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## Subnational Public Financial Management: Institutions and Macroeconomic Considerations

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## IMF Working Paper

Fiscal Affairs Department

### **Subnational Public Financial Management: Institutions and Macroeconomic Considerations**

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#### **Abstract**

**This Working Paper should not be reported as representing the views of the IMF.**

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Transparent public financial management at the subnational level requires institutions and processes that mirror those needed at the central government level, in order to generate better accountability and competition among different subnational governments, critical elements in ensuring good governance and efficiency of decentralized administrations. Further subnational debt also has implications for overall macroeconomic stability that concerns the central government. The key components are identified, with a particular focus on subnational debt monitoring and management.

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Contents	Page
I. Introduction .....	3
II. Community-Based Developments.....	4
III. The public Financial Management Processes.....	5
A. Government Accountability.....	6
B. Traditional Budgeting Models .....	6
Appropriations .....	6
Budget execution .....	7
C. Performance-Based Systems.....	10
IV. Macroeconomic Stability and Subnational Debt Management .....	11
A. Rationale for Managing Subnational Debt.....	11
B. A Typology of Borrowing Controls.....	13
Market discipline .....	13
Rules-based approach .....	14
Administrative approach.....	15
Cooperative approach .....	16
Circumventing borrowing limits.....	17
Enforcing borrowing controls.....	18
C. Dealing with Subnational Debt Crises .....	20
V. Conclusions.....	22
Figure	
1. Brazil: Subnational Primary Balance, 1992–2003.....	9
References.....	23

## I. INTRODUCTION

Practical issues relating to effective public financial management ultimately govern whether or not there is good governance at the subnational level—hence the success or failure of different policy options. Although there is a growing literature on “fiscal rules” and subnational debt management,<sup>2</sup> there has been less attention to the critical governance aspects of public financial management (although see Potter 1997, Momoniat, 2001). Part of this neglect may be due to the presumption that decentralization, together with community-based decision making, would suffice in generating efficient and equitable spending decisions.

Indeed, the emphasis on community participation was a feature of development strategy in the 1950s, largely driven by the Ford Foundation and U.S. foreign assistance programs.<sup>3</sup> Despite a lack of significant success at the time, there has been a resurgence of the policy in recent years due to the efforts of nongovernmental organizations (NGOs). The emphasis on community-driven development was adopted as one of the cornerstones of the World Bank’s Comprehensive Development Framework (World Bank, 2001). However, there is increasing evidence that weak or absent public financial management functions and institutions are likely to negate any advantages that might be inherent in bringing public services “closer” to local communities.

The underpinnings of public financial management relate to the basic institutional and procedural elements that might be enshrined in a constitution, or higher level laws on the budget,<sup>4</sup> or laws or agreements governing subnational operations or levels of indebtedness. In some countries, such as South Africa, where the process has been nicely sequenced, there is a set of consistent and well designed legislation covering all the areas mentioned above.<sup>5</sup>

In order for any level of government to take responsibility for its actions, there must be clarity in its functions, its spending prioritization, its mechanisms for appropriating funds and prioritizing and authorizing spending, and ensuring that the spending is actually carried out and accounted for. Another critical aspect relates to timely and accurate reporting to the respective legislature and any higher levels of administration. In short, questions would need to be posed concerning the transparency and accountability of a government and whether these meet minimum international standards.<sup>6</sup>

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<sup>2</sup> See e.g., reviews by Ter-Minassian and Craig (1997), and Kopits (2001).

<sup>3</sup> See Platteau (2004), who reports that more than 60 countries were involved in this strategy. Mansuri and Rao (2004) provide a very comprehensive survey of this literature.

<sup>4</sup> This may relate to organic budget laws—such as in France (see *Loi Organique, 2001*), or to ordinary legislation in other countries.

<sup>5</sup> See also Republic of South Africa, *The Constitution, Act 108 of 1996; the Public Finance Management Act, Act 1 of 1999; and the Municipal Finance Management Act, Act 56 of 2003*.

<sup>6</sup> For instance, the IMF’s Code of Fiscal Transparency.

Quite often the consequences of subnational spending can be shifted to higher levels of government, or across generations, if there is no hard-budget constraint at a junior level of government (Rodden, Litvack, and Eskelund, 2003). This generally translates into weak or nonexistent control over borrowing. The borrowing might be explicit, for example, through issuance of debt or contracting of loans, or indirect, such as through the buildup of arrears or accounts payable. Under different constitutional arrangements, policy responses vary from enforced controls over subnational borrowing (generally in unitary states) to voluntary agreements or rules (in federations, as well as in supranational conglomerations of states, such as the EU), to sole reliance on the strictures of the market.<sup>7</sup>

In this paper, we introduce the concepts and practices that would apply in the budget processes in unitary and federal states, and also mechanisms to manage overall indebtedness and sustainability of fiscal positions.

## II. COMMUNITY-BASED DEVELOPMENTS

The case for community-based governance depends on the possibilities of local information generation together with the networks of inter-community interactions or social capital. The combination of these factors could, in principle, generate spending tailored to local needs, with substantive local interactions in order to ensure that funds are not diverted from expressed objectives. And as stated above, international and donor agencies have raised these possibilities in the design of assistance programs.<sup>8</sup> But, in practice, there are two substantive difficulties. The first relates to whether or not there might be elite capture,<sup>9</sup> and the second, that would serve to reinforce the first, relates to the type of information that is generated. In the final analysis, the case turns on the effectiveness of local service delivery and whether or not powerful local interest groups are able to garner a significant proportion of funds allocated to the localities.

Bardhan and Mookherjee (2005) discuss theoretical tradeoffs between centralized and decentralized delivery of infrastructure services. Under conditions of considerable inequality, poorer and vulnerable sections of society might be disadvantaged by community based development, as existing social and economic relations might be used by more influential groups to the disadvantage of the usual target groups (Platteau, 2004). Platteau also emphasizes the risks of the outright embezzlement of funds, in addition to wasteful or misdirected spending. These tendencies are likely to be reinforced when as described above the PFM infrastructure, especially information flows and independent audit, are weak.

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<sup>7</sup> See Ter-Minassian and Craig (1997) for a typology, described in greater detail below.

<sup>8</sup> For instance, the HIPC debt relief program for Bolivia is designed to provide direct support to local governments to finance social investments.

<sup>9</sup> See Bardhan, 2002, and also Mansuri and Rao, 2004 for a full review. See also Bardhan (forthcoming).

The evidence on community-based development is mixed, at best (see the survey by Mansuri and Rao, 2004). An assessment of Social Investment Funds suggests that these have been less than successful in generating “ownership” among the local communities (Tendler, 2000), with a mismatch between the preferences of the donors and recipients, despite a “façade” of consultation between communities and donors through the PPA process (Francis and James, 2003).

A strong conclusion by Platteau (2004) is that electorates may not be willing or able to discipline corrupt local leaders, especially if there is some trickle-down and improvement regardless of the magnitude of funds diverted. And competition among donors may make matters worse. His proposals include a sequential disbursement of assistance, based on accurate information on the spending, together with an improved technology of fraud detection. Equally important are the effective mechanisms put in place to prevent and punish misuse of public funds. These translate into the infrastructure of budgeting and public spending, including adequate and effective control and audit mechanisms.

### III. THE PUBLIC FINANCIAL MANAGEMENT PROCESSES

In order to meet the requirement of providing accurate and timely information to policy makers, the legislature and the broader public, there is increasing emphasis in organic budget laws around the world that the budget should comply with the principles of comprehensiveness, unity, and internal consistency. Without the associated budgeting, reporting and audit infrastructure, it is unlikely that the good governance aspects of decentralized operations would be realized.

The principle of *comprehensiveness* requires that the budget cover all government agencies and institutions undertaking government operations, so that the budget presents a consolidated and complete view of these operations and is voted on, as a whole, by the body vested with national legislative authority. Unfortunately, in many cases, donors’ demands to maintain donor funds in extrabudgetary or off-budget accounts have undermined the transparency and financial discipline of government operations (Premchand, 1996), and often generated parallel and uncoordinated budget systems.

The principle of *unity* requires that the budget includes all revenues and expenditures of all government agencies undertaking government operations. This principle is important to ensure that the budget is an effective instrument to impose a constraint on total and sectoral government expenditure, and promote higher efficiency in the allocation of resources.

The principle of *internal consistency* between different components of the budget requires, in particular, that current expenditure needed for the maintenance and operation of past investments be fully reflected in the budget. Moreover, this principle implies that there should be no dual budget systems involving a split between current and capital (or development) spending.

The principles above translate in different ways in terms of information requirements for appropriations, accounting, controls and reporting, depending on the budgeting framework in

use—and we distinguish here between a continuum-based on traditional budgeting frameworks to those on the basis of “performance or outcomes.” These are discussed sequentially below.

### **A. Government Accountability**

Government accountability is an essential principle of democracy through which elected and unelected public officials are obligated to explain their decisions and actions to the legislature and the broader public to ensure an appropriate use of public resources. The framework for government accountability usually includes a combination of political, legal, and administrative mechanisms designed to hold public officials responsible for their performance.<sup>10</sup>

Fixed terms of office and fair elections are key political mechanisms to hold policy makers accountable. With these mechanisms, the electorate could remove elected government officials if their performance is not in line with public expectations. Legal mechanisms of accountability for both elected and unelected officials include all legislation proscribing actions that public officials can and cannot take and well as sanctions against officials with unsatisfactory conduct. A precondition legal accountability is an independent judicial system. Administrative accountability mechanisms entail independent auditors and ombudsmen, to ensure that public officials do not transgress mandates or misuse public monies.

A community-based scheme for government accountability combining political, legal and administrative mechanisms has received increasing attention by international agencies. Particularly important under this scheme are the legal instruments that require input from the communities on certain government decisions or provide access to the press or the broader public to information on government activities.

### **B. Traditional Budgeting Models**

The traditional cycle of budget appropriations, execution, accounting, control and reporting are described for both unitary and federal states. The recent experiences of developing countries in meeting the expenditure accountability requirements of the Heavily Indebted Poor Country (HIPC) initiative are summarized in Dorotinsky and Floyd (2004).

#### **Appropriations**

The typical stages of budgeting include decisions by the administration and authorized by the relative legislature on what to spend—this is the appropriation stage. This would increasingly be placed in a medium-term framework to fully capture the effects of decisions that last for multiple periods.

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<sup>10</sup> U.S. Department of State (2004).

In a unitary state with deconcentrated subnational governments, all the budget decisions would be made by the central government and approved by the national legislature. Such an arrangement would be perfectly compatible with local communities reflecting their priorities to the agents of the center for incorporation in the national list of appropriations, as well as involvement with actual implementation.

In a federal system, the center would appropriate transfers for each level, which in turn would prepare their own budgets. There would then be a premium on ensuring that promised transfers—either special purpose or general, “equalization” transfers—are made in a timely manner.

Under either system, a fundamental rule for preventing rent seeking and ensuring accountability, throughout the entire budget process, is that there should be no spending without adequate appropriations and financing arrangements. In countries with the old Francophone PFM systems, funding could be provided to public entities without appropriations during the budget execution process, and “legalized” as an *ex post appropriation* in the budget of the subsequent year. This practice clearly weakens the possibilities of ensuring government accountability.

In order to ensure macroeconomic stability, the central government has the responsibility of ensuring that overall risks, including debt, are kept within prudent limits. As discussed below, this places a responsibility on the center, even within federal systems, to ensure that prudential debt limits are not exceeded in aggregate—this poses difficult problems of determining the overall debt limits and then apportioning this among the different levels of government. This issue is reflected even in supranational administrations, such as the European Union’s Stability and Growth Pact.<sup>11</sup> And considerable emphasis is needed on a standardized basis for budget appropriations and execution in order to ensure an orderly assessment of budgets and outcomes.<sup>12</sup>

### **Budget execution**

The standardized budget classification is the basis for tracking and reporting expenditures, and for determining whether there have been any diversions of public monies for unauthorized purposes. This is essential even if there has been appropriation at a fairly aggregate level, in order to present consistent and comparable information to the policy makers or the public at large.

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<sup>11</sup> Indeed, as seen with the recent discussion of the debt limits in countries such as Germany, penalties under the pacts must be implemented to be credible; and there should also be a corresponding capability to monitor the compliance with the stipulations (as has recently been illustrated in the case of Greece).

<sup>12</sup> For example, this includes the economic classification as enunciated by the IMF’s *Government Finance Statistics Manual* 2001, and the functional classification described by the UN’s Classification of the Functions of Government.

In some countries, especially in unitary countries, the central government is responsible for establishing standards for the accounting and reporting systems of all levels of governments and usually is also responsible for their enforcement. The development of sound budget, accounting and reporting systems is a complex and time-consuming process and it would not be efficient or cost-effective for subnational governments to develop their accounting and information reporting systems on their own.

While cash-based systems are generally deemed insufficient to cover all aspects of budget execution, relatively few developing countries have the capability to operate accrual accounting. Nonetheless, many countries try to monitor the generation of arrears by registering commitments and recognition of liability. This usually entails the utilization of government financial information systems. These have been relatively expensive, but simpler versions are now becoming available for use in smaller jurisdictions—thus in principle permitting subnational administrations to also operate in an environment as conducive to overall accountability as the center—however, these systems require standardized generation of information (such as through the common budget classification described above).

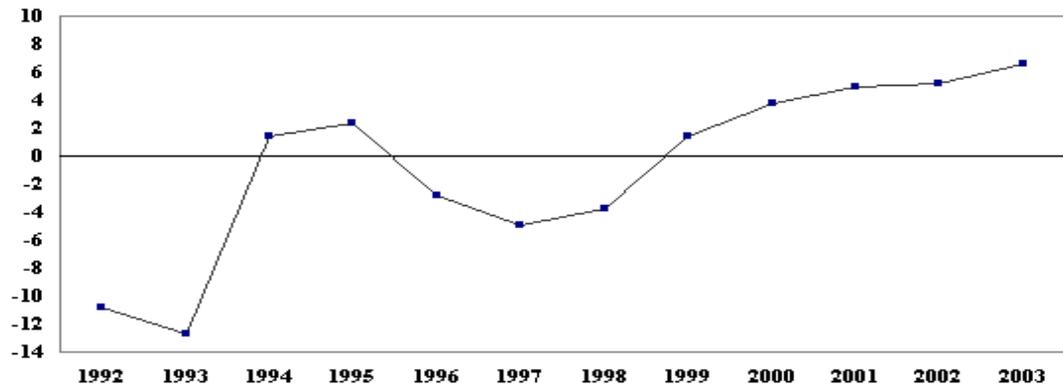
This standardized generation of information was a major feature of the reform of subnational finances carried out in Brazil in the late 1990s, with substantial benefits for the management of the consolidated public finances. A Fiscal Responsibility Law for Brazil was approved in May 2000, which (1) introduced a golden rule provisions; (2) imposed new uniform accounting, planning, and transparency requirements on all levels of government. States and municipalities are now required to submit multiyear plans and reports on the use of resources from privatization, social security funds, and contingent liabilities; (3) attempted to enhance the credibility of the central government's no bailout commitment by prohibiting the central government from bailing out any member of the federation and the central bank from exchanging the debt securities of the states for federal public debt securities; and (4) increased the role given to the judiciary and the penal system in the enforcement of certain of its provisions, mandating prison sentences for illegal efforts to issue bonds and stipulating the dismissal of a mayor or governor if debt limits or personnel expenditure ratios are exceeded. It is too early to assess whether the new legislation has improved the control of subnational borrowing, although the fiscal position of states seem to have significantly improved (Figure 1). Economic growth, improved tax administration, and privatization proceeds have increased states resources and have contributed to improve their fiscal positions. However, the fact that states have not spent all these windfall revenue may suggest a new pattern of behavior.

Some other countries, such as China and Kazakhstan, have established treasury single accounts at the local level as a mechanism not only to enhance cash management and prevent diversion of government resources and accumulation arrears but also to improve financial discipline and transparency of local government operations.<sup>13</sup>

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<sup>13</sup> The creation of a pure TSA implies that all government revenues must flow to the TSA and all spending must be made out of the TSA.

Figure 1. Brazil: Subnational Primary Balance, 1992–2003  
(In percent of revenues)



### *Audit and control*

Developing countries tend to place considerable importance on internal, ex ante controls, as the external controls exercised by supreme audit agencies tends to be deficient or ill-defined—several SAIs in developing countries in Latin America and the Middle East are more engaged in ex ante vetting of operations than in external controls. Indeed this admixture leads to conflict of interest, as the SAI would have to adjudicate in some cases on its own ex ante controls. The lack of independence from the administration is also often a factor that undermines the quality and effectiveness of external controls. As seen in the HIPC exercise, the control and audit mechanisms are a weak link in the spending chain and a major impediment to good governance and accountability (Dorotinsky and Floyd, 2004).

### *Reporting and generation of information*

Both unitary and federal states illustrate a mixture of standardization and some flexibility, but most have minimum requirements that periodic information must be presented in a common format. Where common reporting standards are absent, problems are faced in managing macroeconomic challenges.

In a unitary state, Denmark, municipalities and counties are required to use the standard budgeting and accounting systems defined by the center. However, local councils are free to adapt the accounting system to suit their local needs. Information based on the standard accounting system is collected by the central authorities to monitor development in local governments' expenditure and revenue (Juul, forthcoming).

In Germany, a federal law governs budgetary management at all levels of government, mandating the use of a detailed budgetary classification, a uniform cash-based accounting system, as well as a multiannual financial planning. The law also obliges all levels of government to provide the Financial Planning Council with all necessary information to

monitor fiscal developments for the nation as a whole. *Länder* must provide all relevant information on behalf of their municipalities (Lienert, 2004).

In other federal countries, however, subnational governments can define their own budget and accounting systems. In some cases, this lack of an official standard is not a major problem because lower levels of government are committed to follow internationally accepted budgeting and accounting standards. All U.S. states for instance are free to determine the way their budgets are prepared, adopted, executed and reported. There is no constitutional or legislative requirement to harmonize accounting standards. However, state and local governments follow accounting standards developed by the private nonprofit Governmental Accounting Standards Board (GASB) in line with generally accepted accounting principles (GAAP). Similarly, Canadian provinces have voluntarily adhered to the standards of the Public Sector Accounting Board, the independent and authoritative standard-setting body for the public sector in Canada.

Belgium focuses on monitoring the budget execution of the different subsectors (federal government, the communities, and the regions) and data on budget execution at all levels are now exchanged on a monthly basis. The interministerial conference is the driving force, serving as a forum for peer review and seeking to strengthen the accountability of subsectors (De Smet, forthcoming). In Australia, Commonwealth States and Territories report a minimum amount of financial information in a uniform presentation framework (UPF). While many states and territories continue to prepare their budgets using different budget classification and accounting standards, each jurisdiction attaches data in the UPF format to their budgets (Robinson, forthcoming).

In some other federations such as Argentina, subnational governments are totally free to define their own budget and accounting systems. As a result, local fiscal data is characterized by large inconsistencies in terms of how revenues and expenditures are reported in public accounts. In addition, the lack of an agreed framework or guidelines for presenting state-level fiscal data makes it very difficult to consolidate fiscal accounts at the national level. In the absence of uniform budget and accounting standards, at a minimum a uniform reporting system should be in place at the local level. Credible sanctions for either noncompliance or untimely reporting should be introduced. However, the increasing practice has usually been to reach agreements with lower levels of government on financial reporting requirements. Agreements which do not result in specific sanctions or penalties for breaches of the agreement are generally ineffective.

Poterba and von Hagen (1999) examined the experience in Europe and view the set of rules and regulations according to which budgets are drafted, approved, and implemented as an important determinant of public sector deficits and debts. A similar result was found by von Hagen and Harden (1994), countries with more transparent budget procedures exhibited greater fiscal discipline in the 1980s and early 1990s.

### **C. Performance-Based Systems**

In a number of countries, in particular, industrial countries such as the United Kingdom and New Zealand, there has been a sustained push to inculcate greater accountability for results

into the budgeting process. This has been accompanied by a far-reaching reform of the state, including its functions in providing public services.

The most recent country attempting to follow this path is France, following on from the introduction of a new organic budget law in 2001, together with a restructuring of deconcentrated governments into decentralized levels of administration. The French reforms entail an overhaul of the appropriations system and the introduction of a new budget classification and reporting system, with adequate lead time for preparation (at least five years, and in practice longer).

Many developing countries (especially in Latin America and Africa) attempting to “follow the lead” of the New Zealand reforms often lack the preconditions and necessary preparatory work in order to implement performance budgeting, especially at the subnational level where the public financial management systems are particularly weak.

Without mechanisms to effectively track spending (e.g., on the basis of a consistent budget classification), it would be premature to rush into performance-based budgeting at the subnational level. Moreover, accounting and audit mechanisms would be critical in ensuring that funds are not misappropriated, and that the relevant officials are held responsible for funds received as well as the outcomes of such spending. There is typically greater need for good information systems, not only to track and monitor financial flows and public spending, but also to monitor physical targets and outcomes of the spending.

While performance based budgeting systems are an attractive tool to generate accountability in spending agencies and levels of government, the preconditions for such an institutional change need to be carefully assessed and implemented before a major restructuring is introduced.

#### **IV. MACROECONOMIC STABILITY AND SUBNATIONAL DEBT MANAGEMENT**

##### **A. Rationale for Managing Subnational Debt**

Macroeconomic stability for a country or supranational economic union depends on the overall aggregate exposure to risk—and a critical element of the latter is the borrowing of all the component jurisdictions in the relevant country or economic union. It is important to distinguish between how the borrowing controls are defined and how they are enforced.

Local governments, as well as the center, could better face cyclical downturns and smooth delivery of public services if borrowing were permitted. The need for subnational borrowing could arise from the particular allocation of responsibilities, transfer system, or revenue arrangements between the different levels of government. Subnational borrowing could be called for particularly when local governments are responsible for local infrastructure. Further, local borrowing could then be justified on the basis of the benefit principle. Investments that usually yield benefits over several years should be financed by borrowing, so that future generations enjoying the benefits would also share part of the financing. Further, such investment decisions are not subject to “controls” from higher levels of

administration. In line with this reasoning, many countries including Denmark, Germany, Italy and the United Kingdom have allowed subnational governments to borrow explicitly to finance investment expenditures.

Even if granting borrowing authority to local governments might be justified, handing them the power to borrow without limits may not be appropriate. Imposing borrowing controls at the local level may be needed to preserve macroeconomic stability as well as to safeguard local public finances.

In the absence of any limits on subnational borrowing, the central government faces the risk that local governments may try to free-ride on its efforts to stabilize the economy—effectively passing the costs of excessive borrowing on to other jurisdictions or future generations. Larger subnational governments that are “too big to be ignored” could hold the central government to ransom by bargaining for debt write-offs and other fiscal advantages.

Local governments’ efforts to conduct anticyclical policies—if left unchecked—could also result in ratcheting up public spending. Policymakers are likely to borrow when the economy is slowing down, but may be reluctant to repay the debt when the economy is recovering. In addition, during recoveries voters and vested interest groups often put pressure on local authorities to increase the provision of public goods or decrease the tax burden, reducing any fiscal surpluses available for debt repayment (Buchanan and Tollison, 1987). Local politicians may even take advantage that taxpayers might not correctly discount their future tax liabilities and pursue increasing borrowing strategies to mitigate the current tax bill (Moesen, 1993).

But above all, the need to control local borrowing arises from the common pool problem and the soft budget constraint it implies. The common pool problem stems from the separation of costs and benefits of public spending. If a certain public project predominantly benefits a particular jurisdiction but is financed through a common pool of taxes collected from all over the country, this jurisdiction will pay only a small fraction of the costs of the project while enjoying a large fraction of its benefits. This lack of full internalization of the costs of a project will result in excessive spending<sup>14</sup> and create a clear incentive for the regions to compete for federal transfers that enable them to finance region-specific projects out of a common pool. Ideally, regions would compete on the basis of the quality of their proposed spending projects. Alternatively, they could signal that they are in particular need of federal assistance by running large budget deficits or accumulating unsustainable debts, and hope that the central government grants will eventually bail them out.

The possibility of a bailout does not stem from the existence of a common pool *per se*, but from the way in which it is administered. When transfers are allocated on the basis of *ex post* financial needs rather than *ex ante* characteristics, regions experiencing financial difficulties could be bailed out by the central government. In this case the budget constraint faced by the

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<sup>14</sup> Also see Weingast et. al. (1981) who show that bargaining in a legislature comprised of regional representatives will lead to overprovision of spending programs with benefits concentrated in particular regions.

subnational government becomes “soft:” if regional authorities undercollect taxes, overspend, or default on the debt, they expect the federal government to cover the financing gap. Moreover, lenders also lose incentives to police regional governments as they view their investments as protected by a federal government guarantee.<sup>15</sup>

These problems would not exist, if central governments could credibly commit to never revising transfer allocations *ex post*, that is, to a no bailout policy. Unfortunately, such policy stance, arguably optimal in the long run, is difficult to commit to in the short run especially if it involves a painful local default or a reduction in the provision of basic public services with schools being closed and pensions left unpaid. Persson and Tabellini (1996) and Bordignon et al. (2001) show formally that even a national government maximizing the federation’s social welfare is likely to find it beneficial to bail out a financially distressed region. In addition, a default by one region can increase the cost of borrowing for all other regions in a federation, so neighbors themselves may be interested in providing the defaulting region with a bailout transfer.

## **B. A Typology of Borrowing Controls**

A typology of classification of borrowing controls described by Ter-Minassian and Craig (1997), refers to four broad “stylized” categories: (1) market discipline; (2) rules-based controls; (3) administrative controls; and (4) cooperation between different levels of government.

### **Market discipline**

Some countries rely exclusively on capital markets to restrain subnational borrowing. In this case, the central government would not set any limits on subnational borrowing and local governments are free to decide amounts, sources and uses of borrowing. Provinces in Canada as well as U.S. states have the right to borrow with no central review or control. Similarly, in Argentina, all levels of government are permitted to borrow both domestically and abroad.<sup>16</sup>

Markets have been myopic, as in the case of Argentina, and in many parts of the world, inadequate capital markets at the local level are inadequately developed to conceive of extensive reliance on market-based borrowing, or the ability of markets to discipline subnational government. Moreover, it is increasingly becoming clear that the ratings agencies, where they operate at the subnational level, evaluate all the public financial management criteria described above, as well as the overall design of intergovernmental system.

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<sup>15</sup> For more detailed discussion of soft budget constraints and their consequences see Kornai et al. (2003).

<sup>16</sup> Nevertheless, since the crisis of 2001–2, banking regulations have been strengthened to prohibit commercial banks from extending new loans to the provinces and the nonfinancial public sector, and bilateral agreements have been sought to enhance coordination between different levels of government.

Subnational governments may however decide on their own to adopt a fiscal rule in an attempt to enhance their credit standing in the market. Such self-imposed rules are found for example in Canada, Switzerland, and the United States. In these countries, subnational governments have generally direct access to financial markets to meet their borrowing requirements, and there are few precedents of bailouts of insolvent subnational governments by the central government; hence their desire to maintain a favorable credit rating in the markets. More recently, Argentina sought to follow this approach with the introduction of a Fiscal Responsibility Law and the establishment of a Federal Council for Fiscal Responsibility.

### **Rules-based approach**

In some cases, the central government might try to contain subnational borrowing by imposing a fiscal rule. Both federal and unitary states have relied on various standing rules, specified in the constitution or in laws to control subnational borrowing, in an effort to confer credibility for the conduct of macroeconomic policies. Such rules introduce a constraint on fiscal policy to guarantee that fundamentals will remain predictable and robust regardless of the government in charge.

#### *Types of fiscal rules*

Numeric fiscal rules can undermine a fiscal consolidation effort if poorly designed, not adequately enforced, and easily reversible. We discuss some categories of fiscal rules.

*Ceilings on debt or borrowing* are in general simple and relatively easy to monitor. However, they can be circumvented by asset sales, debt transfers of to local public enterprises outside the governmental sector or by sale-and-lease-back operations. Debt ceilings should be defined in net terms to assess long-term fiscal sustainability, despite the uncertainty and volatility of the value of publicly held assets.

A *deficit target* has the advantage of simplicity and of being easily understood by the wider public, but could fail to prevent debt accumulation because of off-budget items. Fiscal rules targeting the overall budget deficit (for instance in Austria—within a domestic stability pact—Belgium, Spain, and most U.S. states) or operating deficit (for instance in Norway) are the most frequent. However, such rules can be met with higher revenues and expenditures, with possible macroeconomic implications.

*Expenditure rules* place a ceiling on what governments can control most directly—the level of expenditure. These rules are conceptually simple, easy to monitor, and tackle the deficit problem at its source. Several studies have found that expenditure ceilings played a significant role in reducing spending in the United States (see Poterba, 1997, and Schick, 2000). A common expenditure ceiling could be more difficult to implement at the subnational level than a deficit target and not necessarily prevent debt accumulation since spending could be pushed below the line.

*The golden rule* limits subnational governments' borrowing to investment purposes and is quite common in industrial countries. Intergenerational fairness provides the most forceful argument in favor of a golden rule. However, there is no guarantee that increased borrowing for infrastructure expenditure would be consistent with macroeconomic stability and debt sustainability. Moreover, it may not be desirable to allow borrowing for investments without an adequate rate of economic and social return. The German constitution defines a golden rule for the federal and subnational governments. More recently, the law on local finances in Spain introduced a golden rule in the late 1980s.

*Rules related to debt repayment capacity* seek to “mimic” market discipline by linking limits on the indebtedness of subnational government to the projected debt service on the debt, or the other indicators of their debt-servicing capacity (such as past revenue or the tax base). These rules may be better suited to addressing considerations of long-term sustainability and intergenerational equity. In the mid-1990s, Colombia and Hungary established rules for subnational governments related to debt repayment capacity. These rules however might not be effective in containing debt accumulation if financial conditions are manipulated.

### ***Effectiveness of fiscal rules***

Fiscal rules are attractive since they are generally transparent, and relatively easy to monitor. The main disadvantage of this approach is a subtle trade-off between ensuring compliance and preserving flexibility. Strict fiscal rules with universal coverage leave little room for maneuver in case of unexpected economic downturns while more flexible fiscal rules with escape clauses lack credibility and, when easy to circumvent in practice, fail to impose sufficient discipline. In practice, the efficacy of fiscal rules for subnational governments (or for national governments in a supranational economic area, such as the EU) depends critically on the ability to measure and monitor the generation of debts and other liabilities.

Several studies have looked at the effectiveness of subnational government rules in the context of U.S. states.<sup>17</sup> This sample provides a relatively large data set and includes some variation in budget rules. The nature and the scope of balanced budget requirements vary indeed widely across U.S. states. In most cases, limits apply only to part of the state budget, notably the operating budget (general fund), with the exclusion of special funds (such as capital-spending funds, social insurance trust funds). In some cases, the rule is included in the state constitution, in others it is contained in an ordinary law. The general results are that rules do enforce some budget discipline on U.S. states, in terms of lower deficits and quicker reaction to negative fiscal shocks.

### **Administrative approach**

In a number of countries, the central government is empowered with the direct control over the borrowing of subnational governments. This control may take alternative forms, including the setting of annual (or more frequent) limits on the overall debt of individual

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<sup>17</sup> See for instance Bohn and Inman (1996), Inman (1996), and Poterba (1997).

subnational jurisdictions (or some of its components, such as external borrowing); the review and authorization of individual borrowing operations (including approval of the terms and conditions of the operation); and/or the centralization of all government borrowing, with on-lending to subnational governments. In India, for instance, any borrowing by state governments requires prior approval from the center whenever there are any loans outstanding from the latter (which is the case as all states are in debt to the center). Similarly in Spain, foreign debt as well as bond issuances by subnational governments are subject to the approval of the ministry of finance.

A major drawback of this approach is the moral hazard given the implicit or explicit guarantee that the central government's approval may confer to subnational borrowing. Administrative approval by the central government of individual borrowing operations of the subnational governments may well make it more difficult for the former to refuse financial support to the latter in the event of impending defaults. Detailed administrative controls may also involve the central government in microlevel decisions (for example, about the financing of individual investment projects) that would be best left to the relevant subnational jurisdictions.

Several considerations could argue however in favor of direct central government controls on the external borrowing of subnational governments. First, external debt policy is closely linked with other macroeconomic policies (monetary and exchange rate policies and foreign reserve management) that are the responsibility of central-level authorities (in particular, the central bank). Second, a coordinated approach to foreign markets for sovereign borrowing is likely to result in better terms and conditions than a fragmented one. Third, a deterioration of foreign ratings for one or more of the subnational borrowers may well spill over to those of other borrowers, both public and private. Finally, foreign lenders often require an explicit central government guarantee for subnational borrowing or—at a minimum—expect an implicit guarantee.

### **Cooperative approach**

Under this approach, borrowing controls for subnational governments are designed through a negotiation process between the federal and the lower levels of government. Subnational governments are actively involved in formulating macroeconomic objectives and key fiscal parameters, making them co-responsible for their achievement. Through this process, agreement is reached on the overall deficit targets for the general government, as well as on the main items of revenue and expenditure. Specific limits are then agreed upon for the financing requirements of individual subnational jurisdictions. Variants of this approach may be found in some European countries and in Australia.

Austria, for example, introduced in 1996 a consultation mechanism between the different levels of government to ensure that the overall deficit fell below 3 percent. Similarly, in Denmark annual borrowing ceilings for subnational governments are defined in (non-binding) negotiations between the central government and two associations of subnational governments in the context of the annual budget process. In Belgium, a Higher Finance Council (HFC) that comprises members nominated by the federal, community and

regional levels, and the Belgian National Bank, provides recommendations about the borrowing requirements of different levels of government. The federal government then concludes agreements with lower levels to achieve these targets.<sup>18</sup> In Australia, a fiscal institution—the Loan Council—was set up in 1929 to coordinate the borrowing of the Commonwealth and the states. The council is chaired by the Commonwealth treasurer and comprises the premier or treasurer of each state. In recent years, as greater reliance has been placed on market-based discipline, the role of the Loan Council has become one of establishing mandatory fiscal transparency requirements.<sup>19</sup>

The cooperative approach has clear advantages in promoting dialogue and exchange of information across various government levels. It also raises the awareness, at the subnational level, of the macroeconomic implications of their budgetary choices. However, this approach works best when the central government is strong and able to steer effectively the intergovernmental negotiations. This condition may not hold in many emerging markets.

### **Circumventing borrowing limits**

There are a number of innovative mechanisms that have been used by subnational governments to circumvent borrowing limits.

*Off-budget entities* have been used in a number of cases, for instance, in Germany to circumvent borrowing controls. Since the early 1990s, local governments have created independent administrative enterprises to which they outsourced a part of their fiscal activities. The newly created entities could take loans that did not appear in official statistics, since they were local enterprises under private law. In Saarbrücken, for example, while the local government debt declined from DM 658 million to DM 632 million from 1990 to 1994, the debt from administration-related enterprises increased from 0 to DM 227 million (Dafflon, 2002).

*Publicly owned enterprises* have been used in disparate cases ranging from China to Australia for borrowing purposes. In response to the prospect of a resource-led boom in Australia in the late 1970s, the Commonwealth accepted the States' request for higher public sector borrowing for financing large infrastructure projects and established a separate category for such borrowing programs. In early 1980s, the Loan Council decided to exempt from its approval domestic borrowings of large semi-government authorities and relaxed restrictions on foreign borrowing. As a result of the new opportunities, from 1977–78 to 1982–83, borrowing from state public enterprises tripled, reaching at its peak 2.8 percent of GDP. In 1984, the Loan Council adopted a new global limit approach, abandoning the distinction between semi-government authorities and the rest of the government.

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<sup>18</sup> See De Smet (forthcoming).

<sup>19</sup> See Robinson (forthcoming).

*Sale-and-lease-back operations* have been set up, for instance, in Denmark to avoid borrowing regulations. Local governments were converting fixed tangible assets such as schools and office buildings into liquidity reserves to avoid borrowing controls. The first reaction of the central government was to require local governments to deposit the cash in a bank account for a minimum of ten years. Local governments were however not deterred and started even to benefit financially from these arrangements by investing revenues in long-term bonds and providing the leasing company with short-term financing. The central government expanded then the definition of borrowing to include not only short and long-term financing but also renting and leasing arrangements (Dafflon, 2002).

### **Enforcing borrowing controls**

Three basic mechanisms are used by countries to enforce borrowing controls at the subnational level: (1) market discipline (2) intergovernmental entities operating within a cooperative arrangement, and (3) administrative procedures carried out by an entity of the public sector.

#### ***Market discipline***

A well-functioning financial market enforces discipline and sound borrowing practices on subnational governments by imposing increasing borrowing costs or by denying access to financing. There is evidence in the U.S. bond market that state and local governments with higher outstanding debt and lower incomes are faced with higher borrowing costs (Fairchild and Koch, 1998). Similarly, during late 1980s on the Brazilian credit market, private investors demanded higher interest rates and shorter bond maturities from states with precarious finances. At some point, private markets even refused to hold state debt at any price (Dillinger, 1997).

The ballot box—electoral discipline—could also be viewed as an alternative form of market discipline. In Australia, in early 1990s the political cost of relatively marginal downgrades in state credit ratings (e.g., from AAA to A) was far greater than the financial cost. State governments which had presided over unsustainable deficits and growing debt were defeated at the polls (Robinson, forthcoming).

A number of conditions should be satisfied, however, for financial markets to exert effective discipline over subnational borrowing.<sup>20</sup> First, markets should be free and open, with no regulations on financial intermediaries (such as portfolio composition requirements) that could place subnational governments in a privileged-borrower position. Second, adequate information on the borrower's outstanding debt and repayment capacity should be available to potential lenders. Third, there should be no perceived chance of bailout of the lenders by the central government in cases of impending defaults. Finally, the borrower should have institutional structures which ensure adequate policy responsiveness to market signals.

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<sup>20</sup> Lane (1993).

These are stringent conditions, unlikely to be realized in most countries. Typically, especially in developing countries, available information on subnational government finances still suffers from serious weaknesses in coverage, quality and timeliness. Many countries still use various forms of portfolio constraints on financial intermediaries to facilitate placement of government securities at reduced cost. Local governments, particularly in developing countries, maintain ownership or a controlling stake in financial institutions which provide a captive market for their borrowing. Furthermore, many countries have seen various forms of intervention by the central government (or the central bank) to prevent subnational government from defaulting and relatively short electoral cycles tend to make local politicians shortsighted and unresponsive to early warnings by the financial markets.

Moreover, an important shortcoming of market discipline is that it relies on instruments—most notably, interest rate risk premia and sovereign credit ratings—that do not react smoothly to fiscal developments. Instead, they often provide an abrupt response to particularly poor fiscal choices, and as such do not provide very much advance warning for the need to restore fiscal discipline.

The problems created by the buildup of state debts in Brazil illustrate the risks of overly relying on market discipline. Yet even in a country like Canada, with well developed and relatively transparent financial markets and little history of bailouts by the federal government, market discipline has not proven fully effective. Despite a clear deterioration in ratings and sizeable increases in risk premia on provincial bonds provincial debt has risen steadily over the 1990s and only in the last few years of that decade have the provincial government begun to design and implement fiscal retrenchment programs.

### *Cooperative arrangements*

Because the conditions for effective market discipline are so stringent, few countries rely on sanctions and penalties imposed by the market or the electorate. Countries have usually relied on other enforcement mechanisms, based either on centrally organized administrative measures or on cooperative arrangements. In the latter framework, an agreement is sought among subnational governments to impose administrative as well as financial sanctions and penalties. An intergovernmental entity in charge of enforcing borrowing controls could promote the dialogue and enhance responsibility across different levels of government.

In this setting, peer pressure may play an important role. In Denmark, for example, the enforcement of subnational borrowing ceilings is carried out by two associations of local governments (one for regions and another for municipalities) in charge of negotiating agreements for such ceilings with the central government. The associations monitor the performance of their members through the budget process and put political and peer pressure on those deviating from the agreement. Peer pressure is to some extent effective given the strong political position and credibility enjoyed by the associations and the collective nature of the financial sanctions applied to all members of an association.

Cooperative arrangements could be, however, a weak enforcement mechanism if the imposition of sanctions and penalties is subject to the unanimous decision of a body

consisting of representatives from all government tiers. In Austria, sanctions for noncompliance are imposed on subnational governments after a long process and only in cases of major deviations. The National Statistical Office is responsible for reporting major cases of noncompliance to the National Coordination Committee. A conciliation committee is then set up to seek an expert assessment on the extent of the deviation. Based on the expert opinion, the conciliation committee decides the sanctions to be applied (Balassone et al., 2003).

### *Administrative procedures*

Different public sector entities could also enforce borrowing controls on subnational governments through administrative procedures. This responsibility is often delegated to higher levels of government or to the national ministry of finance considering its role in ensuring a sustainable fiscal position for the region or the general public sector. In Belgium, the federal government as well as regional governments can impose sanctions and penalties on a subnational government that breaches borrowing limits. The action of the federal government focuses on limiting the borrowing capacity of a subnational government, while the regional government has the power to enforce, if necessary, expenditure reductions or tax increases.

Greater independence and credibility could be given to the enforcement process by delegating the monitoring as well as the imposition of sanctions and penalties to independent entities such as the national audit office or the judicial system. The national audit office could have the authority to fine institutions or persons, while the judicial system could impose prison sentences and loss of political immunity. In Brazil, the fiscal responsibility law has assigned to the judiciary the enforcement of certain of its provisions.

### **C. Dealing with Subnational Debt Crises**

Should borrowing controls fail to safeguard the soundness of subnational public finances, the institutional framework should include a clearly defined procedure for crisis resolution, if ad hoc bailouts are to be avoided. Several countries have thus strengthened their enforcement mechanisms by incorporating specific regulations to deal with subnational debt crises.

The resolution of such crises should comprise both short term as well as long-term measures. Short-term measures generally include some form of debt restructuring to alleviate the financial difficulties of the subnational government, but usually cannot ensure the sustainability of subnational finances unless they are supplemented with more structural measures. These could take the form of (1) subnational fiscal adjustments plans, (2) administrative intervention by a higher level of government, or (3) judicial procedures for insolvency and bankruptcy.

Subnational fiscal adjustment plans are usually linked to debt restructuring programs and thus are negotiated with the Ministry of Finance at the central level. The plans usually specify revenue or expenditure measures to be adopted by the subnational government to strengthen its fiscal position. In Brazil, for example, the fiscal adjustment plans negotiated in the context of the 1996 debt restructuring program committed states to debt reduction, higher

revenue collection, and reduced payroll expenditure. In addition, the plan included tight conditions for new borrowing and mandated states to use as collateral their own revenue and transfers from the federal government. The plans also committed states to privatize their state-owned enterprises and use privatization receipts to reduce their debt.

Administrative intervention by higher levels of government could start by simply recommending the subnational government to strengthen its fiscal position. More direct administrative interventions imply specific measures to adjust the local fiscal positions. The most stringent administrative interventions consist of temporary takeovers of the local financial administration by a higher level of government, or by a council reporting to the higher level government. The intervention of the U.S. federal government in the finances of Washington D.C. and the intervention approach of the Ohio State are two cases in point.

In 1995, an act by Congress declared the District of Colombia (Washington D.C.) in fiscal emergency, mandated that the District's budget be balanced by fiscal year 1999, and approved the temporary creation of a financial control board (FCB) to take over the District administration. The Act also delegated the appointment of the five members of the FCB to the President of the United States and defined the main role of the FCB. The tasks of the FCB mandated by the Act include the repayment of all borrowing by and on behalf of the District, assistance to the District in regaining adequate access to both short- and long-term credit markets at reasonable rates, and achieving a balanced budget for four consecutive fiscal years. The FCB also received power to reject any local legislation. The board ceased its operations in September 2001, once all its tasks had been achieved.

On the other hand, according to the Ohio State Code of Local Fiscal Emergency, administrative intervention takes a two-phase approach. In phase I, a "Fiscal Watch Program" is announced by the state auditor when the fiscal position of a local government is close to default. During this phase, the state auditor could at the request of the local government recommend specific measures to improve local finances. In phase II, a "Fiscal Planning and Advisory Commission" is established by the state to take over temporarily the administrative control of the subnational government in default and restore its debt service capacity. The commission has the power to freeze salaries and staff levels, raise additional revenues, and build up reserves.

Finally, some countries have assigned the resolution of subnational debt crises to the judicial system, as a commitment to a no-bailout policy. The U.S. introduced legislation on bankruptcy procedures for states and municipalities in 1937 and Hungary enacted legislation on local government bankruptcy in 1996. In such cases, a judicial court coordinates the interaction of debtors, creditors, citizens and government auditors. In particular, it receives, analyzes and approves (or rejects) the request to declare a given subnational government bankrupt. Creditors negotiate with debtors conditions for payment or restructuring of subnational debt and government auditors monitor the financial activities of the insolvent government and impose the necessary penalties.

## V. CONCLUSIONS

This paper focuses on the institutional and procedural backbone of decentralized governance. It illustrates that decentralization relying solely on community safeguards will generally be insufficient to ensure pro-poor spending, and that there needs to be concomitant emphasis on the generation of accurate and timely information on the actual spending, if not on the outcomes. This needs to be supplemented by effective mechanisms to detect, prevent, and punish misuse of resources or diversion of funds.

Even with adequate monitoring of subnational spending, there has to be an emphasis on the effects of such spending, particularly the incurring of debt and other contingent liabilities, on overall macroeconomic aggregates. Again, the implementation of orderly macroeconomic adjustments will rely on the nature of the public financial management infrastructure at all levels of government.

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