

# **Political Economy of Multilevel Information Generation and Liability Management: Some lessons from international experience**

Ehtisham Ahmad

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Zentrum für Entwicklungsforschung  
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# Political economy of multilevel information generation and liability management

## Some Lessons from International Experience<sup>1</sup>

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The issue of managing sub-national liabilities is not only an issue in the EU, but is also being a major concern in South Asia, China and Brazil as much of the public investment needed for sustainable development is taking place at the sub-national level. Different countries and regions have used alternative mechanisms to control sub-national liabilities, ranging from the fiscal rules in the EU and Brazil, to the administrative control mechanisms in China, cooperative arrangements in Austria and market based controls in North America (see Ter-Minassian 2014). Although coordination and control mechanisms vary from country to country, this paper argues that none will work effectively without full and timely information on the nature and timing of the liabilities. Indeed, effective management of the liabilities is critical also to ensuring a better buy-in from the private sector and a more credible environment for greater stability for contracts (Minervi and Vinella, 2014).

Indeed, many of the problems seen in the EU, and now in China, arise because there is incomplete recognition of the magnitude of the liabilities, or which level of government is eventually liable for meeting them. This is often because of game play by SOEs and lower levels of government, seeking to circumvent scrutiny or debt limits. But some of this is also due to the asymmetric nature of contracts, e.g., for Public-Private-Partnerships (PPPs)<sup>2</sup>, where the different parties try to maximize the

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<sup>2</sup> There is a growing literature on the incentive problems associated with PPPs –see Danaou and Vinella (2013); Ahmad, Bhattacharya, Vinella and Xiao (2014).

rents that they are able to extract (including from the state and higher levels of government), or from the private parties concerned. And as seen in countries as diverse as Mexico and Ireland, a build up of private debt, without state guarantees, can be rapidly transformed into public debt in times of crisis or exogenous shocks that begin to affect the banking system. While country-specific mechanisms to handle sub-national liabilities reflect differences in institutional arrangements and legal constraints, including differing constitutional perspectives and foundations, incomplete information in an increasingly complex world can negate many, if not all, of the control mechanisms, including in the most advanced countries.

Ter-Minassian (2014) provides an update of the various control mechanisms that are operational at the present time in the EU—identifying (1) market-based; (2) cooperative; (3) administrative; and (4) fiscal rules-based approaches to the management of liabilities. We argue that the distinctions between the alternatives blur into irrelevance if there is insufficient information available on the buildup of liabilities. Indeed, Escolano et al (2012) illustrate the ineffectiveness of fiscal rules in the EU. In the Brazilian case, monitoring and reporting requirements, facilitated by the Fiscal Responsibility Act of 2000, have led to subsequent sub-national responses for independent budget information management systems. However, the reporting requirements have been tightened by the requirement to adopt the IMF's GFSM standards at all levels of government as part of the Chart of Accounts from 2015.

The need to impose clarity on standards for information generation is now seen in many countries, including Portugal. And in the Mexican case, local autonomy prevented the adoption of uniform standards, and even at the Federal level it has been difficult to adopt the IMF's GFSM standards or establish a Treasury Single Account (TSA). At the subnational level, the implementation of a uniform framework for the generation of information has only just begun.

Section I also presents some insights and lessons from the recent experiences in the EU, particularly Portugal. It suggests that sub-national governments may react to controls or limits on indebtedness by parking liabilities in difficult to monitor activities or vehicles, often adopting more opaque budget management systems as a response. The response of the Fiscal Council is instructive. In contrast, the more measured management of sub-national liabilities in China over the past decade, again emphasizes the importance of timely management together with the establishment of appropriate incentives and information at the sub-national level. In the Chinese case, this involves a reform of intergovernmental relations, including assignments and own-source revenues to generate a credible basis for sustainable access to credit.

Section II examines the different mechanisms to control incentives to cheat on subnational debt, including that related to public sector enterprises, from a "political economy perspective," given imperfect information. It builds on the scope for "game

play” in relation to the usual mechanisms for controlling debt. With incomplete information, some of the options are not workable, and there needs to be a resort to a possible combination of the ideal type policy options.

Section III concludes with an examination of some standards that are needed to make the debt management workable, without negating the need to maintain the autonomy of subnational governments in both Federal and Unitary states, in order to ensure the effective delivery of local services.

## **I. POTENTIAL GAME-PLAY ACROSS JURISDICTIONS**

In order to ensure macroeconomic stability, the central government has the responsibility of ensuring that overall risks, including debt, are kept within prudent limits. As discussed below, this places a responsibility on the center, even within federal systems, to ensure that prudential debt limits are not exceeded in aggregate—this poses difficult problems of determining the overall sustainable debt limits and then apportioning the agreed limits among the different levels of government. This issue is reflected even in supranational administrations, such as the European Union’s Stability and Growth Pact.<sup>3</sup>

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<sup>3</sup> Indeed, as seen with the recent discussion of the debt limits in countries such as Germany, penalties under the pacts must be implemented to be credible; and there should also be a corresponding capability to monitor the compliance with the stipulations (as has recently been illustrated in the case of Greece).

Poterba and von Hagen (1999) examined the experience in Europe and view the set of rules and regulations according to which budgets are drafted, approved, and implemented as an important determinant of public sector deficits and debts. A similar result was found by von Hagen and Harden (1994), countries with more transparent budget procedures exhibited greater fiscal discipline in the 1980s and early 1990s. In practice, the efficacy of fiscal rules for subnational governments (or for national governments in a supranational economic area, such as the EU) depends critically on the ability to measure and monitor the generation of debts and other liabilities. The literature in the US generally has a favorable assessment in the context of U.S. states.<sup>4</sup> However, as suggested above, more recent work suggests that in the EU case the rules have not worked that effectively (Escolano et al., 2012).

In the absence of any limits on subnational borrowing, the central government faces the risk that local governments may try to free-ride on its efforts to stabilize the economy—effectively passing the costs of excessive borrowing on to other jurisdictions or future generations. Larger subnational governments that are “too big to be ignored” could hold the central government to ransom by bargaining for debt write-offs and other fiscal advantages.

Local governments’ efforts to conduct anti-cyclical policies—if left unchecked—could also result in ratcheting up public spending. Policymakers are likely to borrow

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<sup>4</sup> See for instance Bohn and Inman (1996), Inman (1996), and Poterba (1997).



when the economy is slowing down, but may be reluctant to repay the debt when the economy is recovering. In addition, during recoveries voters and vested interest groups often put pressure on local authorities to increase the provision of public goods or decrease the tax burden, reducing any fiscal surpluses available for debt repayment (Buchanan and Tollison, 1987). Local politicians may even take advantage that taxpayers might not correctly discount their future tax liabilities and pursue increasing borrowing strategies to mitigate the current tax bill (Moesen, 1993).

But above all, the need to control local borrowing arises from the common pool problem and the soft budget constraint it implies. The common pool problem stems from the separation of costs and benefits of public spending. If a certain public project predominantly benefits a particular jurisdiction but is financed through a common pool of taxes collected from all over the country, this jurisdiction will pay only a small fraction of the costs of the project while enjoying a large fraction of its benefits. This lack of full internalization of the costs of a project will result in excessive spending<sup>5</sup> and create a clear incentive for the regions to compete for federal transfers to finance their projects out of a common pool. Ideally, regions should compete on the basis of the quality of their proposed spending projects. Alternatively, they could signal that they are in particular need of federal assistance

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<sup>5</sup> Also see Weingast et.al. (1981) who show that bargaining in a legislature comprised of regional representatives will lead to overprovision of spending programs with benefits concentrated in particular regions.

by running large budget deficits or accumulating unsustainable debts, and hope that the central government will eventually bail them out.

The possibility of a bailout does not stem from the existence of a common pool *per se*, but from the way in which it is administered. When transfers are allocated on the basis of *ex post* financial needs rather than *ex ante* characteristics, regions experiencing financial difficulties could be bailed out by the central government. In this case, the budget constraint faced by the subnational government becomes “soft.” Thus subnational agencies have an incentive to under-collect taxes, and overspend, or even default on accumulated debts, as they expect the federal government to cover the financing gap. Moreover, lenders also lose incentives to police regional governments as they view their investments as protected by a federal government guarantee.<sup>6</sup>

These problems would not exist if central governments could credibly commit to never revising transfer allocations *ex post*, that is, to a no bailout policy. Unfortunately, such a policy stance, arguably optimal in the long run, is difficult to commit to in the short run especially if it involves a painful local default or a reduction in the provision of basic public services with schools being closed and pensions left unpaid. *Thus the sanction of not providing funding or transfers for basic services may just not be credible.* Persson and Tabellini (1996) and Bordignon et al. (2001) show formally that even a national government maximizing the federation’s

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<sup>6</sup> For more detailed discussion of soft budget constraints and their consequences see Kornai et al. (2003).

social welfare is likely to find it beneficial to bail out a financially distressed region. In addition, a default by one region can increase the cost of borrowing for all other regions in a federation, so neighbors themselves may be interested in providing the defaulting region with a bailout transfer.

Mourmouras and Rangazas (2014) and Vinella and Minervi (2014) illustrate the incentives for sub-national governments and entities to renege on contracts or be “economical” with the exchange of information on the buildup of liabilities. There are issues related to whether increasing the number of tiers (e.g., the supranational level in the EU) or multiple levels in China, diffuses the responsibilities for spending, makes it harder to impose budget constraints given the limitations on the potential own-source revenues; and complicating the exchange of information.

#### **A. The Case of Madeira**

An interesting example of evading fiscal rules in the EU appeared in the case of the Portuguese autonomous region of Madeira during the fiscal crisis in Portugal in 2011. A number of “hidden” liabilities surfaced—some were related to disagreements with Lisbon in relation to who should bear the burden of meeting “social standards” particularly for health care. But a considerable proportion was due to arrears on construction and other supplies (see Table 1). These were likely linked to an over-supply of tourist facilities that were badly affected by the downturn in demand following the crisis in Europe.

The total hidden liabilities of € 1.1 bn led to an overall debt of €5.8 bn, amounting to 126% of regional GDP, or 927% of annual revenues—and almost half of this was due to SOEs –see Table 2 from Paixão and Baleiras (2013). This pattern of obfuscation of liabilities was repeated in the municipalities on the mainland, and indeed at the central level. The extent of adjustment needed was quite severe (see Table 3, Cardosos et al, 2013), but the Portuguese government entered into an adjustment program with Madeira, paralleling the arrangement that it had with the Troika.

It is interesting that the Portuguese Fiscal Council recommended that:

1. The Budget Coverage needs to be inclusive of the liabilities being generated by SOEs;
2. There needs to be proper accounting for the liabilities in keeping with international standards, including for PPPs;
3. There needs to be a proper Chart of Accounts (COA)—this was required by the Portuguese government in 2007, but was not implemented; and that
4. There needs to be a Treasury Single Account, in order to track the cash.

As we discuss below, the budget coverage issue is critical. To ensure comparability across jurisdictions, it is advisable that the full coverage reflects the standards incorporated in the IMF's Government Financial Statistics Manual that is also synchronized with the System of National Accounts. In addition, the accounting

framework should permit recognition of liabilities, conforming e.g., to the IPSAS standards for PPPs.

Table 1. Madeira: 2011—hidden liabilities € million

<b>Social responsibilities</b>	
• <b>Pharmacies</b>	67
• <b>Health System</b>	42
<b>Construction Companies</b>	690
<b>Other Suppliers</b>	290

Consequently, one of the key messages of the Portuguese Fiscal Council that resonates elsewhere is that the policy framework must be implementable—in other words that there may have to be an overlapping set of rules that generate the incentives to comply, but that these should not be too complex to render the system un-implementable. In addition, there has to be sufficient assurance that the information on budgets and budget execution cannot be manipulated—in order to minimize the possibility of “game-play.”

Table 2. Portugal regional liabilities

<b>Table 6—Retroactive estimate of regional positions <i>vis-à-vis</i> the debt limit contained in the Regional Finance Bill (2009-2012)</b>				
	Unit: million euros			
	2009	2010	2011	2012
<b>Azores</b>				
Current revenue (average previous 3 years (a))	720,6	691,9	699,1	697,5
Debt limit (b)=1,5*(a)	1080,9	1037,9	1048,7	1046,2
Total demandable liabilities (c)	600,5	652,5	728,9	
Deviations:				
Early warning (c)≥(a)	No	No	Yes	
Excessive Deficit (c)≥(b)				
<b>Madeira</b>				
Current revenue (average previous 3 years (a))	966,8	952,5	946,5	963,1
Debt limit (b)=1,5*(a)	1450,2	1428,8	1419,7	1444,6
Total demandable liabilities (c)	2066,2	3053,3	5789,8	
Deviations:				
Early warning (c)≥(a)	Yes	Yes	Yes	
Excessive Deficit (c)≥(b)	616,0	1624,5	4370,1	
Note: Comma is used as the decimal separator; as explained in the text, it was not possible to compute non-financial debt stock in years 2009, 2010 and 2012.				
Source: CFP calculations based on Tables 3 to 5				

Source: Manuela Paixão and Rui Baleiras CFP Occasional Paper 01/2013.

Table 3. Portugal: Overall Subnational Liabilities and Excessive Debt

<b>Table 13—Debt calculations under the Bills and the Excessive Deficit Procedure (2009-2011)</b>			
	Unit: million euros		
	2009	2010	2011
<b>Regional and Local Finance Bills</b>			
Regional Government Debt <sup>a</sup>	2.666,7	3.705,8	6.518,7
Azores debt	600,5	652,5	728,9
Madeira debt	2.066,2	3.053,3	5.789,8
Local Government Debt <sup>ab</sup>	8.168,3	8.422,6	8.843,1
Subnational debt <sup>a</sup>	10.835,0	12.128,4	15.361,8
As % national GDP	6,4	7,0	9,0
Madeira excessive debt <sup>c</sup>	616,0	1.624,5	4.527,1
Municipalities' excessive debt <sup>d</sup>			192,8
Subnational excessive debt <sup>c</sup>	616,0	1.624,5	4.719,9
As % national GDP	0,4	0,9	2,6
<b>Excessive Debt Procedure</b>			
General Government gross debt (consolidated)	141.055,1	162.473,3	185.240,7
As % national GDP	83,7	94,0	108,3
Regional Government gross debt	2.666,7	3.705,8	4.426,7
Azores gross debt	600,5	652,5	690,9
Madeira gross debt	2.066,2	3.053,3	3.735,8
Local Government gross debt	5.858,7	5.871,4	5.684,1
Subnational gross debt	8.525,4	9.577,2	10.110,8
As % national GDP	5,1	5,5	5,9
General Government excessive gross debt <sup>e</sup>	39.937,7	58.757,9	82.601,8
<b>Memo items:</b>			
GDPppm <sup>f</sup>	168.529,0	172.859,0	171.064,8
GDPpc of Azores <sup>f</sup>	3.650,4	3.743,4	3.701,4
GDPpc of Madeira <sup>f</sup>	5.139,6	5.207,5	5.111,5

Note: Comma is used as the decimal separator  
Source: CFP calculations based on Table 6 and 12 and items contained in *Excessive Deficit Procedure (1st Notification of 2013)*

Other notes:

a. The figures for Debt relate to the estimated figures for "Total demandable liabilities".  
b. For 2009 and 2010, figures calculated on basis of balance sheet data (municipalities' and municipalised services' debts to third parties). In 2011, figures calculated on basis of financial debt reported for Local Government in latest EDP and the value of Assumed and Unpaid Liabilities for the Local Government subsector as a whole.  
c. Excessive debt was calculated under the rules in the Bill in question.  
d. Results from applying the rule to the whole of municipalities. In a municipality by municipality analysis, 1  
e. Excessive gross debt was calculated in line with the limit set in the European legislation (60% of GDP).  
f. For 2011, provisional figure.

Source: Cardoso, von Hagen, Baleiras, Kopits, Marinho (April 2013).



## **B. Local Debt and Fiscal Infrastructure in the PR China**

The Chinese case is of considerable interest, as it exemplifies the administrative control mechanism in the presence of imperfect information. However, the Chinese government, since the early 2000s has done a lot of work to institute a new system of budget and treasury functions—based on the GFSM budget classification standards and the establishment of treasury single accounts. However, given the size of the country, these apply, at present to the central and provincial governments, and the within-province implementation still remains to be implemented.

Until recently, the Chinese budget law prohibited the subnational governments from direct borrowing. Any borrowing on their behalf had to be undertaken by the Central Government in Beijing, and some of the rapid increase in subnational debt was due to counter-cyclical policies of the central government in the recent past as a response to the slowdown in global demand (see Table 4 and Chart 1).

The most significant local borrowing, however, has been through investment companies owned by local governments (UDICs) that carried implicit guarantees (Table 5). Local governments also engaged in PPPs especially in the 1990s (Chart 2). This approximated a golden rule on the assumption that the UDICs would borrow to invest. However, it became clearer over time that PPPs were generating public liabilities, and that local governments lacked the own-source revenues.

Table 4: Size of Total Government Debt

Year	Layers	Government Debt	Guaranteed Payments	
			Explicitly Guaranteed	Implicitly Guaranteed
End of 2012	Central	94,376.72	2,835.71	21,621.16
	Local	96,281.87	24,871.29	37,705.16
	<b>Total</b>	<b><u>190,658.59</u></b>	<b><u>27,707.00</u></b>	<b><u>59,326.32</u></b>
	Central	98,129.48	2,600.72	23,110.84
	Local	108,859.17	26,655.77	43,393.72
June, 2013	<b>Total</b>	<b><u>206,988.65</u></b>	<b><u>29,256.49</u></b>	<b><u>66,504.56</u></b>

Unit: 100 Million Yuan

Source: PR China, National Audit Office, 2013, Public Announcement 24.

Table 5: Size of Local Government Debt by Layers of Government

Layers	Government Debt	Guaranteed Payments	
		Explicitly Guaranteed	Implicitly Guaranteed
Provincial Level	17,780.84	15,627.58	18,531.33
Municipality Level	48,434.61	7,424.13	17,043.70
County Level	39,573.60	3,488.04	7,357.54
Village Level	3,070.12	116.02	461.15
Total	108,859.17	26,655.77	43,393.72

Unit: 100 Million Yuan

Source: PR China, National Audit Office, 2013, Public Announcement 24

Chart 1

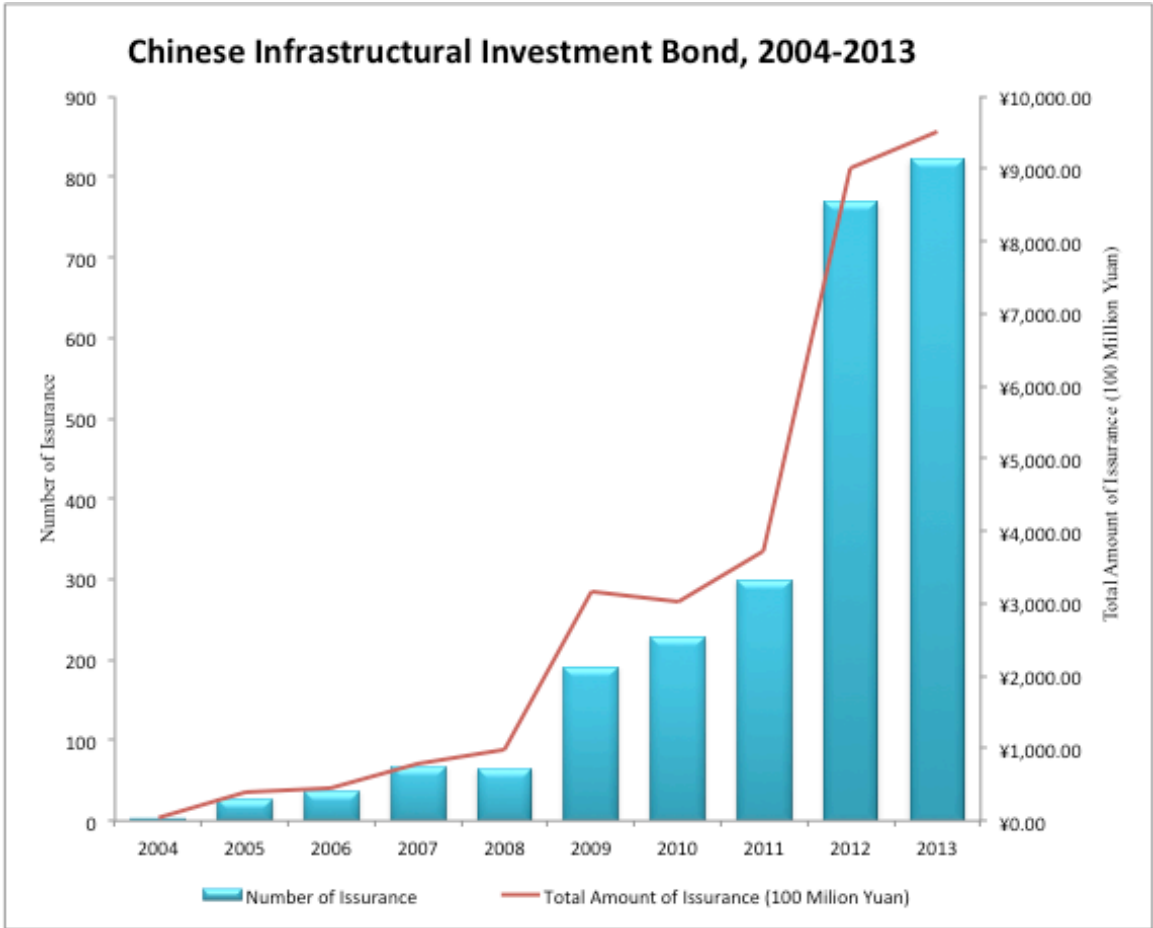
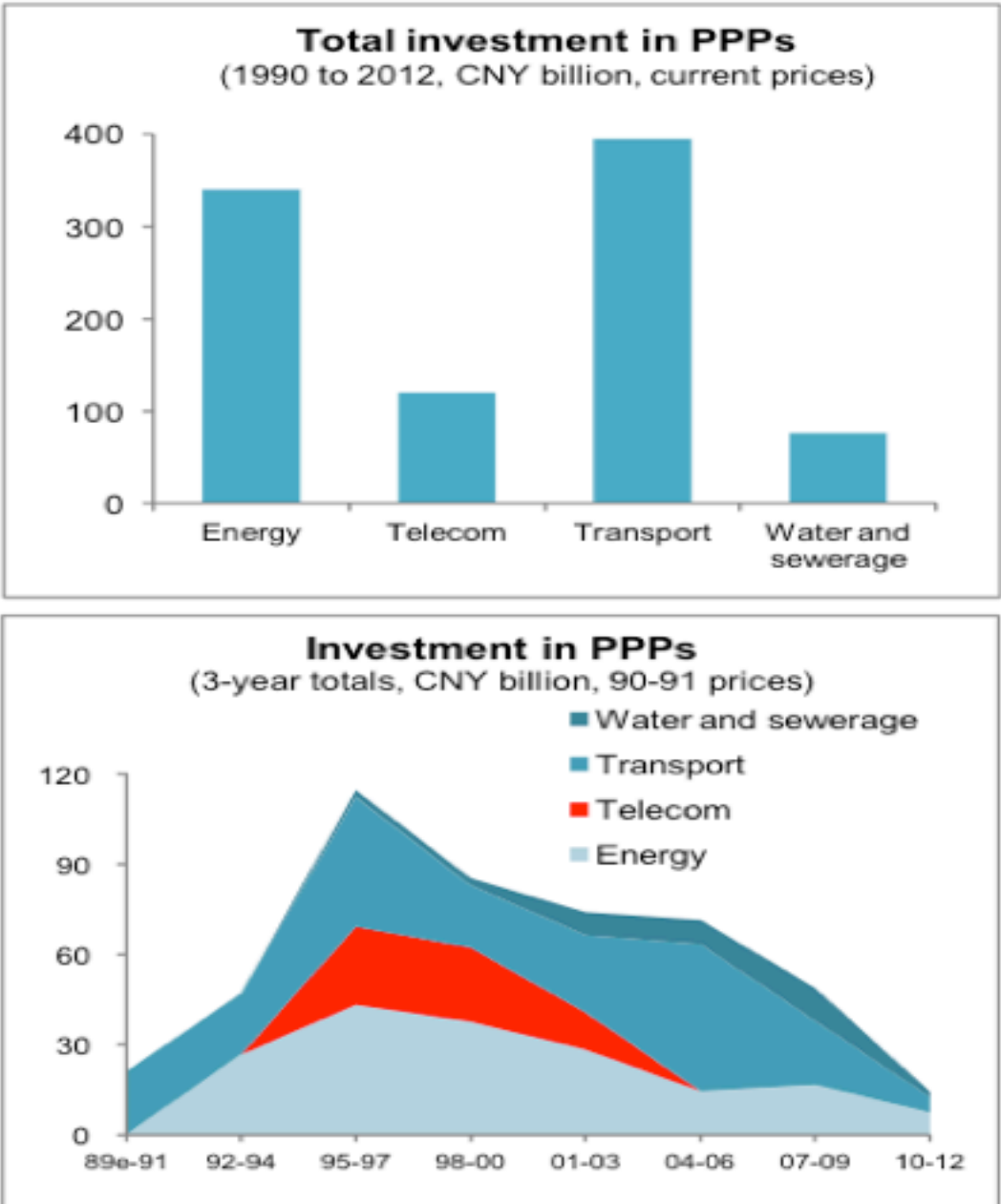


Chart 2



Source ADB.

Consequently, given the likelihood that the public liabilities for PPPs would revert to the Central Government because local governments lacked own-source revenues to service the debt, the recourse to PPPs was stopped by the MOF following the economic crisis.

Similarly, it became clear over time, that the UDICs were not just borrowing to invest (not all the investment was profitable), but had become a mechanism for local governments to indirectly access capital markets. This obfuscation added to the buildup of overall liabilities, exacerbated by the fact that more than half of the liabilities were being generated below the provincial level, that in any case were generally below the radar of the information systems and TSAs being developed at the provincial level. Following the audit reports that showed the rapid increase in subnational liabilities, the indirect borrowing by UDICs was also curtailed.

In order not to choke off all investment, the “no borrowing rule” has been relaxed in 2014 in favor of selective and transparent borrowing by qualified local governments. But in order to make this work, there needs to be better coverage of liabilities buildup in public sector enterprises, as well as generation of incentives to service the liabilities. This will involve the generation of own-source revenues and hard budget constraints through an appropriate “tweaking” of the system of transfers.

It is also important for local governments to again use PPPs, and efficient access to credit to meet the needs for sustainable development—including the rebalancing towards green cities in the interior of the country. While fiscal institutions and information are necessary conditions for managing subnational liabilities, the policy framework involving own-source revenues and transfers is equally important.

The development of a local bond market is also a critical element in a deepening of the financial system that is commensurate with a greater use of the Chinese Renminbi in its attempts to provide alternatives to the dollar and the euro. This is one of the main areas for further work to build on the decision to establish a BRICS Bank and a reserve fund.

## II. LIMITING INCENTIVES TO CHEAT<sup>7</sup>

A key element in responsible management of liabilities is clarity as to the responsibility for spending. As discussed in Ahmad (2014) this involves not just the function carried out by a particular level of government—but also whether it was on behalf of another level—e.g., through earmarks or mandates. Moreover, it is important to be able to distinguish between the “economic” components—such as whether or not the wages are set nationally, and whether different levels of government hire the workers. It is also critical which level of government authorizes and finances the requisite investments against which liabilities are being generated (Dafflon 2006). Note that liabilities may also arise due to arrears on account of current and not just capital spending. These distinctions are rather important and imply that greater care needs to be taken in generating data and defining variable carefully, and rather more than the IMF’s GFS categories or the OECD/UN’s Classification of Functions of Government is likely to be needed—and this is now being attempted systematically by the OECD (Bloechliger, 2014). There is a spate of literature drawing conclusions on intergovernmental issues erroneously relying on incomplete data from the IMF’s GFS yearbook—this should be treated with extreme caution.

Similarly, in examining incentives on the revenue side, it is important to distinguish between own-source revenues over which a level of government may have control

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<sup>7</sup> This section draws extensively on Ahmad (2014).

at the margin, and shared revenues that might accrue to the jurisdiction. Thus, the tax policy element involving jurisdictional controls over rates or bases at the margin is critical in ensuring whether or not a future liability can be financed or whether a sanction is credible (Ambrosiano and Bordinon, 2006). Similarly, whether or not the system of transfers automatically meets deficits greatly influences the incentives to incur and manage liabilities effectively.

An equally important issue is whether there are national or international standards in effect, and whether a local government has the mechanisms to circumvent these, e.g., with information systems under its control.

The international standards for the economic classification of public activities (the IMF's Government Financial System Manual (GFSM) together with the UN's functional classification, COFOG) provide a key for the tracking and reporting of expenditures, and for determining whether there have been any diversions of public monies for unauthorized purposes. This is essential even if there has been appropriation at a fairly aggregate level, in order to present consistent and comparable information to the policy makers or the public at large—particularly the markets that have to judge the relative ability of subnational entities to service the build-up of liabilities that may span several political cycles or decades.

In some cases, especially in unitary countries, the central government is responsible for establishing standards for the accounting and reporting systems of all levels of



governments and usually is also responsible for their enforcement. The development of sound budget, accounting and reporting systems is a complex and time-consuming process and it would not be efficient or cost-effective for subnational governments to develop their accounting and information reporting systems on their own. Besides if sub-national governments were to establish their own government financial information management systems (GFMISs), it opens up the possibility of “game-playing”, particularly in response to a tighter control over liabilities, e.g., as implied by the Fiscal Responsibility Legislation or debt management rules that might be imposed at the national or supranational level (as in the EU). The key to generating standardized information then becomes the common chart of accounts that tracks the budget process in a common manner—facilitating the comparison across jurisdictions.

This standardized information critical in establishing the effective operations of yardstick competition between jurisdictions within a country, and also across countries (along the lines suggested by Salmon, 2013). It is not enough to be able to rely solely on easily observable “outcome indicators” that reflect standards of living. Let us assume that jurisdictions A and B within a country (say Länder) or countries within a common currency area, such as the EU, have similar observable standards of living. However, jurisdiction A has managed to meet its obligations within the agreed Fiscal Responsibility framework including recognition of all future liabilities (e.g., Maastricht). Jurisdiction B also appears to have met the criteria, but has in fact done so only on a cash basis, i.e., not recognizing all the liabilities generated, or

parked them in State-owned enterprises or even private companies (e.g., through PPPs, on which more later).

Relatively few countries utilize the full format of the IMF's Government Financial Statistics Manual 2001 (GFSM2001) for both the central as well as the subnational governments (in this regard the BRICS countries do better than the OECD, including the EU countries). The format is designed to ensure conformity of the financial information with the System of National Accounts.<sup>8</sup> Multiple formats in Mexico at the Federal level and across the states make it difficult to generate standardized information for general government. This makes it problematic to ensure comparability across subnational entities or engender accountable competition across states. Brazilian states, while not conforming to the GFSM2001, perform better than Mexico in that the Federation requires a standardized format to receive, report and report on Federal resources as well as their own resources. Recognizing the dangers of game play, Brazil has legislated the use of the GFSM standards for all sub-national transactions by 2015—this will require adjustments to the Information Systems (SIAFIs in Brazil) and their associated Chart of Accounts that will have to be standardized. Mexico has now also legislated standardized reporting and a common Chart of Accounts for sub-national operations, but this is not due to take effect until

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<sup>8</sup> A number of countries use transition matrices for the reporting of central or general government information to the IMF in the GFSM2001 format. Pakistan, for example, reported data only for the budgetary central government in the latest issue of the GFS Manual. This is inadequate, as much of the social spending takes place at the subnational level. As seen in Ahmad, Bhattacharya, Vinella and Xiao (2014), even OECD countries do not conform to the standards—and this may be a factor in the current crisis.

the end of 2014. Canada has no plans or ability to require provinces to conform to national or international standards.

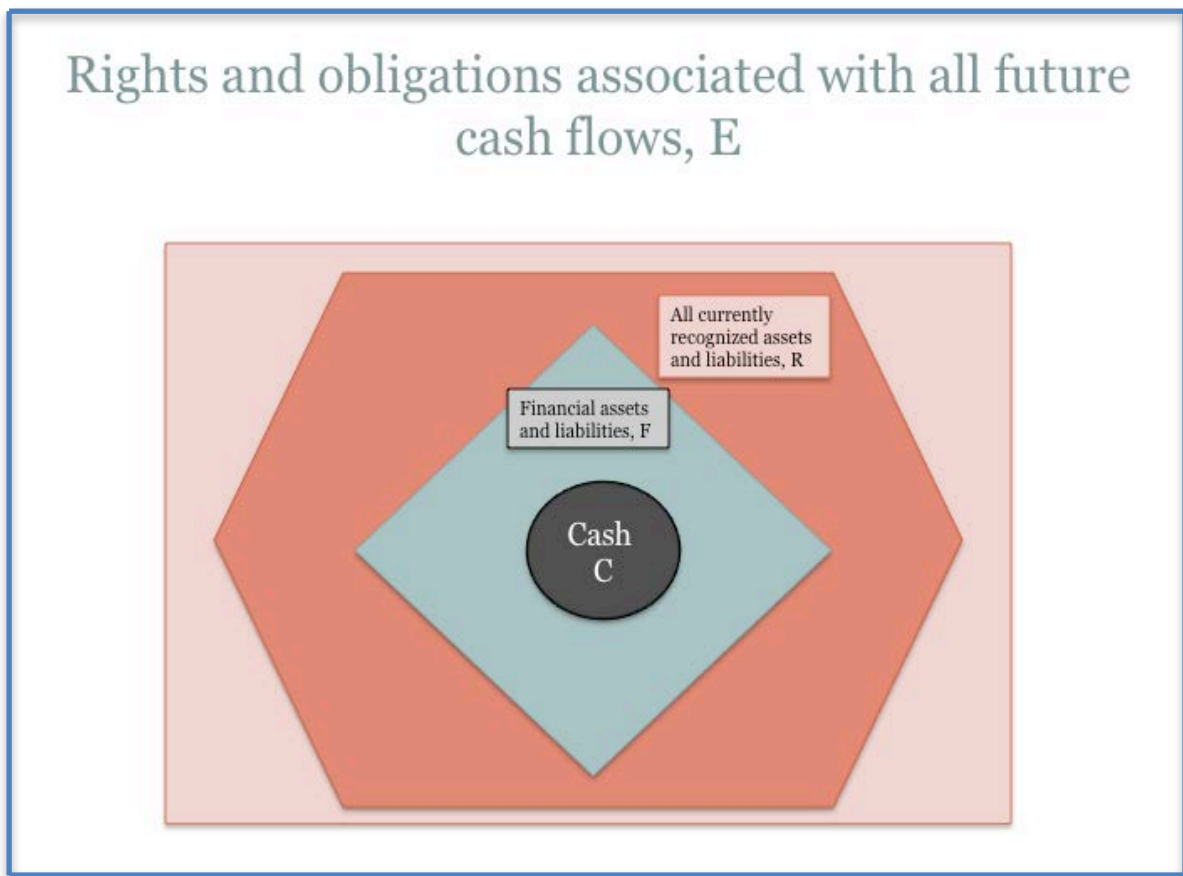
The likelihood of “game-play” by various levels of government or government agencies cannot be ruled out without a complete and standardized format to categorize the cycle of revenues and expenses; in conjunction with a tracking of the cash flows; A typical problem is the inconsistent treatment of budget coverage—with the frequent exclusion of spending of government agencies or liabilities parked in public enterprises.

In the very simple example of Chart 3, the cash transactions of a government are shown as set C. This is a subset of F, which also includes financial assets and liabilities. In turn, F can be denoted as a sub-set of R, which also includes all current assets and liabilities. It is relatively simple for governments to reduce deficits in cash (C) or financial assets (F), without affecting all recognized liabilities (R) or extended net worth based on future flows (E). For instance, (sub-national or national) governments could engage in game-play, by

- Selling non-financial assets in R, for cash in F;
- Assuming future pension liabilities in E, for cash and financial assets in F;
- Securitization C of future revenue streams F (common in Latin American local governments;
- Treating borrowing F as revenue C (several US States).

The sets C, F and R are consistent with the IMF GFSM2001. These represent nested sets of information, and if presented in parallel with E, virtually removes the scope for game-play by governments at any level.

Chart 3



Standardized information is critical for any serious implementation of fiscal rules in multi-level countries/currency unions. This should be based on the consistent and systematic generation of information in the overlapping manner described above.

The importance of the GFSM2001 cannot be over-stressed for the efficient management of finances in multi-level countries and in common markets/currency unions. The more complete agenda for the generation of accurate, complete and standardized information will have consequences for developing countries, and also

for countries in the EU (such as Portugal and Spain) as they struggle to get to grips with the discovery of liabilities in the extended public sector as well as at the regional and subnational levels.

PPPs have been encouraged, including by international finance agencies, as a means of leveraging “private sector” expertise for public investment project, and also bypassing bureaucratic bottlenecks. This is believed to generate efficiencies, and improved value for money, especially at the subnational level. The expectation is that this will generate additional growth through the efficiencies and additional private finances that would be utilized.

The problem is that governments often see PPPs as a means of circumventing budget constraints, especially although not exclusively at the subnational level. This could generate legal obfuscations, and relevant official agencies or governments are either not fully aware of the liabilities, or the ability of the private partner to meet them. Sometimes, the issue of liability for full costs is avoided, often with respect to public infrastructure (highways and hospitals in Europe); and local governments only include the annual contractual cash payment on the budget, and generally only during the tenure of the concerned local government. Often, there is no provisioning for the eventual reversion of the assets to the public sector. Further, there is usually a continuation of public interventions with respect to prices or distribution.

There is also incomplete and asymmetric information, with costs and efforts for projects generally known only to the private partner, and significant incentives for

either the private contractor or the government to renege (Danau and Vinella, 2012, Ahmad, Bhattacharya, Vinella and Xiao, 2014). An example of a growing recognition of limited commitment comes from the UK (which was in the forefront of the PPP revolution). In the 2002-3 upgrading of the London Underground, Metronet the contracting consortium could not borrow the full amount of funds needed for the project. Consequently, Transport for London, the decentralized agency responsible guaranteed 95% of Metronet's debt obligations. Metronet failed, and the UK Government (Department of Transport) had to pay Transport for London a sum of £ 1.7 billion to enable it to meet the guarantee (House of Lords, 2010). The direct cost to taxpayers was estimated to be as high as £410million. Other examples from the UK, e.g., for wind farm projects, show that in these cases the private contribution was financed by complex financial instruments that are tantamount to debt—that has eventually to be taken over by the state.

As a result of the difficulties above, the International Accounting Standards Board (2011) has issued a new set of guidelines (IPSAS 32) <sup>9</sup> that force an upfront accounting for PPPs, and would significantly affect deficits and recognition of liabilities for general government—i.e., for both central and sub-central governments and related agencies. This ensures that the operator is effectively compensated for services rendered during the period of the concession period. It requires the government or granting public agency to recognize assets and liabilities in their financial statements, when the following are met:

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<sup>9</sup> See IASB (2011), IPSAS 32. This standard is also likely to affect the guidelines of Eurostat that are not so tightly defined.

- The government or granting public agency controls or regulates the services to be provided, the target beneficiaries or the price; and
- If the grantor controls through ownership, beneficial entitlement or otherwise, a significant residual interest in the asset at the end of the arrangement.

In the schema of Chart 3, this would involve elements in the areas R and E. This avoids the situation where neither the public or private partner recognizes the asset/liability at the end of the period. Of course, as has been seen in Ireland and Spain recently (and with Mexican road in the early 1990s), even if there are no explicit guarantees by the federal or state governments and there is sufficient pressure on the banking system, it is likely that the state will assume a significant portion of the liabilities. Eurostat has resisted requiring EU governments to follow the new IPSAS rules, as it would lead to an immediate increase in the measured debt of member countries in a time of crisis. However, this type of “satisficing” rules weakens the overall framework under which governments and markets operate.

While cash-based systems are generally deemed insufficient to cover all aspects of budget execution, relatively few developing countries have the capability to operate accrual accounting. Nonetheless, many countries try to monitor the generation of arrears by registering commitments and recognition of liability. This usually entails the utilization of government financial information systems. These have been relatively expensive, but simpler versions are now becoming available for use in smaller jurisdictions—thus in principle permitting subnational administrations to also operate in an environment as conducive to overall accountability as the

center—however, these systems require standardized generation of information (such as through the common budget classification described above.

The standardized generation of information was a major feature of the reform of subnational finances carried out in Brazil in the late 1990s, with substantial benefits for the management of the consolidated public finances. A Fiscal Responsibility Law for Brazil was approved in May 2000, which (1) introduced a golden rule provisions; (2) imposed new uniform accounting, planning, and transparency requirements on all levels of government. States and municipalities are now required to submit multiyear plans and reports on the use of resources from privatization, social security funds, and contingent liabilities; (3) attempted to enhance the credibility of the central government's no bailout commitment by prohibiting the central government from bailing out any member of the federation and the central bank from exchanging the debt securities of the states for federal public debt securities; and (4) increased the role given to the judiciary and the penal system in the enforcement of certain of its provisions, mandating prison sentences for illegal efforts to issue bonds and stipulating the dismissal of a mayor or governor if debt limits or personnel expenditure ratios are exceeded. However, it is becoming apparent that Brazilian states are moving quickly to establish their own GFMISSs (see below). Consequently, the possibility of game-play is reintroduced, and the Fiscal Responsibility Legislation may degenerate into a system that effectively relies on administrative controls by the Federal Government, based on more aggregate information. Consequently, the new requirement that all subnational governments



must use the IMF's GFSM format as an integral part of their Chart of Accounts is a sensible measure that also merits consideration in other multi-level countries.

In Germany, all policy is made at the federal level and implementation is by the *Länder*, both for the revenue and spending sides. The decentralized tax administration with central policy making creates inefficiencies in the operation of taxes such as the VAT (the Court of Accounts regularly publishes estimates of leakages that result—running into several billions of Euros annually). Moreover, it removes major “own-source” of revenues at the sub-national level, except by variations in administration that in turn generates further inefficiencies. On the spending side, a federal law governs budgetary management at all levels of government, mandating the use of a detailed budgetary classification, a uniform cash-based accounting system, as well as a multiannual financial planning. The law also obliges all levels of government to provide the Financial Planning Council with all necessary information to monitor fiscal developments for the nation as a whole. *Länder* must provide all relevant information on behalf of their municipalities (Lienert, 2004). However, the subnational administration opens up possibilities of non-standard applications of the rules, and the Debt Brake legislation now requires that the standardized reporting must be complete by 2020. However, as discussed in this paper, the incentives appear to be moving in the opposite direction (see also Spahn, 2014).

In other federal countries, however, subnational governments can define their own budget and accounting systems. In some cases, lower levels of government are committed to follow internationally accepted budgeting and accounting standards. All U.S. states for instance are free to determine the way their budgets are prepared, adopted, executed and reported. There is no constitutional or legislative requirement to harmonize accounting standards. However, state and local governments follow accounting standards developed by the private nonprofit Governmental Accounting Standards Board (GASB) in line with generally accepted accounting principles (GAAP). Similarly, Canadian provinces have voluntarily adhered to the standards of the Public Sector Accounting Board, the independent and authoritative standard-setting body for the public sector in Canada.

Some other countries, such as China, have established treasury single accounts at the local level as a mechanism not only to enhance cash management and prevent diversion of government resources and accumulation arrears but also to improve financial discipline and transparency of local government operations.<sup>10</sup> Despite a technical ban on direct sub-national borrowing, and strict allocations of credit by the Central Government, liabilities at the sub-national level have risen sharply due to borrowing by investment companies owned by the local governments. Also, and initial excitement about PPPs was tempered by the realization that this also involved a buildup of liabilities that would eventually end up at the doors of the Central Government as the most local administrations (provinces and below) lack

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<sup>10</sup> The creation of a pure TSA implies that all government revenues must flow to the TSA and all spending must be made out of the TSA.

the own-source revenues to service the liabilities, except through inefficient land sales. Consequently, China is now moving from an administrative control mechanism to a more rules-based system permitting access to credit, but with a strong emphasis on the generation of information and aligning sub-national incentives to make it work. This framework becomes even more important as the State Council in 2014 relaxed the borrowing constraints, with the establishment of a framework for local governments to issue bonds (State Council Communiqué, September 26, 2014).

In Australia, Commonwealth States and Territories report a minimum amount of financial information in a uniform presentation framework (UPF). While many states and territories continue to prepare their budgets using different budget classification and accounting standards, each jurisdiction attaches data in the UPF format to their budgets.

In some other federations such as Mexico and Argentina, subnational governments have been totally free to define their own budget and accounting systems. As a result, local fiscal data is characterized by large inconsistencies in terms of how revenues and expenditures are reported in public accounts. In addition, the lack of an agreed framework or guidelines for presenting state-level fiscal data makes it very difficult to consolidate fiscal accounts at the national level.<sup>11</sup> In the absence of

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<sup>11</sup> Mexico promoted higher transparency and publication of debt and fiscal statistics at the subnational level by states, by introducing in 2000 a requirement for states of holding credit ratings. Though to date, all states (with the exception of Campeche)

uniform budget and accounting standards, at a minimum a uniform reporting system should be in place at the local level. Credible sanctions for either noncompliance or untimely reporting should be introduced. However, the increasing practice has usually been to reach agreements with lower levels of government on financial reporting requirements. Agreements, which do not result in specific sanctions or penalties for breaches of the agreement, are generally ineffective. As mentioned above, Mexico is moving towards the standardization of budget processes and reporting at the state level (under an agreement with the States to be implemented in 2014). But in the absence of an alignment of the information systems, or state-level GFMISSs, and agreement on the IMF's GFSM standard (not implemented even at the Federal level), and operation of a common chart of accounts by the independent GFMISSs, it is hard to see how the new arrangements will be effective, even if sanctions were involved.

All of the above factors affect whether the consequences of subnational spending can be shifted to higher levels of government, or across generations, and whether there is an absence of a hard-budget constraint at a junior level of government (Rodden, Litvack, and Eskelund, 2003). This generally translates into weak or nonexistent control over borrowing. The borrowing might be explicit, for example, through issuance of debt or contracting of loans, or indirect, such as through the buildup of arrears or accounts payable. Under different constitutional

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have obtained at least two credit ratings from international credit rating agencies, the Mexican authorities recognize that more work remains to be done in the harmonization of accounting and reporting information by the states.

arrangements, policy responses vary from enforced controls over subnational borrowing (generally in unitary states) to voluntary agreements or rules (in federations, as well as in supranational conglomerations of states, such as the EU), to sole reliance on the strictures of the market.<sup>12</sup>

### **III. CIRCUMVENTING BORROWING LIMITS AND EFFECTIVENESS OF SANCTIONS**

The key elements of circumventing administrative controls, binding rules, and cooperative agreements, arise though the weaknesses in information on the spending and liabilities being generated. Indeed, weaknesses in the intergovernmental structure may make it hard to implement the sanctions or even recognize the imbalances until there is a serious macroeconomic problem (as has been the case in the crisis in the EU).

Often the credibility of a system of sanctions depends on the relative political power of a jurisdiction in relation to the level of government imposing it—e.g., the EU was unable to impose the Maastricht limits on Germany or France. Similar issues may arise in the context of large and important entities within countries—e.g., Catalunya—that may also harbor separatist tendencies.

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<sup>12</sup> See Ter-Minassian and Craig (1997) for a typology, described in greater detail below.

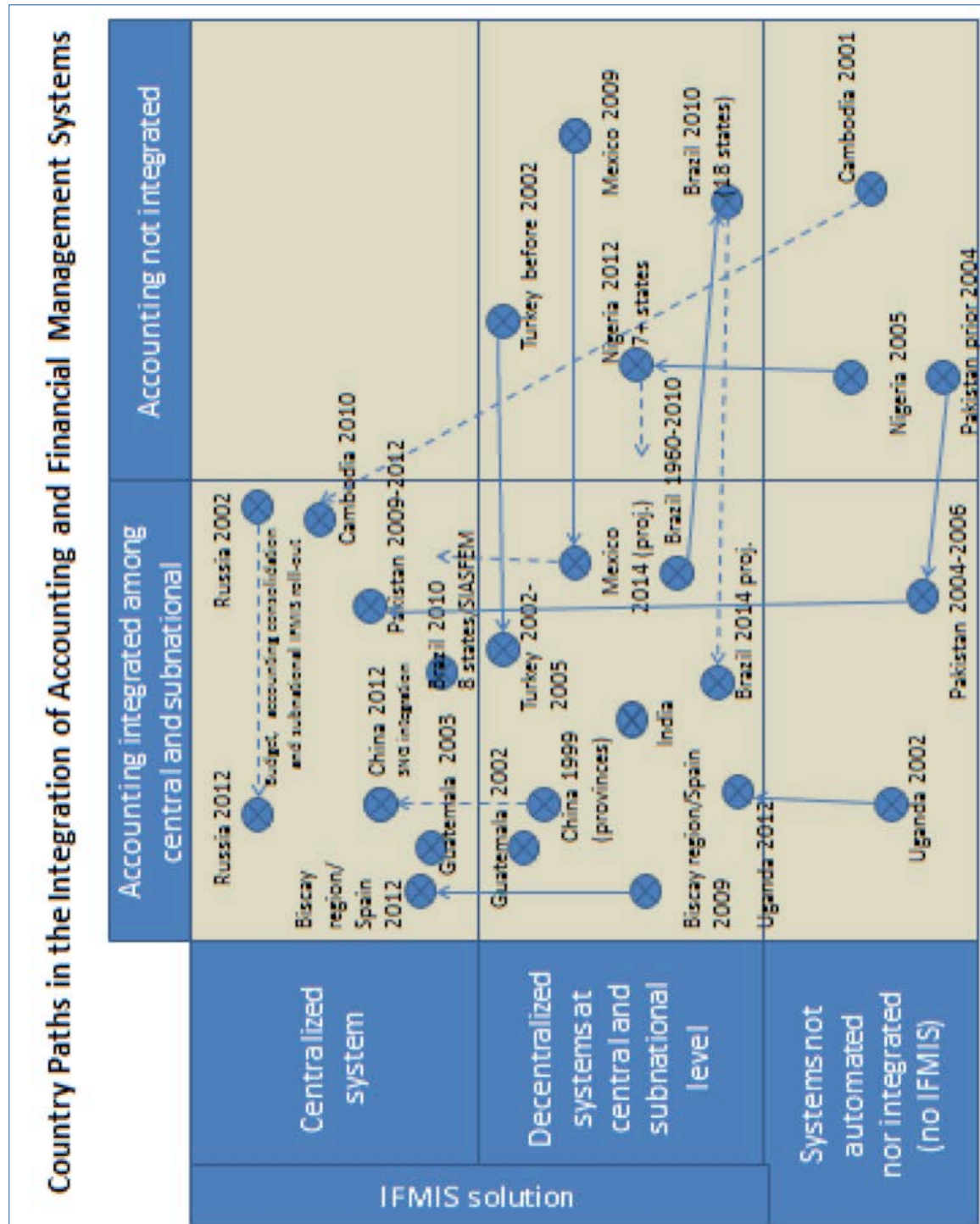
The initial success of the Brazilian Fiscal Responsibility Legislation (FRL) lay in the fact that the Federal Government had a GFMIS (known as the SIAFI) together with a TSA that allowed it to monitor the spending of the sub-national entities in a coordinated and systematic manner—even if they did not fully comply with the GFSM framework to record and manage liabilities. However, increasingly the Brazilian states have chafed at the constraints and have invested in their own GFMISs (see Chart 4). Consequently, with the absence of a GFSM format agreed for all states, the Brazilian government would have been faced with a progressive deterioration in quality and timeliness of the information needed to make the FRL work effectively. The new legislation requiring the use of the GFSM standards by 2015 is a step in the right direction, and recognition of the dangers of a proliferation of standards and systems. Of course a meaningful reform would involve cleaning up spending and revenue assignments to remove distortions and internal barriers to trade. This is part of the fundamental reforms in intergovernmental fiscal relations (especially the tax assignments) needed in Brazil to remove obstacles to sustainable growth.

The Brazilian example has some lessons for the operations of the German Debt Brake that was introduced through a Constitutional Amendment in 2009, in the light of a sharp increase in municipal debt. <sup>13</sup>The "debt brake" (*Schuldenbremse*) amounts to a full injunction to incur new debt for the States from 2020 on.

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<sup>13</sup> The borrowings of municipalities have increased dramatically over the last decade, from €6,9 billion in 2000 to €40,5 billion in 2010.

Chart 4. Potential movements in GFMISSs given institutional changes in different countries



This establishes a requirement for structurally balanced budgets, at all levels of government, although the Federal Government is permitted a margin of 0.35 percent of nominal GDP for macroeconomic stabilization.

As pointed out by Spahn (2014), the impact of the debt brake will be felt most severely at the State level, which, together with the local levels, amount to 80 percent of all spending on public sector investment at present.<sup>14</sup> True, the debt brake does not imply a total ban on municipal debt, which would conflict with the European Charter<sup>15</sup>, but it will be a considerable constraint mainly over the longer run. An incentive will be created for the Länder to push responsibilities down to the municipal level.

The only alternative to local borrowing to finance new local infrastructure appears to be increased local taxation (or higher State grants<sup>16</sup>) since reducing social spending does not appear to be an option. Even preserving the level of replacement investments will be difficult under the debt brake in the light of escalating federal standards. Consequently, to make the debt brake work, there will need to be a better

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<sup>14</sup> The impact of the debt brake on local governments is indirect through the constraint on State finances including municipalities. How to coordinate and control local sector borrowing is left to State legislation.

<sup>15</sup> The European Charter stipulates in Article 9 (8): "For the purpose of borrowing for capital investment, local authorities shall have access to the national capital market within the limits of the law."

<sup>16</sup> Higher State grants to municipalities would imply higher federal grants to the States, since the latter are severely constraint at the spending side of the budget (wage bill) and have practically no own taxing powers.



application of standards to measure and account for the buildup or change in liabilities. However, the resulting compression should lead to renewed debate about the reforms of the German intergovernmental system that were initiated in the last years of the last “grand coalition” (2004-7), but were not taken to completion.

### **Concluding remarks**

In the final analysis, it is clear that full information is needed for any system of controls or coordination to work. However, this is a necessary and not a sufficient condition, and the policy framework that leads to a hard budget constraint is equally important. This involves the operation of own-source revenues and incentive-compatible transfers.

The own-source revenues are critical in providing the basis for a sustainable and accountable access to credit for sub-national investments. And a transfer system that permits similar levels of services to be provided at similar levels of tax effort is critical in ensuring balanced structural change. Thus, any effort to effectively control the buildup of liabilities needs to be placed in the context of a fundamental reform of intergovernmental fiscal relations in many countries, and in order to ensure that the preconditions for sustainable growth are met.

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