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Decentralization and Macroeconomic Management

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Abstract

The literature on fiscal federalism has amply discussed both the potential efficiency and welfare gains from decentralization and the potential trade-offs between decentralization and income redistribution. By contrast, it has generally put less emphasis on the effects of decentralization on macroeconomic management, although policymakers worldwide increasingly have to grapple with these effects. This paper examines the constraints that a high degree of decentralization can place on the ability of the central government to carry out its traditional macroeconomic management functions and explores various ways to minimize these constraints.

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Summary

There is a vast and growing body of literature covering the potential efficiency and welfare gains from decentralization. The literature has also amply discussed the potential trade-offs between decentralization and income redistribution, as well as various mechanisms designed to attenuate these trade-offs. By contrast, in the literature on fiscal federalism there has been relatively little emphasis on the effects of decentralization on macroeconomic management, although policymakers worldwide increasingly have to grapple with these effects. This is the focus of the present paper, which draws on a range of country experiences in this area.

The paper discusses the constraints that a high degree of decentralization places on the central government's ability to carry out its traditional stabilization functions; the macroeconomic impact of subnational governments operations, both under balanced budget and deficit conditions; and the case for, and possible approaches to, the control of subnational government borrowing.

The paper concludes that decentralization—as desirable as it might be on efficiency, as well as political, grounds—can entail significant costs in terms of the effectiveness of the central government in stabilizing the economy. The paper explores various ways to minimize these costs, including the setting of hard budget constraints on subnational governments and a more active involvement of these governments in the central government's macroeconomic management and adjustment efforts.

I. INTRODUCTION

Decentralization is a growing worldwide trend, which reflects more democratic and participatory approach to government, even in countries which traditionally have been characterized by pronounced centralism. The potential **efficiency and welfare gains from decentralization** have been amply discussed in the fiscal federalism literature, and are generally supported by practical experience, especially in those countries which have made efforts to strengthen institutions at the subnational level, to promote transparency in the operations of subnational governments (SNGs), and to increase their responsiveness to local needs and priorities.

The literature has also highlighted the potential **trade-offs between decentralization and income redistribution**, especially in countries characterized by wide regional disparities in resource endowments and levels of development. Country experiences provide various examples of equalization mechanisms designed to attenuate, if not eliminate, these trade-offs (Ahmad, 1997).

By contrast, there has been relatively little emphasis in the fiscal federalism literature on the **effects of decentralization on macroeconomic management**, although economic policy makers worldwide increasingly have to grapple with these effects. This is the focus of the present paper, which draws on a range of country experiences in this area.[2]

The paper begins in section II with a discussion of how a substantial devolution of revenues and of spending responsibilities to the subnational level can affect the **ability of the central government to carry out stabilization and macroeconomic adjustment through the budget**, a function which the public finance literature, as well as historical practice, traditionally attribute to the central government. Section II also briefly discusses the **potential macroeconomic effects of the SNG operations** under conditions of a balanced budget. Section III focusses on the effects of SNG deficits from both the perspective of short-run macroeconomic management and of intergenerational equity. Section IV discusses possible approaches to the control of subnational government borrowing, focussing in particular on the conditions under which financial markets can be expected to impose adequate discipline on such borrowing, and on alternative methods to ensure discipline if these conditions cannot be fulfilled in practice. Section V presents some concluding remarks.

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[2]For a broad survey of country experiences with intergovernmental fiscal relations, focussing in particular on macroeconomic aspects, see Ter-Minassian, ed. 1997.

II. Macroeconomic Effects of Fiscal Decentralization

On a general level, it is clear that the degree of devolution of spending and revenue-raising responsibilities has significant implications for the central government's ability to conduct macroeconomic policies through the budget. **A loss of major tax instruments or of control over a large share of public expenditures can severely constrain the room for maneuver of the central government** in e.g., raising taxes or cutting spending to curb an overheated domestic demand. This is especially the case if the expenditures that the central government is left with are relatively rigid in the short run, e.g., interest payments on the public debt or entitlement programs, such as pensions. Moreover, in a highly decentralized budget setting, **the fiscal operations of SNGs can have important macroeconomic effects**, which, in the absence of effective coordination mechanisms, can run counter to the macroeconomic stabilization efforts of the central government. A **balanced budget expenditure increase** by the SNGs can boost aggregate demand, and affect the balance of payments unfavorably, if the average multiplier for subnational expenditures significantly exceeds the average multiplier for their revenues. Even if the overall level of expenditures of the SNGs is effectively constrained by limits on their taxing and borrowing powers, **changes in the composition of their expenditures**—e.g., in favor of items with relatively large multiplier effects, such as public works or transfers to individuals with high a propensity to consume—can boost aggregate demand, at a time when the central government is trying to contain it.

Moreover, not only the degree but **also the sequencing of decentralization can have important implications for macroeconomic stability and adjustment**. Patterns of decentralization have varied from country to country, as they are often shaped more by political and institutional factors, than by economic ones. In many countries, the decentralization of spending responsibilities, reflecting political pressures or an expectation of efficiency gains, has tended to precede the devolution of revenue-raising responsibilities. In some countries facing several fiscal stress—such as the economies in transition—central governments have simply "pushed down" spending responsibilities, without transferring to the SNGs adequate resources to meet these responsibilities. By contrast, in other countries—such as a number of Latin American ones—a transfer of resources to the SNGs has been mandated by laws, or even by the constitution, before a corresponding transfer of spending responsibilities could be clearly defined and effected.

Neither of these patterns of decentralization is likely to promote fiscal discipline. Large **vertical imbalances in favor of the central government** tend to lead to a recourse to ex-post gap-filling transfers by the central to the subnational governments, or to deficit financing and excessive debt accumulation by the latter. **Substantial vertical imbalances in favor of the SNGs**, on the other hand, tend to promote excessive spending on the functions initially assigned to them, e.g., through overmanning or too generous wage increases for their employees. The rigidity of these expenditures makes it difficult for the SNGs to accommodate within their budgets the additional spending responsibilities that may subsequently be transferred to them.

Thus, **fiscal discipline at all levels of government is best promoted by a broad ex-ante matching of revenues with spending responsibilities for each level of government**. Of course, adequate vertical balance needs to be complemented by carefully designed and transparent equalization mechanisms, to address **horizontal imbalances** among SNGs which are a common problem in countries worldwide.

The design of intergovernmental fiscal relations needs to take into account the fact that increasingly the **degree of spending decentralization called for by efficiency considerations and/or by political pressures, tends to exceed the degree of devolution of revenue-raising responsibilities that would be consistent with optimal tax assignment**. Efficiency and administrative considerations continue to argue for the assignment to the central government of responsibility for the major taxes, especially the corporate income tax, multi-stage sales taxes such as the VAT, and taxes on foreign trade. The bases of the personal income tax and of general or selective single stage taxes can be shared between the central and the regional governments, while the property tax remains the best choice for local government taxation. In conditions of substantial expenditure decentralization, these generally accepted principle of tax assignments are unlikely to lead to vertical balance.

In those circumstances, a systematic resort to intergovernmental transfers is likely to be required. The objective of promoting fiscal responsibility at the subnational level calls for the implementation of **a stable and transparent system of transfers** from the central government to the SNGs, geared to filling any ex-ante gap between the assigned spending and revenue raising responsibilities of the latter. The definition of such a system is as a far from easy task, especially given the need to preserve adequate incentives for tax effort and cost effectiveness in spending by the SNGs.

Stability and transparency considerations call for revenue-sharing (and other general purpose transfers) systems which are formula-based. It must be recognized, however, that **such mechanisms tend to impart considerable rigidity to the central government budget**, and to constrain its ability to carry out an active macroeconomic management. Specifically, an increase in the rates of shared taxes, or successful efforts to improve their administration, aimed at reducing the central government deficit or at curbing an excessive growth of domestic demand, automatically increase the resources available for spending by the SNGs. Unless mechanisms can be put in place to ensure that these additional resources are saved, the intended macroeconomic effects of the tax increase can be partly (or even largely, depending on the sharing coefficients) frustrated by the revenue-sharing provisions. Recent history, including in various Latin American countries, provides examples of more or less successful attempts by central governments to enact such mechanisms. A possible approach to this problem would be a stipulation in the revenue-sharing law that the portion of the revenue transferred to the SNGs would be determined by applying a constant tax rate to the shared tax base.[3]

Moreover, rigid revenue-sharing arrangements can amplify cyclical fluctuations in output. Cyclically-induced booms in national taxes tend to boost the SNG's spending capacity, while cyclical declines in those taxes force the SNGs to cut back their spending (at least if they operate under a hard budget constraint). Thus, swings in SNGs' expenditures tend to exacerbate cyclical swings in output. To address this problem, elements of flexibility could be introduced in revenue-sharing arrangements, e.g., by relating the SNGs' shares in national taxes to a moving average of those taxes, or by requiring the SNGs to constitute revenue stabilization funds (such as the "rainy day funds" mandated by some state constitutions in the U.S.). On the spending side, as long as responsibility for macroeconomic stabilization continues to rest with the central government, it is important that the latter retain responsibility for items of expenditure which are especially sensitive to economic cycles, such as unemployment benefits. This is indeed the practice in most countries.

III. THE CASE FOR CONTROL OF SUBNATIONAL GOVERNMENT BORROWING

The previous section has highlighted the fact that the operations of SNGs, even under conditions of a balanced budget, can have significant macroeconomic effects, that may run counter to the stabilization efforts of the central government, and constrain the ability of the latter to pursue certain macroeconomic objectives. **The destabilizing potential of SNGs' operations is, of course, much greater when they do not operate under a hard budget constraint.** Substantial deficits of SNGs—especially the larger states and cities—if financed from abroad or by domestic bank credit can undermine the conduct of monetary policy, and, even if not financed monetarily, can "crowd out" the private sector.

Thus, **short-run macroeconomic management considerations call for effective limits on SNGs' deficits**, consistent with the national objectives for growth, inflation and the balance of payments. The mechanisms for defining and enforcing such limits vary across countries, reflecting the institutional framework for intergovernmental relations, and the political power balances in each country. Naturally, unitary countries tend to attribute greater powers to the central government in this respect than federations. In most unitary countries, where typically SNGs have limited own sources of revenue and are therefore, heavily dependent on transfers from the central government, the latter exerts extensive influence on the SNGs budgets, providing more or less binding guidelines for their preparation, and monitoring and controlling their execution. The effectiveness of these controls can be substantially enhanced by the adoption by the SNGs, as well as by the central government, of modern, comprehensive, standardized and transparent budgetary and accounting procedures and information systems. The creation of institutional fora to ensure a regular and frequent dialogue between the

[3] See e.g., Schwartz and Liuksila, 1997 and Ter-Minassian, 1997.

central and subnational authorities on current and prospective budget trends, can also be very helpful in this respect. Examples of such an approach can be found in a number of European countries (e.g., the U.K., Belgium and the Scandinavian countries).

In federal countries, where the member states frequently have a constitutionally guaranteed status of sovereign entities, or in any event much greater autonomy than in unitary countries, the central government may not have the legal authority to impose limits on the SNGs' budget deficits. In these cases, attempts by the central government to curb the growth of SNGs' spending by cutting back discretionary transfers to them, may be frustrated by stepped up borrowing on the part of these governments.

In the light of these considerations, it is not surprising that a number of federations have moved toward more **cooperative approaches to macroeconomic management**, in which SNGs are actively involved in the process of formulating the national macroeconomic objectives and the key fiscal parameters underpinning these objectives and are, so to speak, made co-responsible for their achievement. Through a multilateral negotiation process, in which the central government generally takes a leading role, agreement is reached on an overall balance target for the general government, as well as on the guidelines for growth of the main items of revenue and expenditure. Specific limits are then agreed for the financing requirements of individual subnational jurisdictions. Mechanisms are also agreed for the multilateral monitoring of compliance with these limits, and for their revision when necessary. A well developed example of this approach can be found in Australia, through the working of its Loan Council (Craig, 1997), and another variant of it in Germany (Spahn and Föttinger, 1997).

The cooperative approach has the clear advantage of promoting dialogue and exchange of information among the various levels of government. It also raises the consciousness, in subnational-level policy makers, of the macroeconomic implications of their budgetary choices. It seems, however, to work best in countries with a well-established culture of fiscal conservatism and discipline. It may not be effective in preventing a build-up of SNGs' debt in conditions where either market discipline or the leadership of the central government in economic and fiscal management are weak.

SNGs' deficits can affect adversely not only macroeconomic management and performance in the short run, but also intergenerational equity over the longer term. The running up of substantial debt by the SNGs—not unlike the accumulation of debt by the central government—can impose on future tax payers, who may not be represented in today's electoral processes, a heavy burden of servicing that debt (McKinnon and Nachyba, 1997). A review of recent developments in major countries—especially, but not exclusively, of a federal nature—shows that indeed the debt of SNGs has been rising rapidly over the last few decades, reaching in some instances over a quarter of the total national debt.

In this perspective of intergenerational equity, and abstracting from short-run macroeconomic management considerations, **the main criterion governing the access of SNGs** (as well as the central government) **to borrowing should be their capacity to service the debt over time.** The question is: by whom and how should the assessment of this capacity be made? Under what conditions can financial markets be relied upon to impose an effective discipline on SNGs' borrowing? And, when these conditions cannot be fulfilled in practice, is a rules-based approach to SNGs' borrowing preferable to direct controls—when legally feasible—by the central government? The following section attempts to provide some insights into these, far from easy, questions.

IV. ALTERNATIVE APPROACHES TO THE CONTROL OF SUBNATIONAL BORROWING [4]

A. Reliance on market discipline

It has been suggested (Lane, 1993) that **a number of conditions need to be satisfied for financial markets to exert effective discipline on subnational government borrowing**:

- markets should be free and open; in particular, there should be no regulations (such as reserve or other portfolio composition requirements) on financial intermediaries which place SNGs in a privileged borrower position;

- adequate information on the borrower's outstanding debt and repayment capacity should be available to potential lenders;

- there should be no perceived chance of bailout of the lenders by the central government in cases of impending default.[5] An assumption by the central government of the debt of a subnational government imposes an externality on tax-payers in the rest of the country; and

- the borrower should have institutional structures which ensure adequate policy responsiveness to market signals before reaching the point of exclusion from new borrowing.

It is clear that **these are indeed stringent conditions, which are unlikely to be realized in the majority of countries**. Typically, especially in developing countries, available information on the finances of subnational governments still suffers from serious weaknesses in coverage, quality and timeliness. Many countries still utilize various forms of portfolio

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[4]See Ter-Minassian and Craig (1997) for a fuller discussion of these issues and of country experiences in this area.

[5]See Bayoumi, Goldstein and Woglom (1995).

constraints on financial intermediaries, to facilitate the placement of government securities (including of SNGs) at a reduced cost. More importantly, in many, especially developing, countries, subnational governments maintain total ownership or controlling stakes in some financial institutions, which provide a captive market for their bond issues or borrowing. Also, a number of countries have already experienced various forms of intervention by the central government (or the central bank) to prevent default by SNGs on their debts. Finally, relatively short electoral cycles frequently make politicians at the subnational government level short-sighted and unresponsive to early warnings by the financial markets.

Recognition of these realities may be a major reason why **sole reliance on market discipline to control subnational borrowing is not usual.** Examples of a purely market based approach can be found in **Canada**, at least for provincial governments' borrowing, and in earlier years (through the late eighties) in **Brazil. A review of these countries' experiences points to the dangers of an unfettered reliance on market discipline.** Of course, the problems created by the build-up of state debts in Brazil are only too well known to this audience, and need no repeating here. But, even in a country like Canada, with well developed and relatively transparent financial markets and no history of bailouts by the federal government, market discipline has not proven fully effective. Despite a clear deterioration in ratings, and related sizable increases in risk premiums on provincial bonds—more marked for the more indebted provinces—provincial debt has risen steadily over the last several years (reaching about 23 percent of GDP in 1994), and only in the last few years have the provincial governments begun to design and implement fiscal retrenchment programs. Some of the provinces have also instituted legal or constitutional limits to their own borrowing. It may be argued that market discipline is finally starting to work, but only after a "recognition lag" which has necessitated a sharper and more painful retrenchment than would have been the case if provincial debts, and their service, had not been allowed to rise to their present level.

In conclusion, although appealing in principle, sole reliance on market discipline for subnational borrowing is unlikely to be appropriate in most countries, in present circumstances. Over the longer term, however, as financial markets become more developed, transparent and free from government intervention, and in particular as public banks are privatized; as information on recent and prospective developments in the finances of SNGs is improved and widely disseminated; and as a sustained record of no bailouts by the central government (or the central bank) is established, **the scope for effective reliance on market discipline can be progressively enhanced.**

B. Rules-based approaches

A number of countries, both federal and unitary, have relied on approaches to the control of SNGs' borrowing which are based **on standing rules, specified in the constitution or in laws.** Some of these rules set limits on the absolute level of indebtedness of SNGs; others specify that borrowing can be resorted to only for specified purposes (typically investment projects); yet others stipulate that new borrowing is permitted up to a level consistent with a maximum allowed service ratio, etc. Finally, some countries prohibit, or severely restrict certain types of borrowing, which involve greater macroeconomic risks (e.g., borrowing from the central bank or from abroad). Many countries utilize a combination of such rules.

Rules that limit SNGs' borrowing to investment purposes (the so-called **golden rules**) are quite common in industrial countries: examples can be found in Germany, Switzerland and in the majority of the state constitutions in the United States. In principle a good case could be made for restricting borrowing to investment purposes only. However, the golden rule may not be sufficiently restrictive in countries which need to generate government savings to finance at least a part of public investment. Moreover, it may not be desirable to allow government borrowing to finance investments which do not have adequate rates of economic and social return. (Indeed, in many countries, efficient current expenditures on health and education may have higher rates of return than many capital projects.) Finally, in practice, it may be difficult to avoid circumvention of the golden rule through the labeling of certain current expenditures as investments.

Those countries which allow **short-term borrowing for liquidity purposes** generally stipulate that such borrowing has to be repaid by the end of each fiscal year. This is the case, for instance, for some of the states in the United States, and for regional and local governments in Spain. In the enforcement of these rules, it is important to check for creative accounting and build-up of temporary payments arrears at year end.

Examples of **rules that "mimic" market discipline** by linking limits on the indebtedness of SNGs to the projected debt service on the debt, or to other indicators of their debt-servicing capacity (such as past revenues or the tax base) can also be found in some industrial countries (United States (Stotsky and Sunley, 1997), Spain, Japan (Mihaljek, 1997)), as well as in some developing ones, e.g., Korea (Chu and Norregaard, 1997). Effective use of these rules requires, of course, that the projections of the debt service and revenues utilized in testing compliance with the ceiling, be realistic and, indeed, preferably conservative.

Rules-based approaches have the obvious **advantage of transparency and evenhandedness**, as well as of avoiding protracted bargaining between the central and the subnational levels of government, a process the outcome of which often ends up being determined more by short-term political factors than by considerations of sound macroeconomic management. On the other hand, by their very nature, **rules-based approaches lack flexibility and, often, end up fostering the development of behaviors and practices aimed at circumventing the rules**. Such practices include, for instance:

- the reclassification of expenditures from current to capital, to escape current budget balance requirements;

- the creation of entities whose operations—albeit of a governmental nature—are kept off-budget, and whose debts are not counted against the debt ceilings;

- the use of state or local government-owned enterprises to borrow for purposes which should be funded through the relevant government budget;
- the use of debt instruments—such as sale and leaseback arrangements or the so-called private revenue bonds in the United States (Stotsky and Sunley, 1997)—which are not included in the debt limits; and
- the resort to arrears toward suppliers, which are typically difficult to monitor for inclusion in the public debt ceilings.

This non-exhaustive listing suggests that, to be effective, a rules-based approach needs to be supported by: clear and uniform accounting standards for government entities, strictly limiting, and preferably eliminating, the scope for off-budget operations; comprehensive definitions of what constitutes debt; the setting up of modern government financial management information systems, capable of providing timely and reliable data on all phases of expenditure,[6] as well as on financial operations of the various levels of government; and policies, like privatization, which minimize the scope for use of financial and nonfinancial enterprises for government purposes.

C. Direct controls of the central government over subnational borrowing

In a number of countries, the central government is empowered with **direct control over the borrowing of SNGs.** This control may take alternative forms, including: the setting of annual (or more frequent) limits on the overall debt of individual subnational jurisdictions (or some of its components, e.g., 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 for approved purposes (generally investment projects). Control powers generally encompass not only the ex ante authorization of proposed borrowing, but also the ex post monitoring, on a more or less detailed and timely basis, of the subnational governments' financial operations.

As indicated in the previous section, direct control of the central government over subnational deficits and debt is, of course, more common in unitary countries than in federations. Examples of different forms of such controls can be found, among others in the U.K., France, Spain, Japan and a wide range of unitary developing countries. Among federal countries, in India the central government is empowered by the Constitution to approve or disallow recourse to borrowing by those states (in practice all) which have outstanding indebtedness to the center (Hemming, Mates and Potter, 1997). In Brazil, the Senate can set limits on state indebtedness, and recently, in the context of their debt restructuring operations, the states

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[6]Timely and reliable information on obligations to pay, as well as on actual payments, is essential to prevent the accumulation of arrears.

have been entering into agreements with the central government which involve a degree of control by the latter over further state recourse to borrowing (Ter-Minassian, 1997).

Several arguments may be put forward in favor of direct central government controls on the external borrowing of subnational governments. First, external debt policy is intimately linked with other macroeconomic policies (monetary and exchange rate policies, and foreign reserve management) which are the responsibility of central-level authorities (in particular, the central bank). Second, a well 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 have "contagion" effects on the ratings for other borrowers, both public and private. Finally, foreign lenders frequently require an explicit central government guarantee for subnational borrowing. Even in the absence of such an explicit guarantee, pressures on central governments to come to the rescue of insolvent SNGs are likely to be more compelling when the external creditworthiness of the whole country risks being damaged by default on the external debt of those governments. If, then, central governments end up de facto bearing ultimate responsibility for SNGs' external debt, it would seem appropriate that they should have approval power over the SNGs' recourse to this type of debt.

The case for direct central government controls over SNGs' domestic borrowing is clearly less compelling. To begin with, as already mentioned above, such controls are likely to be at odds with the legal and often constitutional status of SNGs in a federal country. Moreover, such controls entail the central government's involvement in micro-level decisions (e.g., about the financing of individual investment projects) which would be best left to the relevant subnational authorities. Finally, 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 an impending default. Thus, on balance, effectively and timely monitored aggregate limits on the overall debt of individual jurisdictions, set in the law and based on market type criteria (such as those discussed in the subsection above) would seem preferable to either centralized government borrowing or to the preapproval by the central government of individual borrowing operations of the SNGs.

V. Concluding Remarks

This paper has attempted to provide an overview of the complex issues relating to decentralization and macroeconomic management, and to draw a few lessons from country experiences in this area.

In summary, it seems clear that **decentralization**, as desirable as it might be on efficiency, as well as political, grounds **can entail costs in terms of the central government's ability to carry out effectively its traditional macroeconomic management functions**. Indeed, it could be argued that countries facing acute macroeconomic and fiscal imbalances should "put their house in order" before embarking on substantial further decentralization of revenue and spending responsibilities.

There are, however, ways to minimize the macroeconomic costs of decentralization. First, the greater the degree of revenue and spending devolution, the more important it is for the central government to seek an active dialogue with the SNGs, and their involvement in macroeconomic management and adjustment efforts. The model of **cooperative federalism** discussed briefly above is likely to acquire increasing relevance worldwide if the decentralization trend continues and indeed deepens. Second, SNGs need to be subjected to **hard budget constraints**, i.e., comprehensive, transparent, and effectively monitored limits on their indebtedness. These limits should be preferably set through standing rules, enshrined in the law, and based on sustainability criteria, relating to the capacity to service the debt with own resources or nondiscretionary transfers from the central government. Market discipline, promoted through dissemination of information and removal of government interference, can usefully complement and support the application of these rules.

All these considerations give cause for cautious optimism that the progress made in recent years by most Latin American countries in stabilization will not be lost, that the maintenance of low rates of inflation will go hand in hand with strong and balanced economic growth, and that governments will persevere with, and expand the scope of, reforms of the public finances.

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