Comments on Papers Presented in Session 2 of the EC Workshop on Fiscal Surveillance in the EMU

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We have heard in this session the presentations of three high-quality analytical papers by well known experts in fiscal decentralization issues, which from different angles have focused on one key issue: how to ensure that the increasing fiscal decentralization that is taking place in Europe, and more generally across the globe, does not undermine macroeconomic stability in the short run and fiscal sustainability over the longer term. The two papers by Professors Bordignon and Rodden have focused in particular on: the role of budget constraints on subnational governments in promoting fiscal discipline; the institutional determinants of soft budget constraints (SCBs); and, relatedly, steps that can be taken to harden such constraints. The paper by Professors Wibbels and Rodden has explored the evidence and possible political economy roots of procyclical fiscal behavior by state or regional level governments in a cross-section of industrial and emerging market countries.

In the short time allotted for discussion, it would be difficult to do full justice to any one of these papers (which are quite rich in analytical and empirical content), let alone to all three of them. Therefore, I will concentrate on a few main themes for each of them and pass on to each of the authors separately more detailed comments by the FAD staff.

I agree with Professor Bordignon's paper main conclusions, namely that lack of clarity in the assignment of spending responsibilities across levels of government; too little revenue autonomy for subnational governments; and excessive discretionality and lack of transparency in the system of intergovernmental transfers are at the root of soft budget constraints, leading to expectations by local governments of ex-ante or ex-post bailouts by the center. This conclusion is in line with consensus views in the literature on fiscal decentralization. I found especially interesting the analysis of the political economy dynamics underlying soft budget constraints, and the evidence that local governments of the same party as the ruling one at the center tend to be more frequently bailed out ex-ante or through higher transfers. The risk of such ex ante bailouts is of course greater the larger the share of discretionary grants in total intergovernmental transfers, reinforcing the case for formula-based transfers.

The paper notes that the probability of bailouts increases as the decentralization trend reaches spending responsibilities, such as education and health, which are particularly sensitive from a political and social standpoint. In these circumstances, however, unconditional transfers are simply not viable, and the central government needs to rely on a system of transfers that creates incentives for subnational governments to ensure adequate quality standards in the provision of such services, i.e., on conditional rather than unconditional grants (provided of course that reasonably reliable indicators of such standards can be developed and monitored, obviously a non-trivial task).

The presence/absence of a soft budget constraint depends on whether local governments can affect the amount of resources they get from the central government (either ex ante or ex post) through policy variables under their control. For example, under-taxing or over-spending by a local government may foster additional transfers from the center. This suggests a simple empirical test of whether central government transfers depend significantly on the locally determined tax rates or expenditure levels. If, after controlling for other variables, this is not the case, then there appears to be no SBC problem. If this is the case, then there is at least potentially the risk of a SCB. This would be a more direct test than the ones present in the paper and, while the practical difficulties of choosing the control variables, allowing for reverse causality, etc., should be acknowledged, they are not more significant than those involved in the econometric tests presented in the paper.

The paper suggests that external constraints such as those imposed by EU fiscal rules can increase the credibility of the central government's commitment not to bail out local governments. The decline of health expenditure in Italy in the run-up to EU is given as an example. However, most of the expenditure savings during that period came from administrative controls on the price of drugs, increased co-payments and restrictions on hiring new personnel—all measures enacted at the central government level. In other words, the decline in health spending reflected more a direct intervention of the central government than a change in the perception by local governments of the likelihood of a bailout from the center.

The paper also argues that, since local government debt is relatively low in Europe, local government finances are in relatively good shape. However, as the author himself points out, *ex ante* bailouts (i.e. higher transfers than otherwise necessary) are as likely an outcome of soft budget constraints as *ex post* bailouts. These ex ante bailouts will not translate into higher deficit and debt accumulation at the local level. Therefore low debt levels cannot be taken as entirely reassuring.

Professor Rodden's paper's main conclusion, that a combination of limited revenue autonomy and freedom to borrow for local governments is likely to lead to fiscal indiscipline, is certainly intuitively plausible. Among the empirical tests of this conclusion which are presented in the paper, I found the one based on credit ratings most interesting. The paper could, however, be enriched by discussing in more detail the policy implications of its findings. In particular, as it is well known, the decentralization of revenue-raising responsibilities tends to lag in most countries well behind the decentralization of spending responsibilities. Both economic (factor mobility), distributional, and administrative capacity factors tend to constrain revenue autonomy at the subnational level, requiring a continuing significant role for vertical transfers among levels of government. Does it follow from this that sole or main reliance on market discipline for subnational governments is likely to remain risky for the foreseeable future? If so, shouldn't we focus on alternative means to attain budgetary discipline?

At the other extreme, can we assume that, if there is a complete revenue autonomy, then there is no budgetary risk? The paper appears to overlook other factors that may affect the

capacity of the central government to commit not to bail out. These may include the size of the jurisdiction in trouble and the social costs of disruption in the provision of public services. More specifically, the author's conclusion that, since EMU member states are not dependent on transfers from the EU central budget, the bailout problem is absent, and deficit rules are unnecessary, strikes me as too extreme. First, in the absence of rules, debt accumulation by one or more of the EU members could lead over time to debt servicing difficulties and possibly even a crisis. It is hard to imagine that in such circumstances the rest of the EU would stand-by, without any form of support. Second, even without a bailout, excessive debt accumulation by one EU member (especially a large one) could put pressure on interest rates for the EU as a whole. And, finally, the convergence of interest rate spreads for individual EU members, despite significant difference in respective debt and (to a lesser extent) deficit positions, suggests that markets are rating a common EU risk, rather than individual ones, as the paper would have predicted.

Professor Wibbels' and Rodden's paper puts forward an interesting empirical analysis of the potential pro-cyclicality of subnational fiscal policies, including from a political economy perspective. It finds that own revenues of state governments tend to be highly pro-cyclical, and that intergovernmental transfers, especially those of a discretionary nature, also tend to be procyclical—albeit to a lesser degree. Consequently, those states that have limited or no resort to borrowing (because of lack of market access or of strict fiscal rules) have to cut spending during cyclical downturns, thereby aggravating the recession. Conversely, in periods of boom, when the borrowing constraints are no longer binding, spending rebounds, adding to domestic demand pressures. In my experience with subnational fiscal developments in emerging markets especially vulnerable to shifts in market confidence, I have certainly witnessed significant evidence of procyclical fiscal behavior at the subnational, as well as the national, level; and, in the US we have seen significant evidence of "pushing down the deficit" by the federal government, through cutbacks in grants, during the recent recession.

However, while the paper correctly identifies procyclical tendencies in fiscal policies of states, it does not offer much by way of recommendation on how to correct them. Surely, a simple elimination of fiscal rules and unfettered reliance on market discipline would not suffice to eliminate procyclicality. After all, national governments which are not constrained by fiscal rules frequently accumulate excessive debts, and are then forced to adjust abruptly, regardless of the phase of the cycle they are in. The question is then: would different rules (e.g., requiring balance over the cycle) be more effective in preventing procyclical behaviors at the subnational (as well as the national) level? What are the impediments to the adoption of such rules? (e.g., data limitations; possible opacity of a concept of structural fiscal balance to the electorate; difficulty of enforcing a structural fiscal rule). Are these impediments likely to be greater at the subnational than at the national level? A systematic discussion of such issues would, in my view, significantly enhance the policy relevance of this interesting paper.