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Is centralization a solution to the soft budget constraint problem?

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ABSTRACT

This paper focuses on the centralization program implemented in Israel in 2004 to analyze whether the administrative subordination of municipalities is an effective policy to deal with problems related to soft-budget constraint of lower level governments. The results consistently show, for different specifications and samples of municipalities, that this program brought a substantial decrease of municipalities' expenditures (mostly because of decreases in salary payments), and an increase of local property tax collection. Our analysis shows that all of the fiscal impact of the program is due to the appointment of an accountant that reports directly to the central government, a relatively mild form of administrative subordination. In contrast, more intrusive forms of subordination, like the central imposition of a recovery program, do not result in any substantial improvement of municipalities' fiscal situation. This leads us to conclude that a mild form of administrative subordination is an effective tool to cope with problems related to soft-budget constraints, whereas political subordination is not an effective tool to reach that goal.

1. Introduction

Whereas the last decades of the 20th century brought about a large wave of fiscal decentralization in countries around the world, we observe in the last few years a move on the opposite direction. Currently, central governments tend to intervene and constraint the behavior of local governments in developed and developing countries. There is a growing body of evidence showing such a trend in developed economies like England (Turner and Whitman, 2005), Germany (Rodden, 2006), Italy (Bordignon, 2013), and the U.S. (Inman, 2003), and in a large number of developing countries like Argentina (Webb, 2003), Brazil (Rodden, 2006), China (Yee, 2012), Hungary (Wetzel and Papp, 2003), India (McCarten, 2003), and Russia (Zhuravskaya, 2010), just to name a few examples. The recent global downturn strengthened the move towards further centralization and administrative subordination of local authorities in Europe and the U.S. (Viver Pi-Sunyer and Martín, 2013).

The move to centralization takes different forms across countries. For example, Putin started centralizing Russia's local governments as soon as he assumed power. He cancelled regional elections for governors in 2005. Since then, Russia's president person-

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ally appoints professional representatives of the central government as governors and heads of regional legislatures (Zhuravskaya, 2010). There are also examples with less intrusive methods of centralization. As stated in Wetzel and Papp (2003), Hungary put in place legislation to regulate local governments that declare themselves insolvent or in bankruptcy. Accordingly, the law states that localities in dire financial situations are solely responsible to pay their debts. In addition, the central government names a financial trustee to monitor the functioning of the municipality and to ensure that an emergency budget is implemented. Argentina's case provides a more moderate example. According to Webb (2003), the Argentinean federal government made available a program of debt relief or debt rescheduling to provinces, contingent on the provinces implementing reform programs.

The original drive for decentralization posited that lower level governments tend to make more efficient decisions over local public revenues and expenditures for a number of reasons. First, due to inter-jurisdictional competition, local politicians have a strong incentive to provide better services to attract more residents (Tiebout, 1956; Besley and Case, 1995). In addition, local politicians are more attune with the preferences of the local population and better informed of their needs and capabilities. Finally, individuals may be able to sort themselves across localities based on their preferences and the characteristics of each locality (Oates, 1972). Hence, the argument goes, when local politicians serve their constituency, transferring decision-making to the local level should lead to policies that better reflect the residents' needs and preferences, and may also increase efficiency if inter-jurisdictional externalities and economies of scale are not too severe.

Paradoxically, it turns out that local politicians' willingness to cater exclusively to their constituencies became one of the main problems of decentralization. In their drive to satisfy their electorate, local politicians face strong incentives to engage in opportunistic behavior, whereby they shift part of the financial burden associated with local provision of services to higher levels (Klor, 2006). That is, when the central government tends to bailout localities in financial distress, localities that repeatedly deviate from balanced budget constraints are able to extract transfers from others, more financially responsible localities. Hence, a common-pool practice behind the financing of local expenditures creates strong incentives for local officials to overspend. This is known in the literature as the soft-budget constraint problem following the seminal work of Kornai (1979).[4]

The central government has a direct way of dealing with soft-budget constraint problems. This includes developing an institutional setting that imposes the right incentives on local governments such as a credible no-bailout policy. In most countries, however, central governments are unable to commit to a no-bailout policy for political reasons (Quian and Roland, 1998). In these cases, central governments tend to resort to hierarchical oversight and regulation to reign on localities' spending and impose on them hard budget constraints. These types of interventions, also called administrative subordination, often consist of centrally appointing local officials rather than electing them.

This paper studies whether administrative subordination is an effective tool to cope with soft-budget constraint problems without affecting the local provision of public goods. For these purposes we focus on a major centralization program implemented in Israel in 2004. According to this program, the central government in Israel uses three types of interventions on local governments. They consist of imposing different degrees of administrative subordination of local politicians to the central government. Within the framework of this program, the central government is entitled to (i) appoint an accountant that has to approve every expenditure of the municipality and reports directly to the central government; (ii) impose a recovery program specifically tailored for each municipality that specifies, among other things, tax collection targets and number of employees that need to be fired; and (iii) dismiss the mayor and members of the municipal council and replace them by a summoned board as the only authority of the municipality. Since their inception, these programs were instituted in more than half of Israel's municipalities in order to curtail their deficits and expenditures.

Despite the widespread use of hierarchical oversight and administrative subordination in Israel and elsewhere there is not, to the best of our knowledge, definite empirical evidence testing the effectiveness of hierarchical oversight on solving the soft-budget constraint problem. Some researchers claim that hierarchical administrative controls are effective in imposing a hard budget constraint in decentralized OECD countries like Canada (Bird and Tassonyi, 2003) and Norway (Rattsø, 2003). Others argue that this approach does not seem to be effective in developing countries like Argentina (Webb, 2003), India (McCarten, 2003), and Russia (Zhuravskaya, 2010). The studies above base their conclusions on a descriptive approach, and do not present systematic empirical evidence trying to estimate the causal effect of hierarchical subordination on the outcomes of interest. The evidence is not conclusive either when looking at cross-countries analyses. Enikolopov and Zhuravskaya (2007) show that administrative subordination does not lead to better economic outcomes using a sample of 75 developing countries. Rodden (2002) finds that restrictions imposed on subnational governments by the central government lead to better fiscal performances using a similar sample of 43 developing countries.

This paper focuses on the widespread use of hierarchical oversight and administrative subordination in Israel since 2004 to analyze their effects on municipalities' fiscal performance and their provision of public goods. The analysis is based on an original detailed panel data set containing all the relevant characteristics of the municipalities between 2000 and 2010. This allows us to control for municipality fixed effects and aggregate years effects, thus identifying the effects of central intervention on the variation of outcome variables of interest across municipalities over time.

[4] Kornai's (1979) contribution started a large and growing literature analyzing the causes and consequences of soft-budget constraints. See Kornai et al. (2003) for a theoretical analysis of soft-budget constraints and a review of the related literature not only covering the framework of local governments, but including applications related to the banking system, other private firms, and nonprofit organizations, just to name a few. See Prud'homme (1995) and Tanzi (1996) for early warnings on the risks associated with fiscal decentralization due to the existence of soft-budget constraints. Pettersson-Lidbom (2010) and Bordignon and Turati (2009) present empirical evidence on the consequences of soft-budget constraints based on Swedish localities and Italian regions, respectively.