

Local Fiscal Discipline: Fiscal Prudence, Transparency, and Accountability

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Developing countries' local government budgets are coming under increasing strain. Rapidly growing urban populations are demanding more services, while tax bases are expanding slowly and central governments are decentralizing functions without additional intergovernmental transfers. Many cities not only face demand for higher levels of service provision, but also must come to terms with significant infrastructure backlogs and the need to allocate additional resources to maintenance and replacement of deteriorating or obsolete infrastructure.

Different local governments respond to fiscal stress in different ways. Avenues of response are a function of the national environment within which they operate and of local capacity and institutional arrangements. This chapter addresses four key questions. What is local fiscal discipline? What is the value of local government fiscal discipline? What are the consequences of poor local fiscal discipline? What institutions at the intergovernmental and local levels are important for local fiscal discipline?

Fiscal Discipline as a Value in Public Financial Management

In most contemporary text on public finance management, reference is made to fiscal discipline, allocative effectiveness, and operational efficiency as core desired outcomes of systems to plan for and allocate public resources.

When Are Governments Fiscally Disciplined?

Fiscal discipline is a key value in public finance management at national and local levels. Given limited resources, expenditure claims would result in chronically high deficits and increasing debt and tax burdens if governments were not fiscally restrained. Fiscal discipline pertains to all key measures of fiscal performance: the total revenue, the financial balance, and the public debt. Typically, fiscal discipline is achieved when constraints on one total (for example, revenue) are accompanied by constraints on other budget aggregates. If, for example, revenue alone is constrained, local governments may find it easier to meet deficit targets by increasing borrowing rather than by reducing expenditure.

But at what level would fiscal aggregates be considered fiscally disciplined? Under certain circumstances, governments may find it wise to borrow—for example, when the economic cost of raising additional tax revenue is likely to be more than the economic cost of borrowing or when borrowing allows two or more generations to share the cost of providing social and economic infrastructure.

Fiscal discipline is inherently connected to notions of affordability. When the budget aggregates are unaffordable, either *ex ante* or *ex post*, a government may be deemed to lack fiscal discipline. Affordability relates to how the level and distribution of public revenue, spending, and borrowing are likely to affect the macroeconomic environment and governments' own financial health in the short and long term.

In this context, notions of what counts as affordable spending have shifted (see Schick 1999). Before World War II, the balanced budget rule was an operating norm. This rule stipulates that spending during a fiscal year, including current and investment spending and revenue, should not exceed that year's revenue. A more relaxed form of the rule is that current spending should not exceed current revenue and that borrowing should be undertaken only to bridge short-term cash flow shortfalls or to finance investment expenditure that will increase revenues. Because the rule neither distinguishes between periods of economic growth and stagnation nor takes account of the short-term rigidity of public spending, governments

infrequently adhered to it. However, it remained the ideal that shaped governments' fiscal policy efforts.

After World War II, governments shifted to a flexible rule that allowed budget totals to accommodate cyclical changes in economic conditions and changes in government policy. A typical version of this rule was that government should maintain fiscal balance over the economic cycle. Over time, the new approach came to mean that government should act through fiscal policy to reduce the gap between actual and potential output.

As ratios of debt and tax to gross domestic product (GDP) continued to rise and economic performance declined and as high deficits and high debt burdens came to be viewed as structural problems that persist through economic upswings, governments concluded that they required increased discipline of budget aggregates. The result was a strategy that permits controlled deficits expressly set by governments in light of fiscal sustainability and of macroeconomic stabilization and growth objectives. The use of modeling techniques to integrate the macroeconomic and public finance impact of target aggregates and to assess sensitivity to internal and external risks is common. Another feature of modern fiscal policy practices is the linkage of target setting with the formulation and implementation of budgets to ensure that actual levels of revenue, expenditure, and borrowing equal targeted levels (Schick 1999: 50–53).

At the national level, fiscal discipline has come to mean maintaining budgeted and actual spending, revenue, and borrowing at levels that are financially sustainable and compatible with short- and long-term macroeconomic objectives, given likely risks. Setting these targets optimally and achieving them is a function of the institutions of the budget process. Publicly available modeling assumptions, up-to-date and accurate macroeconomic and fiscal outturn data, and independent engagement with fiscal policy targets provide important checks on the robustness of governments' fiscal policy and the honesty of supporting projections.

Fiscal decentralization promises improved public services but also creates new challenges for the institutions through which governments manage macroeconomic stability and growth. Prud'Homme (1995), Tanzi (1995), and others warn that decentralization creates new risks. Lack of fiscal discipline at the local level and perverse fiscal behavior by local governments could lead to macroeconomic risk, for example.

The three major functions for public finance management in the public sector are macroeconomic stabilization, income distribution, and resource allocation. According to orthodox fiscal federalism theory, the stabilization function belongs to the national government. A key part of this

function is controlling the fiscal aggregates to achieve an optimal balance between spending and taxes and to allow prudent use of borrowing. Local governments have few or no incentives to undertake economic stabilization policies, the impact of which would be limited. Furthermore, they often lack the necessary macroeconomic instruments to carry out such policies (Fjeldstad 2001; Pisauro 2001).

Whether local governments should be interested in managing local economies through their fiscal policies or whether they should have policy instruments to this purpose remains a much-debated issue in decentralization research, policy, and design. Many commentators appear to argue that local governments should manage local economies through their fiscal policies because of the need for regional stabilization (Shah 2004; Spahn 1997, 2005). Multiple layers of government have challenged the central government's capability to exercise national macroeconomic control.

Decentralizing expenditure responsibilities and revenue-raising ability means giving subnational governments the legal, political, and administrative authority to plan projects, make decisions, and manage public functions (Baltaci and Yilmaz 2006: 3). It also means transferring the risk of fiscal distress and imprudence to subnational governments. Fiscal decentralization programs implemented in many developing countries have given local governments additional service responsibilities, as well as access to greater public funding in the form of intergovernmental transfers or authority to raise taxes from a widened variety of local sources.

When local government conducts affairs such that expenditure responsibilities and costs systematically outstrip revenue, it comes under huge fiscal stress. Fiscal strategies to cope with this stress are important not only for local financial health and service delivery, but also for national economic and financial health.

Why Should Governments Pursue Fiscal Discipline?

The value of fiscal discipline lies as much in avoiding the negative external and internal impacts of high deficits and increased tax burdens that result from weak constraints as in seeking the benefits of hard budget constraints for spending effectiveness and efficiency. The fiscal history of developing countries is rich with examples of how governments in the short term fail to pursue prudent fiscal adjustment strategies in times of looming fiscal stress and thereby compromise their long-term development objectives. Unsustainable fiscal policies can jeopardize the country's international creditworthiness (increasing the cost of future borrowing) and macroeconomic stability.

The destabilization potential of local government fiscal operations is much higher when local governments have access to credit. Such access softens the budget constraint on them and allows postponement of painful expenditure or revenue adjustments in the face of fiscal imbalance, with potentially high medium- and long-term costs internally and externally. Without the possibility of borrowing, local governments are forced to take difficult decisions sooner, making adjustments less painful. However, they have fewer options for financing their crucial development needs.

Governments' borrowing can affect macroeconomic stability when the central bank's independence and monetary policy is compromised through a bailout of state or nonstate banks or local governments directly. A bailout can undermine the bank's role in ensuring price stability. Because fiscal decentralization requires clarity about roles and responsibilities, it can help the central bank pursue monetary and exchange rate policies that protect price stability (Shah 2005: 4). However, when subnational governments build up unsustainable indebtedness to local—and sometimes self-owned—banks, bailouts by the central bank can trigger monetary instability. In Brazil, for example, lending by banks to their own subnational governments without proper assessments of risk caused the 1995 state debt crises. A breakdown of arms-length relationships between governments and the financial system, whether at the national or local level, can threaten monetary policy and the financial system.

At the national level, high deficits and excessive government borrowing from domestic capital markets crowd out and drive up the cost of capital for private sector investment. In principle, excessive local government borrowing can have similar effects. When governments manage fiscal stress by borrowing internationally from banks or international capital markets, they face exchange rate and external instability risks. Only in a few developing countries are domestic capital markets sufficiently mature to allow local government use of capital market debt instruments; few local governments in developing countries have accessed international capital markets. In addition, local governments' failure to service international debt can negatively affect the national government's reputation, undermining the efficiency of the public sector's borrowing operations.

Rather than access credit directly, local governments in developing countries, particularly those in Africa, tend to receive development funds through onlending of international development finance by their national government. In countries that access concessional multilateral and bilateral development financing, prudent management of the total debt stock and of fiscal policy is key to ensuring budget and macroeconomic stability. In

recent years, several countries, including Kenya, Malawi, and Zambia, have faced severe short-term instability and expenditure cuts because of the suspension of concessional finance and other aid flows from development partners after failure to meet fiscal or other policy targets. Although not strictly subnational borrowing, onlending is a source of potential instability, particularly when coordination mechanisms are inadequate to ensure the sustainability of projects or when local governments have to take on the operational cost of inefficient projects, because the national government failed to establish functional aid, investment, and debt management institutions.

Local governments that borrow excessively may find themselves in a debt trap, wherein outflows to redeem past debt are more than the inflows of new debt and debt service cost takes up an increasing proportion of spending, crowding out spending on infrastructure and services. When debt service cost exceeds current income, local governments' ability to deliver services is impaired. However, when local governments pursue fiscally sound policies and reduce their stock of debt (or replace inefficient debt instruments with more efficient ones), they can release revenue for investment without the need to access additional debt.

Fiscal crises exact a significant cost in terms of local government effectiveness. Failure to maintain fiscal discipline during implementation of local government budgets could lead to imposition of in-year expenditure cuts and disruption of local government services. Similarly, avoidance of difficult recurrent expenditure adjustments could lead to postponement or termination of discretionary types of expenditure, perhaps decreasing the quality and quantity of services.

Insufficient expenditure to build social and economic infrastructure has particularly negative consequences for service delivery and fiscal management. In the short term, it decreases the level and quality of service delivery. In the long term, lack of spending on local infrastructure will undermine local governments' economic competitiveness, affecting future revenues. Insufficient expenditure to maintain infrastructure reduces the lifespan of infrastructure, increases future maintenance costs, and can trigger crisis-spending outlays when critical infrastructure fails. Box 3.1 describes one alternative for funding some infrastructure investments.

Fiscal discipline not only helps governments avoid the negative consequences of extreme fiscal stress, but also makes a positive contribution to fiscal outcomes. At the macroeconomic level, fiscal discipline supports the fiscal stabilization function, as discussed. At the microeconomic level, fiscal discipline supports effective distribution and use of resources. In the absence of limits on spending, budget managers may lack incentive to suspend

BOX 3.1 Financing Critical Infrastructure

Petersen and Freire (2004) argue that subnational borrowing can be an alternative for funding some infrastructure investments, especially when the useful life of the investments (such as schools, roads, or public utilities) is long, and they highlight the need for developing efficient access to credit for local authorities. Some countries have begun developing credit markets by establishing municipal finance corporations operated on commercial principles. Municipal rating agencies could assist such corporations in helping local governments borrow for infrastructure investments.

Effective capital markets are dependent on subnational fiscal discipline. But they also contribute to such discipline by demanding transparency in subnational finances. Other necessary conditions for capital markets to develop include effective supervisory authorities, judicially enforceable contracts, tax decentralization, civic norms that promote fiscal prudence, and skilled staff, as well as adequate accounting, disclosure, and reporting standards (Petersen and Freire 2004: 4).

lower-priority activities or seek more efficient ways of achieving objectives so that they can fund new spending priorities. Failure to make difficult decisions about spending trade-offs results in incremental budget growth, which further threatens fiscal discipline.

Intergovernmental Context of Local Fiscal Discipline

Local governments' ability to control their fiscal balances is solely dependent on internal decision-making processes. Increasingly, the degree of spending decentralization tends to exceed the degree of devolution of revenue-raising responsibilities, putting strain on local budgets unless the fiscal imbalance is addressed through intergovernmental transfers. Some institutional arrangements are more likely than others to ensure that fiscal decentralization is consistent with fiscal discipline.

Pisauro (2001), Tanzi (2001), and Wildasin (1997) identify two potential sources of risk for local fiscal discipline that arise because of local governments' position as subparts of a larger state. The first risk is that local governments may behave in fiscally imprudent ways if they have the central government's implicit assurance that they will be bailed out if unable to meet their financial obligations (see box 3.2). The second risk is that local governments perceive the opportunity cost of nationally assigned and collected public revenues to be lower than the revenues' true social cost (the common pool problem). The larger the gap between local governments' expenditure responsibilities and assigned revenue bases, the worse the common pool

BOX 3.2 Hard Budget Constraints, Soft Budget Constraints, and Bailouts

When are budget constraints on subnational governments hard, and when are they soft? Wildasin (1997) argues that fiscal transfers altering the budget constraints of subnational levels of government are insufficient reason to assume that the constraints have become soft. As long as the transfer recipients perceive budget constraints to be binding, the constraints should be characterized as hard. A constraint becomes soft when “altered in some contingent fashion allowing an outcome to occur which would not have been attainable under the ‘normal,’ ‘initial,’ or ‘announced’ constraint” (Wildasin 1997, 6).

When the central government formally assumes the liabilities of the subnational government, the bailout is explicit. An implicit bailout can take many forms, including an increase in transfers, guarantees for debt rescheduling agreements, or a takeover of the local government’s fiscal affairs (as when central government establishes independent bodies with exceptional authority to cut spending, reschedule debt, and boost revenues). Bailouts can occur through the fiscal system or the banking system. When the central bank steps in to bail out local banks—government owned or not—an implicit bailout has occurred. Bailouts may come with or without conditions, including political conditions such as the removal of key policy makers, and with or without a repayment requirement.

Central governments are more likely to step in to prevent debt crises if lower-level governments are too big to fail and provide public services that benefit the rest of society. A central government may also step in when it can reap a political advantage from doing so or will bear a high political cost from not doing so. The political cost of not providing a bailout may be greater for the higher-level government if the reason for the crisis can be traced, at least in part, to that government’s actions. It may have been politically costly for Mexico’s central government not to bail out the troubled states after devaluation of the peso in 1994. The higher the local governments’ tax autonomy, the easier the central government will find it to deny bailouts.

Local fiscal crises’ effects on reputation can be a factor in the central government’s bailout decision. If the debt crisis of a large local government threatens the access of other local governments or the country to efficient sources of credit, a central government may decide that it cannot deny a bailout. Effects on reputation can also work for fiscal discipline. In South Africa, the central government’s refusal to assume responsibility for a provincial government’s bank overdraft soon after the 1994 political transition provided an effective signal to the market that circumstances had changed and was a key contributor to provinces’ subsequent fiscal discipline.

Some experts argue for more central government control over lower-level governments to manage the potential negative impact on national

(Box continues on the following page.)

fiscal balances of poor local fiscal discipline. Other experts argue that the key problem may be insufficient subnational autonomy: smaller governments with higher local tax autonomy increase local political accountability and reduce incentives for bailouts, in turn strengthening fiscal discipline.

Source: Author.

problem. If local sources of revenue were sufficiently large to enable subnational governments to finance their expenditure tasks without having to depend on central government support, the gap between the local and the national opportunity cost of public funds would narrow. However, the moral hazard problem presented by the mere existence of a central government would persist: even if local governments can raise sufficient revenues, they may attempt to externalize the cost of their spending on the common national pool by failing to raise the revenues that will meet their financial obligations and leaving it to central government to bail them out.

Web (2004) identifies a similar free-rider problem that in theory affects local governments' deficit and borrowing decisions. In a national sphere, the central (or federal) government and subnational governments may share the same currency, central bank, and domestic and international credit markets. Thus, they have a common interest in maintaining sustainable country aggregate fiscal balances, price stability, a healthy financial system, and good access to international credit. But a single local government's interest may diverge from that of the rest of the country and prompt the government to behave in fiscally risky ways. If so, the government would receive all the benefits from its behavior but bear only a part of the cost—as long as the other governments continued their good fiscal behavior (Web 2004: 3).

Revenue and Expenditure Assignment and Intergovernmental Transfers

Whether local governments are likely to be fiscally solvent is as much a function of matching their expenditure obligations with sufficient revenue sources as of ensuring that the type of revenue sources matches those obligations. Different developing countries have different expenditure assignments. In many African countries, for example, the central government is responsible for education and health services, and local government is responsible for power, water, and waste management. The type of expenditure responsibilities that rest with local governments should determine in part the revenue sources assigned to those governments.

Spahn (1997) delineates two approaches to achieve stabilization under decentralized government. In the first approach, predictable revenue sources and cyclically stable expenditure responsibilities are assigned to local government. These assignments facilitate local budget planning and leave pro-cyclical budgetary policies to central government. The theory is that the steady behavior of local governments will become an embedded, cyclically neutral, and stabilizing force. In the second approach, expenditure responsibilities that are sensitive to the economic cycle, together with volatile taxes, are assigned to local government. In this case, budget flexibility, including the right to borrow, is needed at the local level. Shah (1998) notes that cyclically sensitive expenditure layouts and revenue bases are usually not assigned to local governments so as to insulate them from economic cycles and give national governments prominence in the stabilization function. Spahn (1997: 2) argues that local governments should carry out the allocation function and should provide cyclically constant public goods and services such as health and education. Stable local revenue sources, such as property tax or local fees for services, together with intergovernmental transfers that are not cyclically sensitive, should finance local governments.

Local governments need less budget flexibility when stable expenditure functions are financed through stable revenue sources, but too little flexibility can trigger fiscal distress. Consider the case of Colombia, where two nationally imposed restrictions on subnational budgets can cause fiscal strain. Colombian subnational governments have little autonomy in managing their expenditures. The revenue-sharing system stipulates how resources transferred by the central government are to be spent. Municipalities are required to spend 30 percent of transfers on basic education, 25 percent on health care, 20 percent on water supply, and 5 percent on physical education. The remaining 20 percent can be used for housing, welfare, debt service, and other uses. In addition, the central government earmarks revenues and makes strict expenditure mandates. Local governments have little control over key cost drivers. For example, subnational governments are responsible for paying teachers' salaries, but the central government determines the size of the salaries. The difficulty that subnational governments have experienced in managing the resulting budgetary inflexibility is reflected in rising levels of debt (Zabala 2004: 283).

The vague assignment of expenditure responsibilities without clearly assigned revenue sources can have equally deleterious effects. In Hungary, the 1990 law on local self-government devolved many expenditure responsibilities to local government but defined the tasks—and therefore the accountability for outcomes—vaguely within a framework of shared responsibilities.

Unconditional grants were to finance the expenditures. Between 1990 and 1998, when general government expenditure decreased, transfers to local governments decreased even faster as the central government struggled to fulfill its obligations. As tight fiscal conditions coincided with expanding fiscal responsibilities and growing investment needs for local infrastructure, local governments responded by becoming more efficient but also by reducing capital investments below replacement levels (Sood 2004).

Four considerations should enter into the design of any grant system:

- Intergovernmental fiscal relations should be based on stable, transparent, nonarbitrary, universal, and nonnegotiable rules (Spahn 1997; 4). Transfers should be based on transparent, standard criteria for fiscal capacity or on expenditure needs that cannot be influenced through the strategic behavior of the central government or recipient governments.
- Local governments should have sufficient access to resources to cover their expenditure mandates. Tanzi (2001) argues that decentralized countries, with the exception of Australia, Canada, and few others, have for the most part provided revenue sources insufficient for subnational governments to undertake their expenditure responsibilities. Consequently, these governments fail to deliver on their mandates or run into fiscal difficulties. The financial resources assigned in various forms (own revenues, shared revenues, and grants) should be sufficient to match expenditure assignments.
- Local government budgets should be flexible to meet local circumstances and needs. The size of own revenues should be sufficiently significant to ensure flexibility and local-level accountability.
- Expenditure mandates should not be too detailed. Local governments should have discretion in determining the mix of outputs or the means to deliver them. Central government's control over key cost drivers such as wages should come with a commensurate commitment to compensate local governments for cost-increasing decisions, particularly if taken in the absence of local government input.

A clear, workable, and substantive framework and rules are critical for a functional intergovernmental system but are insufficient to ensure optimal outcomes. An operational system that facilitates coordination and cooperation among the levels of government is needed. Pisauro (2001: 11) argues that a key objective of the intergovernmental system should be to shift the focus of fiscal policy to general government by building a framework for coordination of budget plans.

A prerequisite for an institutional framework that facilitates cooperation among levels of government is a system of public accounts that includes all levels of government and that makes expenditure and revenue classifications consistent. This system should provide frequent information on planned and actual revenue, expenditure, and borrowing of general government. Timely and comprehensive reporting of budget implementation, including the transfer of resources from the national government to lower tiers of government, is necessary for central government to monitor performance and to detect fiscal stress early on so that remedial action can be taken (box 3.3).

A system of public accounts clarifies accountability for poor fiscal and budgetary performance. In many developing countries with high revenue uncertainty, central governments pass on cash shortfalls to lower levels of government by postponing or suspending transfers, with disastrous consequences for service delivery. Regular publication of up-to-date and accurate information on intergovernmental transfers can act as a disincentive for such practices. Transparency in transfers also acts as a disincentive to aberrant local level behavior. Local authorities cannot plead resource shortfalls if local populations know the timing and level of transfers. In Uganda, transfers for health and education institutions are displayed in the institutions and published in a national newspaper.

Information alone is not enough to ensure cooperation among governments in coordinating fiscal policy. The annual budget process should be sequenced so that local governments can plan their budgets with reasonable certainty about the amount and timing of resource transfers from central

BOX 3.3 Impact of High-Quality Budget Institutions

A fiscal gap is not necessarily associated with lack of fiscal restraint. De Mello (quoted in Pisauro 2001; 15) estimates the effect of some decentralization indicators on the central government's budget balance in 30 countries, 17 of which are in the Organisation for Economic Co-operation and Development (OECD). In the OECD countries, fewer subnational taxing powers (and a higher fiscal gap) tend to improve fiscal outcomes. In the non-OECD countries, tax autonomy does not affect the government deficit, whereas dependency on transfers worsens it. De Mello considers these results evidence that common pool problems are more serious in non-OECD countries than in OECD countries, but Pisauro points out that what really makes the difference may be the quality of budget institutions, which, on average, is higher in OECD countries.

government and that information from local-level fiscal plans can inform the national budget process. Like rules for the payment of grants and sharing of revenues, rules that govern the budget process should be transparent.

In South Africa—where gaps between expenditure responsibilities and transfers from the central government are large for provincial governments but much smaller for local governments—a clear legal framework, cooperative budget structures, and good transparency arrangements help shift the fiscal policy focus from the central government to the general government level. The vertical and horizontal distributions of revenue strike a good balance between predictability in resource allocation and flexibility to respond to changes in the macroeconomic environment. For example, although the distribution of transfers between provincial and local governments is formula driven (minimizing opportunities for any one subnational government to maximize its share), the size of the pool to be distributed is dependent on fiscal policy and a negotiated assessment of expenditure needs at each level. Use of a medium-term framework and the *ex ante* and *ex post* publication of the criteria driving the vertical division of resources between governments facilitates transparency, predictability, and policy coordination. Intergovernmental forums that combine political and administrative leadership—for example, the Budget Council—are active throughout the budget process. Final decision making rests with a session of the extended national cabinet—a session that provides for subnational political representation. The Finance and Fiscal Commission, an independent constitutional body, plays an important advisory role: it annually advises the national parliament on the vertical and horizontal divisions of revenue. Given that parliament is still a relatively weak voice in public finance decisions, the real check and balance is that the commission's research and recommendations are made public and that the national ministry of finance responds to them formally in budget documentation, facilitating further transparency and buy-in by subnational governments. The system, which was initially developed for coordination between national government and provincial governments, now includes local governments, which play an important role in pro-poor service delivery.

In summary, fragmented budget processes, in which decisions about intergovernmental fiscal affairs are murky, contribute to poor local fiscal discipline. Budget institutions and procedures that are aimed at coordination and cooperation can support and may be necessary for fiscal discipline in a decentralized environment. Good information on actual transfers and expenditure, revenue, and borrowing outturns throughout the fiscal year is equally important.

Subnational Borrowing

The discussion above touched on the implications for subnational borrowing of revenue and expenditure assignment and the system of intergovernmental transfers. The operations of local government can have significant macroeconomic effects even under balanced budget conditions (Ter-Minassian 1997). A balanced budget expenditure increase by subnational governments can boost aggregate demand counter to stabilization efforts by the national government if, for example, the multiplier effects of the expenditures of subnational governments outweigh those of their revenues. However, the destabilizing potential of subnational governments is much greater if they do not operate under a hard budget constraint and can access additional financing in times of fiscal stress.

How do intergovernmental institutional arrangements for regulating subnational borrowing affect local fiscal discipline? Web (2004) identifies several channels for strengthening such discipline. He makes two important distinctions in sketching a framework for analyzing country conditions governing subnational borrowing. First, controls on subnational borrowing can operate before or after the fact. *Ex ante* controls usually are rules, regulations, and procedures determined by the central government, whereas *ex post* controls are sanctions that come into play when local governments behave imprudently. Second, controls can be directed at borrowers or lenders. Web argues that lending should be subject to *ex ante* and *ex post* constraints on both borrowers and lenders. Reliance on *ex ante* constraints without consequences after the fact gives irresponsible lenders and borrowers a big incentive to overcome initial obstacles. Reliance on consequences alone may allow large local governments to build up debts so large that the national government will not enforce the consequences.

In economies in which governments own banks and financial institutions and financial markets are not fully liberalized, *ex ante* controls are critical, because market constraints do not operate effectively. Under such conditions, credit allocation decisions are not strongly driven by considerations of protecting lenders' interests. Sole reliance on constraints on borrowers could lead lenders to push loans and local governments to borrow despite the rules. Constraints on borrowers may include higher *ex ante* capital requirements for risky lending to local governments or commensurate capital write-offs for loans not repaid. Fiscal responsibility laws or other rules, regulations, and procedures encourage fiscal restraint by borrowers. Restraints can be formulated using balance sheet items—for example, debt stock or money flow indicators such as debt service. Table 3.1 lists control options.

The ease with which a country can achieve fiscal coordination is not solely a function of its fiscal institutions. Political factors affect the urgency of the need for fiscal control institutions and the likelihood that the institutions will succeed. One obvious factor is the constitutional autonomy of subnational governments (see table 3.2). Other important political factors are whether a majority party is in control or whether government is a coalition or is divided between legislative and executive branches; the strength of party identities and unity; and the strength of the legislature over the executive. Insofar as the constitution, party system, and the politics of the day lead to a centralization of power, the country will have less need for special institutions to coordinate fiscal discipline among levels of government.

TABLE 3.1 Ex Ante and Ex Post Controls on Subnational Borrowing

Control	On borrowers	On lenders
Ex ante controls	Debt ceilings Deficit targets Restrictions on international borrowing Regulation of subnational borrowing on the basis of fiscal capacity criteria (regulations by the central government, the central bank, or another institution)	No direct central bank financing Restrictions on international borrowing Regulations by the central bank or another institution Financial supervision agency Credit rationing to states Increased capital requirements for lending to risky subnational governments
Ex post controls (monitoring and consequences to enforce ex ante rules)	Limits on central bank financing No bailouts (from central government or from international community) and no debt workout without adequate conditionality Central government refuses to accept subnational debt Debt service withheld from transfers to subnational governments Publication of detailed fiscal results	Strong supervision of banks Regulations require capital write-off for losses from subnational debt

Source: Web 2004: 5.

The effectiveness of controls on general government borrowing is dependent on the presence of modern, comprehensive, standardized, and transparent budgetary and accounting procedures and information systems. Establishment of cooperative approaches to fiscal management is also critical. When local governments, particularly large cities, are actively involved in the process of formulating macroeconomic and fiscal objectives and the key parameters for general government fiscal policy, they are made co-responsible for their achievement (Ter-Minassian 1997: 8).

A good example of the possible benefits of a cooperative approach is Australia’s Loan Council. The council is a cooperative forum for analyzing financing requirements of the states and the federal government in the context of general government fiscal policy and for allocating planned public borrowing over the medium term. These activities allow for trade-offs between competing claims. In addition, the council monitors subsequent loan activity; when a government is unable to keep its borrowing within its allocation, it must provide a formal explanation to the council (Pisauro 2001).

A cooperative approach promotes dialogue among levels of government and makes subnational governments aware of the macroeconomic implications of their budget choices. It works best where fiscal discipline is already widely accepted as a driving value in public finance choices. In countries where capital markets are lacking—and where poor discipline’s

TABLE 3.2 Different Demands in Different Political Systems

Federal systems	Unitary systems
Greater policy, expenditure, and tax autonomy to subnational governments	Greater powers to central government
High local discretion to set budget limits, determine output mixes, and make operational choices	Limited sources of own revenue
Higher risk of unfunded mandates	Less discretion in budget planning
Centralized monitoring not guaranteed	More binding guidelines controlling budget preparation and implementation
Accountability decentralized, often shared	Centralized monitoring
Greater ease of bailout denial	Centralized accountability
Greater opportunity for local-level accountability to constrain local-level fiscal decisions	Direct central government control over subnational borrowing
	Higher risk of bailouts
	Less opportunity for local-level accountability

Source: Author.

effects on reputation are therefore weaker—or the leadership of the central government is weak, incentives and opportunities for cooperation are lessened (Ter-Minassian 1997).

The history of subnational borrowing in Brazil illustrates these principles. The 1988 Brazilian Constitution gave subnational governments, including large cities such as São Paulo, a lot of authority and resources. Over the next decade, Brazil had three major subnational debt crises, driven mainly by the largest states' use of their own banks to finance their operational deficits. The crises triggered agreements, but with the negative effect of reinforcing subnational governments' expectations of bailouts from the federal government. The agreements rescheduled debt, allowing debt stock to grow while ensuring that most of the repayment burdens fell on subsequent state and city leaders rather than on those leaders who defaulted and rescheduled debt. The rescheduling placed limits on debt service, thereby reducing the expected future cost of current borrowing. In effect, the agreements meant that both subnational borrowers and lenders suffered few consequences.

In the late 1990s, Fernando Cardoso was elected president because of his achievements as an effective finance minister. Fiscal prudence suddenly had political currency. Cardoso formed an alliance with the four largest debtor states, including São Paulo, and the government instituted five measures affecting borrowers and their creditors. The senate tightened its constitutional control over the fiscal activities of subnational governments with a new framework placing limits on borrowing. It forbade certain types of borrowing altogether. The rescheduling agreement of 1997 established much tighter constraints on subnational governments in default, increasing the cost of fiscal imprudence. The agreement set targets for decreases in debt and deficit ratios, ceilings for personnel spending and investment, growth in own revenue, and the privatization of state enterprises. It also stipulated consequences: no federal guarantees for debt, interest rate penalties on existing debt held by the federal government, increases in the debt service ceilings agreed earlier, and deductions of subnational debt directly out of federal transfers.

At the same time, the National Monetary Council ordered the Central Bank to limit banks' total lending to the public sector and to prohibit lending to any state in default or in violation of the debt and deficit ceilings issued by the Senate. The privatizations required in the rescheduling agreements included the state-owned banks, eliminating them as a source of financing.

Finally, in 2000, Brazil passed fiscal responsibility legislation, setting minimum standards for state budgeting and personnel and debt management. The legislation required that

- the annual budget of each government be in line with the government's multiyear budget and the federal fiscal program;
- all moneys owing to the federal government and its agencies be deducted from fiscal transfers;
- subnational governments seeking loans prove their compliance with the law to the Ministry of Finance;
- all borrowing above the Senate ceilings be paid in full and without interest, penalizing both borrower and lender;
- subnational governments be ineligible for discretionary transfers or federal guarantees and undertake no new debt until they repay all excess borrowing; and
- governors and mayors contract no obligations during their last six months in office.

The law also made debt and labor contracts that violate its provisions invalid—a heavy penalty on lenders, who would effectively lose their money (Web 2004: 8). Another law specified criminal penalties for officials who violate the law. In combination, these measures reduced general government debt and adjustments in personnel spending and public pensions.

The history of subnational borrowing in newly decentralizing countries suggests that sole reliance on market discipline may not be sufficient to encourage local fiscal discipline. Colombia's 1991 constitution brought greater freedom for subnational borrowing, mostly in the form of cash advances by banks. In 1997, Colombia introduced the traffic light law, creating a rating system for subnational borrowing on the basis of debt to current revenues and indicators of interest for operational savings. Highly indebted local governments got a red light and were prohibited from further borrowing. Yellow-lighted governments had to get permission from the finance ministry. In practice, lenders continued to provide credit to red-lighted governments, and some local territories offered inaccurate financial information to avoid a yellow-or red-light rating. Because most of the lending originated from banks, bank regulations were another way of controlling subnational borrowing. Since 1999, banks have been required to provide fully for the debt of any red-lighted subnational government, increasing the cost of lending. Legislation in 2000 imposed restrictions on the operations of subnational governments in an attempt to constrain the drivers of cost increases. In addition, the legislation required subnational governments to obtain satisfactory credit ratings from international rating agencies before borrowing.

Petersen and Freire (2004), Ter-Minassian (1997: 9), and Ter-Minassian and Craig (1997) suggest that many conditions must be satisfied if financial

markets are to be effective in disciplining local borrowing. These conditions include free and open markets and no regulations that make local governments privileged borrowers, adequate information on governments' current financial position and past history, no expectations of bailout by the central government, and borrowers' capacity to respond to market signals before reaching default. Few countries meet these conditions. Even in Canada, where market discipline is the only constraint on subnational credit operations, provincial debt rose in the 1990s, despite a sophisticated market and no history of bailouts, deteriorating ratings, or increases in the cost of bonds.

Petersen and Freire (2004: 4–5) highlight the need for arms' length relationships between governments and between markets and banks, as well as civic norms for fiscal discipline, legal enforcement of contracts, and central government oversight of subnational borrowing. Developing countries typically do not meet these conditions: regulations on financial intermediaries make placement of government securities relatively cheap, timely information on the financial operations and health of local governments is not regularly available and may be inaccurate and incomplete, the state has ownership interests in financial institutions, and a history of soft budget constraints on local governments sometimes may be established. In such cases, local fiscal discipline is best supported by rules or by greater central government oversight of or control over subnational borrowing.

Rules to strengthen market discipline take many forms. Some rules set limits on absolute level of debt or on debt service cost ratios. Others allow borrowing only for specific purposes—for example, investment in infrastructure or short-term borrowing to cover cash flow shortfalls. Yet others limit the types of credit that subnational governments can access, banning international borrowing or borrowing from state banks.

However, local governments can be adept at circumventing fiscal discipline rules and putting off painful expenditure-reducing or revenue-raising decisions, particularly when transparency requirements are inadequate. For example, some governments may reclassify expenditures from current to capital to escape current budget balance requirements. Some may use own enterprises to borrow or may create off-budget entities whose debts are not included in debt stock assessments for debt ceilings. Some may use debt and investment instruments that are not included in balance sheet assessments. Some may borrow from their own capital spending allocations during the fiscal year to finance recurrent spending overruns. Some may run up huge stocks of arrears to contractors; these arrears will not show up in cash-based accounting systems.

These practices highlight the need for comprehensive monitoring of local governments' financial operations. The effectiveness of any monitoring is in turn dependent not only on appropriate frameworks, capacity, and willingness at national level, but also on the quality of local-level budgeting and accountability institutions.

Local Fiscal Discipline Institutions

Local governments can respond in several ways to fiscal pressure without resorting to debt financing. First, they can seek to raise additional revenue by increasing their user fees and charges, creating additional local taxes, or selling off assets such as land. Second, they can seek to improve the efficiency of their financial operations by improving their planning, programming, and budgeting capacity and by deploying productivity programs or seeking out lowest-cost means to deliver services. Third, they can enhance private and nongovernmental participation in the provision of services. To undertake each of these strategies successfully, local governments must have the capacity to assess their revenue streams and expenditure demands accurately and to make the difficult choices and control expenditure in accordance with those choices. Whether local governments have sufficient incentive to build these capacities depends on many factors.

Importance of Flexible Own-Revenue Sources

The discussion above highlighted the need for higher own-revenue financing of expenditure responsibilities at the local level to counter the common pool problem. The discussion on deficit financing made a similar point: local governments require some budget flexibility and autonomous revenue sources to support their credit market credibility. A third function of allowing local governments sufficient own-revenue sources is local governments' accountability to local communities.

When communities bear the cost of local services through local tax and user charges, citizens will realize the true budget constraint and will discipline their demand. Moreover, citizens are likely to place high value on their local governments' fiscal prudence. Local autonomy accompanied by accountability to citizens for service delivery provides robust opportunities for oversight (Shah 2004: 30). In a study of public organizations in six developing countries, Grindle (as quoted in Shah 2004: 30) found that where local autonomy and oversight matched decentralization, governments were "good performers."

Own-revenue capacity is a cornerstone of local fiscal discipline, particularly in a decentralized environment. Without access to their own revenue, local governments have fewer options when faced with fiscal pressure (or even with year-to-year infrastructure development needs). Local governments can respond to fiscal pressure optimally when national legal frameworks give them the flexibility to set local tax rates, determine user fees and charges, and identify additional resources. Typical local government revenues are property taxes, services charges, fees and licenses, rent for the use of facilities, and interest on investments. Some local governments also receive income from business enterprises they own, but ownership of enterprises can also result in contingent liabilities that trigger fiscal crises when they fall due.

Efficient Tax Administration

Flexibility in determining tax and other revenue bases and rates is usually outside local governments' direct control. Efficiency of revenue administration, however, is under local governments' control. Effective collection of tax and user charges and fees involves regular updating of tax rolls and evaluations for property tax. Local governments can increase tax collection on existing tax bases by reducing or removing exemptions and can often gain a lot by tailoring revenue arrangements to their collection capacity. Box 3.4 provides three examples of improved revenue collection.

Improvement of Public Financial Management Systems

As noted, local requisites for fiscal discipline are authorities' capacity to assess accurately their likely revenue inflows and expenditure outlays over the medium term and to undertake disciplined budget implementation. Modern approaches to budgeting involve use of fiscal and budgeting frameworks with a medium-term horizon, development of resource-constrained spending plans, modernization of budget classification and accounting systems, improvement of internal controls, use of performance measures, and establishment of institutions to improve transparency and accountability. Such approaches are critical for maximizing local government effectiveness in the context of limited resources.

As explained, local fiscal discipline is a function of political, administrative, and market constraints on the fiscal operations of local authorities. A requisite for any of these constraints to be effective is local-level fiscal transparency. Systematic political accountability for the outcomes of local financial

BOX 3.4 Examples of Effective Local Tax Collection Reforms

Much can be gained from compromises on the design and implementation of local taxes. In each of the three cases below, tax bases may yield revenue less than that collectable through a perfectly implemented ideal system. However, in each case the revenue collected represents a significant improvement over previous performance.

Hyderabad, India, had great success by deploying a collection strategy for property taxes that was suited to its capacity. Property taxes are, in principle, a good local revenue source, because they are stable and local citizens can perceive direct links between costs and benefits. However, they require frequent updating of tax rolls and tax evaluations. For two decades, Hyderabad did not undertake these two tasks, leaving the city with outdated tax rolls and little success in enforcing payment. The city then introduced a system requiring property owners and occupiers to file returns, assessing themselves on the basis of strict criteria and with assistance from local residence association committees, which exerted moral suasion to draw all liable owners and occupiers into the net. Tax revenues increased by 50 percent within a few months.

Vitória da Conquista, Brazil, had a culture of debt and fiscal deficits and a culture of nonpayment for services and of tax. To address the endemic tax evasion, the municipality began charging the service tax before businesses filed returns. The municipality made preassessments of the likely liability of 100 types of businesses and sent out accounts. Businesses had the right to object but had to provide receipts to prove that they had been overcharged.

In Kenya, a major source of local revenue is business licenses. Over time, the system became encumbered with many different licenses and provided opportunities for rent seeking by officials. Businesses could obtain licenses only after fulfilling conditions such as obtaining health certificates. The solution was to simplify the process by separating out the regulatory functions and creating a single unconditional business permit that all businesses had to obtain but could do so easily. Each municipality had to establish a standard set of tariffs but could choose one on the basis of its circumstances and revenue needs. The new system has significantly increased revenues.

Source: Mase and Devas 2004.

management is unlikely to be present unless citizens are constantly made aware of how well localities are being managed. Transparency can prevent problems from developing into crises. The benefits of local fiscal transparency are enhanced when the availability of accurate and timely information is complemented by the presence of a strong civil society—independent media, responsive opposition groups, good research organizations, and respected commentators.

To make local government finances transparent, the following are needed:

- *Transparency on medium-term fiscal policy and targets.* Several benefits accrue when local governments publicize medium-term revenue targets and expectations, expenditure projections, and financing needs. Transparency encourages investment by making tax burdens predictable, enhances fiscal credibility by lowering borrowing costs, creates an integrated framework for planning of local spending, and enhances the opportunity for local engagement with fiscal projections and targets.
- *Transparency on risks associated with the fiscal aggregates.* Discussion of medium-term targets for the budget aggregates should include discussion of risks, including price risks (for example, risks associated with the on-selling of utilities) and interest rate and exchange rate risks.
- *Transparency on the assumptions and models used to project revenues and expenditures.* Assumptions and models used to project revenues and expenditures should be open to scrutiny by higher levels of government and local stakeholders.
- *Budget comprehensiveness.* Budget and balance sheet frameworks should include all sources of revenue, all expenditure outlays, and all liabilities, including revenues and expenditures of arm's length agencies and other off-budget instruments.
- *Transparency on assets and liabilities.* Care should be taken to make transparent all current debts and all current liabilities, including arrears and contingent liabilities. Local budget statements should include a comprehensive statement of flows and a comprehensive balance sheet statement. Publicizing all planned fiscal operations and the impact of all past fiscal operations makes local governments hesitant to circumvent constraints on main budget operations by creating off-budget operations.
- *Information on budget execution.* The credibility of budget execution is important for local fiscal discipline. Frequent information on local governments' progress in meeting macro fiscal targets should be provided during the spending year.
- *Institutions to guarantee the credibility of financial information.* To deliver on transparency requirements, local governments need sound forecasting, budgeting, and debt and asset management, as well as internal control, accounting, and reporting systems. In addition, external audit practices must be robust to ensure the integrity of revenue and expenditure information.

Conclusion

Across the world, local governments are bearing increasing responsibility for the provision of public goods and services and the management of public moneys. To meet this responsibility effectively, they must have fiscal discipline—that is, the ability to spend only as much as is affordable in terms of their own future financial health and as in accordance with national or local macroeconomic objectives.

Local governments must contend with many exogenous factors that affect their fiscal health. As a subpart of a larger fiscal and monetary entity, local governments are highly vulnerable to national shocks, they are often heavily dependent on sometimes unpredictable fiscal transfers from other levels of government, and they may labor under highly rigid expenditure mandates. However, local governments' perverse fiscal behavior can adversely affect national fiscal and monetary conditions.

No matter the country or fiscal management system, all institutions that govern decisions affecting local fiscal balances—at all levels of government and across all sectors of the economy—must be incentive compatible if local governments are to maintain fiscal discipline and have the fiscal capacity to develop their localities. Whether incentives are effective is often dependent on whether the financial affairs of local governments are subject to scrutiny and whether those who undertake the risks are made to pay the price.

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