Part I

Political, Legal, and Financial Framework

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Chapter 2

Fiscal Devolution

Devolution—the granting of greater political and fiscal responsibility and power to subnational units of government and the performance of more government functions at the subnational level—has been in full swing worldwide for the last decade. A 1994 World Bank report noted that of the 75 developing countries with populations greater than 5 million, all but 12 were in the process of transferring fiscal power from the center to subnational governments (Dillinger 1994). In the once highly centralized communist states with virtually no subnational autonomy, devolution has been a universal phenomenon. In some countries subnational governments have long existed but frequently only as agents of the central or provincial government and with little real authority or financial autonomy. In other countries, a history of tension between competing "sovereigns" at the center and in the regions has left a legacy of imperfect and damaged intergovernmental relationships.

Principle of Subsidiarity

There are well-rehearsed economic and political arguments in favor of devolution that appeal to the efficiency and desirability of grassroots decisionmaking and accountability. To the economist the subnational government's greater knowledge of subnational needs strengthens the links between tax revenues and spending benefits that accrue to subnational taxpayers. Subnational authorities can respond more readily and effectively to local conditions, resulting in improved delivery of government services. Bringing expenditure assignments closer to revenue sources enhances accountability and transparency. Political arguments often adhere to the principle of subsidiarity, that is, in a democracy, the lowest level of government that can determine and effectively meet the needs of its constituency is the most appropriate structure of government.

The details of the extent and effectiveness of devolution are specific to each country. The process can be complex and filled with uncertainty. Making the transition from a highly centralized system of governance to a more localized one is a serious task, subject to interruptions and miscalculations along the way.[1] In the end, the degree of devolution depends on the degree of *de jure* fiscal autonomy and *de facto* willingness and ability to tap resources. Countries vary greatly in both respects.

Borrowing and Devolution from the Subnational Perspective

Subnational access to credit markets usually derives from devolution. Borrowing becomes a critical issue of local initiative only when there is a move toward localized delivery of services requiring capital investments that will not be met by central government resources. Devolution is of great practical consequence for credit markets and for how subnational governments access those markets. If effective, devolution places decisionmaking at the subnational level and erodes what has often been the de facto monopoly of the central government over subnational capital financing decisions, including the use of credit.

With decentralization of finances and financial decisionmaking, investors and lenders care how well subnational governments are managed because they have money at risk, and their scrutiny drives greater transparency and efficiency at the subnational level. However, subnational governments first must have the ability to raise and use resources and to make binding commitments that are politically and legally sustainable. For many countries, this constitutes a huge change in perspective and in the balance of political power.

Measuring Fiscal Decentralization

While the idea of devolving spending, revenue-raising, and borrowing decisions from central to local and regional governments seems conceptually clear, the process has proven cumbersome, contentious, complex, and confusing.[2] The shifting down of spending responsibilities often has not been accompanied by a corresponding shifting down of resources, so that subnational governments have been faced with both mandated spending requirements over which they have little influence and weak and constrained revenue systems.

Most devolutions have involved large shared-tax and fiscal transfer programs that are not tied to specific spending programs. Furthermore, such financial management practices as public deposit management, investments, and borrowing procedures have been slow to adjust to the new devolution-

ary regime, restricting the financial decisionmaking ability of subnational governments and their day to day management and planning (see box 2.1). In India, for example, State Finance Commissions are responsible for implementing the devolution of financial resources to subnational governments. They regularly review the finances of subnational bodies (panchayats and municipalities) and make recommendations on the sharing and assignment of state government revenues and grants in aid (see the India case study, chapter 24).

Quantifying the amount of subnational autonomy in a fiscal system is difficult. Internationally statistics on government finance leave large gaps in understanding the nature of local revenue and expenditure systems and the degree of autonomy that subnational governments have to make "devolved" fiscal decisions (Ebel and Yilmaz 2001). For example, systems with substantial dictated expenditures or programs of large fiscal transfers and tax sharing that are subject to discretionary change at the center do not qualify as devolution, nor do categorical grants from the central government that are restricted to specific uses. Fiscal autonomy is also effectively lessened when subnational governments cannot control either the rate or base of local taxes.

The upshot of devolution in many developing and transitional countries is that subnational governments are undergoing structural change and typically have restricted power to borrow and limited own-source resources for securing debt. Understandably, would-be lenders, unfamiliar with the ways of subnational government and aware of the intergovernmental tumult, have been cautious in their lending.

Budget Constraints and Local Control

Apart from a subnational government's ability to raise taxes, levy charges, and commit resources as it sees fit, effective devolution requires a "hard budget" constraint at the subnational level. A hard budget constraint means that the subnational government must live within its resources and cannot depend on the central government to cover its deficits or repay its debts. A hard budget is possible, as long as certain basic services are provided and the risks are acknowledged and "paid for." Assumption of the risks by those who have decided to take them is an important and often delicate point in governance. Freedom to fail is one of the liberties and consequences that accompany greater subnational government freedom and responsibility in decisionmaking.

Fiscal discipline is achieved only if those taking risks and failing are made to pay the price. Activities and borrowers deemed unsuitable for paying a price for mistakes may be effectively precluded from the markets ei-

Box 2.1. Devolving Responsibility for Elementary School Teachers' Salaries in Romania

In 2000 the Romanian government passed to municipal governments the responsibility for paying public elementary school teachers' salaries; however, the salaries were set uniformly at the national level. The central government transferred revenues to the municipalities to pay the salaries, dedicating a portion of the national value added tax (VAT) for that purpose.

With the new spending requirements, local government budgets increased substantially and their composition changed. The discretionary portion of local budgets plummeted, while the portion going to employee wages rose. The new payments significantly increased overall transfers to localities, especially earmarked revenues.

The change also affects the borrowing status of Romanian municipalities. By law, the increase in current operating revenues from permanent sources increased the amount that a local government could borrow based on total current revenues.However, the new exposure of local government budgets to paying the salaries of a large and influential employee group and the uncertain reliability of future shared revenues from the VAT probably reduced the amount investors are willing to invest. By impairing the future fiscal flexibility of localities and their ability to pledge funds for debt payment, the change may have made borrowing more difficult. The episode indicates the limitations of legally imposed ceilings and the importance of market perceptions in deciding what is prudent behavior.

Source: Petersen 2002.

ther by fiat or by the unwillingness of investors to invest. Both developed and emerging credit markets are full of examples where certain activities and facilities are held as essential to the public sector and cannot be used as collateral to secure borrowings. Markets in developed economies have found ways to achieve sufficient security.

There has been considerable concern, particularly among central governments, about the destabilizing impact of fiscal decentralization, especially of excessive subnational borrowing. They worry that decentralization will permit, if not encourage, subnational governments to spend too much, forcing central governments to run deficits of their own as they bail out the local excesses. This kind of destabilizing behavior arises primarily in one of two largely unrelated circumstances. One is the case of federal system countries with weak fiscal coordinating power by a central government that will not or cannot impose a hard budget constraint on the subnational governments.[3] Another is the case of subnational governments that are the putative borrowers from an entity such as a national development fund but the borrowing decisions are effectively made by the central government, with the localities merely "signing on the dotted line," or where the localities were placed in a position of substantial moral hazard because of the nature of the program design (see the Indonesia case study, chapter 25).

Another part of the devolutionary equation is the need for local control of resources that can be used to secure debt. Two problems are common. First, subnational revenue systems are often inadequate, and meeting expenditures mandated by the central government exhausts the budgetary resources. As a practical matter, even if subnational governments have potentially viable revenue sources and can muster the political will, the inability to raise taxes and spend funds as they wish can be a severe constraint on the ability to borrow. Second, even where localities have substantial physical assets, they are legally precluded from using them to secure credit. This inability to pledge physical assets has been a constraint in many countries where bank lending, in particular, is secured by asset pledges.

Impact of Devolution on Subnational Finances

The impact of devolution on the ability to borrow has to do with how resources are assigned to governments and how resources are balanced against spending responsibilities. Several factors affect the resources available to subnational governments for meeting both operating needs and debt commitments. Among them are the following:

- The overall size of transfers and their size relative to a subnational government's overall operating revenues.
- The extent of earmarking of transfers (as opposed to being generally usable or available for debt service).

- The revenue sources legally available to subnational governments, the revenue potential of those sources, and the ability of subnational governments to use revenues for general rather than specific purposes.
- The flexibility subnational governments have in setting rates or charges and defining tax and charge bases.
- The overall political and institutional risk to which revenue and fiscal transfer systems are subject, that is, the potential for producing changes that can disrupt subnational finances.

On the spending side, a related set of factors affects subnational government creditworthiness and credit access:

- The degree of discretionary spending, the size and type of mandated spending, and the impacts of mandates on the future flexibility of subnational budgets.
- How specific expenditure types are funded, such as those earmarked from specific revenue sources.
- The degree of flexibility a subnational government has in adjusting its budget over the economic cycle or in response to changes in local conditions.
- Demographic and economic factors that determine the demand for services and the ability of localities to control or plan for them.

The more that subnational governments are expected to be self-reliant in financing their activities, the more these factors count. Conversely, to the extent that subnational government borrowing is formally guaranteed by the central government (or that credit markets expect a national government bailout of subnational government debt in the event of difficulty), the less fiscal devolution has taken place; accordingly, the less important local fiscal affairs and demonstrated discipline are to private sector lenders.

Devolution, Borrowing, and Macroeconomic Stability

The subnational government's desire to pursue fiscal autonomy is one side of the devolution coin. The other is the central government's need to maintain macroeconomic and fiscal balance, which implies maintaining subnational debt under limits.

Central government concerns over control of the macroeconomic balance stem from its need to manage the national economy and currency and

so the need to have centralized monetary and fiscal policies. Decentralization of a large share of public expenditures, even when subnational governments are constrained by taxation and borrowing limits, can adversely affect aggregate demand and international competitiveness, undermining national stabilization policy.[4] Similarly, public debt at local levels that becomes effectively "monetized" can interfere with monetary policy and, by extension, hamper the central bank's effectiveness in carrying out national policy.

In theory, decentralization should establish a virtuous cycle of behavior by subnational governments that helps to maintain macroeconomic stability. Bringing expenditure assignments closer to revenue sources should enhance accountability and transparency in government actions. Underpinning the downward shift in responsibility is greater reliance on the benefit principle; taxpayers should pay for the public services they receive and get the services they pay for, linking taxes to the benefits provided. Taxpayers are made aware of the cost of goods and services that they consume and, as consumers, they should be more concerned about efficiency and better able to do something about it.

If poorly conceived and executed, however, decentralization can imperil macroeconomic stability. Given the greater difficulty in coordinating government actions when subnational governments enjoy greater policymaking autonomy, the challenge is to design a system of multilevel public finances that allows the efficient provision of local services while it maintains fiscal discipline nationally and subnationally (De Mello 2000). Much of the concern is rooted in the unwillingness of the central government to let go and in the web of political relationships between the central government and its subsovereign governments. Lack of discipline and transparency may induce subnational governments to spend beyond their means, leading to higher borrowing costs because of the risk premium associated with a higher probability of default.

Avoiding these problems requires that subnational governments exercise fiscal discipline and that their fiscal position be effectively monitored. Thus, decentralization should include either firm rules or strong incentives for prudence in debt and expenditure management. While these notions are conceptually straightforward, decentralization in practice is the product of political decisionmaking, and the required changes create winners and losers. Not surprisingly, decentralization in many countries has been plagued by confusion and compromise that undermine both the transparency of fiscal relationships and the fiscal discipline of the newly empowered subnational governments.

Decentralization of Responsibilities and Revenues

The literature on decentralization suggests rational guidelines for the allocation of responsibilities across government levels, assuming the managerial and technical capacity needed to carry them out. While the functions to be sorted out are many, as are the questions of local or regional points of service delivery and places of tax collection, a brief summation of principles is possible. Looking first at expenditures:

- The central level should retain expenditures that can strongly influence aggregate demand, that involve income redistribution, and that have large economies of scale or public-good characteristics on a national scale; examples include national defense, interstate communications, foreign policy, and research and development. Subnational governments generally assume responsibility for local activities such as local infrastructure and services.
- Sharing responsibilities should be considered in the case where the activity is national in scope but implementation is more effective at the subnational level, as in the case of education or health.

On the revenue side of the ledger:

- Base income taxation should be kept at the central government level to facilitate efficient collection and to preserve the government's macroeconomic stabilization and redistribution functions.
- Overlapping tax bases between the center and subnational levels are common in partial assignments of income tax, where subnational governments can piggyback on the national income tax by applying surcharges.
- To minimize unwanted tax-induced incentives, the central government should retain mobile tax bases such as the corporate income tax. A homogeneous tax system across all subnational governments is important to discourage enterprises from moving to areas with lower corporate taxes and eliminating tax competition among regions that could erode the tax base.
- The central level should receive the most unevenly distributed and fortuitous tax bases (such as natural resources) so that redistributive policies are possible and gross power differentials are not promoted inadvertently.
- Single-stage and excise taxes, such as the property tax, utility fees, and betterment tax, can be effectively assigned to the subnational lev-

el because the base is immobile and there is a close link between the tax and the benefiting user.[5] However, these guiding principles can collide with reality. In many cases, levels of government have traditional scopes of competency unrelated to their ability to raise revenues, requiring the transfer of funds from one level to another in an effort to balance resources and needs.

Intergovernmental Transfers

Transfers from the center reflect the disparity between decentralized revenues and the responsibilities associated with providing certain services at a subnational level.[6] While many services can be decentralized, revenue sources at the subnational level are generally inadequate to fund the services. Intergovernmental transfers, whether as a proportion of a set of central collected taxes or as grants, help fill that gap.

There is a vast body of literature on intergovernmental transfers (see, for example, Bird and Vaillancourt 1998). A critical issue is the impact of transfers during times of fiscal or other economic difficulty. The central government may need additional revenues, but the share of them appropriated to subnational governments is fixed. Grants from the central government tend to be more discretionary than shared revenues, a feature that may create revenue uncertainty for subnational governments in volatile economic times. Thus, an inherent tension exists between the predictability that is helpful to stabilizing subnational government finances and the rigidity that may destabilize the national fiscal balance.

Transfers can be important to credit market development, since they constitute a large share of available revenue and may act as security on subnational government loans and bonds. Transfers also can be limiting. In Hungary tight fiscal policies have constrained budgetary transfers from the central government, impairing the ability of subnational governments to meet the levels and standards of service required of them. Competing claims for scarce budgetary resources have led, in particular, to large funding gaps for local infrastructure investments (see the Hungary case study, chapter 29).

Subnational Borrowing as a Destabilizing Element

Major financial crises in Latin America in the late 1990s and in 2002 were in part a product of excessive subnational borrowing and central government assumption of subnational debt. This experience highlights the negative impact of subnational debt on the national aggregate debt exposure. It

also underscores the difficulty that central governments can have in monitoring the exposure of subnational governments.

In theory, competitive capital markets establish interest rates for government debt according to differences in perceived risk and in the tax and regulatory benefits that holding such debt may afford. Interest rates (risk premia) reflect the borrower's creditworthiness when the risk is assumed by the subnational government and not absorbed by the central government through explicit or implicit promises of bailouts or guarantees. However, even where the central government backs subnational debt, market forces may induce greater fiscal discipline at the subnational level once the debt is traded on the open market. Greater fiscal discipline can improve resource allocation, eliminate waste, and benefit the local population directly by increasing resources. Two key assumptions are that capital markets are competitive and that bondholders or the governments themselves suffer the consequences. Without the threat of "pain," discipline fails on both sides of the market.

Problems in Subnational Debt Markets

Fiscal discipline by subnational governments depends in large measure on their relationship with the center. How much autonomy do they have, and will the central government step in—and, if so, when—to avoid financial calamity? Relationships between central and subnational governments can give rise to the problems of adverse selection and moral hazard.

Adverse selection arises when asymmetric information or misaligned incentives lead to decisions that would have been avoided with more information or a different set of incentives. Subnational governments have an incentive to hide negative information about their finances from potential investors. Information asymmetries, common in all markets, must be mitigated through legislation, regulation, and institutional development. Where well enforced, securities and tax fraud laws can be powerful antidotes.

Moral hazard refers to the creation of incentives that distort behavior because parties are not held accountable for the risks involved in their actions. A local jurisdiction with borrowing privileges needs to maintain fiscal discipline to retain an adequate credit rating and satisfy creditor scrutiny. However, where an explicit or implicit central government promise exists to bail out subnational government, the costs of default are transferred to the center and neither the borrower nor the lender faces the consequences of the borrower's failures. With the penalties removed, the costs of inadequate discipline disappear, so that over-lending and over-spending are "rational be-

haviors" for both borrower and lender. Perceived permissive behavior at the center inverts the incentive system, making it "profitable" for subnational governments not to live up to their obligations.

Worries about moral hazard stem from ambiguities in the relationships among the sovereign government, subnational governments, and potential creditors. Often, national governments have relaxed the subnational budget constraint by permitting or even encouraging excessive spending. Creditors base their investment decisions on the financial viability of the subnational government to which they lend. Because of the unstable flow of revenues and less knowledge about the creditworthiness of the subnational government, creditors often seek a sovereign guarantee. Private sector lenders and multinational institutions and bilateral lenders alike often require that subnational loans carry sovereign guarantees. Private lenders are understandably circumspect about the moral hazard such behavior entails. They are unwilling to extend nonguaranteed loans in competition against the risk-free borrowing that subnational governments effectively enjoy (or risk-free lending that subnational government creditors enjoy) with a sovereign guarantee.

Setting a Precedent

If past interventions by the central government have set precedents for future interventions, the cycle is difficult to break. Moral hazard challenges confront countries from the start of decentralization. In the early stages, when subnational authorities are not fully in control of local expenditures, the central government is expected to fill expenditure holes, as has happened frequently in transitioning countries. As a result, the subnational authority is not held fully accountable for its expenditures. This type of moral hazard should decline once the system of revenue sharing and grants is established and subnational governments are made accountable for the services assigned to them. However, the sequencing of assigning responsibilities and resources and applying appropriate restraints is often defective.

A central government that has a history of bailing out subnational governments sends an implicit message that it will intervene in the future. Changing this perception can be difficult, since the causes are often deeply ingrained in the political and financial systems. In theory, intervention can be designed so that the subnational government bears the costs if it defaults and needs help from the central government. However, convincing creditors that subnational governments need to be creditworthy to have access to credit markets requires a consistent and sustained policy of letting subnational governments default without bailing them out. In weak and

unstable regimes the disruption caused by such failures may not be politically sustainable.

Why have central governments felt the need to intervene in subnational defaults? The answers are rooted in both politics and economics. Defaults where the creditor has effective remedies can lead to lost jobs and reduced services as subnational governments are forced to pay up. Where creditors are not able to enforce claims, private lenders may simply stop lending to those they hold responsible, including the central government. Creditors may threaten a downgrading of sovereign debt if subsovereign debt does not receive central backing.[7] Very large or systemic defaults may undercut the strength of financial institutions and cause them to close or rely on a state bailout of their own.

This pressure to tie subsovereign obligations to the central authority reinforces historical perceptions of the dependency of subnational authorities on the central government. The main prescription, besides disavowing any such implicit central guarantee, is to enforce local reliance on own-source and discretionary revenues. This, in conjunction with effective market regulation and stable central government policies on expenditure assignments and transfers, should mitigate the moral hazard problems of subnational borrowing., However, while a competitive financial market structure should be used to enforce and help instill fiscal discipline, a myriad of other conditions needs to be met as well. Effectiveness of market discipline depends on the extent of local accountability, which is in turn a function of transparency, available resources relative to expenditure assignments, fiscal management, and the political environment.

Transparency and Financial Management

Transparency—easy access to accurate and timely information about a government's finances—is often the major obstacle to financial market development. The few subnational governments that have accessed international financial markets have had to radically revise and upgrade their financial reporting practices (see box 2.2). Having little or no information on fiscal activity impedes reform. In the context of subnational government borrowing, transparency relates to budgeting, accounting, and auditing:

- *Budgeting*. In many countries subnational government budgets do not distinguish between current and capital expenditures or between ordinary revenues and loan receipts, or they provide inaccurate num-

Box 2.2. Rio and the International Marketplace

In the late 1990s Rio de Janeiro's municipal administration, in preparation for an international bond sale, gained a clear understanding of the need for transparency and adequate information disclosure. It was the first and only municipality in Brazil to retain internationally recognized auditors to examine its books. Even though the city's financial reporting was among the more comprehensive for Latin American subnational authorities, it still suffered from serious gaps. The city did not produce a balance sheet and, therefore, lacked a reliable view of its net asset position. In addition, it prepared financial statements in accordance with Brazilian legislation, which at times diverged significantly from international accounting standards. For the launch of its first issue of securities in the international market, Rio dramatically improved its reporting system, even providing regular and updated information on the Internet.

Source: Chapter 15, case study on Brazil.

bers for capital expenditures. The design of the fiscal transfer system may create incentives that foster misreporting of the overall financial picture. As a practical matter, it may be impossible to determine whether borrowing is used for investment or for financing a subnational government's short-term deficit. This lack of information undermines borrowing rules and impedes the ability to monitor for problems and compliance.

- *Accounting*. Deficient accounting rules and practices defeat transparency. Without a well-defined, uniformly applied set of accounting standards, it is impossible to judge a jurisdiction's financial health. Consequently, the absence of accurate reporting and clear applications of definitions undermines the establishment of effective parameters for borrowing, managing local assets and finances, and monitoring financial behavior.
- *Auditing*. Independent, third-party auditing of accounts can help ensure accuracy and legitimacy. Unfortunately, the list of possible auditing candidates in many developing countries is small, and consistent

auditing standards may not have been developed. Furthermore, few incentives exist to promote professional discipline and minimal checks of auditing practices.

Controlling Subnational Government Borrowing

Macroeconomic stability requires reducing the moral hazard that allows subnational governments to borrow too much and investors to lend to them unwisely. Needed is a hard local budget constraint requiring that the future resources to pay the debt be prudently calculated and the door to the national treasury be resolutely closed to bailouts. To accomplish this, some key ideas need to prevail:

- Rules for grants must be clear, and an effective monitoring system must be established for grants targeted to particular uses. Grants for capital purposes should be integrated with "market-based" loans to the extent feasible.
- Central government lending to subnational governments should be curbed where possible and subject to the fiscal capacity of subnational governments. Subnational governments without access to private capital can be "taught" debt management through borrowing from the central government. However, the possibility of graduating to private capital markets must exist, and the lending programs should not undercut the operation of private credit markets.
- Explicit limits on any sovereign guarantees should be set and the use of such guarantees should be avoided. Develop a prudent, rule-driven framework for subnational borrowing, setting forth clearly the appropriate limitations and procedures to follow.
- Any "implied" sovereign guarantee should be explicitly disavowed and procedures for dealing with defaulting or bankrupt subsovereign governments and with creditor rights and processes should be in place

Regimes for Coordination and Control

Controls on subnational fiscal relationships can be cooperative, rule-based, or direct central government regulation (Ter-Minassian and Craig 1997, chapter 7). The choice depends on the political heritage of the country and its form of government, the confidence that can be placed in the efficacy of market discipline, and success in imposing a hard budget constraint.

The cooperative model involves negotiation between national and subnational levels to establish limits on indebtedness that place subnational governments firmly in line with macroeconomic objectives and key fiscal parameters. This approach maintains overall deficit targets and growth guidelines for revenue streams at the central government level. The main drawback is that cooperation may not be politically possible or may be lopsided, with the center unilaterally "forcing down" decisions or the subnational government refusing to cooperate without major concessions. In the absence of a strong center to enforce discipline, the approach requires shared fiscal discipline and a conservative borrowing mentality. Weak fiscal management or weak central government leadership will derail the stability of the system.

A rules-based approach strengthens central control by embedding the framework for subnational borrowing within legislation. By establishing the rules upfront, it avoids the quarrelling between levels of government typical of the cooperative system. Uniform accounting standards are required to eliminate subnational governments' circumvention of the rules. This entails the creation of a financial information system that provides data on the expenditures and financial operations of all levels of government. Enforcement can come through the market or administrative oversight, with professionals attesting to observance of the rules and held culpable if they break them.

Direct central government control may involve setting annual limits on borrowing, reviewing debt proposals, or formally sanctioning specific debt transactions. Central controls allow debt policy to be readily linked with overall macroeconomic policy, but the process has several shortcomings. When there are many subnational borrowers, approvals can be time consuming. There are also issues of competency and corruption. Officials approving the transactions may have little knowledge or interest, and layers of approval always open the door to political discretion and corruption. Central government approval, especially in the context of donor-funded on-lending programs, can be viewed as tantamount to a guarantee. However, in domestic private markets, central review and approval need not imply a guarantee, and borrowing governments can still face a hard budget constraint. Nonetheless, if the central government approves all subnational borrowing, it may be politically difficult not to bail out subnational governments that default.[8]

The regime of subnational borrowing controls needs to be examined in the context of the overall argument in favor of devolution of political deci-

sionmaking. Direct administrative control may be the most comfortable and conservative approach from the center's point of view, but it means a diminution in the fiscal powers and prowess of the subnational governments. It likely means less access to credit markets, a continuing subordination of local self-sufficiency, and continuing, if not greater, reliance on central resources. Eventually, the rules on subnational borrowing will reflect the stage of market and political development of each country, the rigor in employing strict budgetary constraints at the subnational level, independence from political cycles, and the strength of accountability mechanisms. The next chapters review how these components of subnational market development fit together.

Notes

1. A point not to be overlooked is that political and fiscal devolution calls for a substantial element of sacrifice on the part of national politicians that give away power and resources (and patronage) to lower levels of government in the process. As a result, for devolutionary movements to be effective, local political powers need to be persuasive and potent on the national level.

2. Perhaps unappreciated is the difficulty national governments have in reorganizing themselves to operate on a more local basis. In many countries, holding a central government job has been a reward for the brightest and best, and devolution has meant a step down in occupational status and a new constituency to serve. Familiar political and administrative power structures have been capsized in the process.

3. Argentina and Brazil have traditions of high levels of local and regional autonomy. For largely political reasons, the imposition of hard budget constraints proved impossible, and the national governments accumulated large debt burdens to cover the operating deficits of local governments (see chapters 14 and 15 for Argentina and Brazil case studies).

4. Subnational governments, if left unconstrained in their fiscal conduct, cause problems for the national government. For example, the imposition of local taxes on commerce and trade can adversely affect costs and revenues at the national level. Borrowing in foreign currency can lead to build-ups in foreign-denominated liabilities that create demand for foreign currency. Borrowing large amounts from banks can undercut creditworthiness if default looms. These problems are most evident in certain federa-

tions, such as Argentina, where the central government has weak control over subnational fiscal behavior.

5. See table 14.1 in chapter 14 on Argentina for an example of distribution of responsibilities that maps well to these guidelines.

6. Transfers can have other uses, including smoothing regional economic shocks and providing targeted boosts to a regional economy.

7. This alleged "threat" is something of a curiosity in the absence of a specific pledge by the sovereign to make good on local debts. On the contrary, among the major rating agencies, it is the act of bailing out failed borrowers in the absence of such a pledge that can lead to downgrading a rating. That is because once the bailout happens, the entire stock of local debt then becomes a potential contingent liability of the sovereign. The more likely causes of "implicit" sovereign guarantees are the weakness of the banking system if much of the debt defaults and the political power of other investors to force central actions to protect their investments.

8. Approval by the central government can mean different things, including not only implied "sponsorship" by the national authorities but also the kind of tax treatment a security will receive and its eligibility for investment by certain groups of investors. In Russia during the heyday of its "Wild West" municipal bond market, approval of local issues by the Federation's Ministry of Finance was needed to obtain tax exemption and to permit investment by institutions, even though the status of a state guarantee was unclear. In the absence of clear laws, would-be issuers would bargain with the central authorities for designation as an "approved" security, making it a political exercise (see Halligan 1996).