many cases, the aggregate stock of long-term debt must be held to a fixed share of the local tax base. In addition, the case studies will examine a variety of balanced budget rules. For instance, some rules require submitting a balanced budget, and others limit actual expenditures and prohibit deficit carryovers into subsequent years. Some sub-national governments own banks and borrow from them, or borrow through and receive funds from local public enterprises. These entities are often under the direct or indirect political control of the sub-national government, and are used in this way precisely as a gateway to softer budgets. Clearly, this has made hierarchical controls more difficult to implement.

In some cases, a bailout has been difficult to avoid, but has offered the central government an opportunity to strengthen hierarchical mechanisms. Conditions for debt relief can then attempt to reduce or eliminate the incentive problems that engendered the fiscal crisis in the first place. A properly structured bailout featuring institutional reform and new oversight can this way signal that the game to be played in the future will be a different one, rather than signaling that the central government's credibility is weak. Thus some of the case studies view bailout episodes not as policy blunders, but asks whether they might be first steps on a path towards harder budget constraints.

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<sup>14</sup> For overviews, see Ter-Minassian and Craig (1997), Inter-American Development Bank (1997). In our present treatment, we do not consider self-imposed constraints, such as the balanced budget requirements of most US states, as a hierarchical mechanism.

Additionally, laws and other institutions can in general serve to clarify how sub-national fiscal crises will be handled before they actually occur. Clear, well-crafted public bankruptcy laws can be very important in this regard, and will likely have to give creditors limited powers if they are to forestall political intervention and bailouts. Some of the case studies describe such laws, their associated penalties, and methods of enforcement.

Finally, it is important to note that any of these hierarchical mechanisms-- from borrowing restrictions to bankruptcy laws to conditional bailouts-- are only as good as the strength and credibility of the institutions that must enforce them, and obviously the central government that may intervene to change or circumvent them. Thus an important part of assessing the strength of the hierarchical mechanism is to return to the questions about incentives in national political institutions.

## **V. Introduction to the Case Studies**

The rest of this volume builds on the framework established in this chapter to lay out the conditions under which the soft budget constraint problem is most severe, and the mechanisms that are most likely to mitigate it. Our ultimate goal is to flesh out some realistic institutional reforms that can harden sub-national budget constraints in practice. First of all, in each case study, it is necessary to understand the basic pathologies discussed in section two above, those that create the problem in the first place. Some of the case studies include detailed descriptions of the strategic interactions that culminate in

sub-national fiscal crises and, in some cases, bailouts. In other cases, however, fiscal crises have largely been avoided or bailouts denied.

Second, it is useful to examine the role of each of the mechanisms outlined in section three in mitigating the problem. We seek to ascertain which mechanisms work under which conditions, which complement one another and which are antithetical, and perhaps most importantly, which are most realistic as targets for reform.

Most of the case studies point out significant weaknesses in the basic underlying political and fiscal structures. An important lesson is that when higher level government cannot be committed to firmness *ex post*, then hierarchical mechanisms can become an important defense. But in order to understand the nuts and bolts of hierarchical rules, and the conditions under which they work, it is necessary to understand the larger institutional context in which they are embedded. Thus the case studies try to strike a balance between addressing basic, over-arching institutional design issues, and examining specific rules pertaining to borrowing, bankruptcy, and the like.

While the emphasis and most important lessons from each case are different, their contributions aggregate into a very useful body of information. Taken together, the case studies create an impressive database with 11 observations on several important variables. This database is used in the final chapter to make some broad assessments, general arguments, and finally, some specific recommendations.

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