

ACHIEVING FISCAL SUSTAINABILITY

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A well-designed system for fiscal decentralization promises many benefits, including enhanced economic growth and macroeconomic stability. If, however, decentralization is designed badly or implemented and monitored improperly, such a system can foster “soft” budget constraints—loosened controls on the fiscal activities of subnational governments—that may undercut the spectacular economic growth occurring in East Asia today.

This chapter highlights the challenges of decentralization in the context of macroeconomic management, especially in achieving fiscal sustainability and providing a medium-term environment for sustained growth. The focus is twofold. First, the chapter highlights the critical need for central governments to monitor subnational fiscal and quasi-fiscal activities through well-designed reporting, auditing, and financial management institutions, as well as information databases. Second, the chapter addresses the need to institutionalize incentives for subnational governments to publicly and regularly report relevant financial information.

Most East Asian countries are at the early stages of this twofold process. Unless the process keeps pace with decentralization, the result will be subnational arrears and pressures for central bailouts—the latter occurring through ad hoc financial transfers, or accounting “adjustments” that take significant tax and spending activity off-budget. Once countries abandon the discipline of hard budget constraints, systematic budget planning and execution at central

and subnational levels will yield to uncertain inter-governmental flows, capricious revenue policies, and a lack of medium-term fiscal planning.

Much is at stake in getting this decentralization system right. East Asian countries have recovered rapidly from the 1997 financial crisis, posting high growth rates. Regional output grew by 6.7 percent in 2002 and 7.9 percent in 2003 and an estimated 7.8 percent in 2004. Growth is expected to reach 7.1 percent in 2005—the strongest record since the start of the global and regional recession in late 2000. The number of people living below US\$2 per day is estimated to have fallen to around 34 percent in 2004, amounting to some 636 million people—down from 50 percent as recently as 1999, representing 890 million people (World Bank 2004, 2005 table 1.1).

The policy challenge for each country is to maintain its high growth rate while strengthening its fiscal health through intergovernmental coordination and monitoring. Unfortunately, this task is far from straightforward. For a start, whether developing countries experience a causal relationship between decentralization, macroeconomic stability, and economic growth is unclear. The reasons are twofold. First, the data for measuring the extent to which a country has fiscally decentralized are simply not available—a worldwide problem that also exists in East Asia. Second, the line is not always clear between formal and informal institutional arrangements for enforcing hard budget

constraints. Even if the right data and definition were available to measure decentralization, tracking fiscal risks can be difficult when subnational governments have hidden, off-budget expenses and funds, as in some East Asian countries.

Still, the elements of responsible fiscal management, and the criteria for maintaining fiscal discipline in a decentralizing environment, are well known. This chapter therefore focuses on empirical conclusions regarding the links between fiscal decentralization and growth, the role of budget constraints in fostering fiscal discipline, the relationship between subnational borrowing and a country's overall fiscal sustainability, and the resulting need for managing financial risk.

Links between Fiscal Decentralization and Economic Growth

In theory, devolving fiscal responsibilities can improve public sector efficiency, boost competition among subnational governments in delivering public services, and stimulate economic growth (Bird and Wallich 1993). These potential benefits reflect the belief that subnational governments can best make growth-promoting public expenditures in sectors such as education, health, and infrastructure, because they have better information on local circumstances and interregional differences (Oates 1993).¹

East Asia's spectacular precrisis growth and postcrisis rebound have depended significantly on prudent macroeconomic management. However, empirical research has been inconclusive regarding any causal relationship between decentralization and growth in developing countries.

In a study of 46 countries from 1970 to 1989, Davoodi and Zou (1998) found a negative relationship between fiscal decentralization and economic growth in developing countries, and no relationship in developed countries.² The authors explain that "conventional wisdom points towards positive growth effects of capital and infrastructure spending and negative growth effects of welfare and current spending." This implies that in developing countries—where subnational entities spend a larger proportion of their budgets on wages and salaries and social welfare—decentralized systems exhibit slower long-term growth per capita.³ The

time frame for assessing the impact of different types of public spending is also important. Analysts see health and education spending, for example, as an investment in human capital with a long-term payoff, resembling physical investment.⁴

Ebel and Yilmaz (2003) reproduced this analysis by weighing degrees of revenue autonomy. They found that tax autonomy and nontax autonomy have a positive correlation with economic growth, while tax sharing has a negative relationship (see chapter 6). These results suggest that a country's economic performance partly reflects the degree to which subnational governments control their revenues.

In a study of the United States, Xie et al. (1999) showed that further fiscal decentralization with the aim of boosting efficiency and economic growth would in fact harm growth. Akai and Sakata (2002) refuted that finding, incorporating a more elaborate definition of fiscal decentralization. Their study examined the growth impact of giving subnational governments the authority to raise taxes and spend public funds.⁵ Since local governments do not necessarily spend locally collected revenues locally, the authors found that they may not in fact have tax autonomy (Zhang and Zou 2001).

Martinez-Vazquez and McNab (2001) confirmed the inconclusive relationship between fiscal decentralization and economic growth and the importance of individual country circumstances—including noneconomic ones—in determining causality. Lin and Liu's analysis of China (2000), using provincial-level data from 1970 to 1993, suggests that fiscal decentralization has helped spur that country's impressive growth over the past 20 or 30 years.⁶ However, Zhang and Zou (2001) found a negative relationship between fiscal decentralization and economic growth in China.⁷

Subnational Fiscal Discipline and Budget Constraints

Determining the degree of fiscal discipline among subnational governments in East Asia requires identifying the budget constraints they face. Doing so in countries like Cambodia—where subnational governments have little spending and revenue authority and rely almost entirely on transfers from the center—is relatively easy. At the other extreme, about half or more of the resources available to China's subnational governments come from

off-budget sources, over which they have virtually total control.⁸ In Vietnam, off-budget accounts such as the Social Security Fund, the Health Insurance Fund, and the National Development Fund constrain the budget autonomy of subnational governments.

In some East Asian countries, state-owned enterprises at the subnational level receive off-budget resources in the form of deferred taxes or arrears accruals on debt service and other contractual payments. This is a particular concern in China and Vietnam. In Thailand, this problem is mitigated by the fact that subnational governments do not typically own enterprises, and by the inclusion of all state-owned enterprises in the “consolidated public sector’s” budgetary accounts.

Extrabudgetary revenues and expenditures among subnational authorities make their true budget constraints difficult to ascertain. This is especially problematic when data are not reported in a timely manner and are often incomplete, as in most East Asian countries. Thus, when governments rely substantially on extrabudgetary funds, national budgets give only a partial picture of fiscal realities.

Enforcing hard budget constraints among subnational governments requires clear expenditure assignments, formula-based transfer systems, local revenues, prudent subnational borrowing rules, and good financial reporting (see box 1.3 in chapter 1). None of the East Asian countries examined here meet these prerequisites. Such a situation can lead to perverse incentives to overspend, accumulate arrears, and overborrow. Key among such incentives is the prevailing practice of higher-level financial bailouts for subnational governments that are already in or even heading toward default. This is of particular concern if the subnational government is large, as is often the case with soft budget constraints.⁹

A country’s system of intergovernmental fiscal management (or lack thereof) may also motivate subnational authorities to keep their transactions off-budget—especially richer provinces that do not want to cede part of their revenue base to the center for tax sharing. Effective fiscal decentralization requires an institutional structure that minimizes such adverse expectations. In China, “fee-to-tax” reforms aim to bring some off-budget subnational revenues within the budgetary umbrella, but much remains to be done in most East Asian countries.

Information on these quasifiscal transactions remains weak, and work on improving this information base is just beginning, even in China.

Finally, subnational governments in many countries have faced difficulties in planning their activities and managing their finances owing to delays in allocation decisions and a lack of predictability regarding intergovernmental transfers. In Thailand, other than knowing with certainty that their nongrant revenues will equal those of the previous fiscal year, local governments find it difficult to predict their shared tax revenue allocations. This is mainly due to delays in establishing the criteria for distributing the allocations from the center to local governments.¹⁰

Subnational Borrowing and Fiscal Sustainability

Fiscal sustainability means that a subnational government covers its expenditures out of its own revenues, reducing its dependence on borrowing and transfers from the center (Bird 2003). To determine whether a subnational government’s plans are fiscally sustainable, analysts need accurate information on revenues and expenditures at the central, regional, and local levels. Analysts also need to understand the interplay between intergovernmental grants and government borrowing—that is, how hard the subnational budget constraint truly is. Careful analysis of country-specific intergovernmental relations, and the resulting incentive framework, should accompany any analysis of fiscal sustainability.

Subnational governments in most of the East Asian countries examined here rely heavily on intergovernmental transfers. The large bailouts during the 1997 financial crisis and since, such as the recent recapitalization of Chinese state-owned banks in 2004, have undermined fiscal sustainability in East Asia by softening the budget constraints imposed on subnational governments. Discretionary transfers to deficit subnational governments in China, Indonesia, and Vietnam, and unclear assignment of responsibilities throughout the region, have compounded this result.

Many subnational governments in East Asia also have access to onlending from the central government and donors. Such lending is typically in the form of sovereign guaranteed external loans that

the central government contracts but channels to subnational entities at different interest rates. Onlending interest rates and terms vary across countries. In China, the final borrower bears the entire foreign-exchange risk associated with these loans, while in other countries the center assumes some or all of this risk. Most subnational borrowing in Indonesia has occurred through central government onlending mechanisms on terms that are highly favorable to the center. However, the repayment record of Indonesian subnational borrowers has been poor.¹¹ Thailand allows subnational governments to borrow from domestic banks and bond markets, subject to legal ceilings in any given budget year. In Indonesia, the Ministry of Finance sets the aggregate limits to regional borrowing for a particular fiscal year in August of the previous year, and no direct borrowing from foreign sources is permitted. Instead, all such borrowing occurs through onlending arrangements with the ministry. Subnational governments in Vietnam may not borrow at all (see table 3.1).

International experience since the early 1980s, especially in Latin America, suggests that without appropriate accountability and transparency mechanisms, decentralization can encourage dangerous opportunistic behavior by state and local authorities. If left unchecked, such opportunism could undermine macroeconomic stability. The most vivid manifestation of this phenomenon is the softening of subnational budget constraints (Rodden 2000a; World Bank 2002). Avoiding this risk depends on the ability of the central government to prevent subnational authorities from passing their liabilities to higher-level governments.¹² This, in turn, requires institutional mechanisms to discipline borrowing by state and local governments.

Examining experiences in Argentina, Brazil, and India, Rodden et al. (2003) show that unsustainable subnational deficits emerge when provinces have powerful representatives, when they depend heavily on intergovernmental transfers, and when they have autonomous access to sources of deficit financing. The latter can include bonds, loans from domestic banks (which may themselves be state-owned, as in China), nonpayment of employee wages, and contingent liabilities. If these exist where the central government cannot commit to a no-bailout policy, or cannot limit subnational

borrowing, subnational governments have incentives to run unsustainable deficits.

Fiscal, political, and financial institutions that strengthen competition at the local level, especially for capital, can promote hard budget constraints.¹³ If institutions directly or indirectly suggest that the central government will step in to cover subnational liabilities in the case of default, they may encourage subnational governments to “overborrow, overspend, or undertax” (Rodden 2000a).

The Latin American experience suggests that subnational governments that are subject to hard budget constraints are more likely to tax and spend prudently (Bird 2001). Fiscal sustainability is also a forward-looking concept, in that it requires accurate assumptions about revenues and expenditures and key economic variables. Making meaningful assumptions that are palatable to policy makers and their constituents requires a good understanding of institutional and country-specific details.

In Indonesia, for instance, only after it passed Laws 22 and 25 on intergovernmental fiscal relations in 1999 and issued implementing regulations (PP107) in 2000 could regions borrow without strict approval from the center.¹⁴ Subnational domestic borrowing is now subject to a rule-based approach and central government approval. Foreign borrowing is not allowed, except through onlending from the central government or donors.

In view of Indonesia’s public debt burden, however, and as the country establishes local financial management structures, a ministerial decree temporarily banned any subnational borrowing until the intergovernmental fiscal relations Law 25/99 was revised. This ban has been in effect since 2000 but was to be lifted at the end of fiscal year 2004, after the implementation regulations of the revised Law 25 are in place. The goal is to maintain fiscal discipline by strengthening both market and rule-based mechanisms—highlighting the fact that countries may sometimes require strong, centrally imposed fiscal constraints, especially in the early stages of decentralization. Subnational governments may rely on short-term borrowing (with maturities of less than 12 months) to manage their cash flow. In theory, as in China, the Indonesian central government can intercept general grant funds if a region fails to meet its debt service obligations.

TABLE 3.1 Subnational Borrowing Practices

Summary of practices	Cambodia	China	Indonesia	Philippines	Thailand	Vietnam
Borrowing power and practices (excluding borrowing from central government)	LGs cannot borrow. Stipulated according to central government regulations.	LGs may not borrow against general revenues or issue bonds. LGs can and do borrow through asset-holding or project companies. Borrowing by LG (mainly special service units) from China Development Bank; commercial bank loans to "off-budget" funds.	LGs can borrow or issue bonds in domestic market subject to rules and central government approval. Temporary freeze on all borrowing up to 2005.	LGs can borrow or issue bonds; some prudential restrictions.	LGs cannot borrow, domestically or from abroad, without prior approval from CG.	Provinces and cities with provincial status can borrow within prudential limits and as approved by CG.
Borrowing from the government/donor onlending	LGs may not borrow.		LGs borrow mainly from CG through donor onlending and from budget. 50% of latter loans in arrears; 63% of loans to LGs in arrears. New onlending terms being negotiated. Under new PP107, CG can intercept DAU.	LGs borrow exclusively from government financial institutions; largely donor onlending. GFIs monopolize depository bank business, so de facto IRA intercept has led to good LG repayment history. Terms of onlending loans by GFI to be in line with those of local commercial banks, but in practice GFI often sets a lower rate.	LGs not allowed to borrow without prior approval from CG.	

(Continued)

TABLE 3.1 (continued)

Summary of practices	Cambodia	China	Indonesia	Philippines	Thailand	Vietnam
Banking sector	Not much banking sector-related activity; basically a cash economy. Most banks foreign-owned. National Bank of Cambodia opened dollar-denominated accounts for commercial banks in 1998; deposits with the bank are remunerated at 7/8 of SIBOR.	LG-owned companies borrow primarily from commercial banks, mostly 3–5 years; sometimes 10. Interest rates regulated by PBC. Banking sector is burdened by high rate (40%) of nonperforming loans; concern for the ability of LG companies to depend on rollover of bank loans.	LGs borrow short term from banks to cover cash flow. Banking sector still under restructuring; 22 of 27 BPDs recapitalized.	Private commercial bank lending to LGs virtually nonexistent. Land Bank of the Philippines, the largest provider of credit to LGs, now uses its own resources (as well as donor funds): 5 years. Privatized Philippines National Bank still lends to LGs (eligible to be an LG depository): 4–7 years. New GFI players in LG credit.	LGs are only now exploring opportunities to borrow from local commercial banks and public revolving funds. LGs mainly borrow from local development funds monitored by Ministry of Interior.	LG-owned companies borrow from banks to finance infrastructure projects. Commercial banks purchased HCMC private placement bond. Gradual liberalization of interest rate since 1996; State Bank of Vietnam (SBV) removed lending-rate ceiling. SBV launched banking-sector restructuring program in 2001, phasing in SOCB recapitalization.

<p>Capital markets</p>	<p>LG-owned companies cannot issue bonds. Credit to the private sector is 7 percent of GDP, loans are mostly short term. Mainly providing import/export financing and working capital to trade and service sectors.</p>	<p>Defaults of municipal bonds in early 1990s led to ban on LG bond issuance. LG companies issue bonds (Shanghai: 8 years); strict procedures for the issuing corporate bonds (single A or better for issues greater than Y 100 million).</p>	<p>6 LG banks: West Java, East Java, Central Java, North Sulawesi, West Sumatra, and PT Bank DKI issued 12 bonds (1991–2000); 3–7 years.</p>	<p>13 LG bond issues since 1991: 4 issues guaranteed by Home Guarantee Corp. (government agency), 8 issues guaranteed by LGUGC; mostly 7-year. LGUGC established in 1998, owned 51% by Bankers Association and 49% by Development Bank of the Philippines.</p>	<p>LGs cannot go directly to capital markets. Debt financing by LGs has been limited (some revenue bonds issued).</p>	<p>HCMC issued GO bonds in 1995 (D 30 billion, 3-year, private placement) for toll-road project; is preparing another. (Decree 93/2001 allowed HCMC bond issuance.) Ministry of Finance approval required for bond issues; market-rate pricing unlikely. HCMC Securities Exchange established in 2000; bond is 10% of transaction volume; the Hanoi exchange opened in early 2005.</p>
<p>Monitoring of local government credit</p>	<p>Financial accounting centralized in National Treasury and provincial branches. Main financial statement for LG expenditure management produced by Ministry of Finance Budget Dept.</p>	<p>Government financial information system being piloted. LG credit not assessed. Credit-rating agencies exist.</p>	<p>Regional financial information system being prepared; Ministry of Finance starts mapping LG fiscal capacity?</p>	<p>Ministry of Finance pilots new system for LG fiscal/financing reporting. GFI appraises central government transfer and LG tax base. LGUGC has internal credit-rating system.</p>	<p>Ministry of Information monitors sub-national borrowing from local development funds and public revolving funds.</p>	<p>Central budget guidelines. City budget information not disclosed. SOCB evaluates large-scale projects.</p>

Source: World Bank.

Note: BPD = state-owned commercial banks; DAU = *dana alokasi umum*, the main intergovernmental fiscal transfer mechanism in Indonesia; HCMC = Ho Chi Minh City; GO = government order; IRA = Internal Revenue Allotment; PBC = People's Bank of China; LG = local government; CG = central government; GFI = government financial institution; LGUGC = local government unit guarantee corp.; SOCB = state-owned commercial bank.

In Thailand, local governments may borrow domestically and internationally, with prior authorization from the cabinet. These governments may issue debt securities and borrow from official, external bilateral creditors for development projects. In practice, local debt financing is somewhat limited, including from domestic capital markets. The primary source of borrowing has been local development funds managed by the Ministry of Interior. Subnational governments have more recently borrowed from commercial banks and public revolving funds.

In Vietnam, subnational governments may not run fiscal deficits. Provinces may borrow, but only domestically, by issuing project investment bonds, or by borrowing from the Development Assistance Fund.¹⁵ Provinces may use these funds only for projects with prior approval from the Provincial People's Council under the five-year provincial Public Investment Plan. The province must also allocate funds for debt service in future budgets until the debt matures.¹⁶ Local state-owned enterprises that provide essential services, such as waste disposal, water, electricity, and transportation, may borrow from both external and domestic sources. All external borrowing is subject to approval by the central government, which provides a sovereign guarantee.

To promote responsible subnational borrowing, some East Asian governments have disseminated well-defined, transparent fiscal rules. The rationale is that all borrowing decisions should take into account the fiscal implications for future generations.¹⁷ The issue of implementation remains to be addressed, however.

In Indonesia, regulations implementing the decentralization framework limit the debt-to-revenue ratio to 75 percent of the previous year's general revenue, and the debt service-to-revenue ratio to 40 percent in any given budget year. Regulations also govern onlending to the regions.¹⁸ In the Philippines, the central government limits transfers to local governments to 40 percent of their *internal* revenues from three years before.¹⁹ Since the ratio of revenue to gross domestic product has been falling, this rule implies that some local governments may receive higher transfers than intended, or than the central government can afford. Declining trade taxes also build upward bias into the revenue share of local governments. If policy makers

do not intend such an outcome, or if local governments do not use the allocated resources efficiently, the resulting trends will undermine fiscal sustainability.

For such rules to be credible and sustainable, they must be part of a well-articulated fiscal framework that improves the government's position over the long term. Such a framework includes clear intergovernmental fiscal relations, appropriate subnational tax structures, and public pensions.²⁰ The central government needs to clearly define accountability and establish financial management practices to enforce these rules.²¹ In fact, the temporary ban on subnational borrowing in Indonesia is a prudent interim measure until the country establishes a more solid framework for regional borrowing and a regional financial information system. A more solid framework for subnational borrowing must include procedures for handling regional default. Otherwise, without a credible legal or regulatory threat, the center will end up paying the bill.²²

Managing Fiscal Risks

Rules and administrative controls can help reduce the risks of subnational borrowing. Key measures include strengthening the intergovernmental fiscal system and, when the situation warrants, requiring *ex ante* authorization and *ex post* monitoring. For instance, the central government could set annual limits on the debt of individual local governments, review individual loans, including their terms and conditions, and centralize all borrowing, with onlending to local governments.²³ Other measures to encourage fiscally sustainable borrowing include prohibiting subnational authorities from issuing guarantees (see table 3.2 for the kinds of explicit and implicit guarantee mechanisms that may exist at subnational levels), and imposing ceilings on the net worth or loan portfolio of borrowers. Indonesia and Thailand have established ceilings on debt or debt service as a share of local revenues. Other countries, such as Vietnam, require local governments to balance their budgets and restrict their borrowing to specific purposes, such as capital investment.

Countries can also rely on the market to regulate subnational borrowing. A market-based system requires minimum legal and regulatory structures,

TABLE 3.2 Subnational Fiscal Risks

Liabilities	Direct (obligation in any event)	Contingent (obligation if a particular event occurs)
<p>Explicit Government liability is recognized by law or contract.</p>	<p>Local government debt. Arrears (if legally binding). Nondiscretionary budgetary spending.</p>	<p>Local government provides guarantees for debt and other obligations of financial and nonfinancial enterprises and other entities. Local government insurance schemes (such as crop insurance).</p>
<p>Implicit A “moral” obligation on the part of the government that mainly reflects public expectations and pressure by interest groups.</p>	<p>Capital and recurrent costs of local public investment projects. The cost of future benefits under local social security schemes.</p>	<p>Claims arising from local government letters of comfort. Claims by failing local financial institutions and other entities. Claims related to enterprise restructuring and privatization. Claims by beneficiaries of failed social security or other funds, beyond any guaranteed limits. Claims related to local crisis management, such as public health, environment, and disaster relief.</p>

Source: Brixi and Mody 2002.

such as supervision and disclosure practices; guidelines for issuing, settling, and repaying debt; bankruptcy procedures (including creditor remedies); protection against disruption of essential public services; and measures to prevent moral hazard. East Asian countries are only now establishing these institutional structures.

Another market instrument for reducing the credit risk of subnational borrowing is regular monitoring of creditworthiness. Private sector entities can help investors by rating the likelihood that subnational governments will default. Such credit ratings should reflect both the capacity and the willingness of debt issuers to make timely payments on both principal and interest. Key elements of creditworthiness include the subnational government’s economic base (net worth), revenue autonomy and stability, revenue-expenditure balance, intergovernmental fiscal relations, the subnational debt burden, and contingent liabilities. Financial management practices in the region matter, as do guarantees, insurance, and other mechanisms to enhance the credibility of subnational borrowing. However, credit ratings of subnational entities are not yet available in most East Asian countries.

Subnational governments that relax their budget constraints contribute to public sector deficits and threaten national solvency. Hidden budget channels include off-budget borrowing; arrears on civil service wages and payments to suppliers and other levels of government; indirect liabilities through public enterprises or publicly owned banks, which are often insolvent; and other contingent liabilities such as unfunded pension and provident funds. Soft budget constraints and the expectation of central bailouts contribute to moral hazard. Data on these “hidden deficits” in East Asia are just becoming available (Kharas and Mishra 2001). Thus central governments lack the information they need to monitor the fiscal risks of subnational governments. In most East Asian countries, the Ministry of Finance typically receives regular reports on budgetary revenues and expenditures on a cash basis from subnational governments. The ministry does not, however, have access to timely information on many extrabudgetary and off-budget capital expenditures and borrowing, or on local guarantees, financial institutions, pension funds, employment insurance funds, and other transactions that could generate liabilities (Ma and Brixi 2002). Anecdotal evidence on provincial-level

off-budget and contingent liabilities abounds in some countries.

In China—where direct and indirect support of expanded investment and credit to subnational entities has driven much recent growth—reliance on banking and off-budget funds has been important.²⁴ Poor monitoring of such investment implies that the health of the financial sector is at risk. Significant investment in industries such as cement, steel, and aluminum seems even riskier, given substantial excess capacity.

Table 3.2 outlines typical sources of contingent liabilities, which can be explicit or implicit. For instance, the explicit fiscal burden from rising safety net expenditures may generate liabilities for the central or provincial government. Also, what may be “contingent” for the central government may be a direct liability for a provincial or subnational government. Cataloguing such liabilities is an essential first step in establishing a system to assess the obligations and fiscal risks of local governments.²⁵ China, Indonesia, Thailand, the Philippines, and Vietnam are now embarking on this important endeavor.

As provincial and municipal governments gain greater authority to tap domestic and international financial markets, the financial risk at subnational levels will also grow—and will need managing. Weaknesses in regulation and oversight have led to the proliferation of off-budget financing, government guarantees, and other contingent liabilities. Decentralization has given subnational governments a greater role in managing and delivering public services, and more budgetary responsibility for civil service pensions and provident funds. All these factors exert a significant impact on the quality of services and expenditure mix of local governments.

Countries need to estimate the costs of delivering devolved responsibilities so they understand the potential fiscal risks. For example, if Thailand allocates 20 percent of revenues to local authorities but does not devolve commensurate responsibility for expenditures, then the central government bears a significant risk of assuming the resulting deficit.²⁶ These risks will grow if service delivery declines owing to capacity constraints among subnational governments. In China and Indonesia, where subnational governments have more expenditure responsibilities than revenue-raising authority, subnational borrowing and off-budget financing

vehicles that carry explicit or implicit guarantees from the central government raise the latter’s risk. Yet estimating the scope of the contingent liabilities that subnational spending and borrowing impose on the central government is difficult, especially if no one government agency is cataloguing these transactions. East Asian countries are just beginning to undertake this task, at least for large contingent liabilities. China and Thailand have been building the capacity of the central government to manage overall public debt.

Early warnings, such as those used in Brazil, Colombia, and the United States, can provide a good starting point for monitoring the fiscal risks of subnational borrowing, but such indicators may not reliably reflect future financing pressures.²⁷ Ma (2001) has proposed a composite indicator that reflects both fiscal pressures and the current fiscal position of subnational governments. Information on their assets and liabilities, exposure to market and rollover risks, capacity for managing these finances, and the compatibility between revenue and spending responsibilities will enable informed judgment concerning fiscal risks that may need immediate attention. Without sound fiscal reporting and auditing at the subnational level, even the best-designed early-warning system will not be effective. Countries need clear rules for dealing with debt-distressed subnational governments. Vietnam is examining the fiscal risks of borrowing by state-owned enterprises, but most East Asian countries are just beginning to tackle this issue.

Conclusions

A piecemeal approach to intergovernmental fiscal reform is unlikely to succeed because it will not take into account the interdependence between transfers and revenue assignments, or between expenditure assignments and own-source revenues and transfers. To enforce hard budget constraints, institutions must clearly and credibly convey the message that local governments will bear the costs and benefits of their fiscal decisions. One such institution is the capital market, which in theory rations access to capital among subnational borrowers based on the soundness of their fiscal decisions. Institutions that ensure that public officials must answer to the needs and aspirations of the local populace are essential as well. However, such

institutions can work only if local governments have considerable fiscal autonomy, and when the central government makes a credible commitment that it will not provide bailouts (World Bank 2000b). None of the countries in East Asia now meet these conditions for enforcing hard budget constraints.

East Asian countries need a comprehensive approach to intergovernmental fiscal reform, tackling subnational expenditures and revenues at the same time. Subnational governments must have enough revenues to implement their spending responsibilities (see chapters 5 and 6). Toward this end, incentives that encourage cooperation between officials at different levels are essential. China and Indonesia need such incentives, for example.

Central governments need to carefully monitor subnational borrowing and the resulting fiscal risks in order to maintain fiscal discipline and prudent macroeconomic management. Before countries give subnational governments free rein to borrow—domestically or abroad—they need to make information critical to analyzing subnational creditworthiness available to stakeholders. Appropriate checks and balances must ensure that these data are reliable and consistent across provinces. Domestic and foreign capital markets play an important role in diversifying local government funding sources and tracking subnational creditworthiness. East Asian countries—especially those with weak financial systems—will need to implement a complex set of institutional reforms to support these efforts.

Finally, to achieve fiscal sustainability, countries will also need to reform governance, public enterprises, sectors such as power, and the intergovernmental fiscal structure to ensure hard budget constraints for subnational governments. Central governments also must monitor contingent liabilities to ensure prudent fiscal management. Over the longer term, a database and analytical indicators can form the basis for a credit-rating system for local governments. Such a system is critical to opening up subnational borrowing and developing a municipal bond market.²⁸ Also important in minimizing future surprises from the decisions of subnational governments is a clear division of responsibilities across levels of government, formal channels for reporting contingent liabilities and analyzing their potential fiscal impact, and

appropriate early-warning systems for fiscal risks. East Asian countries have begun work in these critical areas, but success will require consistent effort over the short and medium term.

Endnotes

1. This theory assumes that labor and capital mobility will ensure competition among subnational governments for effective public sector service delivery, as well as a match between the preferences of local citizens and governments.
2. Davoodi and Zou (1998) define fiscal decentralization in terms of spending by subnational governments as a fraction of total government spending. Fiscal decentralization rises if spending by state and local governments expands relative to spending by the central government. The authors use the average growth of real per-capita output over 5-year and 10-year periods as a proxy for long-run growth.
3. Davoodi and Zou (1998) did not use disaggregated subnational data to determine which province or region spent more on capital and infrastructure relative to others. The authors also noted that countries may not realize the efficiency gains of fiscal decentralization if central authorities constrain subnational revenue collection and spending, and if local citizens do not elect local officials. Labor and capital mobility may not be as easy as theory assumes.
4. A significant part of spending in these sectors often occurs under “current expenditure.”
5. See chapter 2 in Litvack et al. (1998) for a discussion of the distinction between decentralization, deconcentration, and delegation.
6. Lin and Liu (2000) found that rural reform, development of the nonstate sector, and capital accumulation have also been driving forces in China.
7. In the same study, the authors found a positive relationship between fiscal decentralization and provincial economic growth in India. Questions about the appropriateness of the “decentralization variable” again arise. See Ebel and Yilmaz (2003).
8. See World Bank (2002). Subnational governments in China also often engage in commercial activities to supplement their revenue, using land resources and enterprise assets as their investment capital. Under a model pioneered in Shanghai, many municipalities are creating “corporations” to manage public resources and debt obligations. These corporations may “enhance their debt servicing capacity” by engaging in profit-making activities. The General Corporation of Shanghai Municipal Property Development is one of the first such vehicles, created to help finance the city’s enormous need for facilities and infrastructure.
9. Wildasin (1997) showed that a local government’s ability to extract a bailout from the central government depends on the former’s size. Larger subnational governments thus tend to operate under softer budget constraints, creating incentives for overspending and overborrowing if not adequately monitored by the center.
10. For example, although Thailand’s central government set grant allocations well in advance of fiscal year 2002, it did not disburse these grants until the very end of the fiscal year because of delays in establishing the allocation rule.
11. Empirical evidence in Lewis (2003) suggests that local governments have borrowed “well within their fiscal

- capabilities to repay,” but that they have largely been unwilling to repay these debts. The key issue is therefore one of credit risk rather than fiscal sustainability of subnational borrowing in Indonesia.
12. For example, state-level defaults on debt payments helped trigger Brazil’s financial crisis in 2000. See Rodden 2000a.
 13. Rodden et al. (2003) draw on the experiences of seven developing and transition economies and four OECD countries in identifying institutional arrangements associated with soft and hard subnational budget constraints. This exercise provides lessons for East Asian countries.
 14. States in Indonesia can now borrow for projects that generate a “direct or indirect” financial return, per Implementing Regulation 107 of 2000. However, the central government can restrict borrowing if “general conditions” warrant such a restriction, as in the temporary ban by ministerial decree in 2001.
 15. The Vietnamese Budget Law stipulates that, for a given year, a province can borrow up if its outstanding debt will not exceed 30 percent of its capital budget. Until 2003, local governments had issued only two project bonds, both by Ho Chi Minh City (HCMC). In 2003 the central government approved new HCMC urban infrastructure bonds. In September and October 2003, HCMC issued two-year and five-year bonds at annual interest rates of 8.52 percent and 9 percent, respectively. In December 2003, HCMC issued another five-year urban bond at 8.5 percent interest. As of October 2003, provincial borrowing amounted to 0.43 percent of gross domestic product (D 2.5 trillion).
 16. The Ministry of Finance closely monitors this commitment each year, requiring all subnational authorities to report their debt, interest and principal payments, and borrowing plans by type of instrument. In practice, subnational governments have delayed providing this information.
 17. Hence, these rules are often derived using the fiscal sustainability approach based on the government’s “lifetime budget constraint.”
 18. Decree KMK35 of 2003 in Indonesia stipulates that onlending is allowed only for regional government projects that generate revenue. The decree does not specify how to handle a default by a subnational entity, except in the case of loans from the center, where deductions from the general grant would cover the debt service. KMK35 is currently under review.
 19. This means that the intergovernmental transfer equation excludes trade taxes.
 20. See Kopits (2001). Adopting fiscal reporting in accordance with the IMF’s Code of Fiscal Transparency would signal credibility of rules.
 21. These include best-practice accounting standards and effective monitoring and reporting of government liabilities.
 22. Where the central government tightly controls local spending decisions, as in Cambodia, China, Vietnam, and to some extent Thailand, local governments are more likely to credibly shift blame for a fiscal crisis to the center (World Bank 2000b).
 23. See Burki et al. (1999).
 24. The fixed-assets investment is driven by local governments rather than the central government. For the first half of 2003, central government projects amounted to only ¥ 184.8 billion (12.3 percent), a decline of 7.7 percent over the previous year. However, local government projects amounted to ¥ 1,322.4 billion (87.7 percent), an increase of 41.5 percent over the same period in the previous year. Most of this investment is in infrastructure projects.
 25. Such a system can potentially be used to generate a ranking of local governments based on their fiscal health, and to enable the central government to decide when to intervene and provide emergency assistance (Ma and Brixi 2002).
 26. These risks will be compounded as the local share of revenues grows to 35 percent by 2006.
 27. See World Bank (2002). Brazil had imposed limits on subnational borrowing, Colombia had a “traffic light system,” and Ohio in the United States has a “fiscal watch program.”
 28. See Ma and Brixi (2002) for relevant experiences in Australia, Brazil, Colombia, New Zealand, and the United States, and a list of risk indicators for monitoring the contingent liabilities of subnational governments.

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