

## **THE INSTITUTIONAL FRAMEWORK FOR SUBNATIONAL FISCAL DISCIPLINE: THEORY AND PRACTICES IN EIGHT COUNTRIES**

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Certain key elements of the institutional framework of a country's system of fiscal federalism are conducive to good fiscal discipline (a hard budget constraint) at subnational levels of government. The elements considered in this note are derived from the literature on subnational fiscal discipline and my experience in analysis and reform of policy frameworks for subnational governments.

Brief descriptions of the elements of the framework are listed in the first column of the exhibit beginning on the next page. The elements are expressed as affirmative statements that, at least in concept, can be answered either "yes" or "no" for the policy framework of a country. The exhibit refers to "state" governments, with the intention that the term be understood to refer to all second-tier (immediately below the national) governments, whether their formal names are states, provinces, oblasts, or subjects of the federation. In most multilevel fiscal systems, the institutional and policy framework for governments below the second tier is almost always defined by the second-tier governments, and so often differs among the states. Therefore, the exhibit does not attempt to address the question of the policy framework in each state that may be most likely to ensure good fiscal discipline at lower levels of government.

The remaining columns of the exhibit provide a preliminary assessment of the presence or absence of each element in the fiscal systems of nine countries. I would welcome advice on instances where the evaluation of a country's framework may not be accurate. Where it has not been possible to verify with some confidence the assessment of a particular element of a country's system, the tentative evaluation is qualified by a question mark. Where possible and feasible, evaluations are annotated briefly.

The institutional elements are classified in seven categories:

- A. National policies mandating balanced operating budgets.
- B. State expenditure authority and responsibilities.
- C. State revenue-raising authority.
- D. Budgetary transparency and citizen participation.
- E. National transfer policies.
- F. Policies relating to the authority of states to borrow.
- G. Capital markets and central bank independence.

A useful avenue of further research on these issues, in addition to verification of the evaluations of the details of country frameworks, would be design of a method for weighting the elements in order to arrive at comparable, overall summary evaluations of fiscal systems. Clearly, some of the elements are substitutes, some are far more important than others, and some are of little relevance to systems structured in certain ways.

This exercise was undertaken for a Background Paper prepared for a roundtable on subnational fiscal discipline held in Agra, India, in December 2003. The roundtable was organized by Development Alternatives, Inc., under a contract with USAID and in cooperation with the Ministry of Finance of India. Information on the roundtable and the text of the Background Paper are

*Roundtable: Approaches to Fiscal Decentralization*  
*Wednesday, June 30<sup>th</sup> – 1:30-3:00PM*

available at <http://www.fiscalroundtable.net/>. I want to thank again very much my collaborators in preparation of the Background Paper, Mark Gallagher and Steve Rozner of DAI.

## THE INSTITUTIONAL FRAMEWORK FOR FISCAL DISCIPLINE AT THE SUBNATIONAL LEVEL: A PRELIMINARY INVENTORY OF THE SYSTEMS OF NINE COUNTRIES (page 1 of 4)

Policy	Argentina	Australia	Brazil	Canada and U.S.	Mexico	Russia	South Africa	India
<b>A. National Policies Mandating Balanced Operating Budgets</b>								
1 Constitutional rules mandate balanced operating budgets.	No	No?	No	No	No	No	No	No
2 Statutory rules mandate balanced operating budgets.	No	Yes?	No	No	No	No	Yes	No
3 Effective penalties are provided for state officials responsible for violating the balanced-budget rules.	No?	Yes	No	No	No	No	No?	No
4 A system is in place for implementing conditional bailouts enforced by an independent “bankruptcy” court or agency.	No?	Yes?	No	No	No	No	No	No
<b>B. State Expenditure Authority and Responsibilities</b>								
1 The service responsibilities of the states are clearly defined and the states have the authority to manage their expenditures for the functions.	Generally	Yes	No	Yes	No	No	No	Yes
2 States have the authority to reduce expenditures for such major objects as personnel and salaries in the event of unforeseen budgetary difficulties.	Yes, to a degree	Yes	No (labor costs)	Yes	No (wages in educa. & health)	Yes	No	No specific provision
3 State pension systems are required to operate on an actuarially sound, fully-funded (rather than pay-as-you-go) basis.	No?	Yes	No	Yes (some not all)	No	No	No	No
<b>C. State Revenue-Raising Authority</b>								
1 The states have access to sufficient taxing power (authority to set rates) to enable the typical state to finance at least half its operating budget from its own taxes.	No (roughly 40%)	No	Yes large states; No small	Yes	No	No	No broad-based taxes	Probably
2 The taxing powers of the states are limited to taxes that do not permit substantial portions of burdens to be shifted to non-residents, except to the extent that non-residents can specifically be identified as important beneficiaries of services provided by a state.	Generally	Yes	Generally	No (taxes on natural resource extraction)	Generally	Major problem (tax exporting)	Not applicable	Yes
3 The states have the authority to levy user charges and to collect other non-tax revenues sufficient to enable them to finance public-utilities on a full-cost-recovery basis and to finance substantial portions of the costs of (other) public services for which it is possible directly to charge beneficiaries.	Yes	Yes	Yes	Yes	Yes, but actual charges are “typically” below MC	Yes, but substantial rent-seeking	Not applicable	Yes, but charges are almost always way below MC
4 In general, state revenue-raising authority is sufficient to enable the states to raise additional revenues, at the margin, in the event of unforeseen budgetary difficulties.	Not really	No	Yes	Yes	No	“Very limited” authority	No	Yes

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Policy	Argentina	Australia	Brazil	Canada and U.S.	Mexico	Russia	South Africa	India
<b>D. Budgetary Transparency and Citizen Participation</b>								
<b>1</b> National policy requires publication of (summary versions of) proposed and actual state budgets, conduct of public hearings prior to adoption of a budget, and publication of the adopted budget.	No	No	No	No	No	No	No	No
<b>2</b> National policy requires a public hearing prior to official state approval of every issuance of long-term debt.	No	No	No	No	No	No	No	No
<b>3</b> National policy requires approval in a public referendum of every issuance by a state of long-term debt.	No	No	No	No	No	No	No	No
<b>4</b> National policy prescribes rigorous standards for state accounting and budgeting, preferably including full-accrual reporting of all revenues and expenditures.	No	No	No	No	No	No	No	No
<b>5</b> National policy requires timely independent audit of a state’s annual financial statements and timely publication of the audit report.	No?	No	No	No	No	No	No	No
<b>6</b> A national Fiscal Responsibility Law has been enacted.	No	No	Yes	No	No	No	No	No
<b>E. National Transfer Policies</b>								
<b>1</b> National policies minimize central government reliance on discretionary transfers.	Yes?	Yes	Generally, except debt relief	Yes	No	No (“asymmetric federalism”)	No	Yes, to a substantial extent
<b>2</b> National transfers of general fiscal assistance are distributed on the basis of statutory formulas (including origin, that is, shared taxes), and the variables in the formulas are independent of the actual policies of the states.	“Largely”	Yes	“Mostly”	Yes (very little GFA in U.S.)	No	No	Not entirely	Yes, except under Centrally Sponsored Schemes and some State Plan Schemes
<b>3</b> A substantial portion of general fiscal assistance is distributed by the central government on the basis of a statutory formula that provides for systematic equalization of state fiscal capacities.	No	Yes	Very roughly	Canada Yes U.S. No	No	No, but 1990 reforms	No	Yes
<b>4</b> National categorical grant programs require substantial “matching” contributions from own state revenues to the financing of programs eligible for such assistance.	No	Yes	No	Yes	Minimal pilots beginning in 2000	No	No	Yes, as part of Centrally Sponsored Schemes
<b>5</b> National policies ensure that states are appropriately reimbursed for the costs of spending mandated by the central government.	Goal not practice	Yes?	No	Goal not practice	No	No	No	Goal not practice

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Policy	Argentina	Australia	Brazil	Canada and U.S.	Mexico	Russia	South Africa	India
<b>6</b> National policies facilitate multi-year state budget planning by projecting flows of central transfers several years into the future and by minimizing substantial, unpredictable fluctuations in transfer flows.	No	Yes	No	Yes	No	No, but 1990 reforms	No	To a substantial extent
<b>F. Policies Relating to the Authority of States to Borrow</b>								
<b>1</b> National policy prohibits state borrowing other than for cash-flow purposes.	No	No	No	No	No	No	No	No
<b>2</b> National policy requires advance approval of state bond issues by an entity(s) of the central government. <sup>1</sup>	No	Yes	Yes, but loopholes	No	No?	No	Yes	Yes, when there is outstanding debt to the Central Gov.
<b>3</b> National policy requires registration or reporting to an entity of the central government of details of state bond issues before they are consummated.	Yes, reviewed and registered by Min. of Economy	Yes	Generally	No	Yes	Yes	Yes	No
<b>4</b> National policy prohibits state borrowing from foreign creditors.	No, but approval by the central bank is required	Yes	No, but guarantees must be approved by MoF	No	Yes (Constitution)	Eurobonds closely supervised by MoF	Yes	Yes, statutorily
<b>5</b> National policy imposes a ceiling on the outstanding principal amount of long-term debt a state may have outstanding at any time.	No	Negotiated annual limits	Yes by Senate (Fiscal Responsibility Law)	No	No	Only local borrowing & only annual increase	No	No
<b>6</b> National policy expressly disavows any implication that a bond issue is secured in any way beyond the full faith and credit of the issuing state.	Yes	Yes?	No	Yes	No	Yes	No	No
<b>7</b> National policies explicitly and credibly forbid bailouts of states at risk of defaulting on their outstanding debt.	Yes	Yes	No	Yes	No	No	No	No

<sup>1</sup>References to bond issues should be understood as including state agreements to guarantee debt instruments issued by state-sponsored enterprises and other such entities.

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	Policy	Argentina	Australia	Brazil	Canada and U.S.	Mexico	Russia	South Africa	India
<b>G. Capital Markets and Central Bank Independence</b>									
1	Private entities have the capacity to provide objective ratings of the credit quality of bonds issued by the states.	No	Yes	No?	Yes	Yes	No	Yes	Yes
2	Private entities have the capacity to offer insurance for state bond issues.	No	Yes	No?	Yes	No	No	Yes?	No
3	Private financial institutions are developed to the point of being able to mobilize capital resources sufficient to meet the demand for long-term credit by the states.	No?	Yes	No?	Yes	No	No	Yes	No
4	National regulatory policies do not permit states to own banks.	No	Yes?	No	Yes	Yes?	Yes?	Yes	Not explicitly
5	National law includes a bankruptcy code for state governments that provides for orderly financial workouts in the event that a state default occurs.	No	Yes?	No	Yes?	No	No	Yes for municipalities	No
6	The central bank enjoys a high degree of autonomy and has a strong anti-inflation mandate. (Dillinger and Webb).	Yes	Yes	“Limited autonomy”	Yes	No?	No	Yes	Yes, but no clear anti-inflation mandate
7	National regulatory policies explicitly require creditors to accept losses occasioned by state failures to service debt (Dillinger and Webb).	Yes	Yes?	No	Yes?	No?	No	Yes?	No