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# COORDINATION OF MACROECONOMIC POLICY AND FISCAL DECENTRALIZATION

Otto Gandenberger

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Regional Project on Fiscal Decentralization
ECLAC / GTZ

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## PREFACE

The Fiscal Policy Series has the purpose of disseminating the results of the activities developed by the ECLAC-UNDP Regional Project on Fiscal Policy and by the ECLAC-GTZ Regional Project on Fiscal Decentralization. Both projects operate under close coordination and have objectives and activities covering a vast array of topics related to the public finances and fiscal policy of Latin American Countries.

This paper is part of a more comprehensive project on macroeconomic coordination and fiscal decentralization prepared under the auspices of the Commission Económica para América Latina y Caribe (CEPAL) in cooperation with the German Gesellschaft für Technische Zusammenarbeit (GTZ). In contrast to the other studies presented as part of this stage of the project -four on Latin American countries (Argentina, Brazil, Colombia and Peru)- one presenting the views of the World Bank -the present study will, with all due caveats as to the transferability of international experience, draw on the conditions and experiences of industrialized countries with decentralized fiscal sectors, predominantly so from the European ones: many of the examples cited in this paper will be taken from the conditions and experience of Germany, Austria and Switzerland.

In its hoped that this issue of the Fiscal Policy Series will provide a better understanding of this matters -as well as towards a wide dissemination of the results here presented-among authorities responsible for the formulation, desing and implementation of fiscal policy, as much as mmong all those, within the public and private sector, intererested in the broad of public finances.

## ABSTRACT

Fiscal decentralization, as seen from the perspective of central government, is associated with reduced direct control. A large part of the public sector -typically between one quarter and more than half of total public expenditure- is determined by essentially independent subcentral units. While this may result in efficiency gains of the oft-described nature, it may under some circumstances also lead to losses in efficiency. At the same time it may be associated with special problems of macroeconomic coordination.

Macroeconomic problems tend to have causes that can be described in microeconomic terms. As we shall see, many, if not most of these micro reasons for macro problems are identical with the just-mentioned efficiency problems, in other words, with a lack of incentive-compatibility and of inadequate administrative infrastructure. To that extent, unwarranted macro effects reflect the cumulative impact of dysfunctional effects at the micro level, and the distinction between the Musgravian categories of *allocation* and *stabilization* will be difficult to draw.

As one would expect, these problems present themselves differently for industrialized countries on the one hand and for developing (low or medium income) countries on the other. It is not surprising that the difficulties are particularly great for developing countries that are «*newcomers*» in the world of fiscal decentralization or just have taken important steps in this direction, and hence have not lived through the long adjustment processes typical for most industrialized federations, as is typical for a number of Latin American countries. A general impression, however, is that the difference is not so much in the nature of problems, but in their intensity.

This first of the two Parts of the present paper will start with a more general discussion of the issue of macroeconomic coordination, then proceed to its federation-specific aspects. In its final section, it will give some general and more coherent information on the fiscal system of the three European countries, the conditions and experience of which will be frequently cited in the succeeding part (*Conclusions and suggestions*) of this study. This latter section may be skipped by the time-constrained reader who takes a more direct interest in the results presented.

# I. THE PROBLEM IN PERSPECTIVE

"The traditional discussion about the role of fiscal decentralization is somewhat off the mark because, in today's world, the problem is not how to counter economic cycles but how to remove structural deficits" (Tanzi 1995, p. 32).

## 1. Introduction

Where one asks the principal problems of macroeconomic coordination depends upon what one regards as the main objectives of macroeconomic fiscal policy. The answers may diverge, but from a present-day point of view they may perhaps be broken down into two major types:

The shock protection approach. Under this heading the principal objective of macro fiscal policy is considered to be to help protect the economy against negative consequences of exogenous shocks, be they of short term demand side (*«Keynesian»*) or supply side (*«neoclassical»*) origin, be they of general or of selective impact.

The fiscal discipline approach. Here the focus is on keeping the fiscal deficits within the limits of long-term sustainability. The emphasis, then, is on structural rather than cyclical deficits (see, for instance, the quotation from Tanzi 1995, chosen as a motto for this part of the paper, or, in a similar vein: Wiesner 1994). A convenient -although admittedly narrow- definition and measure of sustainability in this sense, has been developed by Blanchard et. alt. (1990) and the subsequent literature.[1] It amounts to stating that the fiscal policy of a country is sustainable (*«disciplined»*) if the present structural deficits, that is, the deficits corrected for all effects of a purely temporary nature including cyclical ones, will leave at least constant the relative weight of the outstanding public debt, as measured by the ratio of debt to gross domestic product (GDP). In other words, present fiscal policy, as reflected by the resulting structural deficits, is regarded to be unsustainable (and hence indicating a lack of *«fiscal discipline»*) if it leads to increased debt/GDP ratios.

The latter approach, that of fiscal discipline, may be seen as a shorthand -albeit somewhat defensive- way of addressing a whole bundle of more specific macro objectives that are in danger of being negatively affected by *high* or *excessive* deficits. These objectives include securing a fair distribution of burdens between present and future generations; preventing negative effects on capital markets, interest rates and growth; helping to secure price level stability, or -with a somewhat different twist- reducing the conflicts of goals on the way to price level stabilization. Last but not least, drawing a line to the shock protection approach, its function can be seen as that of preserving the flexibility of present and future fiscal policy to cope with adverse extemal shocks, thereby making the economy less vulnerable to such disturbances.

As is already indicated by this latter remark, the two sets of objectives do not stand separately. There is a considerable area of goal harmony. This harmony is almost perfect for times of excess demand (economic boom) and of positive supply side shocks. It also holds for «*normal times*» when severe negative shocks are absent. And even in recessions the difference between the two approaches is not as great as it may seem at first sight, if one keeps in mind that the fiscal discipline issue in the above definition is concerned with structural and not with actual budget deficits.[2]

## 2. The fiscal discipline issue in general perspective

### *a) Predominance of concern with fiscal discipline*

In previous decades, the main if not the exclusive concern had been with the perspective of protection from economic shocks -often in a narrow, Keynesian perspective- at least in the industrialized world. In our day it rather is with fiscal discipline. One main reason for such a shift of attention may be seen in Table 1.

TABLE 1: OUTSTANDING PUBLIC DEBT PERCENTAGES OF GDP
(Total government sector)

| Country | 1978 | 1980 | 1985 | 1990 | 1992 | 1994 | 1995 |
|---|---|---|---|---|---|---|---|
| Countries with decentralized public sector | | | | | | | |
| Australia | 34 | 37 | 50 | 56 | 56 | 59 | 59 |
| Austria | -- | -- | -- | 25 | 30 | 39 | 41 |
| Canada | 47 | 45 | 65 | 72 | 83 | 91 | 91 |
| Germany | 30 | 33 | 43 | 43 | 43 | 51 | 60 |
| USA | 39 | 38 | 48 | 55 | 62 | 64 | 64 |
| Unwt. average | 38 | 39 | 52 | 50 | 55 | 61 | 63 |
| Other countries | | | | | | | |
| Belgium | 39 | 80 | 122 | 131 | 136 | 145 | 145 |
| Denmark | 22 | 33 | 64 | 60 | 62 | 70 | 72 |
| Finland | 13 | 14 | 19 | 17 | 44 | 66 | 71 |
| France | 39 | 38 | 45 | 47 | 53 | 62 | 66 |
| Great Britain | 39 | 54 | 53 | 35 | 41 | 52 | 56 |
| Greece | 29 | 28 | 58 | 89 | 94 | 104 | 109 |
| Ireland | 66 | 72 | 104 | 99 | 94 | 90 | 87 |
| Italy | 62 | 59 | 84 | 101 | 108 | 116 | 118 |
| Japan | 42 | 52 | 69 | 70 | 67 | 70 | 72 |
| Netherlands | 40 | 45 | 68 | 76 | 78 | 82 | 83 |
| Norway | 60 | 52 | 41 | 39 | 43 | 51 | 54 |
| Portugal | 38 | 38 | 66 | 67 | 63 | 70 | 71 |
| Spain | 14 | 18 | 49 | 47 | 51 | 63 | 66 |
| Sweden | 34 | 44 | 68 | 44 | 53 | 80 | 91 |
| Unwt. average | 41.9 | 44.8 | 58.3 | 66.3 | 70.8 | 80.1 | 82.9 |

Source: OECD 1994, Economics Department, Working Paper No. 144.

The ratio of outstanding public debt to GDP -and as a consequence that of inter obligations in relation to GDP (not shown in the Table)- has increased dramatically during the past two decades in almost all of these countries, whether federal or centralized. Hence the problem for many countries is not one of maintaining, but rather one of regaining fiscal discipline and sustainability of deficits; it is one of implementing or continuing a long-term process of fiscal consolidation. Seen against this background, it is not surprising that the fiscal discipline issue has gained unprecedented attention in the industrialized world. What has further contributed to such shift of perspective is that in a majority of industrialized countries the increase of debt quotas was accompanied by an impressive simultaneous growth of the share of government expenditure in relation to GDP (see Table 2) largely due to steeply increasing social transfers.

TABLE 2: TOTAL GOVERNMENT SECTOR EXPENDITURE
(As percentage of GDP)

| Country | 1980 | 1985 | 1990 | 1992 | 1994 |
|---|---|---|---|---|---|
| Australia | 48 | 51 | 49 | 50 | 52 |
| Germany | 49 | 48 | 46 | 50 | 49 |
| USA | 32 | 33 | 33 | 35 | 34 |
| Belgium | 59 | 62 | 5 | 57 | 57 |
| Denmark | 56 | 59 | 59 | 61 | 62 |
| Finland | 38 | 44 | 45 | 58 | 60 |
| France | 46 | 52 | 50 | 52 | 55 |
| Greece | 33 | 48 | 53 | 51 | 54 |
| Great Brit. | 43 | 44 | 40 | 43 | 43 |
| Ireland | 49 | 52 | 41 | 44 | 44 |
| Italy | 42 | 51 | 53 | 54 | 56 |
| Japan | 32 | 32 | 32 | 32 | 35 |
| Netherlands | 55 | 56 | 54 | 55 | 55 |
| Norway | 47 | 45 | 54 | 57 | 57 |
| Portugal | 26 | 43 | 43 | 52 | 52 |
| Sweden | 60 | 63 | 59 | 67 | 67 |
| Spain | 32 | 41 | 42 | 45 | 47 |

Source: Bundesministerium der Finanzen (Germany), Finanzbericht 1995.

This predominance of interest in the fiscal discipline approach holds not only for industrialized countries but also -and perhaps even more so- for developing countries. Much of the material produced during the last decade in the Economics departments of the International Monetary Fund -IMF- and the World Bank as well as at other places, has made this point very clear.[3]

For all these reasons, the focus in the following presentation is on the fiscal discipline approach and hence on the long-term aspects of present fiscal policy. The shock protection issue will be treated only in second place. The author does not want to imply that such an order of interest must remain the same for all countries and for all time. It may reverse for countries or regions under the impact of major negative economic shocks.

### b) *Fiscal stance of industrialized federal versus non-federal countries*

One general message of the figures presented in Table 1 should be kept in mind during the following discussion: the problem of high and unsustainable deficits is a pervasive one in the industrialized world and by no means specific to federations. An offhand evaluation of the figures, see the averages for federal in comparison to other countries in Table 1, rather suggests that fiscally decentralized countries while still showing an unsatisfactory fiscal performance, are doing somewhat better than more centralized ones in this respect.

That federal as well as centralized countries both have severe trouble with respect to their fiscal performance is not surprising if one considers one message of the public choice literature. It is that the «*power to borrow*» (Brennan/Buchanan 1980, p. 103 ff.) in the hands of governments, even in otherwise well-functioning democracies, carries with it dangerous temptations for political abuse, in centralized states as well as in federations. The literature abounds in analyses -and in more recent years also in empirical studies- of such incentives to use deficits and borrowing for «*political profit*», i.e., for purposes of gaining or retaining political power.[4] It goes without saying (and is shown by Table 1) that such abuse does not necessarily have to be in crude forms. Often it is in the nature of a subtle and long term process leading to increasing relative weights of outstanding public debt.

When comparing the macroeconomic performance of the fiscally decentralized versus more centralized countries in Table 1, one should keep in mind that the fiscally decentralized countries listed in that Table are «*old-established* federations of an industrialized, high income nature. The picture may change considerably for the worse if medium or low income nations are taken into account, especially so if such countries are in the process of implementing decentralized fiscal structures. It may well be that the negative effects associated with such fundamental organizational change of the public sector will materialize faster than the advantages of such reform. This may lead to allocational losses that offset a major part of the efficiency gains otherwise achieved by fiscal decentralization (Tanzi 1995). At the same time, and typically in connection with such allocational losses, it will intensify the problems of macroeconomic coordination for these countries.

## 3. The fiscal discipline issue in federal perspective

The following two sections turn to the narrower limits of the topic: the federation-specific aspects of the fiscal discipline issue and of the shock protection issue. As far as the fiscal discipline issue is concerned, the federation-specific problem predominately lies in the unfortunate combination of two aspects: i. that deficits and borrowing by govemment units affect the rest of the federal community and thus have external effects), and ii. that a federal structure under certain conditions breeds some special deficit -generating incentives.

### *a) Federation-specific extemal effects of macro performance*

Not surprisingly, a large part of the problems of macroeconomic coordination in a fiscally decentralized universe are connected with the presence of regional extemal effects (more specifically: with extra-jurisdictional effects), and, in part, also with problems of regional distribution. Another way of viewing such regional extemal effects resulting from uncoordinated action in a federal system is to state the existence of collective good problems at the regional and local levels; this perspective will be taken in part of the following discussion.

The key aspect of the problem is that macro effects of public deficits mainly depend on the global figures of all federal units at all levels of govemment taken together. For this reason, the fiscal performance of any single governmental unit affects the rest of the federal community. This makes securing fiscal well behavior -or at least preventing misbehavior- a matter of general interest for all federal units at all tiers of govemment (see for instance Shome 1995, p. 9 f.). It should be noted that this interest is not only «*top-down*» (higher level authorities being concerned about undisciplined fiscal performance by lower levels), but also «*bottom-up*» (lower level constituencies having an interest in the fiscal stance of the national level authorities).

In the literature on developing and on medium income countries in general and on Latin America in particular, the «*top-down*» perspective seems to dominate. This may be due to some typical experiences of countries such as Brazil or Argentina during the last decade or two (see for instance Ter-Minassian 1996, Tanzi 1995, p. 23 f., Shome 1994, pp. 3-18). Characteristic of this view is the following quote from Shome (1995, p.25):

> "No obstante, la experiencia observada deja bien claro que si los niveles inferiores de gobiemo están libres para financiar sus déficit, el gobiemo federal dispondrá de muy poca flexibilidad para contrarrestar las medidas tomadas por dichos niveles, y esto avivará el desequilibrio maeroeconómico global."

In other circumstances the «*bottom-up*» perspective prevails. The following quotation, taken from a study of the (United States) Advisory Commission on Intergovernmental Relations (ACIR), may serve as example of such subcentral concern about the fiscal conduct of the central authority (ACIR 1987, p.7):

> "Most observers would agree that the policy and practice of the national govemment with respect to deficits and the national debt affects the fiscal environment is facing the states and local governments in important ways. Therefore, improving fiscal discipline in the federal budget is a «federalism» issue, because of the many potentially significant ramifications for the different governmental elements of the American federal symtem."[5]

### b) *Federation-specific deficit-generating incentives: preliminaries*

As already indicated, the difficulties arising from the federation-specific sensitivity to each other's fiscal behavior are compounded by the fact that fiscally decentralized structures by themselves may have deficit-generating effects. More specifically: a federal setting, under certain conditions, may be associated with some typical inefficiencies which, in turn, may, result in increased deficits. Of special interest in the Latin American context is that some of these negative conditions have increased importance in countries which are in the process of implementing decentralized fiscal structures and beyond that, for developing countries in general. The following is a shorthand list of such points. They are all more or less interrelated and in practice may not always be easy to separate.

### c) *First group: "Soft" transfer schemes*

Transfer arrangements may be of a nature which leads the receiving units to (rationally) expect that they will not have to shoulder the full consequences of their present fiscal stance. They may expect, in other words, that the present and/or future burdens of their present deficits and borrowing, including the present or future interest obligations will be "honored" by increased intergovernmental transfers in the future. «*Soft*» transfer schemes amount to «*soft*» balance constraints.[6] Such situation amounts to lowering the tax price of public services as well as reducing the loss in supply of public services induced by lower tax efforts of the low-level unit and hence creates an incentive for the potential recipients of transfers to increase spending, and/or to reduce tax effort. This will simultaneously lead to inefficiencies and -the aspect which is of interest here- will generate increased public deficits. The issue is one of the most difficult ones in the field of fiscal decentralization since it is loaded with goal conflicts. Although it is a relevant one for macroeconomic coordination it shall not be discussed in this study since the topic of intergovernmental transfers is the subject of another study of this series (Spahn 1996, in preparation).

A more dramatic variant of such constellation is the «*bail-out*» problem created for higher-order legislative by fiscal mismanagement or fiscal crisis of a lower order federal unit. To give things a name -and remembering some previous events in the United States- let us call the lower-level authority the city of Baltimore and the relevant next level authority the State of Maryland. Let us assume that the City of Baltimore, due to fiscal mismanagement, approaches a situation of illiquidity. This will place the State of Maryland in a dilemma. If it gives financial support and thus «*bails out*» the municipality in trouble, it implicitly demonstrates to all other local authorities in its territory that taxfiscal discipline can have favorable financial consequences, and thus sets false incentives. If it refuses to «*bail out*» -aside from facing a credibility problem to begin with- it will be confronted with far-reaching negative extemal effects which typically result from the financial breakdown of a large community on its territory.

### d) *Second group: fiscal imbalance and distortion-inducing fiscal competition*

While, with the preceding first group of the list, efficiency problems and deficit-generation are two sides of the same coin, the present and the following section concern efficiency problems of a more general nature where an increase of deficits is only one possible fiscal policy result among others.

### Fiscal imbalance

Expenditure functions on the one hand and financial endowments, including transfer receipts on the other, may be distributed in a disproportionate way. This may be the case between different federal levels (vertical imbalance) or between fiscal units of the same level (horizontal imbalance). The consequence is that the members of the federal community will face an uneven degree of restrictiveness of their balance constraints. This is tantamount to stating that marginal benefits of public expenditures within the federal community will diverge and thus violate Pareto efficiency conditions.

The impression one gets when studying the literature on recent experience in Latin America is that severe disequilibria of this sort, in particular of a vertical nature -and often at the expense of the central government (but not always, and certainly not so in countries with a weakly developed intermediate level)- can be observed in quite a number of countries, such as Brazil and (present-day) Argentina: see for instance Ter-Minassian 1996, Shome 1994. In the case of Argentina, such imbalance seems to be a negative side-effect accompanying an otherwise positive fiscal reform. In the 197Os and l98Os the relation of central versus provincial level deficits in Argentina shows series of drastic changes, due to modifications of revenue assignments (see Porto and Sanguinetti 1993, p. 53n.).

One possible result of such a severely unbalanced distribution of fiscal stress may be that an increase of deficits and borrowing of the fiscal units finding themselves on the unhappy side of the imbalance. But that is only one out of several possible reactions to such a situation. And even if it occurs, increased deficits of these latter members of the fiscal may be balanced out by reduced deficits of the beneficiaries of the present state of affairs.[7] The problem is too far-reaching and too interwoven with fundamental issues of tax and intergovernmental transfer assignment to be discussed at any depth in this study. One particular aspect of this constellation, however, will have to be touched again: because of a severe fiscal imbalance, the public deficit of an individual federal unit may lose in informational value as an indicator of fiscal discipline; both high and low deficits may result from an uneven distribution of fiscal stress.

### Distortion-inducing fiscal competition

Fiscal competition between subnational jurisdictions is a special feature of decentralized government. Depending on the ramifications this may be *efficiency enhancing* (the Tiebout case), but it may also be *distortion-inducing* or dysfunctional (see Oates and Schwab 1988, also for further literature). At any rate, it typically puts upward pressure on the expenditure side and downward pressure on the revenue side of the budget which, among other consequences, may have a deficit increasing effect (Krause-Junk and Mueller 1993). The issue is too far out in the forefront of this topic to be further dealt here.

### e) *Third group: Deficiencies of administrative infrastructure*

Federal systems in comparison to more centralized ones, for the very reason that they imply subcentral autonomy, are in need of greater administrative skills. For the same reasons, their adequate functioning depends on the existence of more refined public expenditure management systems (PEM systems) which secure accountability, including control. Seen from a different angle, this amounts to stating that deficiencies in this respect may be particularly damaging in federations as opposed to countries which depend to larger degrees on direct command.

The skills required to perform in an adequate way the administrative tasks involved are scarce in most countries. They tend to be particularly scarce in developing countries (as well as in economies in transition). Scarcest of all they are in such developing countries which are *newcomers* to the world of fiscal decentralization and hence lack in experience with respect to such tasks. The result may be fiscal disorder, if not (hopefully: temporary) fiscal chaos, and much -if not all- of the allocational gains associated with decentralized government may be lost (for examples see almost any of the country studies presented in the course of this project as well as those prepared in the economic departments of the International Monetary Fund and the World Bank; for a more general treatment see the lucid analyses of Tanzi 1995, and Wiesner 1994, quoted repeatedly in the preceding pages). As one would expect, such deficiencies tend to be severest at the local level of government where it is particularly difficult to provide such skills (see for instance Ferreira and Valenzuela 1993, p. 26, for Colombia; Espinoza and Marcel 1993, p. 50, for Chile).

Inadequacies of such nature tend to have severe macroeconomic repercussions. Obviously they may result in a general deterioration of the quantity and quality of public services supplied. The citizens in these countries may press for the maintenance of such services, be they financed by higher level grants (and thus increase fiscal stress at these higher orders of government: see the preceding section on *soft* balance constraints) -or be they financed by own level borrowing. At the same time local politicians, unwilling to damage their popularity and their new status of government authority, may not be eager to enforce own level tax effort, while at the same time inexperienced local administrators may not be very efficient in enforcing tax compliance. The pressures towards high deficits and borrowing may therefore be strong. As long as the levels of outstanding public debt is low and control as well as legal constraints of local borrowing are weak, local governments may find it particularly tempting to use this source of finance, which so intriguingly promises immediate financial relief. It is for these reasons that the problem of improving administrative performance, in particular at the local level is related to the fiscal discipline issue. It will therefore be taken up again in the «*conclusions and suggestions*» part of this paper.

## 4. The shock protection issue and fiscal decentralization

To say that shock protection is no longer the dominant macroeconomic objective of fiscal policy does not mean that it has become unimportant. The following discussion will consider it from a traditional and from a present day point of view.

### The «*textbook*» Keynesian perspective

In a demand-oriented («*Keynesian*») perspective, the federation-specific perspective of the shock protection issue is a standard feature of traditional public finance textbooks. The line of argument is well known and need not be described here extensively: subcentral units in a fiscally decentralized system can be looked upon as small open economies; hence they can generate only small if not negligible effects within the Iimits of their territories, the host of demand effects will dissipate over the whole country (and beyond)-, therefore these subnational jurisdictions will not be sufficiently motivated to pursue policies of demand stabilization but rather will follow a procyclical course of action.[8] Much stronger is the motivation of central government to react anticyclically or at least to avoid procyclical behavior. Therefore, the argument concludes, a comprehensive responsibility for shock protection should lie with the national jurisdiction. For quite similar reasons, taxes (and transfers) with high built-in flexibility should be assigned to the top level of the federation, and vice versa. This type of appraisal -focusing on macroeconomic disturbances of (a) temporary and hence short-run, (b) demand side, and (c) nationwide (i.e. nationally non selective) nature- still dominates a considerable part of the textbook literature on fiscal federalism.

### The supply-side perspective

Outside the domain of this literature, however, the picture has changed considerably since the early days of the Musgrave (1959) and Oates (1968) contributions. Today, mainstream economists would consider supply side shocks as a main source of (at least the present and the more recent) macroeconomic problems in most parts of the world. A supply side scenario, however -aside from requiring a thorough reappraisal of the role of fiscal policy in general- also sheds a different light on the fiscal policy incentives within fiscally decentralized countries. While these incentives for subnational jurisdictions may still be unsatisfactory, they do not appear to be quite as weak as they are portrayed in the traditional Keynesian low-multiplier perspective. Keynesian appraisal to that extent tends to exaggerate the coordination problems with respect to the task of shock protection.[9]

This holds all the more since supply side shocks typically are of selective nature, affecting some particular industries and/or regions predominantly, or affecting different industries and/or regions in different ways (perhaps even simultaneously some regions in positive and others in negative ways, as in the case of the oil price shocks, see for instance Gramlich 1987, p. 3 1 In.). In other words, in practically every event, shocks tend to have an important regional and local impact, especially so if they are of the supply side variant.

For this reason, the attention shifts even more away from the traditional demand multiplier perspective of fiscal policy towards supply oriented policy measures that tend to have much greater regional and local incidence. Here again, the balance of extemal and internal effects of shock oriented fiscal policy within federal states appears in a more favorable light than in the of Keynesianism.

That taxes and transfers with high built-in flexibility should be predominantly assigned to higher level units has already been stressed from a Keynesian perspective. The standard Keynesian recommendation for fiscal design appears in an important new light when economic shocks are selective. Sala-i-Martin and Sachs (1992; see also von Hagen 1995) have shown that such an assignment also serves as an automatic stabilizer against adverse shocks that have a selective regional incidence (the first author to introduce this type of argument has been Kenen 1969). The negative income consequences of such shocks results in reduced burdens of income-based taxes and in increased receipts of income-based transfers in the distressed areas -without affecting the fiscal status of the regional fiscal constituency itself. Due to the selective nature of the shock, the effect on revenues and expenditures at the national level will remain relatively small; in some cases the effect of these fluctuations on the national budget will be further reduced by the fact that negative regional shocks will coincide with positive ones in other parts of the country.

Sala-i-Martin and Sachs show empirically for the United Stated that this effect has considerably reduced the variance of regional net incomes. Hence the whole setup serves as an insurance device which to a considerable extent protects, the single regions against negative consequences of selective economic shocks. And again, stabilization prospects for federally organized countries in comparison to more centralized ones look less dramatic than they do in a purist Keynesian perspective.

### Second look at demand side shocks

But even in the event that economic disturbances in fact were on the demand side, universal and short run, the mainstream judgment concerning the stabilizing potential of fiscal policy has moved away from the previous euphoria with regard to demand oriented fine-tuning.[10] With the increasing intentional integration of markets, especially in Europe, multiplier effects tend to become weaker. Increasingly longer maturing periods for public investment programs cause expenditure programs to become more inflexible over time; as a consequence, initially anticyclical programs must often be continued, for efficiency reasons, long after the cycle has changed. A further argument is that Keynesian policy suggestions typically do not function well for political reasons. A minimum consensus seems to be that fiscal policy should concentrate on avoiding procyclical action in recessions as well as boom times, thus endeavoring to prevent the public sector from itself becoming a source of instability. The difference between the practical fiscal consequences drawn from the shock protection point of view and the fiscal discipline approach hence tends to be smaller than it may look at first sight.

## 5. The country sample

As stated at the outset, the present study will -with all due caveats- draw from the conditions and experience of European industrialized countries with a decentralized-public sector. At many places in the following "conclusions and suggestions" part it will refer to legal and statutory provisions, institutions, experience and political policy discussion in these countries. For the reader who wishes to place these particles of information into a more comprehensive perspective, this present final section of Part One will give some basic information concerning these countries and a more coherent -albeit cursory outline of their federal system.[11] The time-constrained reader whose interest is more with conclusions and suggestions may, skip this section and turn directly to the second Part of this paper. This does not preclude coming hack to this section for a person interested in placing some of the succeeding hits of information into a more coherent «country-of-origin» context.

### a) *Three European federations*

Following a usual count, there exist six such industrialized countries with developed (in the sense of three-level) federal structures. They neatly fail into two categories: Non-European and predominantly English speaking: Australia, Canada, and the United States of America; and, European and predominantly German speaking: Austria, Germany and Switzerland;[11] as an additional characteristic of this latter group one may add that all three of them border on each of the other two.

One might suppose that because of so much geographical closeness, the federal structures of the three countries have much in common. While this holds for Germany and Austria (notwithstanding some marked differences), it definitely does not for Switzerland. Switzerland is different. If at all, it shows some parallels to the federal system of the United States, an influence that dates back to the making of the Swiss Constitution in 1848.

The difference in size between the three countries should be kept in mind during this discussion. As will be seen, Germany has about ten times more inhabitants than either Austria or Switzerland[13]. This is one of the reasons, among others, why federal life in both Austria and Switzerland can depend on unofficial and unorganized personal contacts to much greater degrees than in Germany. In fact, both Austria and Switzerland are famous for their well-functioning network of such contacts, as well as for an inherent tendency towards consensus and compromise (for Switzerland see Spahn 199'3, p. 54).

### b) *Basic data and some history*

#### Germany

After its unification at the beginning of this decade, Germany has a population of 81 million inhabitants (1994) and a territory of 360.000 square kilometers. Roughly one third of these inhabitants live in the new Eastern parts of the country. The country has 16 Länder (intermediate level units), ten old, previously West German, and five new East German ones, plus the new Land of Berlin, formed by combining the former West and East Berlin. Three of these Länder -Berlin, Hamburg and Bremen- are so-called city states, representing metropolitan areas with no or no fully developed substructure of municipalities. The total number of municipalities is on the order of 15.000.

History. Germany has a considerable, albeit somewhat intermittent, federal tradition, developed from «*particularist*» beginnings during the 19th century, with the foundation of the Prussian-dominated German federation in 1871 as a key date. This tradition came to an abrupt end after World War One. The Constitution of 1919 restructured the public sector towards a considerably more centralized one, and under the Nazi regime the country was turned into a monolithic unitarian and authoritarian State. German federalism in its present form dates back to the foundation of the West German Federal Republic in 1949 with its Constitution, the «*Basic Law*» (Grundgesetz). East Germany, in turn, continued to be a highly centralized state after 1945, now in the Soviet type variant. In 1990, the West German federal structure, like practically all aspects of the West German institutional system, was extended to the new Eastern parts of the country without major amendment.

### Austria

Austria counts 8 million inhabitants (1994) and 84.000 square kilometers of territory. The country is composed of 9 Länder -including the City-state of Vienna, which is Land and municipality in one. Austria has close to 300 municipalities.

History. After the collapse of the pre-World-War-One Austrian-Hungarian monarchy, the new federal republic of Austria was established in 1920 and based on a new Constitution. In the following decade this Constitution was amended in several steps, gradually leading towards more central power, and in 1933 the country turned into a centralized state. In 1938, Austria was occupied by the troops of its neighbor Germany, and, shortly after the beginning of World War Two, formally turned into a part of this country. The Austrian state of today dates back to 1955 when the country regained its independence from the post-war occupation forces. Its new Constitution revived some of the basic structures of the previous 1920 document. In 1994 Austria joined the European Union.

### Switzerland

Switzerland has 7 million inhabitants (1 994) and 4 1.000 square kilometers. It consists of 26 Cantons, having very different size (an important and critical fact for the distribution of power in the Swiss house of state. The country has about 3.000 municipalities.

History. To look into the federal tradition of the country, one must go far back in history. The beginnings of Switzerland date back to 1291, while North America often considered as the cradle of federalism -was still slumbering in its pre-Columbian days. At that date the three «*original Cantons*» Uri, Schwyz and Unterwalden concluded their so-called Everlasting Alliance. Further important dates are 1648 (the Treaty of Westphalia), when the historical nucleus of the country passed from the state of a rebellious mountain area to official independence; (the Congress of Vienna) when Switzerland was confirmed in its present geographical size; and finally 1848 when the country gave itself a new, consistently federal Constitution which in its basic principles is still in effect. To quote Bird (1987, p. 27): "It was this Constitution that finally transformed Switzerland once and for all into a federal state with authority over and above the Cantons in some important respect.

Switzerland was thus created by the aggregation of sovereign states. This historical fact has obviously had very important implications for the development of the Swiss fiscal system."

### c) *Expenditure and revenue structure of public sector*

At first, albeit vague impression of the structure of the public sector of the three countries, as far as expenditures and revenues are concerned, is contained in Tables 3 and 4. Table 3 shows data concerning the expenditure side. Transfers between government units are eliminated. The figures reflect the relatively weak assignment of functions at the central level in Switzerland, as opposed to the more centralized functional structure of Germany and, in particular, of Austria.

TABLE 3. EXPENDITURE STRUCTURE OF PUBLIC SECTOR, 1993
(Percentage of GDP)

| Level | Germany | Austria | Switzerland |
|---|---|---|---|
| National | 14.9 | 24.8 | 8.6 |
| Intermediate | 11.4 | 7.8 | 11.1 |
| Local | 5.6 | 7.4 | 7.9 |
| Social Insur. | 19.8 | 16.4 | 15.5 |
| Total | 51.8 | 56.4 | 43.2 |

Source: Nowotny, E., 1996, Der Offentliche Sektor, 3rd ed.

TABLE 4. STRUCTURE OF TAX REVENUES, 1993
(Porcentage of the total

| Level | Germany | Austria | Switzerland |
|---|---|---|---|
| Shared taxes | 73.1 | 66.1 | 19.5 |
| National | 14.4 | 26.9 | 24.6 |
| Intermediate | 4.6 | 2.4 | 32.8 |
| Local | 7.8 | 4.6 | 23.1 |
| Total | 100 | 100 | 100 |

Source: Nowotny, E., 1996, Der Offentliche Sektor, 3rd ed.

Table 4 shows tax revenues at the different federal levels. As far as tax and transfer assignments are concerned, Germany and Austria differ markedly from Switzerland at least in these characteristics: i) the much lower degree of tax autonomy both at the intermediate and the local level, combined with ii) a much greater extent of tax sharing, 3. the much greater importance of intergovernmental transfers. The Table reflects the outstanding importance of tax sharing in Germany and Austria. The figures appearing under the heading of "intermediate level" in the case of Germany and Austria -small as they are- do not even tell the full story: all parameters of these tax revenues flowing to the intermediate units are determined at the national level. Hence the Länder in both countries as opposed to Switzerland have no own power to determine the rates or any other parameters of these taxes.[14] In this respect again -as in many others-, the Swiss system is more decidedly *federal*. Switzerland has independent income taxes at all three levels of the federation:

federal income tax (named «*direct federal tax*»), a Cantonal income tax, or rather: 26 such taxes (Cantonal double taxation, however, is prohibited by the federal Constitution), as well as a local income fax which is levied as a surcharge on the Cantonal tax and thus implicitly has the same tax base.[15]

Another remarkable feature of the Swiss fiscal system -also with respect to the issue of macroeconomic coordination- is that the maximal rate of the federal income tax as well as the normal rate of the value added tax are fixed in the federal Constitution. In other words the rates of the two most important taxes at the federal level are subject to constitutional constraints.[16] What adds to the weight of this construction is the fact that each constitutional amendment, and hence each change in these tax rates, is subject to approval by referendum. It is not surprising, therefore, that increases of the rates of the two great federal taxes, as well as tax reforms are difficult, in fact they are a rare events.

Considering some problems in countries like Argentina, Brazil and others, one construction element of the German tax system, concerning the income tax, may be of interest. Aside from the sharing arrangement of the income tax, the federation, and it alone, has the constitutional right to levy a non-shared surcharge (Ergaenzungsabgabe) on the income tax. In the German case this levy is intended to be of a temporary nature in exceptional situations. The central government has repeatedly made use of this possibility.[17]

One characteristic of the Austrian intergovernmental tax sharing and transfer system is that the payments going to the municipalities are to a large part -determined at the national not at the Länder level, at least by the letter of the law. De facto, however, the transfer formulas are decided upon in an internationally rather unique three-tier political bargaining procedure. This process -which at present (1996) takes place every two years- traditionally ends in a voluntary agreement among participants which, also by tradition, is accepted by the national parliament without change.[18]

### *d) The state house: three countries. Three different models*

Every one of the three countries under consideration here -in fact all industrialized federations- have a second legislative chamber: a house of the states. And in all countries with the exception of Austria (see below), these institutions have an important influence on the functioning of the federal process. This method of integrating the intermediate level units as a constitutional body into the national level decision-making process may in part serve as a means to overcome the incentives of individual states to take political free-rider positions, also in the area of macroeconomic effects of fiscal policy.

#### The house of states: German version

While each German Land has comparatively modest legislational functions al its own level, the Länder as a group have powerful influence on the federal legislative process through the legislative chamber of the states, the Bundesrat. This second chamber is not a parliament in the proper sense, like the Swiss Sänderat or the US Senate. Its members are not elected by the Länder citizens, but are appointed by the Länder governments and are subject to the binding instructions of these governments, The Bundesrat. In other words, is an arena where the Länder prime ministers and ministers and top level administrators have the say. A further difference from the US Senate (and the Swiss Sänderat, see below) is that the number of delegates -and thus of votes for each Land- is not identical but varies with the number of inhabitants of the Länder according to some crude formula.

The consent of the Bundesrat is required for all laws which affect the interests of the Länder. This "area of interest" is interpreted in an extensive sense. One may say, therefore, that most laws of major (domestic) importance, and practically all laws implying considerable financial consequences, need acceptance by this forum.[19] Thus the Länder have an instrument for injecting their will into the federal legislative process, and "nowhere this role is more *jealously guarded than in the area of fiscal policy* (ACIR 1987, p. 36). As already mentioned, this great influence at the federal level is combined with the rather limited legislational functions of each Land's «*own*» individual parliament. In the tax field this asymmetry is extreme: the Länder through the Bundesrat have powerful indirect influence on tax legislation, while their direct influence on their own tax receipts is nil.

**The house of the states. Austrian Version**

The Austrian state chamber (called the Bundesrat, as in Germany) is fundamentally distinguished not only from its German namesake but also from the second legislative chambers in other industrialized federal countries by its almost complete lack of political power[20]. This constitutional weakness of the state legislational chamber in combination with the comparatively limited «*own level*» functions of the Lánder makes Austria *the least decentralized of all industrialized country federations* (see Bird 1986, p. 98).[21] For this reason, the typical coordination problems described at the outset of this study have much less weight in Austria than in other countries.

**The house of the states: Swiss version**

The Swiss state chamber (Sänderat) is constructed according to the senate principle, in this respect resembling its US American analogue. Its members are elected by the citizens of the Cantons. And -again like the US model- the number of members of the Swiss Sänderat is equal for each Cantons: two representatives each. The oft-disputed consequences are similar, and perhaps even more pronounced than in the US model: this construction gives equal weight (as measured by voting power) to -for instance- the Cantons of Uri or of Giares, with 34.000 and 39.000 inhabitants respectively, as opposed to the Canton of Zurich which (with its 1.2 million inhabitants) counts about one fifth of the total Swiss population.

The remarkable characteristic of this Swiss federal organ is that its functions are on a complete part with those of the first chamber. Each and every law has to pass both legislative chambers, and their decisions have equal weight, to the point that it is a matter of secondary importance which of the two chambers is theorist to decide on a bill. If the two houses disagree, a so-called difference -procedure takes place during which "the issue goes back and forth between the two chambers until agreement is reached" (Spahn 1993).

### d) *The intrafederal organizational network*

As will be argued in the *conclusions and suggestions* part of the paper: intrafederal contact matters, also for macroeconomic coordination. To the extent that such contact takes place in the state house, it is official in nature and directly connected with the national legislational process.

Aside from this type of activity there exists a dense network of organized but more or less informal exchange in all three countries considered. A key part of this web are the standing committees (conferences) of Länder ministers (departmental directors) and Länder prime ministers. These conferences -especially so in Germany, keeping in mind the size of the country- amount to an elaborately organized system of regular meetings which deal with virtually every matter of concern to the Länder as a group. The existence of cross contacts to the committees of the state chamber is natural because the acting persons are part of the same ministerial (Cantonal) administration, or even may be identical. Comprehensive as the system is, it of course also includes matters of macroeconomic coordination of fiscal policy. This holds in particular for the conferences of ministers of finance and of interior (the latter, for instance, being concerned with the constitutional framework of macroeconomic policy).

There are many other systematic intrafederal contacts, in the form of regular meetings of a great variety of standing and ad hoc expert working groups in every one of the three countries, often of mixed central and intermediate composition. To mention just one out of many examples: as the mixed (Federal/ Intermediate/ Statistical Bureau/ business cycle institutes) committee in Germany entrusted with the task of producing (non-manipulated) estimations of expected tax revenue.

A German specialty which may be of interest in the present context is the existence of two standing councils of mixed federal/lender/local as well as central bank composition which both were introduced with the explicit purpose of serving as instruments of macroeconomic policy coordination, and also -in that connection- of intergovernmental aspects of public policy planning (one council presided by the federal minister of finance the other by the minister of economics). These institutions did not develop spontaneously but were created by an act of law in 1967, as part of a larger reform project. None of these two councils has any decision-making power in the formal sense. If the meetings do seem to have an impact that goes beyond that of a general exchange of information and opinion, this is mainly due to the fact that the results of each session are made public in the form of a joint *communiqué*, typically containing a self-obligation of the members to observe certain numerically specified budgetary limits, as for instance not to exceed a certain nominal growth rate of public expenditure (like three percent).

### *f) Social and institutional homogeneity*

One common feature of the former pre-unification West German Republic and of Austria on the one hand -as opposed to Switzerland as well as the non-European industrialized country federations on the other- is a remarkable degree of cultural and social homogeneity (if one does not count a foreign population in the former countries on the order of about one tenth), as well as a high degree of legal and institutional uniformity -as shown by practically identical tax and transfer laws. Some aspects of this homogeneity can in themselves be seen as resulting from the specifics of these countries' federal systems, like the largely uniform legal and institutional structures as well as the fairly equal endowment levels of public infrastructure in the different parts of the country. For Germany, this over-all picture has changed considerably due to the unification, with the new Eastern regions being on much lower economic levels, including a considerably poorer public infrastructure. Switzerland, in turn, shows a different scenario. Its ethnic and language diversity is impressive. So are the differences in legal and institutional structures resulting from a long tradition of jealously guarded Cantonal and local autonomy. This is illustrated by the fact already mentioned that each of the twenty-six Cantons levies its own income tax: definition of income, tax rates, exemptions and all.

## II. CONCLUSIONS AND SUGGESTIONS

"Fiscal decentralization has much to offer, but it is a complicated enterprise." Oates 1994

### 1. Lessons and limits of foreign experience

The following sections to some considerable extent will draw from European and in part also from US - experience. What -if anything- can be learned from such experience? Which conclusions in particular may be drawn from a Latin American perspective? -The usual caveats apply (see for instance Bird 1986, p. 10-13; ACIR 1987, p. 92 ff.; Saunders 1992, p. 243, and many others). Countries are individual entities from the historical and political, as well as the economic and geographical point of view. They may not ascribe equal weights on tradeoffs between conflicting goals. They differ in culture as well as in social and political structure, and, of particular relevance in the present context, in the degree of subcentral autonomy, number of governments etc. The industrialized European federations considered here differ from Latin American countries as a group, and Latin American countries differ among themselves. Institutions, if taken out of country context, may function differently, or not function at all. Even within the same country their effect may change over the time; besides, even from the perspective of ones own country, the institutions or procedures in practice may be far from satisfactory.

Yet, as described in part one of this study, some typical problems of fiscal decentralization tend to show up in impressively similar ways, although they may come in a different guise. This gives reason to expect that -if not the solutions themselves -at least the (substantive or procedural) approaches to solutions may be of more general interest.

At any rate, the following discussion may speak for itself. It will list a number of such conclusions and suggestions:

- a first group aims at tax and (social) transfer assignment as well as at improving-intra-federal cooperation and responsibility;
- a second group centers on constraints to fiscal deficits and borrowing;
- a third group -tailored to the problems of developing countries- is concerned
- with measures to improve personal and institutional infrastructure, especially
- at the local level;
- a final suggestion concerns a framework condition of outstanding importance for macroeconomic coordination: central bank autonomy.

The individual suggestions made in this following discussion should not be seen in isolation but as parts of an over-all program, the elements of which are intended to support each other.

## 2. Federal design: the tax (and transfer) assignment approach

The discussion in part one has shown that as far as shock protection is concerned, one important approach towards macroeconomic coordination of fiscal policy is by tax assignment (as well as, and for quite similar reasons, by assignment of social transfer expenditures, in particular of unemployment benefits).

The first point of the program to be developed here is one that in substance has remained unchanged since the early days. The old assignment rule contained in almost every piece of literature covering the present subject still holds: In order to promote macroeconomic stabilization (as well as for distributional reasons and, to make the area of goal harmony almost complete, largely also for allocational considerations), the personal and corporate income tax on the one hand and unemployment benefits on the other should be assigned predominantly to the higher levels of government. In contrast, taxes of predominantly local incidence should be the domain of the local level. The obvious rationale from the macroeconomic point of view is that the individual and, even more so, the corporate income tax as well as unemployment benefits possess high built-in flexibility while the built-in reaction of local property taxes and of other taxes with predominantly local incidence is low.[22] To quote the textbook argument again: higher level fiscal authorities typically have a stronger incentive to avoid procyclical reactions to adverse demand shocks.

As shown In part one, the argument for a tax and transfer assignment rule of that nature becomes even stronger if one goes beyond the traditional Keynesian presentation, and considers that real world adverse shocks frequently are due to supply side causes and typically are regionally and/or locally selective. As far as such disturbances affect regions differently be they of demand or supply side origin -higher level assignment of taxes and expenditures with high automatic flexibility will serve as an automatic insurance device against the effects of regionally fluctuating incomes and thus contribute to economic stabilization across regions. To the extent that negative shocks in some regions coincide with positive ones in other regions they will even be out in the national budget. In other words: built-in flexibility of the top level tax/expenditure structure tends to automatically reduce the incidence of such selective effects, at least to a considerable degree.[23]

## 3. The organizational approach

### a) *Promoting intrafederal cooperation*

The following discussion leaves the issue of federal design and turns to the fiscal policy process. To stay in line with the general idea of fiscal federalism, the first approach towards macroeconomic coordination to be considered here -although rather neglected in the traditional literature- is through voluntary cooperation of federal units across levels of government (vertically) as well as at the same level (horizontally), or -seen from a policy suggestion point of view- by promoting (encouraging, stimulating, instituting) such coordination. The issue of macroeconomic coordination as a potential outcome of such interplay is connected with other problem areas of coordination within a federal setting; hence the scope of the approach to be considered is (much) broader than the aspect under which it is viewed in this study.

As already mentioned, macroeconomic coordination within a fiscal decentralized system -like other problems of federalism- is of an external effect / collective - good nature. Very generally speaking, one possibility of dealing with problems of this character is by striving for cooperative -and that means: voluntary- solutions. Such voluntary cooperation is feasible -although by no means guaranteed- if the relevant group of actors is small. Just such *«club good»* situation is the normal condition of federations, at least as far as the intermediate (and central plus intermediate) in order of government is concerned. As club good theory shows, the difficulties in developing spontaneous cooperative conclusions tend to increase with the number of players, with the degree of heterogeneity of their interests, of their mentality etc., as well as with the complexity of the collective good problems with which they are confronted.

Considering that the federal entities of the intermediate order typically count from a handful to several dozens and that the problems involved are numerous and often difficult, such cooperation requires (horizontal and vertical) organizational structure, be it based on legal or even on constitutional fundaments or on more or less loose agreements. Viewed from a different perspective: what is to be institutionalized is the organizational basis for an exchange of information and opinion, for a process of consultation and, in the final account, of bargaining over solutions. This process -in its positive aspects- may be interpreted as one of discovering and exploiting advantages of a collective good nature within small groups of actors, including the distribution of such advantages.

To be sure, as far as the real world of fiscally decentralized countries is concerned, only part of such activities can be interpreted in the positive sense of securing superior (*Lindahl-type*) solutions for society. Other activities may have to do with organizing bargaining power for games of vertical and/or horizontal distribution and have neutral or -if leading to vertical or horizontal imbalance- negative effects for society. Still other such endeavors may concern political power-plays, possibly with negative welfare outcome. Hence there is no reason to glorify these processes as such.

What is of interest here, however, is that at least some considerable part of such activity may have important functions of a positive, coordinating nature -also, among other things, with respect to the macroeconomic performance of fiscal policy. To that extent, one may say that intrafederal contact has the potential of playing an important part in the functioning of fiscally decentralized countries.

As shown in Part One, all three European countries under consideration are characterized by a rather extensive network of such intergovernmental contact. Part of such interaction is the automatical by-product of the functions of the state legislational chambers at the national level.[24] Further important elements are the standing conferences of the intermediate level prime ministers (governors) and ministers (department chiefs, or however they may be called in the specific country), an activity which tends to have more or less intense interrelations with the functions of the houses of the states at the national level, including the work done in their commissions. In addition, there exists a rich variety of (standing as well as ad hoc) groups of horizontal and vertical and mixed composition, and of political as well as of administrative nature. A special characteristic of Germany is the existence of two councils of combined federal/state/municipal as well as central bank attendance with the explicit main function of contributing to macroeconomic coordination across the different levels of government.

Leaving aside all details of construction of such networks, the consensus in the countries considered as well as in other industrialized federal countries is that such contact matters. Practically everywhere it is regarded to be a normal, if not indispensable part of the political and administrative life of a federation. The following quote seems to indicate that the topic of analyzing these networks is not a trivial one even for old-established federations. It suggests that deficiencies of such nature may exist even in countries like the United States. The Advisory Commission for Intergovernmental Relations (ACIR), reflecting on the possible lessons for its own country which could be learn from an extensive comparative country study of fiscal federalism (contrasting the US system with that of Australia, Canada and West Germany), draws (among others) the following conclusion (ACIR 1981, p. 95).

> "What is lacking in the United States, as emphasized by comparison with Australia, Canada and West Germany is an institutional structure or set of procedures that can be invoked on a regularly scheduled basis to assess the general directions or overall impact of federal-state-local policies. That is, no arrangement presently exists to develop an overall federal-state-local economic or fiscal policy making framework. Unlike Australia and Canada, for example, the US does not have anything comparable to the basically annual conferences of first and other ministers to hammer out federal-state relationships... "

The general suggestion in the present -Latin-America-oriented- context is that countries where such networks are incomplete or deficient -or, in the case of countries in the process of implementing govemment decentralization which have not yet evolved spontaneously (as an example see Knoop 1994, p. 61, concerning Venezuela)- should consider possibilities of developing more comprehensive structures of such nature. Evidently, each country must find its own solutions; at any rate there is no lack of models in this respect in the intentional field.

### *b) Specification of macroeconomic responsibly*

In order to facilitate intra-federal cooperation of the nature just considered, or at least to prevent obstructive behavior, but also for other reasons, it may be useful to specify -by constitutional or statutory law- an explicit obligation of public agents at all levels of government to *take into account* the macroeconomic consequences of their decisions.

All three European countries considered have constitutional and/or legal rules of such nature. Of interest here are not the technicalities and details of formulation but the general approach. By necessity the endeavors in formulating these texts had been to keep them open to changing macroeconomic challenges, including modified problem perceptions. The formulations vary from the German type concept of *macroeconomic equilibrium* to the simpler Swiss constitutional wording of *taking into account the general economic situation*. To quote what perhaps is the most elaborate legal text of this nature, contained in the German Law for Stabilization and Growth. "The Federation and the Länder, in their measures of economic and fiscal policy must take account of the requirements of macroeconomic equilibrium. The measures shall be of such nature that -within the general framework of a market economy- they contribute at the same time to price level stability, to a high level of employment and to extemal equilibrium, as well as to a satisfactory and sustainable rate of economic growth."

Rules of this character may be of help in facilitating organized intrafederal co-ordination in that they put each member of the federal community under the formal obligation to cooperate in an exchange of information and of views relevant for an evaluation of macroeconomic effects of fiscal policy, and to participate in an effort towards reaching agreement on some outlines of macroeconomic fiscal conduct -at least to the extent where its autonomy stays untouched- or, negatively speaking: to abstain from uncooperative or even obstructive conduct with respect to such endeavors.

In a more legal sense such an explicit clause of macroeconomic good conduct may help to indicate the spirit in which other regulations affecting the macroeconomic performance of fiscal policy within the federal ensemble are to be interpreted. As a long-term effect, an obligation of this nature may also serve to increase the awareness of federal agents at different levels of govemment of the fact that their own fiscal stance touches on the interests of the rest of the community. To close with a quite different type of argument: while their positive effects may be uncertain, depending on the specific administrative and legal tradition of the country, the opportunity cost of having a such set of rules is nil.

## 4. Limitations on government deficits and borrowing

The following sections will discuss approaches to containing deficits and borrowing at the different levels of a fiscally decentralized government: Strengthening the disciplining forces of the capital market, prohibition of central bank borrowing and constitutional or statutory limitations on capital market borrowing for the central and intermediate as well as for the local level.

### *a) Strengthening credit market discipline*

A first important approach towards securing sound fiscal policy at the different levels of government in a federation is by strengthening the automatic steering powers of credit markets. Credit markets in the private sector have important disciplining as well as selective functions. They tend to assure that debtors that represent higher risks in the eyes of the lenders are charged with higher interest rates (in more correct terminology: with a higher risk premium over and above the pure rate of interest), and that debtors that are approaching the limits of sustainability will have difficulty finding access to (additional) credit and, ultimately, may go bankrupt. Rating agencies specialize in an evaluation of credit asks and standardize the relevant information, thus giving an easy-to-interpret, albeit crude and not always reliable, signal as to debtor risk .[25]

It is tempting to consider to what extent this market approach to credit limitation could be applied to government authorities as borrowers. Clearly, public borrowing differs from private credit finance in a number of fundamental aspects, and this -among other things- reduces the effectiveness of market control. But "although one cannot rely solely on market forces to prevent unsustainable behavior, the financial markets have the potential to play an important disciplinary role" (Lane 1993, p. 84; for similar positions see the Delors Report 1989, presented by the EU Commission, paragraph 30; Goldstein and Woglom 1992).[26] A general impression is that in many countries, including European as well as Latin American ones. The chances for activating the automatic forces of the credit market have not yet been developed in a satisfactory, not to speak of a systematic fashion.

More advanced in this respect is the federal system of the United States. As an indication of the actual working of market forces see for instance Moody's credit ranking of 42 individual US states, which notes California in top place (Aaa) and Louisiana last (Baa1). As shown by the Chubb Corporation Relative Value Survey, US traders felt that a comparable California 20-year government obligation would have a market yield of 14.04 basis points below the market yield of a comparable New Jersey obligation and of 84.04 basis points below comparable Louisiana government paper.[27]

The following types of measures should be envisaged to that respect, each of them representing an entire program of institutional reform and having and impact that goes far beyond the present context. They shall enumerated here first, then be specified in somewhat more detail:

- prohibiting central bank lending
- privatization of hanks, and hence the implementation of arms' length relationships;
- credit market deregulation: abolition of regulations that may directly or indirectly favor govemment borrowing;
- defining no-bailout rules for the case of a fiscal crisis;
- introducing *hard* as well as transparent intergovernmental transfer schemes;
- enforcement of clear budgeting rules to prevent public authorities from obscuring their true financial position.

*Privatization of banks*. Privatization in general is an important strategy for preventing political abuse, but this is not the topic of the present paper. What is of interest here is the special issue of public ownership of banks and the particular possibilities of abuse associated with it. Public ownership of banks exists in a variety of forms in quite a number of countries, federal or centralized, also in Latin America. In federations, it can be found at all levels of government, especially at the central and the intermediate one. The resulting goal conflicts for the public owners and for the banks themselves may lead to distortions of credit market competition and obscure the true financial situation of either the fiscal authority or the bank (or both). Publicly-owned banks may be under pressure (or have an incentive) to lend to their owners at more favorable conditions than to other borrowers of comparable rating, to postpone the presentation of debt titles or of interest obligations at maturity as a political favor, 28 and, more generally, to provide their services for covering-up the true amount of present borrowing and of outstanding public debt (see also the last point of the preceding list: enforcement of clear budgeting rules).

Such activities in essence result in capital market distortions at the expense of private borrowers or of taxpayers as well as to obscuring the fiscal status of governments for the political public and for the voters. At the same time -possibly in the way of a political compensation of such services- it may lead to temptations for the public owners to grant political favors such as preferential tax treatment. State ownership of banks becomes particularly disturbing if these banks are equipped with privileged access to central bank credit, like for instance, if they are put in a position to monetarize part of the outstanding public debt, as seems to be the case in Argentina, in the form of *automatic* rediscounts of the provincial banks (Ter-Minassian 1995, p. 12 f.). For all these reasons, publicly-owned banks should be high-priority candidates for privatization.

*Credit market deregulation*. Besides the privatization of public banks, and concerning the credit market in general (including private banks), all regulations and other institutional framework conditions that result in favoring public as opposed to private borrowing should be abolished. The potential list is long and contains measures such as preferential treatment of (domestic) government paper in (public as well as private) bank portfolios by the central bank or preferential tax treatment of government debt titles in the hand of (public as well as private) lenders, like for instance preferential income tax treatment of interest revenues from public debt.

*No bailout*. Higher level fiscal authorities should avoid assuming any legal or factual liability for the debt of lower level units. Such strategy of avoiding bailing-out signals will transmit to the markets that the risk associated with lending to a public authority will ultimately depend on that individual public authority's solvency. When faced with actual or imminent crisis of a subcentral unit, higher level authorities can, to be sure, give financial aid. Because of the negative external effects of subcentral financial disorder, they may even face a problem of credibility it they announce otherwise. But it should be a firm principle that fiscal assistance will depend on the presentation of and adherence to a draconian program of fiscal redressment and that any such aid will not extend to a total or even partial direct repayment of the distressed unit's outstanding debt.

*Introducing "hard" and transparent transfer schemes.* Intergovernmental transfer schemes should be "pre-established, transparent and non-discretionary", to underline the golden words of Porto and Sanguinetti (1993, p. 53), in their study on Argentina:

> ... el funcionamiento del federalismo fiscal implica un régimen de transferencias intergubermentales con criterios pre-establicidos, transparentes y sin posibilidad de ser afectados por decisiones discretionales tanto de las provincias como del gobierno nacional."

This general statement does not say how the principles to be applied in developing transfer schemes that minimize negative incentives with respect to fiscal discipline should look in detail. Developing such more specific principles is one of the most difficult issues of fiscal decentralization, since it is loaded with goal conflicts. It shall not be discussed, here since the topic of intergovernmental transfers is the subject of another study in this series (Spahn 1996, in preparation).

Transparent budgeting procedures. Another important approach to fostering market discipline is an enforcement of transparent budgeting procedures and practices. Such practice will enable lending agencies to improve their evaluation of credit risks and thus make improve the functioning of credit markets. The issue of making fiscal stance transparent (of course) goes far beyond the present context and will be taken up again under the quite different aspect of preventing the circumvention of constitutional or legal limitations on public borrowing.

The general objective of all such measures can be described as:

- making conditions of public borrowing more equal to those of comparable private activities, and by doing so,
- activating the disciplining forces of credit markets, while at the same time
- making the fiscal situation of government more transparent to the political public and to the citizens.

As already mentioned, it is unlikely that such measures will be as effective in promoting financial discipline as they are in the private sector. Therefore, non-market measures of containing public deficits-and-borrowing must be considered.

### *b) Prohibiting fiscal access to the central bank*

An important step in this direction has already been mentioned in the preceding context: prohibition on borrowing from the central bank, or, seen from the central bank side, prohibition to lend (in direct and indirect ways) to fiscal authorities. Central bank lending to government is prohibited in all three European countries here considered: in Germany as well as in Austria and Switzerland. Since 1994 such type of prohibition has become a general rule for all EU member countries, hence for a whole dozen of European states.

With good reason: access to money creation through the budget implies temptations that are extremely hazardous for macroeconomic stability. This is so ecause it works in two ways: it simultaneously tends to weaken fiscal discipline and to reduce control over the money supply. Introducing a ban on such a method of finance is one important step towards improving the incentives for macroeconomic performance. This is a conclusion which holds not only for federal but also for unitary states. In short: access to central bank finance by fiscal authorities, be they central or subcentral, is highly undesirable; it is bad political practice and should be abolished wherever it exists.29

One standard argument against the relevance of such legal prohibition of central bank lending to government is that there are indirect ways of financing public deficits by money creation. Important instruments of monetary policy, like expansive open market policy, involve the purchasing of government credit titles. In practice it may be difficult for the outside observer to determine, let alone to legally prove, whether such actions do or do not follow purely monetary purposes but in fact represent an act of budgetary relief. - While such problems of diagnosis may exist, resigned acceptance seems to be the wrong answer.

Rather efforts should be made in order to strengthen the organizational position of the central bank to the point where such covered-up collusion between the fiscal and the monetary authority becomes less likely. - It should be noted that within a framework of central bank independence of the *hard-core* type the argument has no relevance. Guaranteed autonomy of the central bank - among a number of other positive effects (ibid.) -will serve as an institutional barrier against covered-up collusion between monetary and fiscal authorities of the type just described.

### *c) Limitations on public borrowing: preliminary comments*

If fiscal access to central bank money is barred, credit market borrowing remains as the only means of financing budget deficits. This contributes to hardening govemment balance constraints, and will tend to strengthen the disciplining forces of the private capital market. But, as has been mentioned, one cannot rely on market forces alone to prevent an unsustainable stance of fiscal policy. The power to incur deficits and to borrow is associated with too important temptations of political abuse to be left without institutional limitations; it should be restricted by law at all levels of government, including the central one.

In Germany and Switzerland such restrictions exist at all levels of government; for the national (intermediate) level they are included in the national (Länder, Cantonal) constitutions. For the local level they are fixed in the municipality laws of the different länder. A characteristic of Switzerland, again, is the typical great variety as far as the subcentral orders of government are concerned. Austria, on the other hand does have no such limitations at the central and intermediate level -whereas local borrowing is subject to restrictions comparable to those in the other two countries. A new situation for all EU countries has been created by the Treaty of Maastricht by its criteria of fiscal convergence, introduced in connection with the project to a European Currency Union, to be instituted (if one decides to believe in the official schedules) in 1999. A protocol to the treaty specifies two quantitative criteria: a 3 percent limit for public deficits and a 60 percent limit for outstanding public debt, both in relation to GDP." The Maastricht Treaty has a special implication for the two federal member countries, Germany and Austria, in that these fiscal criteria are specified as global figures, including all fiscal units of the country.[32]

In the following, the issue will be discussed for each federal level separately. Before going into a further discussion of the issue, one general argument against such limitations shall be mentioned. The validity of deficits and borrowing as an indicator of the fiscal performance of a constituency may be impaired in the case of severe fiscal imbalance. Federal units in such a state of public disorder may experience quite diverging degrees of fiscal stress (for Argentina see for instance Porto and Sanguinetti 1993, p. 52n.). Serious as such situation may be, softening of balance constraints appears to be the wrong answer. To the contrary, turning the argument around: not the least of the advantages of such limitations -if they are effective- is that they serve to make public borrowing less available as a palliative to moderate the immediate consequences of fiscal disorder at the expense of future generations. They will thus increase the pressure towards arriving at more balanced assignments, including intrafederal transfer arrangements.

A general danger for the effectiveness of limitations on public borrowing is that they may be circumvected.[32] This may be done by a variety of measures which range from taking public activities out of the general budget, and thus instituting *off-budget activities" or "shadow budgets*, to methods of so-called creative accounting, to a variety of forms of implicit borrowing, like leasing arrangements or installment payments, and even to loosening payment discipline (one author in a detailed analysis of strategies of this nature distinguishes seven different categories of circumvention: v. Klelst 199 1, p. 77 ff.). It should be clearly seen that the incentives for indulging into such strategies of circumvention -unwarranted as they are for many other reasons- tend to increase considerably with the degree of rigor of debt constraints.[33] For these reasons the task of introducing borrowing limitations as discussed in the following text must be envisaged in close combination with an effort to close at least the most important of such loopholes.

### *d) Limitations on deficits and borrowing: national and local level*

#### National level

As has already been mentioned, constraints to deficits and borrowing should apply to all orders of government, including the national one. At the national level, however -more so than for subcentral ones- there exists one difficulty. Central government in a federation typically is under a special obligation to help stabilize the economy against severe adverse shocks, also by using fiscal instruments (one such strategy, for instance, would be to step up transfers to subcentral units if considered necessary to counteract procyclical behavior).

For this reason, it seems to be indispensable that such limiting rule should be combined with an element of flexibility. To provide for such flexibility, a rule -and-exception systematic seems to be useful, in other words a constitutional or legal rule limiting public borrowing should be combined with a clause of exception, allowing that the limit set for normal situations may be overstepped in times of severe macroeconomic disturbance.

The German and the Swiss Federal Constitution follow this pattern; as described above: as does in effect the Maastricht treaty. In Germany the main limitation concerning federal borrowing is contained in article 1 15 (1), 2, of its Federal Constitution:

> "Revenue from borrowing shall not exceed the total expenditure for investment provided for in the budget estimates; exceptions shall only be permissible to avert a disturbance of macroeconomic equilibrium. Details shall be the subject of federal legislation."

The Swiss Constitution in its article 42 bis also follows a rule-and-exception concept, but -much stricter than the German model- prescribes a redemption of outstanding public debt, in other words a policy of budget surpluses for normal economic situations:

> "The deficit in the budget of the federation must be redeemed. In doing so, account must be taken of the situation of the economy".[35]

The problem is that such rule-and-exception approach may be abused. This holds in particular since the definition of terms like public investment in the *rule* part, and disturbance of macroeconomic equilibrium or situation of the economy in the exemptions part -to put it mildly- do not lend themselves very easily to quantitatively exact specification. Experience shows that the issue is plagued with enforcement problems everywhere. This includes Switzerland with its high political morals and the very strict formulation at least of the *rule* part, combined with softness of *exception* part, of its constitutional constraint.

Whether limitations of this type have a considerable practical effect is under dispute. The critics point to the present rapid increase of the relative weight of outstanding public debt which has occurred in spite of these rules-plus-exception constraints (the clause of exception in Germany has been invoked almost regularly in recent years). Other observers, including high fiscal policy officials (including federal ministers of finance in Germany), hold that these constitutional rules, in spite of their lack of operational formulation, are (far) "better than nothing", that they tend to have an important effect quite aside from their direct legal consequences, in that they tend to strengthen the political position of all those who argue in favor of increased budget discipline, and in that they help the budgetary authority in its daily struggle against losing fiscal control (see Gandenberger 1990).

The present state of debate -in the opinion of the author- does not permit to sort out any single superior solution.[36-37] While there and more detail-oriented suggestions as to the *exceptions* part which are not of particular interest here (see for instance Gruber 1996, chapter two, for Germany), the menu from which to pick for normal macroeconomic situations, in other words: the *rule* part, includes suggestions like limiting the maximal amount of borrowing to a narrowly defined concept of public investment, or a fraction of it,[38] or -in the search for more operational criteria- to a percentage of public expenditure (like 5 percent), or to a maximum relation with respect to GDP (like in the Maastricht Treaty), or -not to forget- to zero,[39] this latter concept amounting to a balanced budget rule for the normal case.

Of particular interest in this context is the approach suggested in a Swiss reform project developed by a mixed federal/cantonal commission in preparation of parliamentary hearings on the federal deficits issue (scheduled for fall 1996).[40] The key aspect of that project is that it ties deficit limitations to the rate of GDP growth. The concept defines three types of situations: if and only if GDP growth is below 0.5 percent deficits are allowed; if growth is between 0.5 and 1.8 percent a balanced budget is prescribed, and if GDP grows is by more than 1.8 percent a budget surplus must be achieved. In this latter respect the concept goes beyond even a simple balanced budget rule, not to speak of the fact that it suggests an operational formulation for the three different alternative situations envisaged.

**Intermediate level**

As far as the intermediate level of government is concerned, borrowing constraints should be at least as strict as for central government. Whether they should be more rigorous, in particular whether they should also contain a clause of exception (as is the case in Germany), is hard to determine in general terms. One argument for applying stricter limitations for the intermediate level is that in most countries part of intermediate investment is financed by the central government's conditional grants.

It is interesting to note that a majority of individual US states -by their own initiative or that of their citizens- have given themselves a constitutional or statutory balanced budget rule going beyond the above mentioned Swiss federal model (to be distinguished from the regulation at the cantonal level to be mentioned in a moment), in that they prohibit deficits and borrowing completely (some US states forbid the governor to sign a budget law if it shows a deficit); a number of individual US states (24 according to ACIR 1987, p. 38) go even further and prescribe budget surpluses for normal times (to build up *rainy day* funds) in order to enable fiscal authorities to react to adverse shocks. [41-42]

One consequence in the US seems to be that the state as well as the local level for a number of years now are reporting global budget surpluses (the considerable deficit problem of the US being a federal problem entirely. Evidence presented by Bayoumi and Eichengreen (1995) shows that the over-all fiscal behavior of state and local government while having been procyclical between 1972 and 1985 turned to being predominantly anticyclical after 1985 (ibid., p. 35ff.)[43]... one possible reflection of this change in priorities was the creation of explicit budget and economic stabilization funds" (ibid., p.37). Poterba, 1994, reports similar results, he observes that US states with relatively tight constitutional or statutory rules that make it more difficult to run deficits, are more rapid to make fiscal adjustments when revenues fall short of expectations or spending exceeds projections (ibid., p. 818). Rather strict limitations of public deficits and borrowing also exist in a number of Swiss cantons, some of them of quite recent origin (Basle-Stadt, since 1995; Fribourg, since 1994). The oldest experience in this respect has the canton of St. Gallen which is practicing what amounts to a balanced budget rule since 1929; it is interesting to note that this latter canton has the third lowest amount of per capita outstanding public debt of all Swiss cantons (see Vemehmlassungsbericht zur Schuldenbremse 1995).

Most of these regulations are too new -in the sense of not having been tested yet for times of severe adverse shocks- to permit any definite conclusions. Future experience in the United States and in Switzerland with this type of rigorous institutional practice should be carefully observed. At any rate, in the light of the results reported so far, a balanced-budget rule for the intermediate level must be considered as a serious alternative to the *softer* type of regulations described above.

### *d) Limitations on deficits and borrowing: local level*

The case for local borrowing is special and different from that for higher-level borrowing for several reasons. Most of public investment takes place at the local level (in Germany more than two thirds of total public investment). Seen from the perspective of a single municipality, investment expenditures are characterized by a marked discontinuity whereas for higher level units they typically are a more or less continuous stream. On the other hand, a large part of local investment expenditure is typically financed by grants from a higher level of government (although the practice in this respect differs considerably from country to country). Also, higher level authorities are typically bound to provide financial help in case of severe exogenous disturbances,[44] be they of national, or regional, or -like floods or earthquakes or the failure of a large local enterprise- of predominantly local incidence.

The basic approach to limiting local borrowing (leaving aside a myriad of variations in detail) is remarkably similar in all three European countries studied: a. municipality borrowing is permitted, but subject to strict regulation by the municipality laws of the intermediate government of each of these countries; b. the legal limitations with respect to local deficits and borrowing in general are much stricter than those for the other orders of government; c. and finally, compliance is subject to direct control by the intermediate level surveilling agencies.

It is this latter element of enforcement by direct control which makes these constraints more *binding* than quite similar regulations would be at the upper tiers of government. It is the Länder/Cantons themselves which interpret the exact meaning of the often very general clauses of the municipality laws. In other words it is they who have the "power of interpretation"[45] together with the *power of enforcement*. And their reading of the legal texts in cases of doubt tends to be strict. Hence the issue of containment of local deficits and borrowing is not plagued with the enforcement problems typical for the national and intermediate levels.

What is suggested here with respect to Latin America quite simply is that similar principles and procedures be followed:

- Local borrowing should be permitted in principle.[56] It should, however, be limited in relation to local (net) investment in a narrowly defined sense.

- Permissible for credit finance should not be the full amount of investment but only some fraction of it. This fraction should be smaller than (the self-financed part of) local investment (for instance, 60 percent).

- Besides, as an independent -second limitation, regulations for the local level should specify an obligation of municipalities to stay within the limits of long-term sustainability of the outstanding public debt. In other words, local borrowing should be limited according to debt servicing capacity, or to other indicators of sustainability such as past revenues, or taxing capacity. To follow Ter-Minassian (1996, p. 1 l), this can be seen as an imitation of the market discipline.

- Compliance with these rules should be enforced through a strict monitoring process by the relevant higher order jurisdiction.[47] This surveilling activity, however, must keep in line with the basic principles of fiscal federalism, in other words, there must be a legal and factual guaranty that the monitoring agency will observe the general limits of local autonomy (the principle of subsidiarity), and hence does not interfere with the details of fiscal decisions. This, of course, does not at all preclude giving helpful advice. An important function of such surveilling is to prevent financial mismanagement, or where it actually happens, to detect it at an early stage.

## 5. Three approaches to the problems of developing countries and of «newcomers» to fiscal federalism

"The basic presumption behind the arguments by the proponents of decentralization is that local democracies are in place and work. When they do not the case of decentralization becomes weaker" Tanzi 1995, p. 10.

### *a) general comments*

As repeatedly mentioned in the preceding text, most of the typical problems of fiscal decentralization tend to raise their ugly heads with particular intensity within developing countries, in particular if these countries are implementing fiscally decentralized structures. To repeat: the differences between industrialized and developing countries in this respect are not in the nature but in the intensity of such problems. For this reason, most of the measures and approaches discussed in this present part of the present study not only just apply to these countries, but may be of particular relevance to them. One set of difficulties, however, shall be taken up here again since it tends to create particularly severe and obstinate problems for this set of countries: the development of a satisfactory personal as well as institutional infrastructure. Typically the greatest difficulties in that respect arise at the local level. The problem has vast dimensions and cannot be treated at any depth in the present context.

The appropriate functioning of the fiscal process in federations depends to a much higher degree than in more centralized countries on such infrastructure, in personnel as well as in institutions. With subcentral fiscal independence, as with any decentralization, there is an increased need for qualified personnel capable of making independent decisions (while centralized states to a larger degree function by direct command). At the same time, rational fiscal federalism is institution-intensive -very, institution intensive: its proper functioning depends on a much more differentiated institutional infrastructure than would be needed under government centralization.

The outstanding difficulty here is the great scarcity, if not complete absence of experienced administrative and political personnel, especially in many newly established fiscal units, often small in size and sometimes located in remote areas. This lack in the field of administration typically is aggravated by the fact that the intergovernmental relations are poorly defined and that the public expenditure management (PEM) devices, including monitoring and control structures, are not (adequately) developed. The country studies prepared in connection with the present project of decentralization in Latin America abound in descriptions of such problems (particularly impressive: that on Colombia by Ferreira and Valenzuela 1993).

It is here where the difference between most industrialized countries and the developing ones is most pronounced in that in the former group of countries such infrastructure typically is in place. The author -after having looked into the relevant documents and other material of the German Land of Bavaria, the Swiss Canton of Zurich and the Austrian Land of Tyrol- is convinced that a comparative study of such texts and practices regulating the relations between the intermediate and the local level constituencies as they exist in industrialized federations would be of particular interest to countries in the stage of implementing federal structures. He suggests that a project of that nature -not necessarily based on the same country sample as this study- he included further stages of the CEPAL program.

### *b) Municipality surveillance*

Three attempts to counteract the problems just mentioned seem to be of particular interest: this present section shall deal with the subject of municipality surveillance; the next section will discuss that of making transfers contingent upon adequate administrative and fiscal behavior of the receivers; the last of these three subjects will be that of auditing as an "own-level" control activity of municipalities, to be distinguished from surveillance as a higher-level function.

Municipality surveillance as an indispensable coordinating device for all federal states has been touched upon repeatedly in the preceding sections. For low and medium income countries as well as countries in the process of implementing federal structures this instrument is of such paramount importance that it seems desirable to give it a second look.

According to basic federal principles, the proper place for such surveillance activity in a developed (three level) federation is with the intermediate level, with the states (provinces, cantons, länder). As already mentioned, its typical functions cover a large field of action, comprising the enforcement of legal obligations and the surveillance of the sustainability of the fiscal stance in general and of deficits and borrowing in particular. Another activity of a more civil nature, also of much increased significance for new federations is counseling -in other words: giving advice and help- in matters of an administrative or managerial or legal or technical nature. It goes without saying that such counseling in a number of areas must take the form of providing written guidelines or even extensive handbooks (like for instance on what is to be considered when planning a new school building or when buying fire protection equipment).

As already mentioned, the subject of municipality surveillance is a delicate one because with some of the activities just described, a balance between surveillance and local autonomy must be found (even in the innocuous looking case of counseling, if it takes the form of recommendations). The problems inherent in this type of activity is one of the reasons why its functions -as well as its limits must be specified clearly in the relevant legal texts. It is not surprising, therefore, that the municipality laws of the Lender/Cantons in all of the three European federations under consideration are extensive documents of many paragraphs.[47]

A necessary condition for the intermediate authorities to be able to perform such monitoring functions is that municipalities be obliged to give information on all relevant activities. Since some Latin American countries reports deplore the low quality of information on local level fiscal matters (see for instance Murphy Lopez 1995; Wiesner 1994, pp. 192 f.), the relevant passage of the municipality law of the German Land of Bavaria (art. 111) is quoted here in full text:

"The surveilling agency (of the state of Bavaria, O.G.) has the right to keep itself informed about all matters concerning the municipality. In particular, it can inspect any offices and institutions of the municipality. It can check the complete administrative and fiscal conduct of the municipality. It can also require from the municipality the preparation of reports and the presentation of documents".

In extreme cases of financial incompetence -rare in long-established federations, but likely to be more frequent in the initial stage of a decentralized structure of government[49]- the surveilling agency must be ready, and in a legal position, to increase the rigor of its control. In the extreme case it must take action to put incapable or corrupt local functionaries out of office and even to step in temporarily with its own administrators. Acts of delinquency (proved by orderly legal procedures) must have threefold consequences:

- punishment according to the criminal law;
- personal financial liability for damages caused by delinquent activity; and -within the administration- internal measures of a disciplinary nature.

To the extent that such surveilling agencies and procedures do not yet exist or do not function well, great attention should be directed to their development. To repeat: this (as well as the subjects touched in the following two sections) is a field where technical aid by international institutions may be particularly useful.

### c) *"Making transfers contingent"*

In a fiscally decentralized setting, intergovernmental transfers are of particular importance for overcoming local and regional extemal effects, for securing adequate regional distribution, and also, sometimes, for protection against regionally selective negative shocks. Such transfers- in connection with the just-mentioned approach of municipality surveilling, and with many cross-relations to it -open a chance to set some special incentives or even pressures, for observing the rules of accountability and orderly administration as well as adequate fiscal performance. Receipt of such transfers or grants can -and in the initial stage of fiscal decentralization should- be made contingent on some minimum tax collecting effort as well as on the observance of a set of principles of correct administration. Fiscal authorities should receive intergovernmental transfers if and only if they abide by their legal obligations (as specified, among other places, in the municipality laws). Again: care must be taken that such procedures stay in compliance with the rules of subsidiarity and hence do not touch the essence of fiscal autonomy.

More specifically, the right to receive transfers can (and in the stage of implementation should) be made dependent for instance:

- on a minimal own tax effort on the part of the receiving units, to repeat a point of particular political weight already mentioned; such minimal effort should be explicitly defined;

- on the willingness of the receiving unit to abide by the rules of appropriate fiscal administration, such as the procedures of orderly administrative bookkeeping;

- on the readiness of municipalities to fulfill their specified informational and other obligations towards the higher level authorities;

- on the submission of public contracts to orderly procedures of competitive bidding, with the most favorable bid to be chosen;

- if considered appropriate: on the condition that local personnel participate in training courses for administrative aptitudes (see for instance Broadway and Shah 1992; Wiesner 1994, p. 180);

- at the risk of mentioning a point of self-evidence: surveilling procedures must (of course) make sure that conditional grants are used for no other purpose than the one specified.[50]

### d) *Auditing as "own level" activity*

Distinct from the surveilling activities just mentioned, municipalities al their own level (but possibly with the help of the surveilling agency) should be held responsible for organizing and submitting themselves to an effective auditing procedure. In contrast to surveilling as higher level control function, the auditing agency -unhampered by obligations to abide by the principle of subsidiarity will be free to probe into matters not only of "correct" but also of efficient and cost-effecive local management.

A general problem in this connection is that small local units typically do not have the administrative activities for carrying out such activity. The following three types of solutions practiced in European countries may be of interest:

- Municipalities in a number of instances are encouraged to, and frequently do use the services of private auditing agencies.

- Some German länder, such as Bavaria, have established an independent agency specializing in municipality auditing, the services of which are used by municipalities below a certain minimum size.[51] To make it clear that this work is done in the interests of the municipalities, this activity is (and should be) financed by fees which the auditing agency charges to the municipalities to cover the cost of its services.

- A different and interesting -albeit somewhat unorthodox- solution, practiced by the Canton of Zurich, is worth noting. The municipalities of this Swiss Canton -besides having the right to choose the services of a private auditing agency- at their own choice may also entrust the Cantonal, in other words the intermediate level surveilling agency with such auditing service (to repeat: auditing is not to be confused with surveilling proper). Thus the surveilling agency, if chosen by the municipality, performs an additional function, this time as an agent of the municipality, providing a service in the interests of this local authority. Quite in the spirit of this activity, the canton covers the costs of its auditing service from the municipalities by levying a special fee (not so, of course, for its surveilling activity). The arrangement seems to function well in its helvetic context, and it is reported that a great majority of the municipalities make use of this service. The suggestion concerning this latter procedure is not unequivocal: aside from having positive synergetic effects, it may also be associated with conflicts of interest.

## 6. Coordination by separating monetary and fiscal policy: central bank autonomy

The subject of this final suggestion of the present study -central bank autonomy goes far beyond the scope of the preceding discussion. It concerns what is perhaps the most powerful single approach to macroeconomic coordination. The outstanding point of interest here is in particular that recent empirical findings suggest that *strict* or *hard core* central bank independence,[53] aside from its more obvious effect on price stability, typically has a powerful positive influence on fiscal performance as well (See for instance Masciandaro, Spinelli 1994; Alesina, Summers 1990, p. 1 ff.; Grilli et al 1991, p. 268, p. 320; for a survey: Gruber 1996- the seminal contribution has been by Parkin 1987).

All three European countries under consideration here have such ("hard core") central bank independence. According to recent measuring attempts, Germany and Austria rank high in degree of monetary autonomy according to the different measurement concepts, while Switzerland takes the top place of all countries considered (Grilli et al. 1991, p. 366 ff.; Cuklerman 1992, Banalan et al. 1994). The project of a European Monetary Union will extend the principle of central bank autonomy to all participating countries. As it is well known, also the United States has an independent Federal Reserve System. In sum: central bank independence is not atypical for industrialized federal countries; during the last two decades the idea has also found resonance in a number of the more centralized countries (such as France and Spain in the EU as well as New Zealand).

The main reason for such influence on fiscal performance seems to be due to the simultaneous effect of four factors:

- one, as has already been stated, with a regime of central bank autonomy, government authorities can be more effectively barred from direct as well as indirect access to central bank credit than with government-controlled monetary policy;

- two, with central bank autonomy, governments are unable to influence their receipts of seigniorage by inflation, resulting from self-determined monetary expansion;

- three, with central bank autonomy, the central governments do not have the power to soften the real burden of their outstanding public debt by inflation; hence an important incentive for monetary expansion is eliminated;

- four, with central bank autonomy, governments know beforehand that destabilizing fiscal expansion will typically entail a tighter course of monetary policy and thus may lead to negative effects on employment and growth.

The issue of central bank independence is too complex to be dealt with more comprehensively in the present context. But it certainly is an extremely interesting one, also for Latin America. This is so not only for its more obvious monetary perspective but also because of its typical indirect effects on macroeconomic fiscal performance. Together with fiscal decentralization on the one hand and with privatization on the other, it may be seen as one of the most important single steps towards the rational containment of (central) government power.

## 7. Survey of suggestions

In conclusion, the main suggestions presented in this part of the present study shall be summarized in condensed form.

*Tax assignment*. The old assignment prescription still stands: In order to promote macroeconomic stabilization (as well as for distributional reasons), taxes and social transfers with high built-inflexibility, such as the personal and corporate income tax and unemploynent benefits, should be assigned predominantly to the higher levels of government. Taxes of predominantly local incidence should be the domain of local government. The case for such strengthened is looked upon from a supply side of point of view.

*Promoting intrafederal cooperation*. One way to cope with coordination problems, including problems of macroeconomic nature, is by promoting voluntary cooperation between federal units. Cooperation between independent entities presupposes a process of exchange of information and o opinion, of consultation and of bargaining. Such process needs organizational infrastructure (standing *conferences*, *councils*, working groups etc., with broader as well as more narrowly defined tasks), both of horizontal and of vertical nature. In developing countries such networks often are deficient or poorly organized or -in particular in countries still in the stage of implementation- not yet (fully) developed. Hence it is suggested that countries should analyze their intrafederal organizational structure, and in case of deficiencies endeavor to develop a more comprehensive and effective network.

*Coordination by specification of macro responsibility*. In order to facilitate such cooperation. or at least to prevent obstructive behavior -but also for other reasons, it may be useful to specify by constitutional of statutory law an explicit obligation of public agents at all levels of government to *take into account* the macroeconomic consequences of their decisions. All three countries considered in his presentation have introduced constitutional and legal clauses to that respect.

*Strengthening credit market discipline*. An important step toward hardening government budget constraints is to strengthen the disciplining power of credit markets. The following groups of measures should be envisaged to that respect, each of them representing an entire program of institutional reform: (a) prohibiting fiscal access to the central bank, (b) instituting pre-established, transparent and non-discretionary intergovernmental transfer schemes, (c) instituting no-bailout rules for the case of a fiscal crisis in a federal unit; (d) privatization of publicly owned banks and hence implementation of arms length relationships between government and its lenders, (e) eliminating regulations that directly or indirectly give public authorities a comparative advantage with respect to private borrowers; (f) enforcement of clear budgetary rules to prevent public authorities from obscuring their true amount of borrowing and of outstanding debt. Besides improving market control, each of the approaches suggested here also contributes to improving fiscal performance and -in a large sense the efficiency of the economy as well as the effectiveness of the political process.

*Prohibiting fiscal access to the central bank*. Fiscal access to the central bank is highly undesirable since it endangers macroeconomic stability from two sides simultaneously: by softening fiscal balance constrains, and by reducing control over the money supply. Thus it should be barred for all government units within the federation. For similar reasons, government owned banks should not have any privileged access to central bank credit (much to be preferred, such banks should be privatized.

*Constitutional limits on capital market borrowing: a general comment.* Public borrowing should be limited by direct constitutional or statutory constrains at all levels of governments, including the national one. This task should be combined with a considerable effort to close off the most important possibilities of circumvention of such limitations, like hiding public borrowing and public debt in *off-budget activities*, or by implicit borrowing (leasing arrangements), or by all sorts of so-called creative accounting.

*Constitutional limits on deficits and borrowing: the national and intermediate level.* As far as the national level of government is concerned, there is no way to single out the superior set of solutions. Account should be taken of the fact that the central level fiscal policy must be in a particular position to cope with adverse economic shocks. Limiting *rules* for public borrowing should therefore be combined with a clause of *exception*, to be invoked in case of severe macroeconomic disturbance. As far as the *rule* part is concerned, the menu from which to pick includes suggestions such as limiting borrowing to the amount of public investment in a narrowly defined sense, or to a fraction thereof, or to a fraction of public expenditure (for instance 5 percent), or to a maximum ratio to GDP (as in the Maastrich Treaty), or -a rule increasingly favored in the reform discussion to zero, tantamount to introducing a balanced budget rule for the normal case. Of interest in this context is a Swiss reform project defining three types of situations: periods of low GDP growth (less than 0.8 percent)where a deficit is permitted; periods of normal GDP growth (0.5 to 1.8 percent), for which situation a balanced budget is prescribed; and periods of high GDP growth (more than 1.8 percent) where a surplus must be achieved.

*Borrowing constraints at the intermediate level should be at least as strict as those for the central level.* A case could be made for a rule-and-exception approach, for reasons similar to those for the national level of government. Recent developments in individual States of the US have been revolutionary in that they have introduced strict balanced budget rules for these intermediate units. In some US states -somewhat similar to the *high growth* part of the just-mentioned Swiss federal project- such prohibition is combined with an obligation to achieve surpluses (to feed a *rainy day fund* in both normal and boom legal texts, regulating the relations between the intermediate and the local level as they exist in industrialized federations could be of particular interest to countries implementing federal structures and to developing countries in general. He suggests that a project of that nature - not necessarily based on the same country sample as this study- be included in further stages of the present (CEPAL GTZ) program.

*The strategic role of municipality surveillance.* Municipality surveillance is an indispensable coordinating device for all federal countries. It should include control of adherence to carefully specified legal obligations (including the observation of the limitations on public borrowing just mentioned). Another important function is counseling, in other words giving advice and help in matters of an administrative, managerial, legal or technical nature. In countries where this set of functions is deficient, attention should he directed to its improvement.

*Making transfers contingent.* Higher level transfers to municipalities offer a chance to strengthen the incentives for observing the rules of accountability, orderly ministration and fiscal performance. Receipt of such transfers or grants can -and in the initial stage of fiscal decentralization should- be made contingent on an adequate fiscal effort to collect own revenues and on the observation of a set for principal rules of orderly administration.

*Auditing as an own-level local activity.* Municipalities all their own level should be held responsible for implementing an effective auditing procedure and should be legally obligated to do so. They should he free to turn to private auditing agencies. One typical solution, applied in some German Länder, is the establishment of an agency specialized in municipality auditing, especially for those of small size (below five thousand inhabitants). To make it clear that such service is an activity of the Municipalities themselves, it should be financed by cost-covering fees charged to these municipalities. A different -albeit somewhat unorthodox- solution, practiced by the canton of Zurich, is that municipalities- besides having the right to choose the service of a private auditing agency, at their own choice may entrust the (intermediate level) surveilling agency with such an auditing service for the payment of a cost-covering fee. The argument for that latter procedure is not unequivocal: it may create conflicts of interest.

*Central bank autonomy as means of securing fiscal discipline.* Much beyond the scope of the preceding items goes the concept of (*hard core*) central bank independence resulting in a complete separation between fiscal and monetary policy. Empirical findings strongly suggest that such separation, aside from its more obvious effects on price stability, typically has a powerful positive influence also on fiscal performance. The issue of central bank independence is an extremely interesting one. Together with fiscal decentralization on the one hand and with privatization on the other, it may be seen as one of the most important single steps towards the rational containment of (central) government power.

## NOTES

1. See for instance, Heinemann, 1992; for an evaluation within a general survey of deficit measurement concepts, see Blejer and Cheasty, 1991, pg. 1654n.
2. Keeping structural deficits constant in times of economic slump thus is compatible with an increase in actual deficits to the extent that they result from the built-in flexibility of the revenue/expenditure structure.
3. As a prominent example see the paper of Tanzi, presented at the World Bank's Annual Conference on Development Economics in 1995 as well as the extensive number of recent IMF studies and other literature mentioned therein. See also the exposition of federalism problems for Latin American countries by Wiesner 1994.

4. For a survey of both the theoretical and the empirical literature, see Gruber 1996. - As far as empirics are concerned, the one seminal paper for recent research is Roubini and Sachs 1992. Following its lines: Corsettl and Roubini 1992, Edling and Ohlsson 1991, Grilli et al. 1991, Crain and Tollison 1993, de Haan and Sturm 1994. Other recent empirical studies: von Hagen 1992, Poterba 1994.
5. The background of this statement of course is that during the past two decades the problem of high deficits in the United States has been one of the federal level of government alone, whereas the states, taken together (as well as the municipalities, taken together) -under the impact of severe borrowing constraints as well as obligations to build up *rainy day funds*- have been achieving a fiscal surplus
6. For a definition of the concept of softness/hardness of balance constraints, see Kornai 1980, for a public deficits and borrowing perspective on this concept, see Gandenberger 1986, p. 205.
7. This seems to have been the case in Austria during the previous decade. The transfer rules were changed to the disadvantage of the intermediate units which led to increased deficits on this level of government, but at the same time the deficit of the central level decreased by approximately the same amount, so that the global deficit remained essentially unchanged-, one Austrian author (Smekal) calls this *borrowing substitution* (Stellvertreterverschuldung) between levels of government.
8. The textbook would readily admit that some qualifications may apply for areas which are economically (California) or geographically remote (to stay within the United States: Hawaii, Allaska).
9. For a more extensive discussion of this and the following point, see for instance Berthold 1995.
10. For a survey of the arguments see for instance Schlesinger at al. 1993.
11. For more comprehensive descriptions of the fiscal systems of these countries -as well as of the three Anglo-Saxon federations- the reader may turn to a variety of English language country studies: Krause-Junk and Mueller (1993, published in this same series, includes an extensive sample of federal and non-federal industrialized countries); Spahn (1993, seen from an Australian perspective, includes Switzerland); Bird (1986, seen from a Canadian perspective, includes Austria and Switzerland)- ACIR (= Advisory Commission for Intergovernmental Relations), 198 1, seen from a US'-American perspective, with respect to Germany: based on a preparatory country study by Zimmermann 198 I)- for Austria: Nowotny 1996; Pernthaler 1983
12. Switzerland has four official languages. German, French, Italian and Romansh. The German-speaking part of the population amounts to 70 percent of the total, French speaking are 20 percent, Italian-speaking 10 percent, and Romansh-speaking a minority of 50,000.
13. Even three of Germany's länder count a larger population than Austria as well as Switzerland.
14. Criticism concerning the tax assignment at the intermediate level in Germany and Austria is widespread, especially so in Germany. This system provides practically no revenue from self-determined tax sources. This is a pronounced example of a violation of the principle of fiscal equivalence which, in its strict sense, means that each federal constituency should perform its functions with self-determined taxes

and thus have full legislative competence at least as far as the rates of these taxes are concerned.

15. In some cantons even the municipalities, in their turn, deviate from the tax base as defined by the canton.

16. These limitations date back to the introduction of these taxes which in the case of the federal income tax was in World War One, almost half a century before similar concepts became a topic of discussion in the wake of the Californian tax revolt (1978).

17. It does again since 1995. The estimated revenue for 1995 is in the order of 3 to 5 percent of total tax receipts

18. The results are complex indeed. As writes one knowledgeable insider: "... (The transfer schemes are) an extremely complicated matter which frequently can be explained less under aspects of economic rationality than under political and historical aspects" (Nowotny 1996, p. 147).

19. A veto by the Bundesrat blocks the passage of a bill. It can only be overridden by (the rather improbable case of) a two-third majority of the first legislational chamber the Bundestag. In the normal case of dissent, an organized process of mediation and compromise takes place. This, among other things, leads to the of criticized effect of obscuring political responsibilities, especially so when party majorities in the two legislative chambers differ

20. Rejection of a national bill by the Austrian Bundesrat has only retarding consequences and thereby, normally, is of only marginal effect-, as far as the national budget is concerned, the Bundesrat does not even have the right of *rejection* in this formal sense.

21. One should keep in mind, however, the importance of informal contact in the Austrian political scene. Inside observers agree in asserting the existence of a considerable political influence of the Länder as such, in particular of the Länder chiefs of government on federal politics.

22. For a more comprehensive discussion of the subject see in particular the collection of articles presented by McLure (ed.) 1983, *Tax Assignment in Federal countries*; see also Krause-Junk and Mueller 1993, p. 50; Tanzi 1995. To quote the latter author (P. 27)-. "...the more weight the government assigns to the objectives of income distribution (through progressive taxation) or to stabilization (through the use of built-in stabilizers) the better it is to leave certain tax bases, such as the progressive income tax and corporate income tax, to the national government."... "(Also, O.G.) ... the more mobile is a tax base, the greater is the presumption to keep it at the national level".

23. As already noted, the argument has first been presented by Kenen (1969), and has been corroborated by empirical evidence with respect to the United States by Sala-i-Martin and Sachs (1992). Their result for the United States (ibid, p.216) is as follows: ...we found that a one dollar reduction in a region's per capita income triggered a de crease in federal taxes in the neighborhood of 34 cents and an increase in transfers of about 6 cents. The final reduction in disposable per capita income was, therefore, of only 60 cents. That is, between one third and one half of the original one-dollar shock is absorbed by the Federal Government.

24. The coordinating power of such second chambers depends considerably on their basic construction principles. A construction according to the Senate principle (members elected by the regional citizens) differs in its coordinating thrust from a construction according to the principle of direct representation of intermediate government, as in the German case. This issue, interesting as it is, shall not be pursued here further.

25. For example: the qualitative descriptions of the ratings of Mood>,s Investor Service for US bonds are: Aaa -best quality; Aa -high quality; A -upper medium quality-, Baa -medium grade; Ba -possesses speculative elements; B -generally lack characteristics of desirable investment- Caa -poor standing, may be in default; Ca speculative in a high degree, often in default; C -lowest grade, very poor prospects. In addition to each broad category, a number l, 2, or 3 can be added to the letters to indicate whether the borrower is in the high, middle or low end of the ratings category.

26. See the Lane and the Goldstein /Woglom articles for a more comprehensive treatment of the market discipline issue on the basis of modern credit market theory.

27. For more factual information and an econometric analysis see Goldstein and Woglom 1992.

28. To mention a Latin American example: "In Colombia banks accord *grace periods* to local authorities for interest payments on borrowing that correspond to the term of office of non-reelectable mayors" (Tanzi 1995, p. 35).

29. See for instance Ter-Minassian 1996, p, 17. - A step in the right direction in Brazil has been the abolishment of the system of automatic central bank credit of lower level governments ("zeragem automatica") in 1990 (Shome 1995, p. 20).

30. Public deficits on the one hand and public borrowing on the other then turn into two different sides of the same coin, into two different aspects of *deficits-and-borrowing*; hence limitations on public borrowing can be viewed as limitations on public deficits, and vice versa (see Gandenberger 1986, p. 2O5n.)

31. The idea is that member countries must *in principle* meet these criteria as a pre-condition for joining the European Currency Union, and they must -again, in principle- abide by them continuously once they have entered it. The treaty makes clear that overstepping these limits is not considered as a violation per se but will automatically set off a procedure of analysis and of reporting of the EU Commission to the EU Council (of ministers) which may end in an official act of disapproval and -in the ultimate of cases- in financial sanctions. Ironically, in the year of 1995 no EU country (with the sole exception of Luxembourg) fulfills every one of the quantitative criteria of the treaty.

32. This raises a problem which is in striking parallel to the one existing in federally organized countries of other parts of the world, if confronted with special stipulations of the World Bank or the international Monetary Fund concerning fiscal discipline, for instance as a precondition for receiving foreign aid or a foreign currency credit (see for instance: Krause-Junk and Mueller, 1993, p. 96). As with all EU treaty stipulations, it is the central level authority which is under direct legal obligation to ascertain that the country will meet these limitations. The question is-

how can it ascertain such compliance within a federal universe where the subcentral units in principle are autonomous.

33. See Julfaian and Marlow 1991-, v. Hagen 1990. - For Latin America-. Ter-Minassian 1996, p. 12, Wiesner 1994, p. 226, Espinosa and Marcel 1994 (Chile), and a number of other country studies. - For the OECD see Saunders and Klau 1985- for USA, among many others-. von Kleist 1990-1 for US states in particular-Bunch 1991 for Germany: Gruber 1996, chapter three, for Austria: Nowotny and Winckler 1994, p. 229, Smekal 1992.
34. This is impressively shown by the experience of US-American states after the introduction of deficit limitations.
35. As far as the Swiss cantons are concerned, there exist limitations of deficits or borrowing in at least the following three cantons. Sank Gallen (since 1929), Fribourg (since 1994) and Basel-Stadt (since 1995).
36. For a summary discussion of the following see Wissenschaftlicher Beirat 1984, p. 49 ff.
37. One approach, favored by a number of participants in the US American discussion: for a summary reference see ACIR 1987) seems unconvincing, however.. namely, to make public deficits and borrowing depend on the consent of a quorum of -say-two thirds of the votes in parliament. The problem is that such procedure can be abused for political extortion, in the sense of making political consent dependent on more or less unrelated issues (for a criticism of this type see for instance, Wissenschaftlicher Beirat 1984, p. 49).
38. One reason among others for setting the limit ´below, the full amount of investment is that the conventional statistical concept current public investment spending does not take into account the depreciation of the public capital stock (see Wiesner 1994, p. 220).
39. Gandenberger 1995, with a review of arguments-, in a similar sense Schlesinger et al. 1993.
40. This 60-page report is unpublished: Vernehmlassungsbericht zur Schuidenbremse,
41. The first of these funds was set up by the state of Michigan in 1977, which was then followed by 34 other states-, for a description of the details, see ACIR 1989, pp. 39 ff.
42. A balanced budget amendment for the federal level of the US has been under discussion several times during the last decade, Recently they were part of the "Contract for America on which Republican Party candidates successfully campaigned in the 1994 midterm election (see Bayoumi and Eichengreen 1995, p. 32).
43. In the period from 1960 -71, according to these findings, it had been cyclically neutral.
44. Such reaction to disturbances for exogenous reasons should not be confused with bailouts which have to do with self-inflicted disturbances such as a local fiscal crisis caused by incompetent or corrupt management.
45. In cases of doubt as to the sustainability of a municipality's fiscal stance, some länder in Germany call for external (private) expertise.
46. This does not seem to be the case in Chile (see Espinoza and Marcel 1994, p. 58).

47. The natural level for the performance of such function is the intermediate one. This presupposes that developed federal structures exist as is the case in Argentina and Venezuela. Chile and Peru, however, "display a more fragile and almost non-existent link (between states/provinces and municipalities, O.G.), while Columbia is in an intermediate situation" (Jarmillo 1995, p. 4). To the extent that an intermediate order of government does not exist, of course, such function must be performed -totally of partially- by the central authority.

48. The relevant law of Bavaria, for instance, comprises 123 articles, covering 47 pages of current text. The first article in the section of this law which concerns the surveilling function specifies as a general clause that such activity must respect the general limits of fiscal autonomy of municipalities

49. Germany has had some unpleasant experiences to that respect after the reunification with dozens of municipalities in the new parts of the country when the surveilling activity of the just-created länder did not function well and municipality personnel lacked administrative experience. The typical course of events seems to have been that some all-too-clever entrepreneurs from the Western parts of the country talked municipality officials into engaging in ambitious investment projects which were over-dimensioned and/or turned out to be much more expensive in the end than had been planned at the outset (for a press coverage of such experiences, see for instance Frankfurter Allgemeine Zeitung, No. 180, of Aug. 5, 1995, p. 13).

50. For instance, if a municipality chooses not to raise a local property tax, contrary to its legal obligation, as has been reported from one Latin American country, it should not qualify for the receipt of horizontal or vertical transfers: federalism degenerates if it is abused by individual fiscal authorities as a means to live at the expense of others;

51. Conditional grants should not be accorded too lavishly. To the extent that the benefits of a project accrue to the receiving unit, such grants should depend on this unit's own contribution. This basic rule of efficiency is frequently violated in Germany; for critical comments to that respect see for instance, Peffekoven, 1994, p. 299 f; for a similar criticism concerning federal state transfers in the United States see Gramlich 1992, p. 303 f. -For Switzerland see Bericht des Eigenóssischen Finanzdepartments 1996.

52. The Bavarian Municipal Auditing Association, housed in Munich (counting 200 employees), in charge of auditing (obligatory) -and, if desired, also giving advice with respect to problems of budgetary efficiency- of all Bavarian Municipalities of less than 5,000 inhabitants. This activity is documented in Annual Reports, with plentiful details as well as studies on special new problems of administrative relevance, the 1994 issue has had a volume of 250 pages. The institution has long tradition: it has just celebrated its l00th birthday.

53. Central bank independence is no easily defined concept, and such independence must be measured in several dimensions. It is useful to distinguish between formal and material (*strict* or *hard core*) central bank independence. There exist several attempts to define material central bank independence (see the literature just quoted, in particular Masciandaro and Spinelli 1994, pp. 434 ff., and Gruber 1996). The legal commitment to the goal of monetary stability is, by itself, by no means considered sufficient for achieving high rank on the scale of central bank

independence, even if it is combined with a ban on the financing of public deficits. What is also taken into account is the appointment procedure as well as the term of office of central bank directors, the participation or non-participation of government representatives in the decision-making process, the extent of freedom of choice between instruments of monetary and credit policy (including exchange rates!) and other factors.

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