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Inter-American Development Bank
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Research network Working paper #R-399

Subnational Government Bailouts in OECD Countries: Four Case Studies

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November 2000

Cataloging-in-Publication data provided by the
Inter-American Development Bank
Felipe Herrera Library

Subnational government bailouts in OECD countries : four case studies / by Jürgen von Hagen … [et al.].

p. cm. (Research Network working paper ; R-399)
Includes bibliographical references.

1. Banks failures--OECD countries. 2.Intergovernmental fiscal relations—OECD countries. I. Hagen, Jürgen von. II. Inter-American Development Bank. Research Dept. III. Latin American Research Network. IV. Series.

332.109177 S744--dc21

©2000
Inter-American Development Bank
1300 New York Avenue, N.W.
Washington, D.C. 20577

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Abstract*

We present four case studies of bailouts of subnational governments in Australia, Germany, Italy and Sweden. The case studies show that bailouts can occur in a diverse set of institutions shaping the relations between central and subnational governments. Surpisingly, there is little evidence in favor of the "too big to fail" argument explaining bailouts. In contrast, elements of political favoritism play some role in most cases. The cases also indicate the importance of properly designing principal-agent relationships in the decentralization of public finances. Constitutional mandates for uniform provision of public services and attempts by the central government to dominate subnational governments in matters of fiscal policy seem to be conducive to bailouts.

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1. Introduction

Problems with weak local public finances and bailouts of subnational governments have moved to the forefront of the debate over public finances in Europe. Recent interest in this issue was triggered, on the one hand, by the preparation of European Monetary Union (EMU), as the introduction of the common currency raised concerns about the ability of some member states to maintain sustainable public finances. The "Excessive Deficit Procedure" of the Treaty on European Union, and the subsequent Stability and Growth Pact, which restrict the member states' financial policies, clearly reflect these concerns. On the other hand, recent experiences in several EU member states with financial crises of subnational governments have attracted attention to the institutional weaknesses creating soft budget constraints.

In this paper, we review the experience of three European countries and Australia, which have experienced such problems. Specifically, we consider the history and experience of the Australian Loan Council, the near-defaults and bailouts of two states of the Federal Republic of Germany, recent developments in local public finances in Italy, and bailouts of municipal governments in Sweden. Each of these cases brings its own specific factors to bear in the causes of the financial crisis and the explanation for why a bailout occurred. Together they point to a variety of structural weaknesses in local public finances that lead to fiscal weakness and profligacy. These institutional problems point to political opportunism and flawed principal-agent relations as the principal factors behind bailouts.

The four cases covered in this paper include different types of government structures. Germany and Australia are two countries with a federal structure, yet with different degrees of financial autonomy of the state governments. German state governments are unrestricted in their borrowing autonomy, while state governments in Australia relinquished their borrowing autonomy under the Australian Loan Council arrangement. Italy and Sweden are unitary states, yet again with very different degrees of financial autonomy of local governments. Italy's regions, which are the focus of the attention here, have no authority to borrow at all, while Sweden's municipalities are financially largely autonomous and form a sizeable part of the Swedish public sector. The wide differences in the fiscal constitutions of the countries reviewed in this paper indicate that bailouts cannot be traced simply to the distinction between unitary and federal states, nor to that between a large and a small degree of financial autonomy at the local level. Explaining the occurrence of

bailouts, and, consequently, trying to prevent them through institutional design requires digging deeper into the distribution of authorities and obligations between different levels of government.

The remainder of this paper is organized as follows. Section 2 reviews and compares the structure of the public sector in the four countries as necessary for our purposes. Section 3 presents the four case studies in some detail. Section 4 concludes by drawing a few lessons from the four cases.

2. Institutional Background

2.1. Australia and Germany

The two federal countries considered in this study, Australia and Germany, each have three levels of government, federal, state, and local or municipal, and each of these levels has genuine fiscal responsibilities. Australia became a federal state in 1901, when the six former British colonies of New South Wales, Victoria, Queensland, South Australia, Western Australia, and Tasmania established the Commonwealth Government under a new federal constitution. Local government is the third tier of government in Australia. It is not recognized by the constitution and exists under state legislation alone.

Total public sector spending amounted to 35.2 percent of GDP in fiscal 1997-98. Of this total, 51.3 percent was spent by the Commonwealth government, 43.7 percent by the states and territories, and five percent by local governments. The bulk of tax collection is executed by the Commonwealth government, whose ratio of own resources to outlays is 138.7 percent. This compares to 51.8 percent for the states and territories, and 66.7 percent for local governments. Australia's public sector had a net debt of 18.6 percent of GDP, of which 71.5 percent was Commonwealth debt, 28 percent was owed by the states and territories, and only 0.5 percent by local governments. Borrowing of the state and territorial governments evolves under the rules of the Australian Loan Council Agreement, which will be reviewed later in this paper.

The Federal Republic of Germany consists of 15 states; prior to unification in 1990, it consisted of 10 states and West Berlin, which had a special political status. The authorities and obligations of the state and the federal government are defined by the constitution, while those of the municipal governments are defined by state law. Total government sector spending, excluding social security, amounted to 33.5 percent of GDP in 1996; of this, 38.5 percent were spent by the

federal government, 42 percent by the state governments, and 28 percent by the municipalities. The ratio of own resources, including taxes assigned to each level of government, and user fees to total spending was 82.8 percent at the federal level, 86.7 percent at the state level, and 74.1 percent at the local level. This signals a fairly high degree of financial independence of the subnational levels of government.

Note, however, that the most important taxes are shared between the federal and the state governments, with shares fixed by constitutional law. The rates of these taxes can only be changed by agreement among the states and the federal government. Thus, the individual state government has little command over tax rates. Similarly, the definition of the tax base is fixed by federal law and hence uniform across states. Tax collection, however, is carried out by the state tax administrations, and casual evidence suggests that there is a fair degree of variation in tax effort across states.

An important feature of German federalism is the system of horizontal equalization, "*änderfinanzausgleich*." Under this system, state governments share tax revenues from their main taxes and all states are guaranteed per capita tax revenues close to the national average. Specifically, states collecting per capita revenues above the national average are required to make payments to states collecting revenues below the national average, reducing the gap between the maximum and the minimum revenues collected per capita to plus/minus five percent of the national average. This gap is further narrowed by additional grants from the federal government.

State and local governments in Germany have the authority to borrow in their own right, although municipal borrowing is controlled by the state governments. All governments operate under the constraint that annual borrowing must not exceed annual investment outlays. However, the definition of investment in this rule is a purely administrative one and arbitrary from an economic point of view. Governments have found it relatively easy in the past to get around this restriction. Beyond this rule, the total public sector has been subject to the annual deficit limit of three percent of GDP under the Maastricht Treaty since 1993. The implications of this restriction for subnational governments are, however, an issue of ongoing debate between the different levels of government. In 1996, total public debt stood at 60.1 percent of GDP; of this, 64 percent was owed by the federal government, 26 percent by the state governments, and 9.5 percent by the municipalities.

2.2 Italy

Italy has four levels of government: central, regional, provincial, and municipal. There are 20 regions, around 100 provinces, and more than 8,300 municipalities. Municipalities and provinces are administrative bodies, while regions are legislative bodies as well. In principle, higher levels of government supervise and coordinate the work of lower levels of government. In practice, there is no hierarchical relationship between these different levels. Instead, each local government is relatively autonomous in pursuing its policies, and there are few financial links between the different subnational levels of government. Instead, each subnational government has a direct financial link with the central government, which finances at least part of its current and capital spending.

Total public spending in Italy, excluding social security spending, stood at 32.5 percent of GDP in 1998, down from a peak at 43.1 percent in 1993. The central government spent 59 percent of that total, down from 68 percent in 1993. Thus, most of the reduction of spending relative to GDP during the 1990s was achieved by the central government; local government spending fell from 14.7 percent of GDP in 1991 (14 percent in 1993) to 13.2 percent in 1998. Meanwhile, social security spending rose from 14.7 percent in 1993 to 16.4 percent of GDP in 1998.

The central government's ratio of own resources to spending stood at 134 percent in 1998, up from 102 percent in 1993. Local governments have a ratio of 59.4 percent. Public debt amounted to 117 percent of GDP in 1998, of which 96 percent were owed by the central government.

An important aspect of intergovernmental relations in Italy is the existence of overlapping administrative functions between different levels of government. In the education sector, for example, the central government is in charge of financing teachers' salaries and school equipment, while local authorities finance outlays for building maintenance. Municipalities pay the salaries of non-teaching personnel in kindergartens and science-oriented high schools, and provinces pay for non-teaching personnel in technical high schools, while the central government pays for the non-teaching personnel in classical and professional high schools. The result is that responsibilities for the quality and financing of public activities are completely opaque and that local politicians cannot be held accountable for low quality and financial waste in the provision of local public services. Furthermore, the overlap of

responsibilities promotes free riding of local governments on other levels government, as local policymakers find it possible to evade financial controls from above.

2.3 Sweden

Sweden, a unitary state, has three levels of government: national, county, and municipal. Public sector spending amounted to 64 percent of GDP in 1997; of this, 58 percent were spent by the central government, 11 percent by the counties, and 30 percent by the municipalities. Counties and municipalities mainly spend from their own resources. Their ratios of own resources to spending were 92 percent and 84 percent, respectively, in 1997. Local authorities have the constitutional right to determine their own local income tax rates. In 1994, local income tax rates ranged between 13 percent and 22 percent, with an average of 19 percent. 57 percent of local government revenues are from local income taxes; central government grants account for 22 percent. Municipalities have the authority to borrow in their own right. In 1997, central government debt amounted to 59.7 percent of GDP, county debt amounted to four percent of GDP, and municipal debt to 14 percent. The latter ratio is larger, however, if the debt of companies owned by municipalities is taken into account. Their debt stood at 15 percent of GDP in 1997, implying a total debt ratio of 29 percent for the municipalities.

3. Four Case Studies[1]

3.1. Australia: Federal Strictures and Experience with Bailouts

3.1.1. The Australian Loan Council

Australia's constitution did not provide for the coordination of borrowing among the states and the Commonwealth government. Until 1922, the Commonwealth and the states borrowed independently, at times competing against each other for funds in the London capital market. Before 1914, borrowing operations by the states were coordinated by R. Nivison & Co. in London, which served as underwriter and assured that the borrowing operations of one state would not affect the operations of other states (Eichengreen and von Hagen, 1996a). The war-time and post-war scramble for funds caused this arrangement to break down. Uncoordinated borrowing increasingly became a nuisance

[1]For more details on the subsequent case studies see the background reports to this paper, Bordignon (2000), Dahlberg and Pettersson (2000), Grewal (1999), and Seitz (2000).

when the states were under pressure to raise loans to finance new programs of economic development and to pay unemployment benefits, while the Commonwealth was under pressure to raise new loans to refinance its war debts. In 1923, therefore, the Commonwealth and the states agreed on the formation of a voluntary Loan Council with the aim of coordinating the timing and the conditions of new loans issued in London.

The voluntary arrangement worked reasonably well, but occasionally the full support of all members was not forthcoming. In February 1924, for example, the Commonwealth requested the states to withhold their loan offerings until its own loan had been dealt with. While Queensland, Western Australia and Tasmania complied with this request, New South Wales, Victoria and South Australia did not. New South Wales pulled out of the voluntary Loan Council after the Labor Party won an election in July 1925 and Jack Lang became the Premier of that state. The state rejoined the voluntary Loan Council after Labor lost office in December 1927.

The voluntary agreement was replaced by formal legislation to establish the Australian Loan Council in 1927. The Loan Council came into being when the six states and the Commonwealth signed the "Financial Agreement," which was later ratified by their respective parliaments. By a referendum in 1928, the Australian constitution was amended to secure the necessary basis for the Agreement. At the time, much of the public support for the new arrangement was due to the general hope that the Financial Agreement would strengthen the fiscal discipline of the governments and bring to an end what was perceived to be an episode of profligate borrowing.

The content of the Financial Agreement and the functions of the Loan Council went far beyond the mere coordination of borrowing operations. The Agreement empowered the Commonwealth to manage and take over state debts, to regulate the borrowing of the states, and to borrow for them. The Loan Council was given the sole authority to determine the amounts, terms, conditions, and timing of all loans raised by the Commonwealth and the states. The Financial Agreement provided that the Loan Council would determine the total amount of loans raised during a particular year and to allocate this amount among the states. In a response to increasing attempts by state governments in the early 1930s to circumvent the Loan Council's borrowing limits by borrowing through off-budget entities, the Council's authority was extended to cover the borrowing of local and semi-government bodies by the "Gentlemen's Agreement" among the states and the Commonwealth in 1936.

In return for the infringement of the states' financial autonomy, the Financial Agreement provided for several changes to intergovernmental finances with important implications for the states' financial discipline. These included the Commonwealth takeover of existing state debts and Commonwealth grants to states to enable them to meet their obligations for interest on debt and to make their contributions to the newly created National Debt Sinking Fund.

The Loan Council consisted of the Prime Minister and the Premier of each of the six states, the Prime Minister of the Commonwealth government, and the federal treasurer. Each state had one vote at the Council, while the Commonwealth had two votes and a casting vote. This enabled the Commonwealth to impose its views on the states, as it took the Commonwealth only two states to have a majority, but it took five states to form a majority against the Commonwealth.

Over time, the Loan Council increasingly became an institution by which the Commonwealth government exerted control over state finances and managed the fiscal stance of the Australian economy. From 1950 onwards, the Loan Council provided a framework in which the Commonwealth underwrote the states' collective borrowing program, first through special loans, and later through capital grants as well. This enabled the states to borrow at better rates than they could have obtained themselves and thus finance bigger expenditures, but it also strengthened the domination of the Loan Council over their finances. During the 1950s and 1960s in particular, the states repeatedly had to accept borrowing allocations smaller than their desired amount of borrowing. The Commonwealth only relaxed its control in the late 1970s when, faced with increasing efforts by the states to expand their borrowing, it took a new approach to borrowing for infrastructure financing.

3.1.2. State Defaults in 1931 and 1932

The Great Depression hit Australia with a severe economic downturn, falling export prices, and rising unemployment. Budgetary revenues fell sharply in fiscal 1929-30. Responding to the crisis, the Loan Council reduced the 1930-31 loan program by 45 percent compared to the preceding year and asked all governments to balance their budgets in the following year. However, after a sweeping victory in the October 1930 elections in New South Wales, in which he ran on a platform opposing balanced budgets, the premier of that state, Jack T. Lang, notified the chairman of the Loan Council that his state could not balance the budget and needed more time to pass legislation for additional

taxation. In December 1930 Lang's letter was answered by the Chairman of the Commonwealth Bank, who insisted on the need to balance budgets. Nevertheless, some financial accommodation was made for New South Wales, enabling the state to meet its interest payments on 1 January 1931. In February 1931, Lang proposed to the Loan Council a conditional repudiation of overseas debts and a compulsory reduction of interest rates to three percent, arguing that these measures were necessary to make bondholders share with wage-earners the burden of sacrifice of economic recovery.

The Loan Council, including the premiers of the other states, rejected Lang's proposal. Lang unilaterally defaulted on overseas interest payments in April 1931. However, the Commonwealth immediately paid the interest due on behalf of New South Wales. High Court proceedings against the state government were initiated, but subsequently dropped after the latter had reimbursed the Commonwealth and accepted the Loan Council's decision to balance budgets by June 1934.

In January 1932, Lang defaulted again on overseas interest payments, after his request for additional borrowing had been turned down by the Loan Council. This time, the Commonwealth waited for ten days before paying the interest, a period of intense financial stress for the state. Afterwards, the Commonwealth passed legislation under which it accepted the liability for state debts and enacted procedures enabling it to seize state revenues if a state had violated the Financial Agreement. Challenging the constitutionality of this legislation, Lang ordered his financial administration to ignore the Commonwealth directive and deposit revenue receipts into the state treasury accounts. On 13 May 1932, Lang was dismissed as premier after refusing to withdraw his order. Eventually, his push for a forced reduction interest rate payments became the basis of the 1931 Commonwealth Debt Conversion Act, which authorized the Commonwealth on behalf of the Loan Council to convert existing Commonwealth and state debts into new stock by invitation to the bondholders. The interest rate on the new stock had been reduced by up to 22.5 percent from the original rates. The conversion program was immensely successful, with almost all bondholders consenting to the operation.

3.1.3. Erosion of the Loan Council Controls

Responding to a widely expected resources-led boom in Australia in the late 1970s, the Commonwealth accepted the states' demands for increased public borrowing from 1978 onwards.

In 1978, the Loan Council approved new guidelines for borrowing programs that had special significance for economic development. In 1982, it exempted state electricity authorities from Loan Council borrowing approval. In 1983, other large semi-government authorities were given similar exemptions. From July 1983, states could borrow virtually freely for infrastructure programs in the overseas market and allocate the funds according to their own priorities. Borrowing by the state-owned public trading enterprises increased sharply in the late 1970s and early 1980s, as the states took full advantage of the weaker borrowing limits. New ways of financing were invented by the states, allowing them to circumvent Loan Council controls. Thus, in the early 1970s, borrowing by state-owned public enterprises totaled less than one percent of GDP; in contrast, it amounted to 2.3 percent of GDP in fiscal 1981-82, 2.8 percent in 1982-83, and 2.7 percent in 1983-84. While the Loan Council approvals had still covered 95 percent of the borrowing by state semi-government authorities in 1979-80, their coverage fell to 25 percent in 1983-84. Thus, the power of the Loan Council to control public sector borrowing eroded quickly.

In light of this situation, the Loan Council abandoned the distinction between semi-government and government borrowing altogether in 1984 and adopted a new procedure, called the Global Limit approach, instead. Under the new approach, the Loan Council set global limits for the borrowing of the Commonwealth and the states. An aggregate global limit for all states and territories was determined in light of the previous year's approved limit and macroeconomic policy conditions as judged by the Commonwealth. This aggregate amount was then allocated to the individual governments based on the size of the state populations. Limits for the aggregate amount of overseas borrowing by state authorities were set by a similar procedure. Thus, the individual borrowing limits took no account of the fiscal needs of the individual states. Compliance with the Global Limits was voluntary, but all state governments agreed to keep new borrowing within the new framework. Over time, the Global Limits were extended to cover deferred payments, trade credit, leasing arrangements, and installment purchases in addition to conventional loan operations.

The Global Limits approach succeeded in reducing the growth of state government borrowing initially. The Commonwealth, however, tried to use the Global Limits again as an instrument of aggregate fiscal management and cut the ceiling on state borrowing in subsequent years. Starting in 1985-86, the Commonwealth imposed a policy of harsh fiscal restraint as part of a strategy to fight an excessive current account deficit. Real net Commonwealth payments to the

states and the Northern Territory were cut by 0.5 percent in 1985-86, 1.1 percent in 1986-87, and 4.4 percent in 1987-88. At the 1988 meeting of the Loan Council, the Commonwealth asked for reduction in state borrowing by 22 percent. Faced with an even tougher cut in its Global Limit by the Commonwealth government, Queensland refused to endorse the Global Limit and refused to provide the Loan Council with information about its borrowing activities. The Commonwealth nonetheless forced the state to comply after threatening to deduct any excess of Queensland's borrowing over its Global Limit from the Commonwealth's financial assistance to the state.

In 1990, the Loan Council decided to move the allocation of Global Limits increasingly to a rule based on equal per capita amounts. From fiscal 1989-90 onwards, the Commonwealth ceased to borrow on behalf of the states, remaining responsible only for debts that it had issued on behalf of the states in the past. Thus, the states became responsible for their own debts. The new arrangements exposed the states to the scrutiny of financial markets. Depending upon their individual credit ratings, states now face different interest costs for their borrowings, whereas all states were charged the same rate of interest by the Commonwealth government under the old arrangement.

Agreement was also reached in 1990 for the states to progressively redeem the debt that the Commonwealth government had issued on their behalf so that by 2005-06 these debts would be fully taken over by the states. In 1992, it was agreed to amend the Financial Agreement to give formal recognition to the new arrangements. A new Financial Agreement was signed in 1994 and became operative from 1 July 1995.

Responding to the restraint imposed by the Commonwealth government in the late 1980s, state governments began to exceed the Global Limits in subsequent years. In 1991-92, total borrowing amounted to 172.4 percent of the Global Limit, and in 1992-93 it reached 118 percent of the Global Limit. In 1991-92, the total borrowing of Victoria increased from $1.5 billion to $2.7 billion, far exceeding Victoria's Global Limit. Victoria's budget had deteriorated over the previous two years due to the economic effects of the 1987 stock market crash, the financial troubles of the Victorian Economic Development Corporation, and the failure of the subsidiary of a state-owned bank. In 1991-92, the state government borrowed heavily from the Victorian Development Fund, an off-budget financial entity. A few weeks before ending the fiscal year, these borrowings were refinanced as medium-term loans from the Victorian Public Authorities Finance Agency in order to take the temporary loans off the Development Fund's balance sheet. The medium-term loans,

however, caused Victoria to breach its Global Limit. The Victoria government reported this action to the Commonwealth treasurer, who, contrary to ordinary procedure, decided not make this public. When the incident became public nevertheless, the treasurer was accused of currying political favor for the Victoria government which, being of the same party as the Commonwealth government, was facing elections at the time.

The Loan Council took no formal action, as compliance with the Global Limit was considered voluntary. Instead, the Council retrospectively approved additional borrowings for Victoria in respect of its excess borrowings in fiscal 1991-92 and 1992-93 at its December 1992 meeting. The Loan Council approved further special additions to Victoria's loan limit in May 1993. This brought the state back under the framework of the Global Limits and cleared the deck for the dealings of the new state government elected in 1992 with the Loan Council. Following this "Victorian Loan Affair," the Loan Council strengthened its reporting requirements and shifted greater attention towards the budgetary situation and strategy of each jurisdiction.

At the December 1992 meeting, the Loan Council concluded that the Global Limits approach had increasingly lost effectiveness and was at the point of breakdown. In view of this, it replaced the Global Limits by Loan Council Allocations from July 1993 on. Under the new arrangement, each jurisdiction nominates a Council Allocation based on its own budgetary situation and strategy. If the aggregate of all nominated allocations is deemed inconsistent with macroeconomics requirements, negotiations are undertaken to settle the differences.

3.1.3. Conclusions

The Australian Loan Council is an interesting case of institutional capture in a federalist setting. Originally created for the purpose of improving debt management and avoiding competition among the states in the London capital market, the Loan Council arrangement soon became the institutional tool for coordinating the states' fiscal policy from a macroeconomic perspective under the leadership of the Commonwealth. For some time in the 1920s, the Loan Council served to mitigate development competition in which the states engaged in excessive borrowing and development spending, but each state could reduce those expenditures only if all states did likewise (Schedvin, 1970). The Financial Agreement of 1927 helped to implement a cooperative solution to this coordination problem.

Over time, however, the arrangement became increasingly dominated by the Commonwealth. The dominant role of the Commonwealth in fiscal policy was strengthened by a High Court ruling that excluded states from the taxation of goods and consumption almost entirely, and by the Commonwealth's monopoly on taxing incomes from 1942 on (Grewal, 1998). Under the Loan Council arrangement, the states effectively renounced their fiscal powers for the benefit of the Commonwealth's guaranteeing their debts. Significantly, the Commonwealth paid little attention to the states' individual financial needs in the allocation of funds. This is illustrated in the fact that the states' loan programs remained virtually unchanged between 1950 and 1980, although their economies exhibited very different patterns of economic development (Scott, 1983). Instead, the Commonwealth used these allocations for macroeconomic management. The conflict between the states' interest in cheap borrowing and their interest in pursuing their fiscal and development policies eventually lead to the erosion of the Loan Council Agreement. Today, the Loan Council has returned to its original purpose of coordinating state borrowing rather than implementing a national fiscal policy.

3.2 State Government Bailouts in Germany

In 1988, the state governments of Saarland and Bremen turned to the German Constitutional Court for support of their demands for financial assistance from the federal government to help them cope with their high public debts. Both state governments claimed that their debts had been caused by negative economic developments that were outside of their own control. In the case of Saarland, this was the secular decline of coal mining and the steel industry, the two main industries of the state's economy. In the case of Bremen, it was the decline of the shipbuilding industry, the backbone of its economy. The two governments argued that the fiscal burdens associated with their high public debts made it impossible for them to fulfill their constitutional duties, and that, if left alone with their financial obligations, they would have to cut expenditures drastically, resulting in severe deteriorations of the supply of public services. This, they argued, would violate the constitutional mandate to provide equal living conditions across the states. Furthermore, both governments argued that they could not keep the constitutional requirement that limits budget deficits to the amount of public investment. Finally, the two governments argued that the majority of their expenditures, e.g., social welfare payments, were fixed by federal law and, hence, could not be controlled by the

governments themselves.

The Court took five years to arrive at a decision. In its 1992 ruling, it upheld the claims of both states, arguing that the Federal Constitution, and especially the design of fiscal federalism in Articles 104 to 107, aims at establishing homogeneity of fiscal conditions and equalization of living standards throughout Germany. In the court's view, these objectives could only be achieved by mutual support between the states and the federal government and among the states. Thus, the Court stressed the constitutional principle of solidarity and concluded that a state—or, as it might be, the federal government—experiencing extreme budgetary hardship was entitled to financial support from the other members of the federation. The Court, like the two state governments before, concluded that there was indeed extreme budgetary hardship in the two states on the basis of three observations: the poor economic performance of the two states, the high levels of per capita debt of the two states, which far exceeded the German average, and the unusually high ratio of debt service to total expenditures in the two states.

3.2.1. Economic and Institutional Background

Starting in the early 1980s, employment in Saarland and Bremen began to decline, while unemployment rates sharply increased. The unemployment rate in Saarland rose from around six percent in 1980 to almost 14 percent in 1985; unemployment in Bremen rose from around six percent in 1980 to almost 16 percent in 1986. After 1980, unemployment rates in both states always exceeded the West German average; today, they are comparable to the high unemployment rates in the East German states of the former socialist German Democratic Republic. Unemployment rates would surely be even higher if the two states had not lost significant parts of their population due to migration. Population shrank by 6.1 percent in Bremen and 2.5 percent in Saarland in a period when West Germany's population grew by 7.5 percent.

The severe economic downturns in the two states were first triggered by the oil price shock of 1973-74, in which both states lost a large number of jobs that were never regained once the recession was over. Because both states are small and non-diversified economies, there was not enough compensating labor demand from other industries to absorb the loss of jobs in coal mining, steel, and shipbuilding.

The erosion of their economic bases created enormous fiscal pressures for the two

governments. On the revenue side, the result was a decline in tax revenues, which, however, was compensated by an increase the transfers received from the other states under an equalization system. As indicated above, raising tax rates was not an option for the state governments in any case. In fact, the issue of declining tax collections was never raised in the Constitutional Court. On the expenditure side, government spending increased strongly, driven mainly by two types of expenditures. Welfare payments, which, on a per capita basis had been above the West German average in both states since 1975, increased faster than the West German average after 1980. These payments rose particularly fast in Bremen after 1980. Furthermore, both governments began to pay huge investment subsidies to industries in their states. Saarland paid huge investment subsidies between 1981 and 1983 in an unsuccessful effort to keep the local iron and steel industry viable. Similarly, Bremen began paying large investment subsidies to shipbuilders in 1987, again without the desired success of keeping an ailing local industry alive. While Saarland kept the growth of personnel expenditures in close line with the West German average over the past two decades, personnel expenditures rose faster than average in Bremen. As a result of the diverging revenue and expenditure trends, both states incurred deficits significantly larger than the West German average on a per-capita basis.

3.2.3. The Bailouts

In 1993, the German federal government made a contract with the two state governments, promising them annual grants over a period of five years to reduce the financial burden caused by the high debts.[2] The contract granted Bremen an annual payment of about DM 1.6 billion and Saarland an annual DM 1.8 billion, or 22.5 percent and 18 percent, respectively, of their annual expenditures. These grants were not to be repaid by the two states. In turn, the states committed to keeping their annual expenditure growth below three percent, a limit that was reduced to two percent in 1997. According to the contract, the grant had to be used for the reduction of the public debt and the resulting savings in interest payments had to be used either for further debt-reductions or for additional infrastructure investment. Furthermore, Bremen and Saarland were obliged to present regular reports on the progress of their fiscal consolidations to the federal and the other state governments. Thus, both state governments were forced to explain and justify their fiscal policies.

[2] Prior to this, the two states had received small annual grants helping them to deal with the debt burden. Between 1987

The fact that each of their moves was closely monitored may have had some influence on their fiscal choices.

A principal objective of the 1993 bailout contract was the reduction of state debts over the five-year period. Both states had debt levels close to DM 16 billion in 1992; for both, the aim was to reduce debts to DM 11.5 billion at the end of 1998. This target was missed considerably, as the debts remained at DM 16 billion in both states. Note also that the reduction of the ratio of interest payments to total expenditures was only modest in the two states. This ratio fell from 14.8 percent in 1993 to 12.8 percent in 1998 in Saarland, and from 15.8 percent in 1993 to 14.2 percent in 1998 in Bremen. The small size of this reduction is particularly noteworthy as it occurred in a period of generally declining interest rates.

The 1993 contract specified that an intensive evaluation be made of the financial situation of both states in 1997 as a basis for deciding whether or not further assistance would be required beyond 1998. However, neither in 1997 nor in 1998 a decision could be achieved on this issue, which was settled only in the spring of 1999. The fact that the prime minister of Saarland, Mr. Lafontaine, was a fierce political opponent of the federal chancellor, Mr. Kohl, in the 1998 elections, while Bremen was governed by a coalition involving the parties of both, may have contributed to this apparent stalemate. Although all the other state governments and the federal minister of finance regarded the results of the contract as disappointing, almost all states and the federal minister of finance supported the prolongation of the contract in early 1999. The new contract between the federal government and the two state governments extended the grants to the year 2004. By the end of this period, Bremen will have received a total transfer of 69 percent of its 1992 debt, and Saarland will have received transfers amounting to 88 percent of its 1992 debt.

The 1999 contract also introduced two novelties. First, the grants are declining annually from DM 1.2 billion (1.8 billion) in Bremen (Saarland) for 1999 to DM 500 million (700 million) in Bremen (Saarland) for 2004. Second, further transfers after 2004 are excluded. In total, Saarland will have received DM 16.7 billion from the federal government by the end of 2004, and Bremen DM 13 billion. This corresponds to slightly more than twice the 1998 volume of total state government spending for Saarland, and 165 percent of 1998 spending for Bremen.

In order to assess the effects of the bailout contracts, Seitz (1999) compares the debt

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and 1993, Saarland received DM 75 million and Bremen DM 50 million annually.

performance of the two states with hypothetical debt figures obtained from simulations. Simulation 1 assumes that the two states adjusted primary expenditures such that they grow at three percent or the average growth rate of primary expenditures in the West German states, whichever is less, in 1994-96, and by two percent or the average growth rate of primary expenditures in the West German states in 1997-98. This corresponds exactly to the commitment of the two states under the 1993 contract. In simulation 2, primary expenditures in the two states grow at their observed rates in 1994-98 and but the transfers from the federal government are deducted from the revenues of the two states. Comparing the hypothetical with the actual changes in state debts for each year, Simulation 1 evaluates the "own" contribution of the two states to debt reduction, while Simulation 2 evaluates the contribution of the federal transfers. Table 1 reports the results. Note that this takes into account the savings in interest payments occurring from the reduced stock of debt.

Since the hypothetical increase in public debt resulting from an exact aplication of the primary-expenditures requirement in the 1993 contract would have been larger than the actual increase (i.e., that the "own contributions" are positive), Table 1 shows that the two states actually underwent tighter expenditure discipline that required by the contract. This indicates that the transfers from the federal government were not misused to finance additional expenditures. Furthermore, Table 1 shows that, without the federal transfers, debt would have increased over the whole period by an additional DM 9.2 billion in Saarland and DM 10.3 billion in Bremen. During the same period, the other West German states increased their debt levels by a total of 17 percent on average, much less than the 54 percent increase for Saarland and 60 percent for Bremen that would have occurred without the federal transfers. This shows that the federal transfers were indeed critical for achieving a stabilization of the debts of the two states.

Table 1. Debt Simulations (millions of DM)

Year	Saarland		Bremen	
	own contribution	contribution of federal grants	own contribution	contribution of federal grants
1994	101	1597	166	1836
1995	151	1719	144	1894
1996	58	1835	179	2066

1997	119	1949	25	2192
1998	209	2099	100	2330

Finally, Table 1 indicates that the own contributions from the two state governments were marginal compared to the contributions of the federal grants. Thus, the federal government carried the largest part of the fiscal adjustment burden. In addition to these payments, Saarland and Bremen received implicit transfers from the federal and the other state governments by being granted an exemption from shouldering financial responsibility for public transfers to East Germany. Specifically, the East German states received transfers from West Germany through the German Unity Fund during 1991-94. This Fund was entirely debt financed. At its dissolution in 1994, the federal government and the West German states reached an agreement distributing the Fund's debt between them. In view of their high debt levels, however, Bremen and Saarland were excused from accepting part of this debt. As a result, Bremen and Saarland were left with financial liabilities from the German Unity Fund amounting to DM 350 and DM 310 per capita, respectively, about half of the DM 730 per capita accepted by the other West German states.

3.2.3. Market Responses

The ruling of the Constitutional Court in the Bremen and Saarland cases can be viewed as an important signal to the financial markets about the quality of German states as borrowers. Recently, leading international credit rating agencies have started to monitor the debt and debt-servicing activities of state governments in Germany. In March 1999, the rating agency of Fitch IBCA reached the conclusion that there were no differences in the credit risks of German states and extended an AAA rating to all of them. In its press release of 25 March 1999, Fitch IBCA gave three arguments for this decision. First, it argued that the states and the federal government are interlinked by strongly interdependent decision-making processes and interactions between powers at the federal and the state levels. Second, the agency referred to the 1992 Constitutional Court ruling, pointing out that the German constitution read in this way requires the federal government to bail out state governments. Third, the agency noticed that the fiscal equalization system in Germany was designed to prevent states from falling into financial difficulties arising from revenue shortfalls. On this basis, there seems to be no room left for risk premia differentiated among the states. The implication is that

Germany can no longer rely on market discipline to enforce fiscal prudence on the state governments.

3.2.4. Conclusions

The bailouts of Bremen and Saarland point to a fundamental flaw in the design of Germany's federal system. This is the contradiction between the states' autonomy in spending and borrowing decisions and their limited freedom in determining their current revenues. This contradiction is sharpened by the constitutional mandate to provide a uniform standard of government services in all states. A narrow reading of this mandate can only lead to the conclusion, reached by the Constitutional Court, that German states and the Federation together are bound by mutual solidarity.

The two cases then show how solidarity can turn into a mutual liability for severe policy errors. Ultimately, the Court ruling forced the federal government to pay for the two governments' flawed economic policies, which were trying prevent necessary economic restructuring by outdated programs of industrial policy and government spending.

3.3. Problems of Soft Budget Constraints of Italian Regions

In 1972-73, a massive tax reform was introduced in Italy, aiming at rationalizing and modernizing an antiquated tax system. Several indirect taxes were repealed, and new personal taxes and a VAT were implemented. Tax administration and enforcement, which previously had been partly attributed to the local governments, became completely centralized. The tax reform also abolished a variety of municipal taxes for which municipalities had previously had the right to choose the tax rate and to define the tax base. Other taxes, whose revenues were shared by the municipalities, were replaced by new taxes that did not allow for revenue sharing at the local level. Several new local taxes were created, such as taxes on capital gains, waste collection, and the use of urban land, but these proved highly income inelastic.

3.3.1. Crisis of Local Public Finances in the 1970s and 1980s

The effects of this reform on municipal financial autonomy were devastating. Until 1972, own tax revenues covered about 50 percent of the total current revenues of municipalities. By 1978, this figure had dropped to less than 10 percent. Central government grants rose from less than 30 percent of current revenues to almost 80 percent in 1978. This attack on the fiscal autonomy of the

municipalities was a deliberate political choice at the time, responding to the severe economic and political crisis of the early 1970s. Centralizing all tax revenue was thought to be a way to increase social cohesion in a country shattered by social unrest. Specifically, local taxes were to be replaced by a systems of grants designed to equalize the spending capacity of all municipalities, thus eliminating the differences in local public expenditures due to different local endowments of resources, especially the large differences between the North and the South of Italy. These grants were to be based on a vast number of "objective" parameters. Furthermore, financing local governments through transfers from the central government would give the center better control over the subnational governments.

However, the results of the reform were very different from those anticipated. Eliminating all fiscal autonomy at the local level, the reform also allowed local governments to ignore all cost considerations of increased public spending, thus enticing local politicians to increase the demand for increased public services and higher salaries. Current expenditures rose at an average rate of 20 percent annually between 1970 and 1977.[3] Current revenues, in contrast, did not rise sufficiently to keep in pace with spending. Confronted with this, local governments responded by cutting capital expenditures and by financing current spending through borrowing from commercial banks. By the end of 1977, total municipal debt had tripled from the level of 1970. Confronted with interest rates above 20 percent, many municipalities quickly found themselves unable to finance interest payments and debt service. Bankruptcy seemed imminent for many cities.

In this situation, the central government stepped in to rescue them. In 1977, emergency measures were passed that placed ceilings on the growth of local expenditures, restricted local government borrowing and increased central government transfers. In 1978, the central government assumed responsibility for the debts accumulated by the municipal governments before 1977, including interest payments due. Transfers were raised by almost 300 percent. As a result, the financial situation of the municipalities was quickly reversed. In exchange for the financial rescue, the central government imposed strict limits on local spending and imposed a ban on borrowing to finance current expenditures. These measures proved to be effective, witness the fact that the growth rate of local government spending was kept under tight control in the subsequent years, and local government debt remained stable at 10 percent of GDP throughout the 1980s.

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[3]Real current expenditures rose by six percent annually during this period.

The financial crisis had more long-lasting effects, however. On the one hand, local governments had learned that the central government would come to their rescue in times of difficulties. This created a moral hazard problem resulting in fiscal irresponsibility at the local level. Thus, the central government had to maintain tight control of local government expenditures in the following years. On the other hand, these tight controls did not solve the soft budget-constraint problem, but rather moved it from bailing out debts and deficits to the determination of central government grants. That is, the central government, in order to save the municipalities financially, simply increased its transfers to them so as to approximately balance their budgets. In doing so, it gave an implicit premium to those municipalities that had accumulated the most debts. Subsequent attempts to revise the grant system and make grants depend more on fiscal needs and costs and less on past fiscal profligacies never succeeded. Thus, according to Emiliani (1997), more than 50 percent of the grants paid in 1993 still depended on the debt accumulated in the 1970s. The absence of reliable data on cost and expenditures and the true tax base at the local level was one reason for the failure of these reform attempts. Furthermore, the frequent turnover of governments at the local and at the central level implied that the central government never acquired the ability to engage the local governments in a long-run oriented reform of the transfer system. Instead, transfers to municipalities were and are decided on an annual basis in negotiations between representatives of the municipalities and the central government.

3.3.2. Financing Ordinary Regions

Introduced first in the 1970s, “ordinary regions” became the center of Italian local government in the 1980s. In 1992, ordinary regions spent 71 percent of their total resources on health services, 6 percent on transportation, 10 percent on economic services, and 4.5 percent in general services. Almost three percent of their revenues came from own taxes, and 96 percent were central government transfers and grants. Of these central government funds, however, only four percent were unconditional grants. As in the case of municipalities, a deliberate political choice had been made in the 1970s to make ordinary regions highly dependent on transfers from the central government. This was thought to give the central government better control over the quality and the regional distribution of public services, which was deemed particularly important in the health sector. Here, a passage in the country’s constitution was read as implying that all Italian citizens had

a constitutional right of access to the same quality of health services. As a result, each region should provide exactly the same services and impose the same fees for them.

Conditional grants from the central government to regions specified not only the type but also the detailed purposes of the expenditure. Confronted with very specific guidelines on how to spend the money transferred to them, the ordinary regions were left with very little room for using their own legislative powers. As a result, regional politicians and administrators had little accountability to the citizens of their regions. But at the same, they were not accountable to the central government either, as there were few controls monitoring their compliance with central government guidelines. Lack of reliable data and the absence of adequate accounting procedures for

hospitals and local health units made monitoring the quality and cost of local health services impossible.

While the central government largely succeeded in assuring the same levels of spending on health services across regions, its lack of control capacity implies that the level and quality of services varied considerably. Thus, uniformity of standards and strict guidelines were not sufficient to guarantee uniformity of services. Worse than that, by eliminating the room for managerial decisions at the local level, the incentives for local politicians and administrators to provide services efficiently and in accordance with local preferences were largely destroyed. Instead, the overlapping of competencies in the health sector promoted fiscal irresponsibility, waste, and excess spending. Throughout the 1980s, various attempts to control health spending more effectively by setting strict budget rules remained unsuccessful, as health spending continued to run consistently above planned expenditures. Thus, at the beginning of the 1990s, actual expenditures exceeded planned health expenditures by about 15 percent annually, in 1990, even by 25 percent. The regions refused to accept responsibility for this, arguing that they were just applying central government guidelines and did not have the managerial freedom to promote efficiency.

In the annual budget cycle, the central government determined the size and the distribution of the National Health Fund (NHF), from which health expenditures were to be paid, in negotiations with the ordinary regions. In doing this, the central government deliberately underfunded the NHF, making its appropriation just slightly larger than the appropriation of the preceding year. This allowed the central government to produce a better-looking national budget, reducing the need to push for unpopular spending cuts or increasing taxes. The regions accepted this underfunding, anticipating that the budget constraint for health spending would turn out to be soft during the year. Faced with insufficient funds to finance the required expenditures, the regional health administrations were able to borrow effectively though payment arrears and local banks, thus circumventing the ban on outright borrowing by regional governments. Sooner or later, generally with a lag of one or two years, the central government was forced to step in and cover the deficits thus incurred. Note that such operations did not affect the central government budget deficit, although they did contribute substantially to the rising public debt. As private suppliers of health services expected delays in payment, delay, this process promoted overpricing of services. Thus, all actors involved were happy with the arrangement. In the end, however, the central government lost

the ability both to control and to program health expenditures.

3.3.3. Public Finance Reforms in the 1990s

1992 marks a watershed year in Italian public finance. Two critical events, Italy's falling out of the European Monetary System and the disclosures of the "clean hands" judges, which shattered the Italian political system, prepared the ground for sweeping reforms. At the heart of these reforms was the effort to increase fiscal responsibility at the local level by reducing the role of transfers from the central government and increasing the revenue and spending autonomy of the local governments.

In 1993, the two earmarked health taxes were attributed to the ordinary regions and the central government reduced its responsibility for health spending. Regions were given more resources and fiscal and managerial autonomy in exchange for charging them with the responsibility for health care and any deficits incurred in the context of health spending. In 1995, all conditional and unconditional central government grants except those through the National Health Fund were abolished. In return, the regions were allocated a share of the revenues from the national gasoline tax collected on their territory, and they obtained the right to impose a regional surcharge on this tax. To match the difference between the former grants and the revenues from shared taxes, a temporary, unconditional Redistribution Fund was created, which was scheduled to be abolished once the revenues from shared taxes exceeded the former grants. As a result of the new arrangement, the share of non-earmarked revenues in the regional budgets increased.

In 1997, the two taxes earmarked for health spending and several small regional taxes were abolished and replaced by a regional tax on all productive activity, which gave the regions a strong own tax base. Beginning in the year 2000, the regions will have some authority over the local rate of this and other taxes. Also in 1997, legislation was passed to reduce the scope of formal central government control over the regions and give the latter more autonomy. Today, ordinary regions receive conditional transfers only to finance health expenditures; for the rest, they are self-financing or receive money from sharing national tax revenues under the Redistribution Fund.

Regarding municipalities, legislation was passed in 1990 that reduced the role of the central government in the direct financing of local governments. In 1993, a new tax on residential property was introduced. Municipalities were granted the right to choose their tax rate in a range between 0.4 and 0.7 percent, and, progressively, they have obtained the right to define tax deductions from this

tax and to monitor their tax bases. Central government transfers were cut in 1993 by the equivalent of the revenue from this tax at the minimum rate of 0.4 percent. In 1997, municipalities were allocated a share in the revenue from the regional tax on all productive activities. In 1999, municipalities were granted half a percent of the tax base for income tax in their territory, with the possibility that this share be increased to one percent in later years. Similar steps were taken for the provinces. Today municipalities finance more than 50 percent of their total expenditures with own resources; this ratio is to rise to 65-70 percent for the municipalities in the North of Italy.

In order to increase the accountability of local governments, new electoral laws were passed, substituting the old, proportional electoral system by more majoritarian systems. Under these new rules, the positions of president of a region, president of a province, and of the mayor have been strengthened considerably. This has lead to the emergence of a new, local political class largely independent from the national parties. Casual evidence suggests that the new electoral rules, coupled with more local budget autonomy and managerial flexibility, have been instrumental in increasing efficiency of local government.

3.4. Bailouts of Swedish Cities in the 1990s

Decentralized decision making at the local level has a long tradition in Sweden, and the principle of local self-government is enshrined in the Swedish constitution. Local governments are independently responsible for the provision of social services such as day care, education, and others. Local government operations can be divided into mandated operations (accounting for about 40 percent of total local expenditures) and voluntary operations. Education and social services are prominent among the former; cultural, recreational, and technical operations are among the latter.

3.4.1. Bailouts in the 1990s

Until the late 1980s, Swedish municipalities were generally considered to be financially healthy. In the wake of the Swedish economic and financial crisis of the early 1990s, however, several municipalities found themselves in financial hardship. The financial capacity of Swedish local governments was restrained from 1991 to 1993 by national legislation suspending the right of municipalities to raise their own tax rates. Between 1996 and 1998, a large number of municipalities applied for extra financial help from the central government, arguing that they could not resolve their financial problems on their own.

In 1992, the city of Haninge was the first municipality to turn to the central government for financial help. The reason given by the city was that a city-owned housing company, for which the city was also the main creditor, was unable to meet its financial obligations, and that the city in turn was unable to take care of its debts, which amounted to SEK 1.3 billion. Thus, bankruptcy of the city was imminent.

After two years of negotiations, the central government and the city reached an agreement by which the central government effectively assumed responsibility for the debt owed by the housing company. The city lost almost all its shares in the company to the central government, which gave the company a rescue loan of SEK 600 million. In 1995, the city received an extra grant of SEK 850 million from the central government to pay back the remaining debts of the housing company. The city was also mandated to raise its local tax rate by one percentage point.

A second, interesting case of bailout involved the city of Bjuv. Again, the reason for the financial troubles of the city was the overindebtedness of its housing company. In 1995, the city informed the central government that its financial situation was precarious. In 1996, it applied for an extra central government grant of SEK 200 million, arguing that the city could not resolve the crisis itself. The city's total debt amounted to SEK 627 million in March 1998. The settlement negotiated between the central government and the city was remarkably different from the Haninge case. Here, the city was allowed to keep possession of the housing company, although it received a grant from the central government to pay back the SEK 150 million debt of the housing company, along with an additional SEK 9 million in fresh money for the company.

3.4.2. Econometric Evidence

The Haninge case quickly found imitators. By 1998, 87 of a total of 288 municipal governments in Sweden had applied at least once for central government help out of financial crisis. Thus, the perception that a bailout was a viable solution quickly raised the demand for central government aid. Econometric evidence provides some insights into the determinants of that demand.

The econometric exercise conducted in Dahlberg and Petersson (1999) uses data for 1996-98 and takes as dependent variable an indicator which is zero if a city did not apply for central government aid and one if it did. Probit regressions then estimate the probability of a city applying for central government aid. The dependent variables of interest are the per capita debt of the

municipality, its degree of vertical fiscal imbalance, the number of inhabitants, the political affiliation of the majority in the city council, and the number of changes in power in the city council between 1974 and 1994. Vertical fiscal imbalance is measured by the ratio of central government grants received by the municipality and its total revenues. In addition to these variables, a number of controls are used, the share of people under age 17 and above age 65 in the population, the migration rate, the unemployment rate, population density, and the ratios of foreigners and of refugees in the total population.

The results of these estimates indicate that the size of municipal debts is the strongest determinant of the demand for bailouts. Increasing a municipality's debt by SEK 1,000 per capita of its inhabitants increases its probability to demand a bailout by about 1.5 percent. Furthermore, cities whose councils are dominated by a socialist majority (i.e., the same party in power in the central government during the period) are significantly more likely to apply for bailouts. This indicates the perception at least that bailouts are granted not only on the basis of financial considerations, but also on the basis of political opportunity. Neither vertical fiscal imbalance, population size, nor the frequency of government changes plays a significant role in the demand for bailouts. That vertical fiscal imbalance plays no important role may be due to the fact that the degree of imbalance is relatively small overall in Sweden.

4. Lessons and Conclusions

That decentralization of political decision making exposes the central government to the risk of having to bailout subnational governments is an old insight in public finance. Our four case studies show that this risk is real and important in OECD countries, both in federal and in unitary states. The review of these four cases also sheds some light on traditional and new analytical themes regarding bailouts.

A first and venerable theme is the "too big to fail" hypothesis (e.g., Wildasin 1997). According to this argument, the size of a subnational jurisdiction positively affects its likelihood of demand and obtaining a bailout, as the central government is unable to commit ex ante to refusing a bailout. In essence, the political cost of letting a subnational government go bankrupt is too large for the central government to accept it. Interestingly, however, this hypothesis receives no support in our four cases. To some extent, the opposite even seems to be true. The two German states that

were bailed out in the 1990s were the smallest in the West German federation. In Italy, the tendency to ask for bailouts seems to be stronger for small regions and municipalities than for larger ones. One explanation is that large jurisdictions internalize more of the fiscal cost of bailouts than small states, i.e., large jurisdictions have a greater reason to be fiscally responsible in the first place. Another explanation is that the central government may be more willing to grant a bailout to small states, because the fiscal cost is likely to be negligible in terms of its own budget even if it is important in terms of the local government's budget.

There is, however, a version of the "too big to fail" argument which is visible in our cases. This could be dubbed "too sensitive to fail." Central governments seem to be more likely to grant bailouts, if refusing to do so puts at risk the orderly provision of public services which are regarded to be especially sensitive. Thus, the central government would be unable to commit ex ante, because the political cost of refusing a bailout would be excessively large. Anticipating this creates incentives for subnational governments to threaten to stop providing such services if they do not receive financial assistance from the central government. Clearly, health services, which are of central importance in the Italian case, would seem a plausible sector for this, as would be housing, which is at the center of the Swedish case. Thus, these two cases show that "size" should not only be measured in terms of geographical extension, but also in terms of importance in public opinion.

A second traditional theme regarding bailouts is political favoritism: Central governments grant bailouts to subnational governments if the latter are closely connected to them through party affiliations or ideologies. This factor seems quite significant in the Swedish case, where being from the same party as the central government raised the municipalities' likelihood of asking for a bailout. It also seems to have played a role in the German case, where the renegotiations over the terms of the second bailout contract dragged on in 1997-98, as the central government and representatives of states with governments involving the CDU in the federal parliament did not want to threaten the survival of the coalition government between the CDU and the SPD in Bremen.

The Italian case, in contrast, exhibits a different version of political favoritism. In Italy, bailing out regions became a habit that benefited all political actors, allowing them to get around formal constraints on fiscal policy. Local policy makers were happy with a system that reduced their accountability and effectively left their discretion for using public monies relatively unconstrained. Policy makers at the national level were happy with the same system as it allowed them to spend

large sums outside the ordinary budget process, giving them more political clout than the ordinary process. The experience shows that it took a severe financial and political crisis to shake up this political equilibrium.

The Australian case stands in stark contrast to the three European ones in this regard. Even if they were successful obtaining bailouts, state governments paid a high political price for what voters obviously perceived to be fiscal profligacy. Following the first default by the New South Wales under Jack Lang, the Federal executive of the Labor Party expelled the New South Wales executive, which caused some members of the New South Wales Labor Party to resign and form a new Lang Labor Party. More importantly even, Lang's government was defeated badly in the elections following his second default and his subsequent removal from office. Queensland's refusal to comply with Loan Council regulations in 1989 was followed by a defeat of the ruling party in the subsequent state elections. Similarly, the ruling Labor party was soundly defeated in the elections following the "Victoria Loan Affair." The apparent political consensus of Australian voters that state governments should avoid bailouts has likely been a strong protection of the Australian federation against more severe and more costly bailout episodes.

The Australian case, in contrast, bears an element lacking from the other three cases, namely central government concern for the country's reputation in international capital markets. The two bailouts of the Lang administration in the 1930s are clear cases of such considerations. Here, the central government paid the interest owed by the state immediately in order to avoid any damage to Australia's international reputation as a debtor. Similarly, the Commonwealth treasurer defended his decision not to make Victoria's 1991 breach of its Global Limit public, arguing that doing so would have created turmoil in the financial markets.

Another reason for bailouts suggested in the literature is vertical imbalance paired with the authority of subnational governments to borrow in their own right. According to this argument, subnational governments that do not dispose of strong own tax bases are prone to overborrow and become unable to meet their financial obligations. In the absence of sufficient local resources to resolve the problem, the central government then has no choice but to assume their debts.[4]

Our set of four cases contains two, Sweden and Germany, where vertical fiscal imbalance is relatively low, and two, Australia and Italy, where vertical fiscal imbalance is large. Note that, confirming Eichengreen and von Hagen's (1996b) suggestion, subnational governments in the two states with large vertical fiscal imbalance are subject to borrowing restraints. Nevertheless, bailouts

[4]Eichengreen and von Hagen (1996b) show that the degree of vertical imbalance explains the incidence of borrowing restrictions on subnational governments. Borrowing restrictions are imposed to protect the central government against bailouts.

occurred in these and the other two states. The German case in particular suggests that what matters is not the ratio of own resources to total revenues alone, but also subnational government's room for maneuver in raising local tax rates. The Swedish incident, which occurred after the central government had restricted the ability of municipalities to change local tax rates, confirms this suggestion. The implication is that the necessity of borrowing restraints should be evaluated in view of the ability of local governments to raise additional revenues on their initiative, together with the average dependence of these governments on financing from above.

The other two cases, however, provide a healthy warning against relying on legal borrowing restraints. The Italian case demonstrates most clearly that such restraints can be evaded in the absence of proper administrative and budgeting procedures that create clear responsibilities and accountability.

Finally, two important themes arise from the four cases, which so far have been largely overlooked in the analysis of bailouts. The first is the role of constitutionally mandated standards for the provision of public goods by subnational governments, which is of prime importance in the German and Italian bailouts. In both cases, national constitutional law requires the subnational governments to provide nationally uniform levels of public services as part of an attempt to guarantee equal standards of living to all citizens of the country, regardless of where they live.[5] Unless the standards to be guaranteed are perceived to be rather low, leaving all but the poorest jurisdictions with the choice of providing higher service levels and better service quality and paying for them out of local resources, such mandates are a form of regional income equalization in countries where regional per capita incomes differ widely. This intention was indeed quite explicit in the Italian case.

To meet such constitutional mandates, local governments must be provided with the proper financial resources. If local government revenues differ widely, and local governments have little discretion to raise additional revenues, a conflict arises between the requirement to deliver the necessary level and quality of services and the financial ability of the local governments to pay for them. Both in Italy and in Germany, local governments used this conflict strategically to support their demands for bailouts. In both cases, the basic justification for asking for extra central government

[5]The Canadian federation has a similar rule which is regarded the legal basis for the Canadian system of horizontal fiscal equalization. In Canada and Germany, the mandate to provide uniform levels and quality of public services is regarded as an outflow of the rule of equality of all citizens before the law. See von Hagen (1993).

money was that the local governments could not deliver the public services required of them by the national constitution. In both cases, the central government had little choice but to give in and provide the necessary funds.

The experience bears an important lesson for the design of decentralized political decision making, namely that local governments should either have the right to choose the level and quality of public services freely, or that the central government should provide and finance these services according to its desire to provide uniform standards throughout the country. In fact, one of the main justifications for decentralized provision of public services, that local governments can choose quantity and quality according to local preferences, is explicitly eliminated by the constitutional mandate unless the latter is interpreted in the sense of minimal standards.

The second theme is the potential conflict of interest between state governments and the central government that arises if the latter abuses federal or national fiscal strictures to impose its own preferred fiscal policy on subnational governments. This theme stands out in the Australian case, where the loan allocations set by the central government paid no attention to the fiscal needs of the states over long periods of time. Instead of facilitating cooperative federalism, the Loan Council Arrangement increasingly became an instrument of fiscal dominance of the Commonwealth over the states. It is interesting to observe that a first attempt to create a Loan Council was rejected by the states in 1908 for the very fear that the Commonwealth would use such an arrangement to impose a fiscal policy on the states that the latter did not desire (Scott, 1983). One particular version of the same theme is visible in the conflict between the Lang governments and the Commonwealth governments in the early 1930s: Here, disagreement over the extent to which (foreign) bondholders should be forced to shoulder part of the cost of adjustment to the Great Depression stood at the center of the conflict. A similar type of conflict may have played a role in the Swedish bailouts, which occurred only after the central government, in its attempt to resolve the national financial crisis of the early 1990s, restricted the municipalities' right to determine local tax rates.

The point here is that federal—or national—strictures designed to coordinate the fiscal policies of subnational governments in order to make them consistent with a desired aggregate fiscal stance at the national level can become instruments of central government domination. However, if the policies imposed on subnational governments differ too widely from the policies desired at the subnational level, the subnational governments will try to avoid these constraints. Bailouts are but

one form of such efforts. The implication is that institutions designed for the coordination of subnational fiscal policies must carefully balance the power of the central and the subnational governments, leaving the latter sufficient freedom to pursue the policies they see fit and in their own interests without resorting to bailouts and other policies that erode the effectiveness of the coordinating mechanism.

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