



# Assist or desist? Conditional bailouts and fiscal discipline in local governments



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## ABSTRACT

Central government bailouts of local governments are commonly viewed as a recipe for local fiscal indiscipline, as local governments learn that the center will come to the rescue in times of trouble. However, little is known about the consequences of bailouts granted conditional on local governments first making efforts to improve the situation. We examine a case in which the Swedish central government provided conditional grants to 36 financially troubled municipalities. We use the synthetic control method to identify suitable comparison units for each of the 36 municipalities. To compare the development of costs and the fiscal surplus of admitted municipalities to that of their most similar counterparts during the decade after the program, we then estimate fixed effects regressions on the resulting sample. The analysis suggests that conditional bailouts did not erode, and may even have improved, fiscal discipline.

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## 1. Introduction

Should central governments bail out local governments in financial distress? On the one hand, refusing to bail out local governments may lead to defaults, which can be very costly both economically and politically. On the other hand, bailouts may create problems of soft budget constraints: noting that the central government comes to the rescue in times of trouble, local governments may come to expect that bailouts will be available when needed. Thereby, their incentive for fiscal discipline is eroded.<sup>1</sup> Several empirical studies of fiscally decentralized countries indicate that bailouts lead to lower fiscal discipline.<sup>2</sup> The relevance of the dilemma is further illustrated by the development in the Euro area and the US after the financial crisis in 2008, with recent examples both of Euro countries (e.g., Greece) and regions (e.g., Andalusia and Valencia) receiving bailouts and of US cities (e.g., Detroit) going bankrupt.

A possible way out of the dilemma may be to bail out the local government, but condition payment on actions that lay the ground for future fiscal discipline. We investigate a program run during 2000–2002 in which the Swedish central government provided conditional bailouts to 36 municipalities in fiscal distress: the municipalities were granted extra funds, but payment was contingent on them first cutting costs and achieving budgetary balance.<sup>3</sup> The conditions were enforced: no municipality received the full grant

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<sup>1</sup> For theoretical explanations of the existence and effects of soft budget constraints, see e.g., Kornai (1979), Wildasin (1997), Goodspeed (2002), Inman (2003), Desai and Olofsgard (2006), and Sas (2014).

<sup>2</sup> See Rodden (2002), Rodden et al. (2003), Plekhanov (2006), Bordignon and Turati (2009), Pettersson-Lidbom (2010), Fink and Stratmann (2011), Lusinyan and Eyrard (2011), Sorribas-Navarro (2011), and Baskaran (2012). Kornai et al. (2003) survey the theoretical literature and provide further empirical examples.

<sup>3</sup> The transfers were not last minute rescue attempts in the face of imminent defaults. We use the term “bailout” to comply with the terminology in the literature on soft budget constraints, where the term is also used to denote discretionary transfers to cover deficits (see e.g., Fink and Stratmann, 2011, p. 367).

until both conditions were met. As all municipalities admitted to the bailout program eventually managed to meet the conditions, their fiscal discipline evidently improved in the short run. However, the more interesting question is whether their newly acquired fiscal discipline was retained after the program had ended. To examine the long run effects, we analyze the evolution of operating costs of services and revenues net of costs (henceforth referred to as the *fiscal surplus*) during the decade after the launch of the program.

To draw firm conclusions about whether and how the bailout program affected fiscal discipline, we would ideally have wanted municipalities to be randomly assigned to the program. However, non-random assignment is an inescapable feature of bailout programs since they, by design, are directed only to units in fiscal distress. In the current context, this is illustrated by the fact that out of the 290 Swedish municipalities, only 59 chose to apply to the program and no more than 36 of these were admitted. The experience of applying to but being denied to participate in the program is also a kind of treatment: a signal that the budget constraint is hard, or at least harder than expected. We therefore examine the 23 rejected municipalities as well.<sup>4</sup>

To deal with the selection problem, which pertains to both the admitted and the rejected municipalities, we combine matching with fixed effects (FE) estimations. For each municipality that applied to the program, we use the synthetic control method – developed in Abadie and Gardeazabal (2003) and Abadie et al. (2010) – to construct a synthetic municipality from the set of municipalities not affected by the program. We then estimate FE regressions on the samples of actual municipalities and their synthetic controls. Our FE model identifies the effect of the program if the average outcomes of the actual and synthetic municipalities would have followed a parallel path in the absence of the program. We believe this assumption is more likely to hold for the matched sample than for an unmatched one, as both the levels and trends of costs for actual and synthetic municipalities are very close during the pre-program period, and they are similar with respect to important predictors of costs and fiscal surplus.

According to our preferred specifications, the admitted municipalities have on average reduced costs permanently and increased the fiscal surplus most years after the program. As the synthetic control method enables us to examine the difference between the actual and synthetic costs of each admitted municipality, we moreover analyze each case separately. We find that the average cost reduction is driven by a third of the admitted municipalities; most of the others have not reduced costs significantly, while only two seem to have increased costs. The “cost-reducers” do not drive the positive average effect found for the fiscal surplus, however. This suggests that most of the admitted municipalities sought to deal with their fiscal problems, though by different strategies. As for the rejected municipalities, we find little that indicates important or lasting effects on their fiscal discipline.

One concern for the policy implications of our results is that we can only estimate how the applicants fare relative to municipalities that did not apply to the program. As all Swedish municipalities were most likely aware of the program, their fiscal discipline may in principle have been indirectly affected by it. Such spillover effects may imply that it would have been better for the central government to abstain from granting bailouts, even if the admitted municipalities compare favorably to municipalities that only heard about the program. It should however be noted that the average fiscal surplus of the Swedish municipalities have increased quite sharply in the period after the program ended (Persson, 2013). This development suggests that the program has not had detrimental effects on the fiscal discipline of municipalities in general.

Spillover effects may be especially likely to pertain to municipalities that are neighbors to the admitted municipalities (c.f. Pettersson-Lidbom, 2010). This presents us with a dilemma, as neighboring municipalities share many features with the treated municipalities and thus figure prominently in the synthetic controls. Upon excluding the neighbors from the comparison group, the estimated impact of the program on the admitted municipalities becomes insignificant, while the estimations indicate adverse effects on the fiscal discipline of the rejected municipalities. As the exclusion of neighbors imply considerably worse fit of the synthetic controls, it is however difficult to know how much confidence to put in these estimates. Moreover, the program was not a clear-cut signal of a softened budget constraint to municipalities that were not admitted: it was clearly delimited in time, employed relatively clear selection criteria, and rejected a large share of applications (almost 40%). Additionally, a substantial share (36%) of the neighbors to the admitted municipalities are also neighbors to at least one rejected municipality. These neighbors received a mixed signal about the availability of bailouts.

Importantly, none of our estimates support the idea that the bailout program has undermined the fiscal discipline of the admitted municipalities. The admitted municipalities furthermore compare favorably to the rejected municipalities, despite that the rejected municipalities received a signal of hard(er) budget constraints. Even a cautious interpretation of our results thus stands in contrast to findings from settings with bailouts that were not given conditional on local governments first making efforts to improve their situation (see the examples in footnote 1). This suggests that conditions of the type used in the Swedish case may be key to dampening the soft-budget effect of central government bailouts.

A plausible interpretation of our findings is that the conditions reduce the attractiveness of future bailouts – put differently, conditions increase the attractiveness of retaining fiscal discipline. The lack of variation in conditions prevents us to test this explanation directly, but our paper is, to the best of our knowledge, the first attempt to empirically investigate the impact of this type of conditional bailouts on the fiscal discipline of local governments. While we certainly do not advocate bailouts in general,<sup>5</sup> for a policy maker contemplating *how*, rather than *whether*, to assist local governments in financial trouble, the type of conditional assistance used by the Swedish government seems like a better option than the unconditional bailouts used in many other cases.

The rest of the paper is structured as follows: Section 2 outlines the institutional background, Section 3 presents the data, Section 4 describes our estimation strategy and introduces the synthetic control method, while Section 5 contains the estimation results.

<sup>4</sup> As most municipalities do not end up in fiscal distress, we are interested in the average treatment effect on the treated (Imbens and Wooldridge, 2009).

<sup>5</sup> It would in many cases be preferable to put in place institutional arrangements that prevent bailouts in the first place. The empirical results in Foremny (2014) suggest some ways to mitigate the soft budget problem in fiscally decentralized countries.

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