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Decentralization and Fiscal Discipline in Subnational Governments: The Bailout Problem in Uruguay

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Abstract

This paper analyzes the reasons behind Central Government (CG) bailouts of Subnational Governments (SNGs) in the case of Uruguay. We argued that Uruguay represents a good example of the risks of fiscal decentralization, in the context of adjustment policies, and when SNGs' responsibilities and resources have not been carefully defined. We show that, in unitary countries where SNGs lack the opportunities to misbehave that they have in federal countries (e.g., public debt issuance, international borrowing), SNG officials find ways to finance deficits through non-compliance with politically contestable obligations. In particular, SNGs in Uruguay finance their deficits by accumulating debts with other government agencies and obtaining discretionary transfers from the CG. Through statistical analyses we show that debts and deficits are mainly related to vertical fiscal imbalances and economic conditions in the SN jurisdictions. Yet, the analysis of recent bailout episodes suggests that institutions and political factors play a role (i.e., they are important ex-post factors). This implies that bailouts have been more than simple compensations for structural imbalances, thus creating opportunities for strategic behavior on the part of SNG authorities (partly confirmed by the disparate fiscal performance of Montevideo vis-à-vis the rest of the country).

1. Introduction

During the 1980s few regions have made an effort comparable to Latin America with regard to fiscal discipline. In effect, a region characterized by a growth model that relied heavily on fiscal deficits has for the most part became a fiscally austere region. Improving the tax system, cutting expenditure, curtailing clientelistic practices and reducing the size of the state apparatus have all been widespread practices and policies in the last decade and a half. In fact, while in the early 1980s almost all of the region's countries had deficits greater than 3 percent of GDP, by 1996 this was true of only 8 countries. The average deficit was nearly 10 percent of GDP in 1982, but by 1996 it had been reduced to slightly below 3 percent (IADB, 1997).

The challenge facing the region today is institutional reform. It implies going beyond state reduction and improving the institutional framework in such a way that it contributes to the good functioning of the economy as a whole. Decentralization has in this sense become a top priority and a widely accepted strategy for improving government and resource allocation. Yet together with the promises of decentralization come comparable risks. While some of the literature on decentralization has argued that it improves fiscal discipline, both empirical findings and theoretical analyses suggest that such an assertion should be considered carefully.[1]

While Latin America has advanced in regard to fiscal discipline, it has done so by attacking the sources of fiscal indiscipline in the state areas where they were most evident: the central apparatus and state-owned enterprises. Provincial, regional and local government have been less affected by these policies, and both tax evasion and inadequate control for irresponsible expenditure are very much a reality in many countries in the region.

The fiscal performance of subnational governments (SNGs) is key to the global fiscal performance of national governments, as central governments (CGs) are normally called to the rescue of SNGs when these are unable to fulfill their obligations. While the problems associated with subnational fiscal autonomy in federal states has been the object of numerous studies (Hunther and Shaw, 1998; Jones, Sanguinetti and Tommasi, 1997a and 1997b; Kraemer, 1997; Ma, 1998; Porto and Cont, 1998; Stein, 1998; Stein, Talvi and Grisanti, 1998), there is a paucity

[1] Brennan and Buchanan's (1980) optimistic hypothesis that decentralization would, through the introduction of competition among subnational governments (SNGs), favor fiscal restraint, limit the growth of goverment and favor discipline, is far from unproblematic when the Latin American experience is considered. While decentralization has proven to have a number of merits (particularly with regard to resource allocation, participation, and accountability) it has at the same time, created new risks and challenges.

of analyses considering the particular situation of SNGs in unitary states. Subnational fiscal indiscipline in unitary states is usually less dramatic than in federal systems, partly because SNGs enjoy a lesser degree of financial autonomy. However, studying the performance of SNGs in unitary states may still be useful from the broader perspective of fiscal federalism. These analyses should not only contribute to a better understanding of the benefits and costs of fiscal decentralization in different contexts, but they should also make it possible to identify "second generation issues" that may arise in federal systems after the most obvious reforms have been implemented.

A small country of three million people, with half of its population in the capital city and a strong unitary tradition, Uruguayan *Intendencias* (the SNGs that administer the only formal subnational jurisdictions: the *departamentos*) were traditionally considered to be of little economic or social significance. Yet, when the country is placed in a comparative perspective, this image needs to be qualified. While, not surprisingly, Uruguay ranks behind the federalist states of Latin America in terms of the proportion of public expenditure managed by SNGs, it is still one of the unitary countries with the greatest participation of SNGs in total public expenditure. In effect, only the SNGs of Bolivia and Colombia, also unitary states, spend proportionally more than those of Uruguay.

Furthermore, the country has not escaped the decentralization trend that has recently spread throughout the region. In 1996 Uruguay ranked sixth in its decentralization effort when compared with all other countries in Latin America (IADB, 1997). That same year a major constitutional reform was passed that would begin to change CG-SNGs relations as of 2000 (Correa Freitas, 1997). The amendments include a number of innovations that may lead to greater fiscal decentralization. Among other measures, a previously "informal" *Congreso de Intendentes* has been recognized in the new constitution as an interlocutor of the CG in matters of fiscal policy, and the national and subnational elections will from now on be held separately. These institutional reforms respond not only to the increasing acceptance of decentralization goals among elites and the population at large, but also to the challenges posed by political, economic and institutional transformations that have taken place in the last fifteen years. When some recent fiscal management problems at the SNGs level are considered (see below), these reforms raise some distressing possibilities.[2]

Despite these trends, most evidence would have suggested that SNGs should not represent a major problem for fiscal management in Uruguay. In effect, Uruguay has comparatively limited problems of vertical fiscal imbalances, its legal framework precludes ownership of banks by SNGs, and there are stringent legal constraints on SNGs' ability to borrow. Other factors would also make Uruguay an unlikely candidate for fiscal indiscipline at the subnational level. First, the electoral framework prevailing until now had national and subnational elections held simultaneously and precluded split-ticket voting, thus increasing the Executive's prevalence over SNGs controlled by the same political party (usually a large proportion of all SNGs, given the characteristics of the party system and electoral legislation). Second, Uruguay ranked first in Latin America with regard to political autonomy and participation at the SN level, and these factors have been mentioned as contributing to fiscal discipline. Considering these factors, it is interesting to examine the determinants and mechanisms of subnational fiscal indiscipline in what appears to be an unlikely scenario for its occurrence. The study may help in identifying some "cracks" that could still lead to fiscal difficulties after countries with more autonomous SNGs implement a first generation of discipline-enhancing reforms.

2. The Political and Institutional Context of SNGs' Budgets

2.1 A Redefined Landscape

Uruguay returned to democracy in 1985, restoring its 1967 Constitution. This constitution defines Uruguay as a unitary state that recognizes partially autonomous forms of political administrations at the subnational level. The *Intendencia* as an administrative and political entity has limited but nevertheless important roles. It sets some local regulations, provides some general public services (some *Intendencias* have limited but still important roles in the provision of health services), and is responsible for urban infrastructure, including sewage and waste management systems.

[2] Putnam (1993) describes a process in which initially modest decentralization measures ended up being the beginning of much deeper changes in the roles and functions of SNGs.

With the return of electoral politics came renewed political competition at the SNG level. In the last 15 years the country has witnessed the rising visibility, power and appeal of subnational political office. This process has been fueled by two autonomous transformations that had a distinct effect on the relevance of SN politics. On the one hand, both expenditure and resources have increased in SNGs relative to the central government. In effect, both as a percentage of GDP and as a percentage of total government expenditures, SNGs' expenditures have shown a remarkable upward trend. This suggests an increased role of the *departamentos* in the social, political and economic life of the country. Economic growth has also been accompanied by concrete formal and informal transformations in the responsibilities and institutions of SNGs, which have materialized in the constitutional reform of 1996.

On the other hand, a number of reforms implemented in recent years have strongly curtailed the clientelistic practices that used to be pervasive in the CG. The bloating of the state through unnecessary expansion of employment, the granting of special benefits through the pensions system, the fast lane in circumventing red tape and discretionary access to telephone lines, water or electricity, are now much less frequent than they used to be. Technological innovations, massive access and renovated political practices at the national level have all contributed to this process. But this is not true for all SNGs. Many of them, subject to less scrutiny than the central government from national media and watchdog organizations, have become the last strongholds of clientelism.

Due to these trends, and in the extremely competitive political environment of democratic Uruguay, SNGs have come to play a key role in electoral politics and in the parties' strategies. These two parallel processes seem to have contributed to transforming subnational politics into a critical arena in the competition for power at the national level and, thus, also to increasing the power of local political elites within their parties and inthe political system as a whole. In other words, comparatively loose fiscal policies at the subnational level have, by force of political realities, found their way into a system that in principle was supposed to be deficit-proof. After briefly outlining the political and legal framework of SN fiscal policy, the rest of this paper explores some of the determinants and mechanisms of fiscal indiscipline.

2.2 The Political Context

The Uruguayan Congress consists of two houses. While *senadores* are elected in a single national jurisdiction, *diputados* are representatives of the *departamentos*. Yet, this local representation is more formal than real. Under a system that ensures strict proportional representation in the lower house, *diputados* follow party discipline in all major matters rather than representing local interests. This does not imply complete absence of territorial representation of interests, as the *Intendentes* serve as the de facto representatives of the *departamentos* vis-à-vis the national government. They are the ones that come to Montevideo to negotiate with different central government authorities regarding financial resources for their *departamentos*, joint projects and local implementation of national policies.[3]

The political authorities of the *departamentos*, both the legislative and executive branches, are elected directly by the citizenry. The *Juntas Departamentales* represent the legislative branch of the *Departamento*, while the *Intendente* and Department Directors constitute the SN executive branch. An important aspect of the electoral system is that the party of the elected *Intendente* is automatically adjudicated a majority in the *Junta Departamental* (a minimum of 16 of 31 seats; see Moraes, 1999). This guarantees budget approval as long as the incumbent party representatives vote as a bloc in the *Junta*. Given the fractionalized nature of Uruguayan parties, this does not mean that the budget approval process is smooth or free of political bargaining, since the *Intendente* cannot generally take the disciplined vote of a majority of the *Junta* for granted. In fact, rather lengthy negotiation processes between the *Intendente* and the different party factions are frequent during budget approval periods.[4]

Until the constitutional amendment of 1996, the elections for SNG office were held at the same time as national elections. Furthermore, split-ticket voting was not allowed, meaning that the same party had to be chosen for the national election (i.e., presidential and congressional elections) and the *departamental* election. As with presidential candidates, in the pre-1996

[3] Despite the general negative opinion about the bargaining process, pressure and lobbying in Montevideo is recognized as the only way to obtain resources and favorable policies. "Nosotros estamos tocando las puertas de todos los ministerios todos los días. El surco nuestro ya lo conocemos y sabemos quien es portero de quien, quien es quien, y estamos todos los días tramitando nuestros recursos; los recursos que nos dió la Constitución. Los que vienen por convenio nos cuestan un poco más." (Interview with Jorge Saldombide, Canelones, May 6, 1999).

[4] According to Intendente Giorello, "Part of the toughest negotiating takes place between me and my party." Interview with the *Intendente* of Lavalleja, March 16, 1999. The Director of Finance of another *departamento* (Rivera) said; "Los sectores minoritarios para conformar la mayoría [de 31 votos del Intendente en la Junta], en realidad lo tienen al gobierno de rehén. Siempre que hay algo importante que votar que se necesiten los votos, termina en un reparto de cargos. Es tradicional, un hábito." Interview with Isidro de los Santos, April 16, 1999.

system, each party was allowed to run with multiple candidates for *Intendente*, and the process ended with the election of the most voted candidate of the most voted party.[5] This allowed *Intendentes* to be appointed with relatively few votes that they could call their own—that is, votes to their own candidacy. Indeed, since 1985 there have been cases of *Intendentes* elected with less than 20 percent of direct votes to their name, as a share of the *departamento*'s turnout.

One very important factor to analyze in examining the political dynamics of *Intendencias* is their relationship with the national government. Besides Montevideo, the *Intendencias* have been ruled by the *Nacional* (also called the *Blanco*) party and the *Colorado* party. The 1984 election, which elected a *Colorado* President, also led to a map of predominantly *Colorado departamentos*. In turn, in 1989 the *Blanco* party won the national election and most of the *Intendencias* in the country. Yet, when a *Colorado* President was elected in 1994, the *Blanco* party was able to retain a majority of *departamentos'* governments.

[5] Uruguay has traditionally attracted political scientists' attention because of this peculiar electoral system in which the primaries and the final election were held simultanously. It is interesting to note that, while the constitutional reform has forced parties to present only one presidential candidate beginning in 1999, the equivalent rule for SNGs is being phased out gradually. Parties will be able to present two (and maybe three) candidates in the election of 2000, and in 2005 they will they be required to present only a single candidate for *Intendente*.

Table 1. Political Incumbency by Departamentos (*)

	1984	**1989**	**1994**
Departamentos	*National Government* *COLORADO*	*NACIONAL*	*COLORADO*
Montevideo	Colorado	F. Amplio	F. Amplio
Canelones	Colorado	P.Nacional	Colorado
Maldonado	Colorado	P.Nacional	P.Nacional
Rocha	Colorado	P.Nacional	Colorado
T.Tres	P. Nacional	P.Nacional	P.Nacional
Cerro Largo	P. Nacional	P.Nacional	P.Nacional
Rivera	Colorado	P.Nacional	Colorado
Artigas	Colorado	Colorado	Colorado
Salto	Colorado	P.Nacional	Colorado
Paysandú	Colorado	P.Nacional	P.Nacional
Río Negro	Colorado	Colorado	Colorado
Soriano	Colorado	P.Nacional	P.Nacional
Colonia	P. Nacional	P.Nacional	P.Nacional
San José	P. Nacional	P.Nacional	P.Nacional
Flores	P. Nacional	P.Nacional	P.Nacional
Florida	Colorado	P.Nacional	Colorado
Durazno	P. Nacional	P.Nacional	P.Nacional
Lavalleja	Colorado	P.Nacional	P.Nacional
Tacuarembó	P. Nacional	P.Nacional	P.Nacional

Source: Albornoz (1989, 1992, forthcoming)
(*) *Intendentes* can only run once for re-election.

Finally, Montevideo deserves special mention. In this *departamento*, the left-wing coalition *Frente Amplio* won the elections of 1989 and 1994, representing its only appointments to public executive office in the country's history. Furthermore, while 1989 was a highly competitive election, 1994 was an easy win for the *Frente Amplio*. Well before the election approached, surveys showed a comfortable margin in favor of the incumbent.

Besides the considerations regarding turnover and crisscross of parties ruling SNG and the CG, *Intendencias* also present differences for each period related to the relative political power of the *Intendentes*. Their electoral backing and their number of seats in the *Junta* varied among *departamentos*, and from period to period. The table below summarizes the situation.

Table 2. Political Support of the Intendentes

Department	Election 1984		Election 1989		Election 1994	
	Own seats in *Junta* (%)	Own votes, as % of the party's	Own seats in *Junta* (%)	Own votes, as % of the party's	Own seats in *Junta* (%)	Own votes, as % of the party's
Montevideo	29.0	56.3	51.6	100	51.6	100
Canelones	22.6	43.8	19.4	37.5	35.5	68.8
Maldonado	29.0	56.3	22.6	43.8	48.4	93.8
Rocha	16.1	31.3	32.3	62.5	35.5	68.8
T.Tres	32.3	62.5	38.7	75.0	22.6	43.8
Cerro Largo	32.3	62.5	25.8	50.0	29.0	56.3
Rivera	32.3	62.5	35.5	68.8	32.3	62.5
Artigas	32.3	62.5	29.0	56.3	32.3	62.5
Salto	25.8	50.0	32.3	62.5	48.4	93.8
Paysandú	45.2	87.5	25.8	50.0	51.6	100
Río Negro	25.8	50.0	41.9	81.3	35.5	68.8
Soriano	38.7	75.0	32.3	62.5	22.6	43.8
Colonia	29.0	56.3	16.1	31.3	25.8	50.0
San José	25.8	50.0	41.9	81.3	32.3	62.5
Flores	29.0	56.3	35.5	68.8	19.4	37.5
Florida	25.8	50.0	25.8	50.0	32.3	62.5
Durazno	29.0	56.3	35.5	68.8	29.0	56.3
Lavalleja	41.9	81.3	16.1	31.3	51.6	100
Tacuarembó	29.0	56.3	48.4	93.8	19.4	37.5

Source: Albornoz (1989, 1992, forthcoming).

The political map that is briefly sketched above will be shown to play a role in the SNGs' fiscal performance. The political color of the *departamento*, its alignment with the party and fraction in office at the national level, the turnover within the *departamentos*, and the political power of the *Intendente* within his party and his *departamento*, are all variables that will be considered later in the analysis. The political map of the country will also be shown to have played a role in the decisions by the CG to bail SNGs out of financial difficulties.

2.3. Fiscal Policy Institutions

2.3.1 SNGs' Revenues

SNGs' revenues fall within two broad categories. On one hand, strictly local revenues, and on the other, national fiscal resources made up of transfers from the central government and revenues from national taxes (in some cases, collected at the SN level and/or legally destined to the SNGs).[6] Among strictly local revenues, the bulk of SNGs' resources come from property taxes (on urban and suburban real estate) and automobile excise taxes, as well as fees for local public services (such as sewage and others related to maintenance of urban infrastructure and provision of services).

National fiscal resources are diverse and have changed in level and composition during the last three terms. First, the *departamentos* are distributed a fixed portion of some national taxes, based on a population-cum-area-based formula (e.g., taxes on gasoline, alcoholic beverages and tobacco products). Second, with the exception of Montevideo, SNGs receive transfers from the central government that pay for their payroll contribution (i.e., employer's contribution) to the national social security system. In this case, the formula was defined so as to induce employment and salary restraint (see below).

Third, the SNGs also receive transfers from the CG and state-owned enterprises for joint implementation of certain projects. The main portion of these transfers is related to investment in public infrastructure by the *Ministerio de Transportes y Obras Publicas* (ministry in charge of the transportation infrastructure and other construction investment), the *Banco Hipotecario* (state-owned, mortgage lending bank) and other ministries (such as Education, Housing and Tourism).

Finally, other discretionary transfers take place. Quantitative data on these is much less detailed so, in the analysis below, they will be estimated by difference between total revenues and other identifiable resources.

[6] Such is the case of the *contribucion inmobiliaria rural* (tax on non-urban real state).

Table 3. Types of Transfers to Subnational Governments in Uruguay

	Share of National Tax	*Fixed Amount*	*Ad hoc*	*Reimburse-ment of Expenditures*
By origin of revenue	Rural Property tax	No	No	MTOP
Formula	IMESI (1986) *	BPS. 1990-2000 Budget prescrip.	BPS. 1985-1990 Budget prescrip.	MTOP
Reinbursement of cost	No	No	No	No
Discretionary	No	No	Bailout	Catastrophes MVOTMA

Source: Ruocco, Benaderet and Medina (1994), based on IADB's classification system.
* Tax on sales of fuel, tobacco and alcohol.

2.3.2 Budget Process Rules

The budget process at the SN level consists of five main phases. Like the national budget, SNGs' budget is proposed by the executive branch and approved by the legislative branch. The rules that govern this process are also similar, with the executive having the primary initiative. In fact, the legislative branch can modify the budget bill, but the executive may veto all or part of the changes. In case the legislative branch adds expenditure items or increases the allocation, it must provide for the necessary resources. In any case, the final decision rests with the special majority required to overrule an executive veto (that is, three-fifths of the *Junta Departamental*).

Table 4. SNGs' Budget Process

Proposal	Approval	Implementation	Internal controller	External controller
Executive Branch	*Junta* Departamental	Executive Branch	Contaduría Deparamental	Tribunal de Cuentas De la Nación

Source: Constitución Nacional, 1968 and 1996.

Once the five-year budget has been approved, the executive is responsible for implementing it. At the end of each fiscal year, the executive must submit to the *Junta Departamental* an interim financial statement and any proposed adjustments to the budget, which must be approved by a majority of the *Junta*. In other words, both for the national and subnational governments, budgets are approved for five years and can be adjusted yearly. Yet, in recent periods, the national executive has followed a policy of submitting only financial reports with no proposed adjustments, as a way of eliminating the opportunities for expenditure increases by the legislative branch. This policy has not been followed by the SNGs.

Internal audit and control is the responsibility of a specialized department within the SNG structure. The external auditor and controller is the *Tribunal de Cuentas de la Nación* which is under the aegis of the national executive branch.[7] It must be noted, however, that Congress (i.e., the *Asamblea General*) is the final arbiter of disputes over the proper management of budgetary resources at the SN level. Each time the *Tribunal de Cuentas* objects to stipulations in the SNGs' budgets or their interim reports, the joint assembly of both houses of Congress is the final arbiter. This mechanism is rarely used in practice, implying that either the SNG takes the initiative to accept the objections of the *Tribunal* (essentially, to avoid the image costs of being exposed to public scrutiny), or the objection is ignored without consequence. In other words, the mechanisms to allow external audit and control exist but there is weak enforcement, with potentially significant consequences in terms of fiscal discipline at the subnational level.[8]

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[7] Although the members of the *Tribunal de Cuentas de la Nación* are proposed by the national Executive, their appointment must be approved by a special majority of the Senate. In recent terms parties have agreed to designate representatives of all three major political parties.

[8] The Constitución de la República stipulates: "Las Juntas Departamentales sólo podrán modificar los proyectos de presupuestos para aumentar los recursos o disminuir los gastos, no pudiendo prestar aprobación a ningún proyecto que signifique déficit, ni crear empleos por su iniciativa. Previamente a la sanción del presupuesto, la Junta recabará informes del Tribunal de Cuentas, que se pronunciará dentro de los veinte días, pudiendo únicamente formular observaciones sobre error en el cálculo de los recursos, omisión de obligaciones presupuestales o violación de disposiciones constitucionales o leyes aplicables. Si la Junta aceptase las observaciones del Tribunal de Cuentas, o no mediarán éstas, sancionará definitivamente el presupuesto. En ningún caso la Junta podrá introducir otras modificaciones con posterioridad al informe del Tribunal. Si la Junta Departamental no aceptase las observaciones formuladas por el Tribunal de Cuentas, el presupuesto se remitirá, con lo actuado, a la Asamblea General, para que ésta, en reunión de ambas Cámaras, resuelva las discrepancias dentro del plazo de cuarenta días, y si no recayera decisión, el presupuesto se tendrá por sancionado" (Art. 225).

3. Deficit Financing and Bailouts

The Uruguayan Constitution determines that the SNGs (*Intendencias*) can only pass balanced budgets. However, *Intendencias* do incur deficits and these must be financed in one way or another. The bailout problem of SNGs originates in the financing of these fiscal deficits. Formally, the decentralization scheme in Uruguay has the mechanisms to avoid unsustainable debt accumulation but, as will be shown, these are not always binding.

The SNGs balance the excess of expenditures over revenues by incurring debt with several creditors. Formally, the *Intendencias* are allowed to borrow from International Financial Institutions for investment projects and only with the previous approval of the Planning and Budget Office (under the aegis of the Presidency). There are also provisions to allow them to borrow from locally established financial institutions. The *Banco de la República*, the largest state-owned commercial bank, is supposed to set borrowing limits for each *Municipio*, based on their financial performance, and those limits should apply to total debt with financial institutions.[9] However, there is some informal evidence of political management of credit to SNGs by state-controlled banks that were nationalized during recent financial crises.

Once they have exhausted other sources of financing, SNGs finance their deficits by incurring debt with government agencies (typically, the social security institute) and with the state-owned enterprises that control the supply of basic utilities (i.e., the electric power company, the potable water and public works company, and the telephone company). As a response to this situation, provisions have been established (since 1986) to allow the central government tideduct past-due bills with state-owned enterprises from the *municipios*'share of national taxes (i.e., their participation in the indirect tax IMESI).[10] This mechanism, however, has not prevented the growth of some SNGs' debt (see below). Moreover, when confronted with recurring imbalances, some *Intendencias* have even tapped on funds owed by their employees' to the *Banco de la*

[9] Currently the SNGs are allowed to accumulate debt with the Banco Republica for up to one sixth of its budget obligations.

[10] Appendix 1 presents a sample of a monthly statement, including distribution of tax shares and deduction of debts with public utilities. It can be seen there that many *departamentos* do not receive any of the produce from IMESI, due to deductions related to their debts with state-owned enterprises. In many cases, the participation in IMESI is not enough to cover the debt. Interview with Agustín Canessa, April 5, 1999. See also following sections.

República, which the *Intendencias* are supposed to deduct from the payroll and simply remit to the bank.[11]

Table 5. Types of Debt of Subnational Governments in Uruguay by Type of Regulatory Framework and Creditor

	Public Entities	*Private Entities*	*International Creditors*
Regulated	Banco de la República	Private Banks	International Financial Institutions
Ad hoc regulation	State-owned Enterprises; Social Security Institute	Private Enterprises	No

Sources: Ruocco, Benaderet and Medina (1994), and interviews by the research team.

Except for sparse press reports (see below), it was impossible to obtain detailed information on SNGs' debt with state-owned enterprises that would have made it possible to determine the significance of the problem and the amount of "transfers" being received by the *Intendencias*. Through interviews, it was possible to determine that transfers take the form of renegotiations with very favorable conditions (i.e., below-market interest rates, delinquency fees, and cancellation periods), or outright debt forgiveness. The availability of information is slightly better regarding debts with the public social security system, partly because these bailouts have been made official in the national budget (see below).

Besides transfers made in the cancellation of debts with government agencies, and unusually favorable treatment obtained from the state-controlled financial institutions, interviews with key informants suggest that there have been other forms of more or less hidden bailouts. In these cases, *Intendentes* obtain resources to cover unpaid wage bills and other operational expenditures. These amounts are not transparently identified in national accounts (they used to

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11 "[actualmente] ningún funcionario de la Intendencia puede sacar crédito en ningún banco. Los que tienen deudas con la Caja Nacional no pueden operar. Muchos funcionarios están en el Clearing de informes, porque si bien la Intedencia les descuenta un 30% de su sueldo para el pago de la salud mutual, la Intendencia no lo abona en la mutualista. Pero tampoco los aportes obreros que son descontados al trabajador son abonados en el BPS." Edil Edison Silva (Frente Amplio), Rivera.

be identified as "advances from the Treasury" that were to be later "regularized" in the yearly *Rendiciones de Cuentas*). Press analyses and interviews with key informants made it possible to identify two cases in 1994, benefitting the *Intendencias* of Canelones and Rivera.[12]

3.1 SNGs' Debts with the Social Security System

Like any employer, SNGs must pay a proportional payroll tax to the social security system. Until the reform of social security in 1996, the pensions system was a "pay-as-you-go" scheme managed by the government through the *Banco de Previsión Social*, in which employees had little incentive to monitor the fulfillment of their employer's obligations. The characteristics of the system made SNGs' obligations with the BPS easy targets for "credit-thirsty" *Intendencias*. Like other obligations with government agencies, contributions to social security may be politically contested and, therefore, they can become escape valves from the tight budget rules under which *Intendencias* are supposed to operate.

The financing of SNGs' deficits through accumulation of debt with the social security system is not a recent phenomenon. In the national budget approved immediately after the return to democratic rule (Bill 15.809, of 1985) Congress allowed the Executive to pay SNGs' debt with the BPS originated in the 1985 fiscal year.[13] This initial assistance did not solve the problem. Throughout the whole 1985-89 term, accumulating debts created tensions between the Board of the BPS and some *Intendentes*, and also between the latter and the national Executive. However, the enforcement mechanisms that would have applied to private employers carried little weight vis-à-vis SNGs. Thus, debts with the BPS became object of political dispute by *Intendentes* that felt their financial difficulties were partly caused by decisions made at a higher level of government (see above).

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[12] *Diario La República* (1/10/1994) and *La Mañana* (13/9/94). In this case the Intendente de Canelones publicly declared that he would not pay wages given financial impossibility. In this case, it is known that the central government stepped in and openly bailed out that SNG. However, both cases are particularly different according to the interviews conducted for this study. In the case of Canelones, "El salvataje fue devuelto, [porque] vino con la cláusula de que el 14 de febrero había que devolver 4 millones y medio de dólares. Casi tres millones fueron devueltos en dicha fecha y el saldo fue descontándose de otras partidas"(Jorge Saldombide). But in the case of Rivera, the only bailout for the three periods was during the Lacalle administration. "Eso fue una transferencia a título perdido. Una donación". (Isidro de los Santos, Finance Department of Rivera).

[13] The Executive was allowed to use up to N$ 42 million (close to US$ 340 thousand) to pay outstanding debts, a small amount but a symptom of emerging problems.

In 1990, the newly elected government was faced with significant delinquent debts and with a new political map in which a vast majority of SNGs (16 in 19) had gone over to candidates of the President's own political party. Table 6 below describes the debt situation. It presents the figures used by the government to determine explicit transfers that were going to be institutionalized in the national budget for the 1990-1994 term (Bill 16.170, December 28, 1990).

Table 6. Outstanding Debt with the Social Security System (BPS) in December 1989 and Estimated Payroll Tax for 1990, by Departamento *(*thousands of US$)

	Debt as of Dec. 31,1989	Estim. dues for 1990	1989 debt/ 1990 dues (%)	1989debt/ avg. expend. 85-89 (%)
Artigas	598	598	100.0	23.56
Canelones	0	1,771	0.0	0
Cerro Largo (a)	728	556	130.9	31.48
Colonia	665	830	80.1	34.5
Durazno	505	589	85.7	29.49
Flores	212	229	92.6	19.63
Florida	522	550	94.9	28.75
Lavalleja	40	528	7.6	2.37
Maldonado	0	2,592	0.0	0
Paysandu	228	678	33.6	9.43
Rio Negro	469	484	96.9	21.79
Rivera	736	605	121.7	25.68
Rocha	670	795	84.3	34.74
Salto	68	919	7.4	2.44
San Jose	342	403	84.9	26.65
Soriano	704	803	87.7	28.73
Tacuarembo	727	946	76.8	23.13
Treinta y Tres	390	495	78.8	28.54
TOTAL	7,604	14,371	52.9	

Source: Ruocco, Benaderet and Medina (1994).
(a) Accumulated debt as of March 31, 1990.

The table shows that, by 1990, arrears with the social security system were a significant problem but one that affected SNGs in very different ways.[14] While outstanding debt was close to 50 percent of one-year's dues for the whole group of *Intendencias*, some *Departamentos* had literally no debt or were owing less than 10 percent of a year's dues (notably, Canelones, Lavalleja, Maldonado, and Salto). Still, others had unpaid obligations equivalent to more than a full year of contributions (Cerro Largo and Rivera). For the vast majority, the debt with the BPS was close to a whole year's dues. Analyzed below are the possible determinants of debt accumulation. Relative to average expenditure, unpaid obligations ranged from zero to 35 percent, with a median value of around 25 percent.

The Central Government (Executive and Congress) then implemented several measures that would structure later bailouts. First, Congress ruled that BPS should re-schedule outstanding debts to December 31, 1990, in 100 equal monthly payments, free of delinquency fees and interest.[15] Second, a new expenditure item was added to the national budget to assist the SNGs in paying their future social security obligations until the end of the term. The transfer was going to be paid directly by the Treasury to the BPS and would be effective beginning in 1991. The total amount of the transfer (i.e., the amount to be distributed among the eighteen *Intendencias*) was estimated on the basis of the recorded dues for 1990 (i.e., close to US$ 15 million for the initial year 1991). Third, the legal obligations of SNGs were modified (reduced), which would determine that the *explicit* transfers from the CG to SNGs would decline over the term.[16] Though not stated in the Budget Bill, it was implicitly assumed that any additional obligations with the BPS, generated by the SNGs through their employment policies, would be their exclusive responsibility. Several regulations and the text of the Budget Bill stated that SNGs should collaborate with the central government's efforts to reduce public employment, which were considered a key element of the stabilization package designed by the new administration.

[14] Montevideo was excluded from the transfer system so no data is available on its situation regarding social security obligations.

[15] It was not possible to obtain information on the age of the stock of debt, which would have permitted estimating the amount of transfers received by SNGs in the form of forgone interest and delinquency fees.

[16] This measure was probably intended to facilitate passing of the Bill by a "difficult" Congress. From the perspective of the actual incidence of the bailout package, and provided the central government pays the whole amount of the SNGs' payroll obligations, it does not really matter what is the tax rate because the deficit of the BPS is also financed by the Treasury. However, a declining amount of transfers would make the bailout more palatable to legislators of the opposition parties who would be demanding resources for other constituencies and would see the bailout package as a partisan measure to favor *Intendentes* aligned with the Executive.

Interestingly enough, the "BPS transfer" was not distributed among the *Intendencias* on the basis of the value of their social security obligations (which would be influenced by SNGs' employment *and* salary levels). Instead, the Budget Bill stipulated that the transfer would be distributed according to each *Departamento*'s share in total SNG employment as of August 1990 (with figures to be supplied by the *Intendencias*). The table below shows the distribution coefficients established in July of 1991 and the share of each *Intendencia* in the 1990 SNGs' social security bill. The third column, which shows the difference between the two, is one indicator of who won and who lost by the choice of distribution criterion. These are not the only "benefits" distributed by the bailout package: the rescue measures also convalidated any employment expansions enacted prior to the reference date of August 1990, independently of their relationship to the efficient provision of local public goods.

Table 7. Distribution of "BPS Transfers" and Intendencias' Initial Share in Total Obligations to BPS

	Coeff. for distr. of transfer (%)	Share of total estim. dues 1990 (%)	Coeff. - Share in Dues	Share of total BPS transfers 1991-94 (%)	Deviations from formula (Share in tot.-Coeff.)
	(a)	(b)	(c) = (a) - (b)	(d)	(e) = (d) – (a)
Artigas	6.12	4.16	1.96	5.41	-0.71
Canelones	13.98	12.32	1.66	14.22	0.24
Cerro Largo	5.68	3.87	1.81	6.05	0.37
Colonia	5.67	5.78	-0.11	5.16	-0.51
Durazno	4.39	4.10	0.29	4.11	-0.28
Flores	1.91	1.59	0.32	2.30	0.39
Florida	4.81	3.83	0.98	4.46	-0.35
Lavalleja	4.49	3.67	0.82	3.58	-0.91
Maldonado	8.48	18.04	-9.56	9.17	0.69
Paysandu	4.67	4.72	-0.05	4.85	0.18
Rio Negro	3.95	3.37	0.58	4.79	0.84
Rivera	4.66	4.21	0.45	5.10	0.44
Rocha	5.37	5.53	-0.16	5.24	-0.13
Salto	5.60	6.39	-0.79	5.75	0.15
San Jose	3.12	2.80	0.32	3.01	-0.11
Soriano	6.20	5.59	0.61	6.82	0.62
Tacuarembo	7.11	6.58	0.53	6.58	-0.53
Treinta y Tres	3.79	3.44	0.35	3.38	-0.41
TOTAL	100.00	100.00		100.00	

Source: Ruocco, Benaderet and Medina (1994), POM and own estimates.

Considering the difference between 1990 obligations and the transfer coefficients, the biggest loser from the choice of distribution criteria was the *Intendencia* of Maldonado, one of the wealthiest *Departamentos* and one of the few *Intendencias* that did not have outstanding debts with the BPS as of 1989 (while the "loss" is much smaller, Salto is another good payer and relatively rich *Departamento* that lost). Note, however, that the loss reflects, among other things, that the average salary in Maldonado is much higher than in other *departamentos*. In this sense, the formula used to distribute the transfers may have been intended to provide an incentive to keep salary growth at bay (the fact that the formula for the whole period was based on initial year's employment figures would also create the incentive to keep employment growth under control). Among the biggest winners from the choice of distribution formula are some big debtors (Cerro Largo) and some politically sensitive *Departamentos* (Artigas, one of the two *Intendencias* retained by the coalition partner, the Colorado party, and Canelones, traditionally a Colorado stronghold and key to the Blanco national electoral victory).

From the perspective of the moral hazard problem, the formula chosen to distribute the transfer implied a reward for some SNGs that may have not made any effort to keep employment growth under control.[17] Though it was not possible to obtain detailed evidence on the management of this transfer, the transfer is recorded in the revenue side of SNGs' accounts and the figures suggest that the distribution formula was more indicative than binding. In fact, accumulated transfers in the 1991-94 period deviate slightly from the original formula as shown in the fourth column of the table.[18]

Also "indicative" were the calls for employment restraint. In fact, as shown in the Table below, many big debtors of 1989 did not internalize the "austerity" message of the Budget Bill and fiscal adjustment package and expanded public employment very significantly in the term. Interestingly, many of them expanded employment *after* the bailout was passed, offsetting some of the achievements of the first years of the administration. There is not, however, evidence of the size of the debt being (lineally) correlated with the growth in employment after the bailout: the Pearson correlation coefficient between values in the first and third columns of the table is only 0.097, statistically insignificant at all customary levels.

[17] An interview with a financial advisor of a "responsible" *Intendencia* revealed that good behavior, and the fact that it is not recognized in bailout episodes, is latter used as "credit" in the process of political bargaining for access to other resources managed by the central government.

[18] Table A.1, in the Appendix, presents the correlations between the deviations from the distribution formula and different variables. The results suggest that deviations from the formula were not motivated by economic or fiscal difficulties of the *departamentos*. They may have been politically motivated, as *Intendentes* of the President's *party fraction* seem to have benefited from deviations more than others (although belonging to the same *party* does not seem to have had a significant effect), and were associated with greater expenditure restraint in the election year of 1994. The deviations do not seem to have fostered employment growth either during the term or in the election year (at least, not in a direct, linear way).

Table 8. Size of Debt in 1989 and Change in Employment in Following Term and after Bailout

Departamentos	1989 debt/ 1990 dues (%)	Change in SNG employment	
		1989-94 (%)	1991-94 (%)
Artigas	100.0	-2.00	1.25
Canelones	0.0	-21.51	16.52
Cerro Largo	130.9	-34.64	-29.70
Colonia	80.1	-7.55	3.05
Durazno	85.7	24.94	26.89
Flores	92.6	5.13	8.11
Florida	94.9	19.90	14.29
Lavalleja	7.6	-22.10	-11.59
Maldonado	0.0	17.51	6.09
Paysandu	33.6	9.40	4.82
Rio Negro	96.9	-30.94	-12.43
Rivera	121.7	45.53	68.55
Rocha	84.3	14.75	17.70
Salto	7.4	4.16	9.71
San Jose	84.9	-3.24	16.57
Soriano	87.7	-13.53	-8.42
Tacuarembo	76.8	-10.04	6.48
Treinta y Tres	78.8	21.71	31.79

Source: Ruocco, Benaderet and Medina (1994), POM and own estimates.

The 1990 Budget Bill was not the last episode in history of the "BPS transfer." The financial situation of the *Intendencias* was not much better in 1995, when the new *Colorado* administration was inaugurated with even weaker support in Congress and a larger number of opposition (i.e., *Blanco*) *Intendentes*. Thus, the votes needed to pass the Budget Bill were—according to some accounts—partly obtained in exchange for a renewal of the "BPS transfer."[19] According to the same accounts, the financial assistance to the *Intendencias* was key in the negotiations leading to formation of the government coalition between the Colorado and Blanco parties.

It seems that this time the Executive, with Congressional backing, intended to implement more permanent corrective measures. First, it increased the amount of the transfer to ease the financial pressure on SNGs. The total amount of the (explicit) "social security transfers" received by SNGs grew by a factor of 1.9 between 1994 and 1995 (in inflation-corrected terms). This

[19] Interviews with members of Congress cited in Altman (2000).

increase was a consequence of the new formula used to determine the amount: the Budget Bill ruled that the transfers would be based on the average monthly obligations with the BPS generated in the first quarter of 1995. In practice, this meant convalidating any previous expansions in salaries and/or employment, including those that the previous bailout package intended to prevent. As the table above shows, there was clear evidence at the time that several *Intendencias* had not complied with the calls for employment and expenditure restraint.

Simultaneously, the Budget Bill established an yearly adjustment formula for the amount of the transfer that was intended to induce *Intendencias* to keep their wage bill in line with the policies of the central government: it was established that the transfer would be subsequently adjusted at the same time, and by the same rate, of salaries paid by the central government to its employees.[20] The 1995 Budget Bill also determined that other debts of SNGs with the BPS should be re-scheduled and bilaterally negotiated between debtor and creditor before specified deadlines. Finally, it determined that the social security transfers were to be paid directly by the Ministry of Finance to the BPS, to avoid any possible “misuse” of the funds.

Unfortunately, quantitative data on debts with the BPS as of 1995 is not available. This limitation makes it impossible to discuss—even casually, as above—the distribution of benefits from the bailout package. Analyzed briefly below are the factors may be behind debt accumulation and what may explain the decisions, by two different administrations, to bail out SNGs in 1990 and 1995.

3.1.1 What Determined Debt Accumulation?

Data on debt with the BPS in 1990 is used to explore the determinants of “misbehavior” on the part of SNGs. Fiscal misbehavior (i.e., failing to fulfill legal obligations with the state-run social security system) is a necessary condition for a bailout, though it is obviously not sufficient. In other words, accumulated debt can be used to explore the *ex ante* determinants of bailouts. The indicator of SNGs’ fiscal behavior used here is accumulated debt in 1989 relative to average yearly expenditures in the term (1985-89). It reflects how much of a year’s expenditures an SNG was financing, by the end of the term, through unpaid bills of another government agency. To allow for possible non-linear effects of explanatory factors on financial performance, a dummy

[20] The CG has since then been following a policy of nominal wage adjustments that seeks to avoid significant real wage falls and is consistent with the gradual abatement of inflation indices.

coded 1 (one) for debt-to-expenditure ratios greater than 10 percent and zero in other cases is used as dependent variable.[21]

Given the small size of the cross-section sample, only three regressors at a time are considered. They account, respectively, for three possible determinants of fiscal (in)discipline. The first is an indicator of vertical balance: SNGs' own revenues (excluded transfers) relative to total expenditures.[22] Second, per capita GDP is considered to test whether, *ceteris paribus*, poorer *departamentos* have a greater probability of becoming big debtors. Finally, it is important to consider whether debt accumulation is explained by politics. Thus, employment growth in the term is directly considered as an indicator of clientelistic practices. Substituting this direct indicator with other political variables that could be related to fiscal indiscipline is also tried. Specifically, successively tried are the share of "own votes" of the *Intendente* in total party vote is tested (weaker *Intendentes* would find it harder to avoid "pork barrel" politics), a dummy indicating whether the *Intendente runs* for re-election (re-election ambitions are expected to prompt fiscal restraint, but they could also lead to clientelism), a dummy marking the *departamentos* where the *Intendente* was of the President's party (to test the "party discipline" hypothesis) and another dummy marking where the *Intendente* was of the President's own party fraction (to reflect the characteristics of the fractionalized Uruguayan party system).

Table 9 summarizes the results. The strongest and clearest conclusion is that the main determinant of the probability of being a "big debtor" is vertical fiscal imbalance. The indicator of vertical balance enters all the equations with the right sign and its coefficient is statistically significant in most cases. When controlling for vertical imbalance, economic conditions seem to have an opposite-to-expected effect: relatively richer *departamentos* appear more likely to be heavy debtors than poor ones. Finally, politics does not seem to be a significant factor in explaining the probability of becoming a big debtor, when controlling for vertical imbalance and economic conditions: none of the political variables enters significantly in the logistic regressions, nor do they add significantly to the explanatory power of the simpler model without political indicators (equation 6).[23]

[21] The test for robustness is perform with the same analysis using an alternative definition of the dependent variable, using 25 percent as the cut level.
[22] Due to lack of data, the vertical (im)balance indicator is based on 1989 figures rather than on averages for the term, which would be better indicators of longer-lasting conditions.
[23] Defining the dependent variable cutting at 25 percent of average yearly expenditure, the results are essentially the same, both in terms of signs and significance of the estimated coefficients.

Table 9. Results of Logistic Regression (Dependent Variable: Debt with BPS in 1989 Greater than 10 percent of Average Yearly Expenditure)

Equation (Regressors Estimated coefficient and signif. Value)	(1)	(2)	(3)	(4)	(5)	(6)
Vert.Balance (a)	-20.6897 (.1029)	-23.7980 (.1137)	-18.3606 (.0706)	-14.8260 (.1778)	-17.9692 (.1196)	-19.5908 (.0766)
p.c.GDP	5.3587 (.2943)	5.6057 (.2841)	4.0949 (.4204)	3.2773 (.5475)	4.973 (.3545)	5.9047 (.2210)
Growth of empl. in term	-.0250 (.5146)					
Intendente's "political capital" (b)		.0565 (.3410)				
Intendente runs for reelection			-7.7199 (.9010)			
Int same fract. of President				-10.2683 (.9028)		
Int. same party of Pres.					-10.1711 (.9134)	
Constant	4.6945 (.3780)	1.7828 (.6743)	11.8193 (.8497)	12.9969 (.8774)	12.3836 (.8948)	2.5771 (.5275)
Model						
Log likelihood	11.103	10.592	10.921	8.069	8.500	11.566
Goodness of fit	14.024	10.434	14.947	7.286	8.262	15.519
Overall predicted	88.89%	88.89%	94.44%	88.89%	88.89%	88.89%
Chi-sq, df, signif.	10.168 3 .0172	10.678 3 .0136	10.350 3 .0158	13.201 3 .0042	12.771 3 .0052	9.705 2 0.0078
Cox & Snell R^2	.432	.447	.437	.520	.508	.417
Nagelkerke R^2	.623	.645	.631	.750	.733	.601
N	18	18	18	18	18	18

(a) *Departamento*'s own revenues as % of total expenditure (data for year 1989).
(b) Votes for the *Intendente* as % of the party's total vote in the *departamento*.

3.1.2 Why were SNGs Bailed Out?

The fact that the two "social security bailouts" were blanket measures benefiting heavily indebted and non-indebted SNGs, and the fact that there are only two episodes to analyze, make it impossible to attempt a statistical analysis of their determinants. However, some of the hypotheses discussed in the literature can be considered in light of these episodes. Briefly discussed are the following: (a) *size matters*—a bailout is more likely the larger the possible externalities from SNGs' default; and (b) *politics matter*—bailouts are more likely if and when they can be exchanged for political support or they pay off in the political market. Since political incentives to grant financial assistance to troubled SNGs change with political conditions and the political cycle, there are several variations on the *politics matter* hypothesis, and discussed here is the question of which would best fit the "BPS bailouts."

Size of possible externalities does not seem to have been a key factor in the central government's decision to assume some of the SNGs' obligations with the BPS. While the total population with residence outside Montevideo was close to 1.7 million in 1989, the top five debtors (in absolute value) account for 47 percent of the accumulated debt with the BPS and only 21 percent of the population (i.e., 360 thousand inhabitants outside the capital district). At the other extreme, 41 percent of the population lived in the five least indebted *departamentos* (which account for less than 5 percent of total debt in 1989). These figures may not fully reflect the significance of the economic disruptions caused by the possible default of highly indebted *Intendencias*, but they suggest that other "costs" probably entered the calculus of the Executive and Congressional coalitions designing the bailout packages.

Our conjecture is that *perceived political costs and benefits* played a key role in the decision to rescue the *Intendencias,* in the details of the bailout packages and, to some extent, in their timing. A priori, it could be speculated that the central government would be more willing to extend a bailout to troubled SNGs if (i) it can blame other political parties' administrations (national or SN) for causing the crisis, and (ii) it can obtain an electoral benefit from doing so, or (iii) it can obtain something from opposition parties in exchange for bailing out some of "their" SNGs. These conditions would make it possible to predict, for example, that a bailout to an SNG held by the same party that controls the national executive would be more likely to occur at the beginning of the term if the central government can blame another political party (ruling the SNGs or the CG) for causing the crisis. These same-party bailouts would be more likely to occur close to an upcoming election, if no such evasion of responsibility is possible. At the same time, SNGs held by opposition parties would be more likely to be bailed out early in the term, when the national government is engaged in coalition building, but will find it difficult to be financially rescued when an upcoming election is close.

The “BPS” episode corroborates some of these hypotheses. Though constitutional provisions that define the budget cycle have obviously conditioned the timing of the two bailout packages, it is very significant that two governments with different agendas and political styles chose to operationalize the bailout in a similar way and using the national budget as its mechanism. Conceivably, the governments could have found other means of providing financial relief to the SNGs, but they both chose to include it in the negotiation of the budget bills which take place in the first year of the term. This was probably helped by the turnover at the national and SN levels. As indicated above, bailouts would have been expected to be more likely at the beginning of a term if another political actor could be blamed for its causes.

Despite the similar timing, it seems that related but different logics can be associated with each episode. In 1990, the central government and the majority in Congress were controlled by the Blanco party, which has been traditionally strong in the *interior* (i.e., outside the capital) and a strong defender of decentralization. This party also gained control of the overwhelming majority of SNGs, winning many of them from Colorado *Intendentes*. Then, in addition to having the possibility of escaping responsibility for the SNGs’ financial situation, it was in the Blanco party’s best interest to provide their own *Intendentes* with the means to avoid the harsh adjustment measures that would have been required. In this instance, the decision to grant a blanket measure was basically a way of reducing the political costs of excluding only two *departamentos* governed by *Colorado intendentes*. Nevertheless, the fact that no such logic was extended to Montevideo proves the significance of yet another factor, namely, the need to build legislative support, that was key in the 1995 episode.

The logic explaining the 1995 bailout would involve the need to create a legislative coalition with a party that still controls many SNGs. In fact, the *Colorado* party won the 1994 national election with the vote of only one third of the electorate. The *Blanco* party received only 1 percent less of the national vote and its support was badly needed if the Executive wanted to avoid being a lame duck from inauguration day onward. Therefore, while the BPS bailout of 1995 did benefit many *Colorado intendentes* who also wanted to avoid adjustment measures, it was very clearly made possible by the minority position in Congress of an otherwise fiscally austere Executive.

In brief, two governments with different ideologies and political agendas chose to implement bailout packages early in the term, and as blanket measures that would supposedly help all the SNGs (though the Left-controlled Montevideo was excluded in both cases), blurring their distributional implications and reducing the political costs. The bailouts were implemented upon despite the fact that the most heavily indebted *Departamentos* were "small" (in population and, presumably, economic size). The avoidance of harsh adjustment packages by party allies that are key pieces in the electoral machinery, and the need to build a legislative coalition with an opposition party that controls several SNGs, were critical factors that probably raised the perceived political costs of denying the bailouts beyond those associated with the economic disruptions of some SNGs' potential default.

3.2 SNGs' Debts with State-Owned Enterprises

It is the main thesis of this study that politically contestable obligations create "leakages" in apparently indiscipline-proof decentralization schemes such as Uruguay's. These politically contestable obligations are thus the sources of a potential bailout problem. Obligations with other government agencies are easy targets for "credit-thirsty" SNGs. Their politically contestability is a critical link in the design of a decentralization scheme in which there is actual or perceived vertical imbalance and central governments have discretion to assist troubled entities.

The apparent tightening of the "social security transfer" scheme in 1995 reduced the degrees of freedom available to the *Intendencias*. However, they seemed to have adapted to the changes in the rules of the game and found other means of financing their fiscal imbalances. The table below shows the debts with three state-owned enterprises as of September 1998, and the ratio of total debt to 1997 total expenditure. The first column results from adding debts with the electric power company (UTE), the telephone company (ANTEL) and the water works company (OSE), which sell goods and services to the *Intendencias*.

Table 10. Debts with State-Owned Enterprises(thousand of US$)

	Debt with State-owned Enterprises 1998	Expenditure in 1997	Debt 1998 to 1997 Expenditure (%)
	(a)	(b)	(c)=(a)/(b)
Artigas	607	17,490	3.5
Canelones	10,159	74,585	13.6
Cerro Largo	10,439	17,263	60.5
Colonia	570	26,941	2.1
Durazno	1,362	17,243	7.9
Flores	1,151	9,459	12.2
Florida	2,114	18,570	11.4
Lavalleja	824	15,712	5.2
Maldonado	62	85,306	0.1
Montevideo	12,152	304,300	4.0
Paysandu	116	25,584	0.5
Rio Negro	1,258	15,283	8.2
Rivera	1,677	16,895	9.9
Rocha	13,632	28,066	48.6
Salto	408	30,850	1.3
San Jose	28	16,830	0.2
Soriano	168	18,825	0.9
Tacuarembo	4,575	24,595	18.6
Treinta y Tres	2,344	13,961	16.8
TOTAL	65,644	777,758	8.4

Source: Own estimates, based on information from *Semanario Búsqueda* (September 24, 1998).

The “state-owned enterprises episode” has not ended yet. *Intendentes* of the most troubled *departamentos* have been pushing for some form of relief, but the boards of the state-owned enterprises resist assuming the significant losses that would be involved. It cannot be concluded that SNGs have been or will be bailed out, though there is ample casual evidence (confirmed by interviews with SNG officials and other government officials) that significant transfers already take place in the form of forgone delinquency fees and interests.

From the perspective of this study, it is interesting to note that the accumulation of debt with state-owned enterprises in 1998 follows a very similar geographical pattern to the recorded debts with the BPS in 1989. The Pearson rank-correlation coefficient between the *departamentos*’ rankings by per capita debt with BPS in 1989 and per capita debt with state-owned enterprises in 1998 is 0.581 (significant at a 99.9 significance level). The result reflects that *departamentos* that were leading per-capita debtors with BPS tend also to be high in the list of per-capita debt with the enterprises. The strong correlation reveals that whatever disciplining effect the 1995 BPS bailout had, highly indebted *departamentos* of 1989 also exhibit large debts with other government agencies six years later.

A logistic analysis of the probability of being a highly indebted *departamento* also confirms the results obtained from debts with BPS: the single most important determinant of the probability of being a big debtor is vertical fiscal imbalance.[24] The vertical balance indicator enters all the equations with the right sign (i.e., the higher the indicator of vertical balance the smaller the probability of being big debtor) and is statistically significant in most cases. Per capita GDP does not seem to be a key factor, and neither do the different political variables. If these variables do play a role, their effect seems to take place through the vertical balance factor. The similarity of results with the ones presented in the previous section reinforces the suspicion that debts with state-owned enterprises have replaced debt with BPS as the source of financing for *departamentos* that spend in excess of their revenues.[25]

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[24] In this case, big debtors are those whose stock of debts with state-owned enterprises in 1998 was greater than 5 percent of their average yearly expenditure in 1995-97. The results are essentially the same if the definition is modified to consider those whose debts are greater than 10 percent of the average yearly expenditure.

[25] It was not possible (because of constraints on acess to data) to test the hypothesis that indebtedness with state-owned enterprises has actually *followed* the resolution of the BPS problem. It could be that the two forms of debt with government agencies have all along been two faces of the same problem. If that were the case, it must be the case that the CG has chosen to treat each of these two forms differently. Debts with enterprises must have been cancelled through reserved, bilateral dealings between the latter and the SNGs, since there is no record (at least in the SNGs' fiscal accounts) of transfers being received/made.

Table 11. Results of Logistic Regression (Dependent variable: Debt with State-Owned enterprises in 1998 greater than 5% of average yearly expenditure)

Equation (Regressors estimated coefficient and signif. Value)	(1)	(2)	(3)	(4)	(5)
Vert.Balance (a)	-15.8633 (.0543)	-11.0953 (.1086)	-12.6016 (.0724)	-12.6345 (.0713)	-12.5191 (.0687)
p.c.GDP	.9545 (.8051)	-1.4024 (.6589)	-1.0356 (.7690)	-1.1834 (.7449)	-1.3584 (.6808)
Growth of empl. in 5 yrs.	.0574 (.1979)				
Intendente's political cap. (b)		-.0245 (.4330)			
Int. same party of President			.3926 (.7604)		
Int. same fract. of President				.1632 (.9068)	
Constant	8.1184 (.2143)	9.9158 (.0990)	8.7240 (.1730)	9.0078 (.1574)	9.2036 (.1316)
Model					
Log likelihood	16.048	17.236	17.800	17.881	17.895
Goodness of fit	19.230	18.090	20.254	19.432	18.787
Overall predicted	77.78%	72.22%	77.78%	77.78%	72.22%
Chi-sq, df, signif.	8.009 3 .0458	6.821 3 .0778	6.257 3 .0998	6.176 3 .1034	6.162 3 .0459
Cox & Snell R^2	.359	.315	.294	.290	.290
Nagelkerke R^2	.487	.428	.398	.394	.393
N	19	19	19	19	19

(a) *Departamento*'s own revenues as % of total expenditure (averages 1995-97)
(b) Votes for the *Intendente* as % of his party's total vote in the *departamento.*

3.3 Discretionary Transfers as a Bailout Modality

As seen above, the CG assumed the obligations of the SNGs with the national social security system. The form in which the bailout was implemented was through the creation of a transfer from the Treasury to the *Banco de Previsión Social* (BPS) to pay for what would otherwise be the SNGs' responsibility. The "BPS transfer" created in 1990 was another item in a longer list of *transfers from the central government to SNGs*. Intergovernmental transfers play a crucial role in the *departamentos*' financial equation. Indeed, in 1997, various transfers from the Central Government accounted for 30 percent of gross spending of the *departamentos* (excluding Montevideo).

Accordingly, to the extent that these transfers "follow" SNGs' deficits, the transfer system may be considered to operate as another modality of bailout. Note this does not imply any attribution of administrators' but just analyzing the working of a given set of fiscal institutions. This section tests the hypothesis that "transfers" (i.e., resources other than *departamentos*' strictly own, distributed to them by the CG) accommodate the behavior of SNGs' deficits. Even if the evidence does support this thesis, it may be (as pointed out by Kraemer, 1997) that transfers are a response to vertical imbalances that need not reflect irresponsible fiscal policies by SNGs or the CG. Thus, an assessment of the efficiency of the whole fiscal decentralization scheme should consider other aspects as the alternatives available to finance the provision of local public goods demanded by citizens. Nevertheless, the incentives to keep deficits under control may be weaker if the transfer system actually accomodates previous deficits.

The empirical analysis conducted in this section is based on a panel consisting of data for the 19 Uruguayan *Departamentos* in the period 1989-1997. All the fiscal and economic variables used in the following analysis are expressed in constant pesos of 1989 and in per capita terms. To determine the extent to which transfers accommodate to deficits, the following equation is estimated:

$$NT_{it} = \beta_1 DEF_{i,t-1} + \beta_2 GDP_{i,t} + FixEf_i + PerEf_t + \varepsilon_{it}$$

where:

NT_{it} = Non-formula-based national transfers received by *departamento i* in time *t;*

DEF_{it-1} = *Departamento i*'s deficit (including total national transfers in the revenue side) in time *t-1;*

GDP_{it} = *Departamento i*'s GDP in time *t;*

$FixEf_i$ = Estimated fixed effect for *departamento i*;

$PerEf_t$ = Estimated fixed effect for year *t*.

This equation has as dependent variable the amount of non-formula-based transfers received by each *departamento* (at each point in time). Contemporaneous GDP is included among the explanatory variables to determine if national transfers were affected by cyclical economic conditions.[26] The lagged deficit is included on the right hand side to test if transfers accommodate past fiscal performance.

The estimation method used here allows for the possible existence of fixed effects by *departamentos*. Fixed-effects model procedures are designed to take advantage of the panel nature of the data. They are useful in identifying the idiosyncratic differences among *departamentos* that cannot be captured adequately by the inter-departmental variability of past fiscal deficits and GDP. The primary objective of fixed effect estimation is thus to control for characteristics that are specific to the *departamentos* but invariant over time, over and above elements that are captured through other independent variables. The analysis was further enriched by testing the significance of a second set of fixed effects, controlling for year-specific characteristics by jointly estimating *departamento*-specific and time effects (through dummy variables for each year in the period).

Ordinary least squares based on model (1) are run and the data is allowed to decide among the different models nested in the equation (i.e., the Two Factor Fixed Effects Model is estimated). The Breusch and Pagan's Lagrange Multiplier statistic is then used to decide between the one-factor model and the classical regression with no group specific effects, and the F-ratios

[26] It must be noted that interregional mobility of the population (particularly in the *departamentos* that are closer to Montevideo) blurs the economic significance of per capita GDP. Nonetheless, GDP is preferable to alternative indicators of economic conditions in the *departamentos* since subnational figures for other economic variables (e.g., unemployment rates) are affected by relatively larger sampling errors.

to decide between the model with only *departamento* effects vs. the model with both *departamento* and time effects.

Results of the pooled regression estimation of equation (1) are presented in Table 12. The heteroskedasticity-corrected estimates suggest a very good fit for the model; adjusted R^2 is 0.93. National transfers received by the *departamentos* (in per capita and constant prices terms) are positively and significantly associated with past fiscal deficits. In other words, in the analyzed period transfers have grown with past deficits. On the other hand, a statistically significant response of national transfers to economic conditions is not detected. Put another way, the transfer system does not "discriminate" among *departamentos* depending on specific economic conditions.

Table 12. Economic Determinants of Transfers
Pooled Least Square Dummy Variable Results for Equation (1)
Fixed Effect model: Group Dummy Variables and Period Effects

Regressors	**Explained Variable (in per capita terms)**
	Non-Formula Based National Transfers
Departmental deficit per capita lagged one period	0.00221* (0.09)
Contemporaneous GDP per capita	0.0066 (0.33)
Departamento-specific effects (one factor model) 1/	91.42*** (0.00)
Departamento-specific effects and time specific effects (two factor model) 2/	1.468 (0.59)
Adjusted R^2	0.92
Residual first order autocorrelation	-0.08

Number of observations: 152
p–values (in parenthesis) are computed using White corrected standard errors.
(***) significant at 1% level; (**) significant at 5% level; (*) significant at 10% level.
1/ F-statistic under the null of overall constant (p-values in parenthesis).
2/ F-statistic under the null of no statistical difference between the "one factor" and "two factor" model (p-values in parenthesis).

The values obtained for the LM statistic suggest that the adequate model is the "one way fixed effect model"; that is, that transfer decisions to each *departamento* have been influenced by other *departamento*-specific determinants (most likely, political and institutional factors).

To conclude, regardless of the intentions of legislators and the national executive, the transfer system does behave as another form of bailout, helping to finance the deficits of SNGs. A thorough efficiency assessment of this feature of the Uruguayan decentralization scheme goes beyond the scope of this study. Nevertheless, it can reasonably be expected that budget constraints would be perceived as "softer" if SNG officials recognize that—whatever the reason and mechanisms—the CG eventually "assists" those who are unable or unwilling to reduce the deficits.

4. The Determinants of SNGs' Deficits

4.1 SNGs Outside the Capital District

It has been shown above how credit-constrained SNGs have financed their deficits by accumulating debt with government agencies. Also, discretionary transfers from the CG were shown to follow past SNGs' deficits, then acting as an implicit bailout mechanism. While it goes beyond the main objective of this essay, the next logical question to ask is what is behind the SNGs' deficits, which are the ultimate cause of the bailout problem. To analyze the determinants of deficits, a pooled-time-series database is built that includes indicators of fiscal performance, economic conditions and political variables. This approach makes it possible to analyze simultaneously the effects of economic and political determinants of deficits. The cases in the database are defined by term and *departamento*; i.e., the analyzed sample consists of 36 cases resulting from considering all *departamentos* except Montevideo, and the two complete election cycles since 1985 (for each *departamento*). The decision to exclude Montevideo from the analysis is based on data availability issues and the peculiarities of this jurisdiction (i.e., geographic size, population, status in terms of transfers received from the CG).[27]

[27] An alternative approach would have consisted of generating a panel based on yearly data for the eighteen *departamentos*, like the one used in the previous section. However, this did not seem the best option for several reasons. First, yearly data on vertical fiscal imbalance is not available for more than one complete electoral cycle. Second, it is not clear that yearly changes in this variable should have an impact on (yearly) fiscal performance; it seems more reasonable to assume that more permanent imbalances are behind the accumulation of deficits over the medium term. Finally, some of the political factors of interest do not vary on an yearly basis (such as the *Intendente*'s political career or the identity of the parties in office at the SN and national levels).

The dependent variable in the analysis is an indicator of fiscal performance over the whole political term: the sum of yearly deficits (in per capita and constant pesos terms) over the five calendar years that correspond to the political term.[28] It is attempted to determine the effect on SNGs' fiscal performance of three sets of factors: (a) economic conditions in the jurisdiction, (b) degree of vertical fiscal imbalance, and (c) political factors. Average per capita GDP in the *departamento*/term is used as the proxy for economic conditions. Economic conditions could affect deficits either because SNGs pursue active counter-cyclical policies or because the business cycle changes the value of the tax base and makes revenues pro-cyclical. Vertical fiscal imbalance refers to the divergence between a SNG's fiscal responsibilities and its capacity to finance expenditure with its own (local) sources. The ratio of own resources (i.e., revenue excluding transfers from the CG) to total expenditure is used as an indicator of fiscal imbalance (it should be kept in mind, though, that the variable actually reflects fiscal *balance*, and the signs of its coefficient must be read appropriately).[29]

Politics may affect fiscal performance in different ways. Broadly speaking, *partisan effects* refer to the influence the identity of the incumbent may have on fiscal performance. Three types of partisan effects are considered. First analyzed is whether belonging to a certain party has a noticeable effect on performance. A dummy variable is used to differentiate *departamentos*/terms in which the *Nacional* party controlled the *Intendencia*. Only the *Nacional* and *Colorado* parties have run SNGs outside Montevideo in this period, and the former has been traditionally a stronger defender of local autonomy and decentralization. The other two partisan variables are dummies reflecting whether the *Intendente* belongs to the President's party, and whether it belongs to the President's same fraction. The latter is important given the fractionalized nature of political parties in Uruguay. More broadly, the intent is to test the party discipline hypothesis that states that *Intendentes* of the President's party should behave more responsibly than those of opposition parties when, as was the case in the period, the Executive is pursuing adjustment policies.

[28] Since the 5-year term goes from March to February and elections take place in November of the last year, the first year in our sum is the calendar year the administration was inaugurated and year 5 is the year elections happened. Robustness is tested for by running the same regressions using the average deficit to GDP ratio as the dependent variable.

[29] Due to data availability it is necessary to use vertical balance estimated for the fifth year of each term as the proxy for what should be a variable reflecting more permanent (structural) conditions.

Also of interested are possible *political business cycles* (PBC) effects. The PBC hypothesis generally states that incumbents manipulate policies to create favorable economic conditions close to election time, as a strategy to maximize the chances of re-election for themselves or their party. PBC effects are tested for by using three indicators: growth in expenditure in election year (based on yearly per capita expenditure at constant prices), difference between actual expenditure in election year and the long term (13 years) trend prediction for the year (also using per capita figures in constant prices), and a dummy marking those cases (*departamento*/term) in which the incumbent *Intendente* run for re-election at the end of the term (*Intendentes* can compete once for re-election in a consecutive term, and more than once in non-consecutive terms). The first two indicators test for the possible effects of opportunistic expenditure in election year on total deficit for the term, while the third variable is more neutral and tries to determine whether a stronger re-election motive is reflected in some way in the fiscal performance of the SNG. Table 13 presents the results of the econometric analysis.

Table 13. Regression analysis of the determinants of deficits in SNGs
(Dependent variable: Sum of per capita yearly deficits at constant prices)

Equation:	**(1)**	**(2)**	**(3)**	**(4)**	**(5)**	**(6)**	**(7)**
Regressors: (a)							
Average p.c. GDP	-3.55E-02	-3.62E-02	-4.24E-02	-3.38E-02	-3.23E-02	-3.74E-02	-3.85E-02
	(-3.326)***	(-3.229)***	(-4.246)***	(-3.440)***	(-3.012)***	(-3.595)***	(-3.861)***
Vertical fiscal imbalance(b)	-44.645	-46.244	-18.238	-54.93	-46.208	-39.731	-33.945
	(-2.011)*	(-1.898)*	(-.797)	(-2.612)**	(-2.125)**	(-1.800)*	(-1.414)
Partisan effects:							
Dummy P.Nacional	6.514						
	(1.037)						
Dummy Party of President		2.435					
		(.312)					
Dummy Fraction of President			-15.639				-11.038
			(-2.517)**				(-1.673)
PBC effect:							
Expend.yr.5/Expend.yr.4				46.449			33.326
				(2.553)**			(1.721)*
Expend.yr.5 - Trend in exp.					-0.67		
					(-1.607)		
Incumbent runs for re-election						-8.979	
						(-1.357)	
Constant	65.322	69.319	74.452	25.021	67.283	76.283	40.362
	(3.718)***	(3.867)***	(4.803)***	(1.053)	(4.092)***	(4.524)***	(1.623)
Model:							
F	6.25	5.75	8.94	9.035	7.022	6.642	7.857
Signif.	***	***	***	***	***	***	***
Adj. R sq.	0.31	0.289	0.405	0.408	0.34	0.326	0.439
Total number of cases	36	36	36	36	36	36	36

(a) Entries in table are unstandardized coefficients and t-statistic; (b) SNG's own resources/expenditure, due to data availability, based on year-5 figures; * significant at 90% confidence, ** significant at 95% confidence, *** significant at 99% confidence level

The statistical analysis reveals that economic conditions were significantly related with fiscal performance of the SNGs in the two terms (even if the numerical impact of average p.c. GDP on accumulated deficits tends to be small). The economic variable is significant in all estimated equations, and the coefficient shows that "wealthier" *departamentos* have tended to incur in smaller deficits than poorer ones.

The indicator of vertical fiscal imbalance enters in the equations always with the right sign but the estimated coefficients are not always statistically different from zero. The more vertically balanced a *departamento*'s budget, the smaller the (accumulated) deficits. Not surprisingly, this result is consistent with the previous analysis of the determinants of *debt* accumulation. Interestingly enough, there seems to be a distinct effect of vertical imbalance on deficits, *in addition* to the effect of economic conditions captured by the average per capita GDP.

Finally, there is mixed support for political effects. Only two of the variables reveal themselves as significant explanatory factors: it seems that belonging to the fraction of the President has a negative effect on accumulation of deficits, and larger increases in expenditure in election year are associated with overall poorer fiscal performance (i.e., larger accumulated deficits). The respective coefficients are statistically different from zero when the political variables are entered individually, but their significance is weakened when they are entered simultaneously (equation 7). Other indicators of political dynamics do not appear to have a statistically significant effect on accumulated deficits.[30]

Before concluding, it must be noted that the usual indicators of vertical imbalance (such as the one used in the analysis) are problematic from a political-economy point of view. In fact, as operationalized in the present study, as well as others, vertical balance reflects a structural element (the divergence between fiscal responsibilities and resources) but also the endogenous outcome of the government's efforts (or lack of effort) to balance the budget. Therefore, one should exercise care in interpreting the previous results as definitive evidence against the political causation of deficits or in favor of an inadequate design of the decentralization and transfer scheme. In particular, there is some

[30] All these results are robust to the definition of the dependent variable. The signs and significance of coefficients, and model statistics, are almost identical when the same analysis is performed with average deficit to GDP ratios as the dependent variable.

evidence that SNGs respond to incentives and/or threats, as implicit in the behavior of the CG. With some necessary and important caveats, the case of Montevideo in the last two administrations seems to point in that direction.

4.2 The Moral Hazard Hypothesis: The Case of Montevideo

The hypothesis regarding transfers and econometric findings on transfers to SNGs and deficit finds additional support when the case of Montevideo is compared with the other SNGs. Between 1989 and 1997, Montevideo presents "good" indicators on a number of dimensions. First, Montevideo, in contrast with the other SNGs, looks more like the central government regarding the evolution of deficits. In fact, in the long run Montevideo seems to be increasing its fiscal discipline, while the rest of the SNGs (as a group) show signs of recurring imbalances (Figure 1).[31]

This is not due to a major contraction in expenditure but to a systematic effort to increase "own" revenue. In fact, Montevideo's collection effort measured by *total* per capita revenue (in constant pesos of 1989) is roughly comparable to that of other SNGs (Figure 2). However, this happened while the most populated subnational jurisdiction saw its access to transfers from the CG *decrease*. Even when expenditures have grown proportionally (Figure 3), Montevideo has kept deficits under control (while other SNGs have not; see Figure 1). The employment figures (Figure 4) show that Montevideo has reduced it while many other SNGs have allowed it to grow significantly (even if the totals for the *interior* show an overall stable situation since 1991). Finally the responsiveness of employment, expenditure and revenues in Montevideo to the PBC is far less marked for Montevideo since 1989 than for other SNGs. In brief, Montevideo has increased own revenues, controlled expenditures and thus limited its deficit.

[31] In the words of a majority legislator: "En la realidad, cuando uno va a las cuentas, observa que la primera intedencia colorada con todos los aportes que tuvo del gobierno central y todas las ventajas desde todo punto de vista, dejó un déficit que luego se aumentó con el primer gobierno frenteamplista y que hoy por hoy se ha estado disminuyendo. Aun no se ha transformado en un superávit—y creo que nunca se va a transformar en un superávit. Y digo que nunca se va a transformar porque no tenemos la intención de que se produzca un superávit. Tenemos una intención de que haya un equilibrio técnico de las cuentas. En todo caso el déficit es bueno o es malo en la medida de qué es lo que la origina. Si el déficit está como ahora, originado por una gran inversión en obras, nosotros lo justificamos políticamente y lo podemos defender. A pesar de todo, en 1998 cerramos con superávit, más allá de que en el acumulado para todo el período tengamos un déficit absolutamente manejable". (Interview on May 7, 1999.

Figure 1.

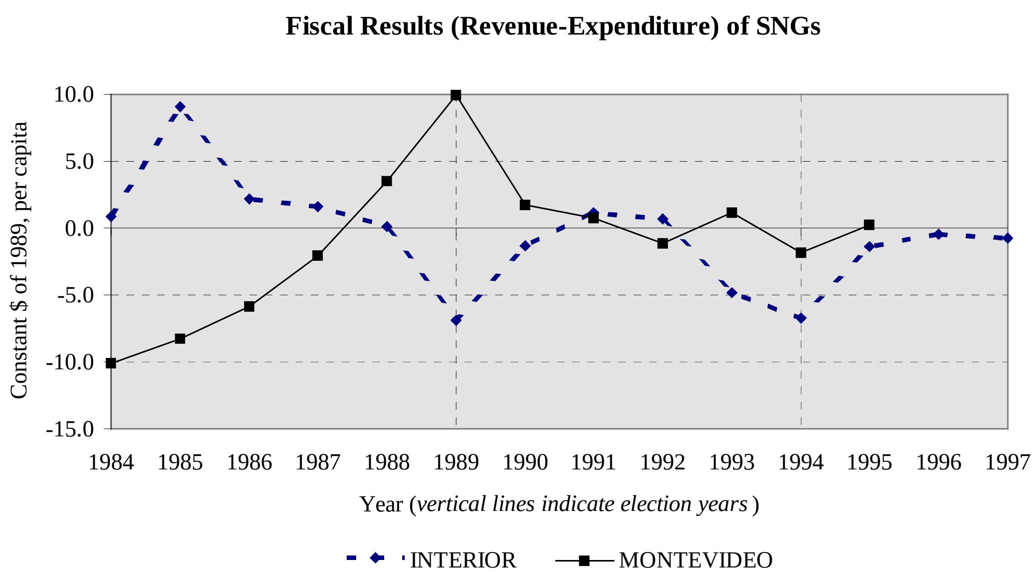


Figure 2.

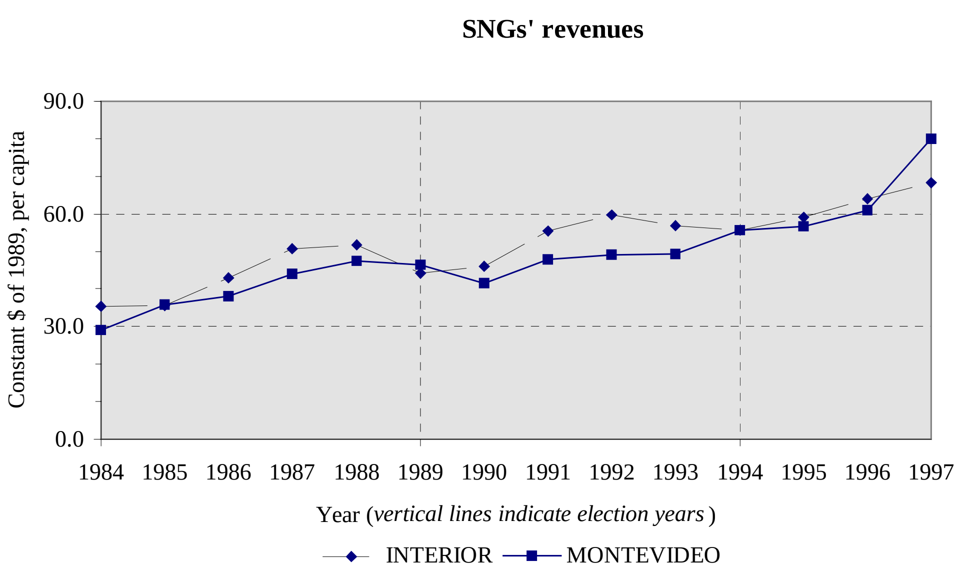


Figure 3.

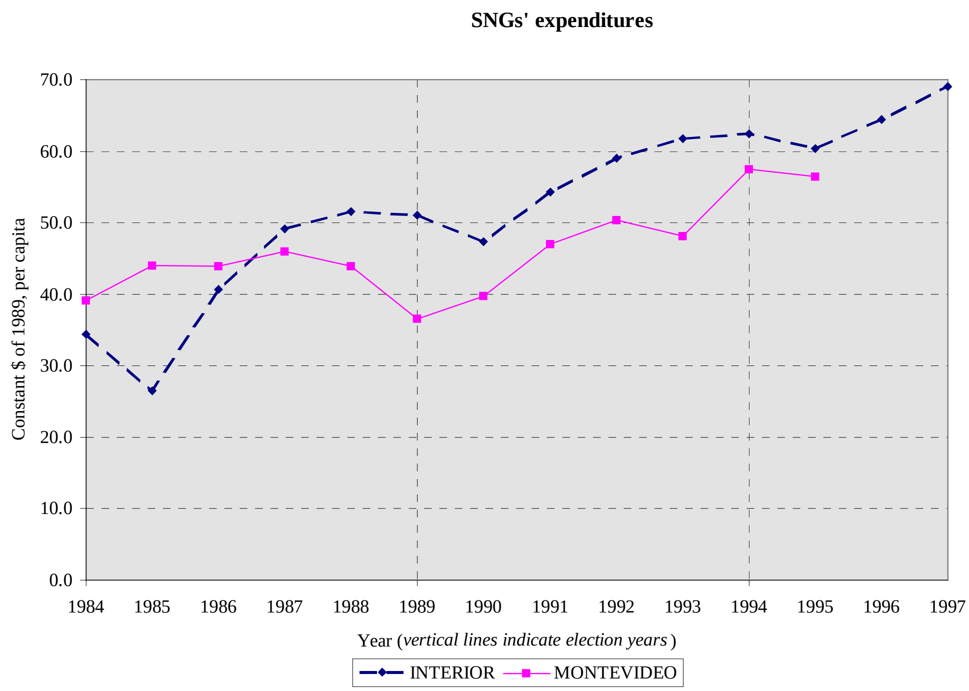
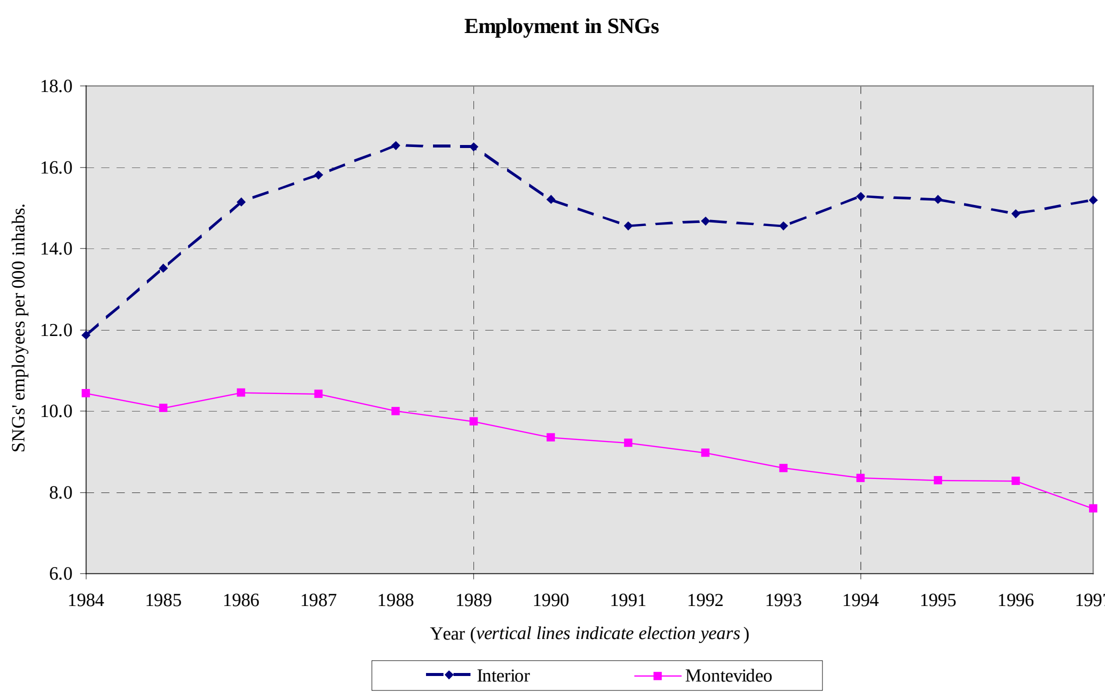


Figure 4.



Of the different hypotheses on what factors might be behind fiscal discipline, one clearly has to be ruled out in this case. It is unlikely that these results reflect a cooperative relationship between the left-wing coalition and the national Executive controlled by *nacionalistas* or *colorados,* or any form of direct political influence to collaborate with adjustment programs. Instead, the notion that policies regarding transfers from the CG to the SNGs may induce discipline of SNGs clearly has greater merit in this case. National transfers from the CG to Montevideo—historically lower than those to other SNGs—dried up fast and almost completely after the left-wing coalition gained office in Montevideo. Given the tradition of political confrontation between the *Frente Amplio* and the *Blanco* and *Colorado* parties, it was quite clear for those governing Montevideo that no help could be expected from the CG if they ran into trouble, and that a collection effort proportionate to the expenditure plans was required to avoid fiscal paralysis.

Another factor may also be behind the relatively better fiscal performance of the *Intedencia de Montevideo*. While the *Blanco* and *Colorado* administrations of many SNGs had difficulty in obtaining support from their own SN legislators for austerity measures and disciplined fiscal policies in general, the politically besieged *Frente Amplio* has exhibited greater discipline of its legislators, when the time comes to pass bills proposed by the SN executive. Tabare Vázquez first and, to a lesser extent, Mariano Arana later commanded the majority's 16 votes in the *Junta*. This implied that less bargaining and pork barrel politics had to be conducted in order to pass the budget and other important regulations, helping in the management of the *Intendencia*'s budget.

Finally, the incumbent party's chances of being unseated may also influence fiscal behavior (particularly, in election years). In the case of Montevideo, the 1994 election presented little risk to the incumbent party; this decreased the appeal of opportunistic fiscal behavior. The evolution of employment figures over terms of office also supports this notion.

More recent data (not yet compiled to be compared with the rest of the information analyzed here) suggest that the fiscal situation may have deteriorated in 1998 and 1999, which is probably related to the recession prompted by the regional crisis. To determine if the previous hypotheses remain valid, one should compare Montevideo's performance with that of other SNGs in the same period. Yet, even a “pass” grade in this “test” should lead to a careful conclusion about the extent to which Montevideo has internalized fiscal discipline in its policy institutions. It may be the case that the *Intendencia* simply exploited opportunities to expand its tax base that are not available to other SNGs. In fact, the most important caveat regarding Montevideo’s recent performance relates to the fact that it actually *had* the means to raise taxes significantly, which may not be an option for other *Intendencias* with notoriously weaker tax bases.

5. Summary and Policy Implications

The analysis of the Uruguayan experience helps to explain the factors leading to SN fiscal misbehavior and government bailout when the typical enabling conditions of federal countries are not present. Three findings are important to highlight.

First, decentralization might very well inhibit processes of fiscal discipline at the SNG level. This typically happens when, in highly competitive electoral environments, SNGs become the last resort for clientelistic politics. In effect, the process of adjustment unleashed at the central level has as its natural counterpart increasing pressures on SNGs to play the role of particularistic exchange that has always been a feature in national political life. The key role of SNGs (and local leaderships) in the electoral apparatus of national parties then makes it harder for CG authorities to deny financial assistance to troubled SNGs. In other words, in the context described above, politics plays a key ex-post role in the bailout cycle.

Second, SNGs’ widely heterogeneous tax bases and vertical balances make national transfers an inherent characteristic of SNG-CG fiscal relationship. In this context, the absence of institutionalized mechanism to deal with deficits creates perverse effects by allowing strategic behavior on the side of SNGs. Furthermore, deficit and debt accumulation were shown to be dealt with through discretionary transfers and blanket bailouts. In the first case, the behavior of discretionary transfers would favor negative reputational effects that increase the likelihood of fiscal profligacy. Regarding debt accumulation and the bailout modality seen in the case of the social security system, again there were perverse effects. The blanket measures—most likely decided on political grounds—implied that good behavior was not rewarded (or at least not explicitly so), while bad behavior (even if perhaps economically justifiable) was.

Third, the chief factors behind these perverse effects, besides the vertical imbalance that many SNGs confront, include budget institutions, management of government agencies such as enterprises and social security and, though the findings are somewhat fuzzy, politics itself. The coefficients for formula-based transfers have not been updated for more than 25 years and thus hardly represent SNGs' real needs. This implies that corrective transfers have to take place at some point, and discretionary transfers play this role to some extent. Yet, rather than tackling the issue openly, debt with state enterprises and discretionary transfers to cover deficits have operated as adjustment mechanisms. This lack of a clear and carefully thought-out "decentralization contract," and the fact that debt is accumulated with government agencies, leads to political bargaining and to strategic behavior rather than systematic analysis of distributional and efficiency issues in the decentralization scheme. Concretely, it cannot be ruled out that SNG-CG political relations play a relevant role in deficit production and fiscal effort of SNG, even if the statistical analysis identify the somewhat ambiguous vertical imbalance indicators as more important than more direct political indicators.

As this study was being concluded a bargaining process was taking place between the central government and the SNGs to define new rules for formula based transfers. Depending on how well they mirror SNGs' real needs and tax base, the system might take a big step towards a healthier dynamic. Together with this, though, clearer criteria for debt management of the different government agencies that interact with SNGs, should constitute a major challenge for policy makers. If vertical imbalances and debt negotiation are tackled, discretionary transfers and blanket bailout might be avoided (or their likelihood reduced) and incentives for fiscal discipline increased.

Finally, a word of caution on the case of Montevideo is in order. While the simplicity of the argument makes it attractive, this same simplicity makes it misleading. It is undoubtedly true that after transfers (both automatic and discretionary) were restricted, Montevideo made a significant effort at raising resources. Yet, Montevideo is the richest *departamento* in Uruguay, and a disciplined and hegemonic political force could carry out a fiscal effort of this kind. In other words the left-wing coalition ruling in

Montevideo wanted, could and did modify its budget constraints. This is not the case with most *departamentos*. That is precisely why adequate transfer mechanisms (both adequate distribution coefficients and procedural rules that limit and punish strategic behavior) are a first needed step before moving to purely “disciplinary” actions on the side of the Central Government.

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Appendix

List A. Key Informants Interviewed

- Minister from the Tribunal de Cuentas de la Nación, and Former Chief Accounting Officer (Internal Auditor) of the *Intendencia de Montevideo* (1989-1995): Ariel Alvarez.
- Chief General Accounting Officer of the Nation: Isaak Umansky
- *Intendente* of Maldonado: Camilo Tortorella
- *Intendente* of Lavalleja: Jorge Giorello
- Director of Finances, *Intendencia* of Canelones: Jorge Saldombide.
- Director of Finances, *Intendencia* of Rivera: Isidro De los Santos.
- Director of Finances, *Intendencia* of Salto: Inés Hackembruch.
- Director of Finances, *Intendencia* of Montevideo. Ruben Díaz .
- Director of Finances, *Intendencia* of Florida: Eduardo Aramburu.
- *Frente Amplio* Edil (SNG legislator) from Montevideo: Carlos Varela
- *Frente Amplio* Edil (SNG legislator) from Rivera: Robinson Silva.
- Sub-Director of Planning and Budget Office (Presidencia de la República): Agustín Canessa.

Table A.1

Correlations between Deviations from Formula and Other Variables

Variable	Pearson Correl. Coefficient	Significance Probability
Average GDP p.c. 1990-94	.139	.583
Average Vertical Balance 90-94	.163	.517
Debt with BPS as % of One-Year's Dues	.036	.886
Dummy for Party of President	-.047	.853
Dummy for Fraction of Pres.	.305	.219
Growth in Expenditure in Election Year ('94)	-.289	.245
Growth in Employment After Bailout	-.042	.868
Growth in Employment in Election Year ('94)	-.067	.792

Source: Own estimates, based on data from Ruocco, Benaderet & Medina (1994) and POM.