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Fiscal Decentralization and the Challenge of Hard Budget Constraint

Jonathan A. Rodden, Gunnar S. Eskeland, and Jennie Litvack
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476 pp.

In many countries around the world, central governments are transferring responsibilities to lower levels of government. This process has generated a debate about the benefits and costs of decentralization. The traditional literature on Fiscal Federalism has stressed the potential efficiency gains that can be obtained through the decentralization of the allocation of some public goods and services (Oates, 1972). Nevertheless, fiscal decentralization also brings with it potential costs, mainly in terms of macroeconomic stability (Prud'homme, 1995, Tanzi, 1996). Hence, one of the main challenges presented by decentralization is the maintenance of fiscal discipline in lower level governments. Fiscal discipline is obtained when their budget constraints are hard, which means that lower level governments have to face the full cost of their expenditure decisions.

The distinction between *soft* and *hard budget constraints* was introduced in the seminal work of Kornai (1979). He used the term *soft budget constraint* to describe the behavior of state-owned enterprises in socialist economies that could count on increased subsidies when their losses increased. This term has been broadened and nowadays it is used to refer to lower level governments that look to a higher level government to recover or *bail out* their excessive deficits. The term *bailout* refers to the additional funding that the higher level government provides to the lower one when it would otherwise be unable to service its obligations. Fiscal rescue or bailouts can take various forms, but the most typical one is the intergovernmental grant. In recent years, papers have appeared that study this phenomenon and attempt to determine its explanatory factors and its consequences. The natural way to model a bailout in fiscal federalism is as a sequential game (e.g. Wildasin, 1997, Carlsen, 1998 and Goodspeed, 2002). There are also more descriptive papers that explain bailouts occurring in some countries (e.g. the German case, Seitz, 1999).

An important contribution to this literature is the book ***Fiscal Decentralization and the Challenge of Hard Budget Constraints.*** It is the result of a multicountry research project done by the Decentralization and Subnational Thematic Group of the World Bank. It provides the framework for analyzing the factors that influence the relative hardness of the budget constraint of lower level governments, and then applies this framework to the study of eleven countries which have soft budget constraint problems of varying degrees of severity and vastly different institutional settings. The book is divided into five sections.

The first section provides the analytical framework and is organized as follows. Firstly, the soft budget constraint problem is described. Decentralization typically involves increased autonomy for lower level governments, and thus it raises incentives for opportunistic behavior among lower level governments that try to shift the burdens of subnational programs onto the nation as a whole (i.e. to expand expenditures without facing the full cost). Secondly, the reasons why the central government cannot credibly commit to a no bailout fiscal policy are analyzed. There exist economic and political motives for a bailout. On the one hand, if the central government fails to rescue regional government deficit, the welfare of this region will fall below the desired level due to inefficiently low levels of regional public goods and services. On the other hand, this may have negative electoral consequences for the central government because the regional government can shift the blame for their failures onto the central government politicians who failed to provide the needed and expected support. Thirdly, the economic and political institutions that can minimize these perverse incentives are analyzed. These can be summarized in four groups: *fiscal institutions, political institutions, market mechanisms* and *hierarchical control*.

There are three principle aspects of intergovernmental *fiscal institutions* that could harden budget constraints of lower level governments: i) transparency and predictability of intergovernmental transfers; ii) low regional transfer dependency and reliable and effective regional revenue raising capacity; and iii) clear, stable and appropriate distribution of responsibilities between the different levels of government. With regard to *political institutions*, if the interests of regional governments are well represented in the central legislature, or if decisions in the legislature are made through regional logrolling, the expectation of a bailout by the central government will be high. On the contrary, if political competition exists (i.e. voters can punish fiscally irresponsible representatives by voting them out of office), politicians will have incentives to harden the budget constraint. Subnational fiscal discipline may also be enforced by *market mechanisms*. If there exists an efficient credit market, the poor fiscal performance of a regional government will result in reduced access to credit and higher interest rates. Moreover, if there exists an efficient land market in the context of mobile factors, excessive debt can reduce regional property values, and hence, encourage the exit of economic agents to other regions. Thus, the efficiency of these markets hardens the regional budget constraint. The *hierarchical mechanisms* used to harden budget constraint are constitutionally or legislatively imposed balanced-budget constraints, limitations on debt issues, and well designed public bankruptcy laws.

The rest of the book applies the analytical framework established in the first section to study the experience of different countries in order 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. The countries studied have been chosen so as to represent the widest possible diversity in fiscal and political decentralization as well as different institutional settings. The second section is devoted to the study of four decentralized OECD countries: the USA, Canada, Norway and Germany. The first chapter of this section has both a theoretical and descriptive approach. It puts many of the issues raised in the first section into the form of a sequential bailout game and provides the first case study: the USA. The third section examines developing countries with histories of federalism and fiscal decentralization and recent manifestations of the soft budget constraint problem: Argentina, Brazil and India. The fourth section considers countries in a transitional phase leading to decentralization: China, Ukraine and Hungary. The fifth and final section provides a summary of the main lessons emerging from the study of the various countries . The analysis points out that there are different frameworks that are consistent with subnational fiscal discipline (i.e. there is no single way to obtain a hard budget constraint).

The states of the USA and Canadian provinces are clear examples of balanced budget constraints obtained by market discipline. As they borrow in competitive capital markets, without any constraint imposed by the central government, persistent deficits will lower credit ratings and raise borrowing costs. Hence, when faced with fiscal deficit, they have political pressure on them to adjust the budget situation , using their high level of fiscal autonomy. Other subnational public sectors with balanced budgets are the local sectors in Norway and Canada, but they obtain this balance by applying vigorous hierarchical oversight. In these cases the central government applies strict rules and regulations on local spending and borrowing decisions. These mechanisms, market discipline and hierarchical oversight, are not mutually exclusive, as can be seen in the Hungarian local public sector, which has budget constraint achieved through the combination of both mechanisms.

The Brazilian and Indian states and the Argentine provinces have severe soft budget constraint problems. In the three cases the market mechanisms have failed to harden the budget constraint due to the dominant role of the central government in regulating state borrowing. Attempts at hierarchical oversight have also failed due to the lack of credibility of the central government's commitment to enforce it. The loss of credibility with regard to the central government's commitment not to bailout subnational governments is mainly due to aspects of the intergovernmental fiscal and political institutions: the unclear distribution of responsibilities between the different levels of government (e.g., Brazilian states), the subnational provision of national public goods (e.g., Brazilian states and Argentine provinces) and the weak and/or fragmented political parties and presidents (e.g., Brazil and Argentina). Thus, a fundamental reform of fiscal and political institutions is needed to alter the incentives for budgetary decision-making.

To conclude, ***Fiscal Decentralization and the Challenge of Hard Budget Constraints*** is a relevant contribution to recent literature studying the phenomenon of bailouts in the public sector. It provides a good summary of the wide range of institutions that individually or collectively affect subnational fiscal discipline. Moreover, each one of the eleven cases studied gives an exhaustive and very valuable description of the institutions that exist in the different countries. However, this book provides only a descriptive approach to bailouts, since it does not include any quantitative analysis. The severity of the soft budget constraints problem in lower level governments is measured by the proportion of fiscal deficit to total revenues, and this is the only numerical analysis included in the book. In short, this book is a good starting point for the reader who wishes to understand the soft budget constraint problem and will help determine the type of institutions that can harden budget constraint.

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So-called soft budget constraints allow these subnational governments to expand expenditures without facing the full cost. Until now, however, there has been little understanding of how decentralization leads to large fiscal deficits and macroeconomic instability.Â Suggested Citation. Jonathan A. Rodden & Gunnar S. Eskeland (ed.), 2003. "Fiscal Decentralization and the Challenge of Hard Budget Constraints," MIT Press Books, The MIT Press, edition 1, volume 1, number 0262182297, March. Handle: RePEc:mtp:titles:0262182297. Jonathan A. Rodden, Gunnar S. Eskeland, Jennie Litvack. In many parts of the world, lower levels of government are taking over responsibilities from national authorities. This often leads to difficulty in maintaining fiscal discipline. So-called soft budget constraints allow these subnational governments to expand expenditures without facing the full cost.Â Until now, however, there has been little understanding of how decentralization leads to large fiscal deficits and macroeconomic instability.This book, based on a research project at the World Bank, develops an analytical framework for considering the issues related to soft budget constraints, including the institutions, history, and policies that drive expectations for bailouts among subnational governments.