Federalism and Fiscal Policy Learning: The Politics of Fiscal Responsibility Laws

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ABSTRACT *This article advances an institutionalist perspective to address a subset of issues that led to the relative success of Brazil and the absolute failure of Argentina in confronting the financial crisis of the late 1990s. It adds to the literature on the politics of fiscal federalism, documenting that fiscal crises prompt policy responses whose effects are mediated by institutional choice and the broader political dynamics and the incentives both generate. By analysing the adoption of Fiscal Responsibility Laws in two federal polities that had been challenged by similar financial and territorially-induced constraints, it tentatively shows that success in containing subnational fiscal profligacy, which has been causally related to the national overall financial weakness to confront the late 1990s crises, is contingent upon the internalisation of the value of fiscal responsibility by subnational administrations. These findings suggest that prevailing views on s*ubnational actors as debt-ridden and passive spectators of fiscal policies for which national governments had taken full responsibility should be reconsidered. Given favorable institutional incentives, subnational interests are not necessarily incompatible with national programs of fiscal adjustment and stability.

Keywords: Comparative Fiscal Policy; Federalism; Fiscal Responsibility Laws; Argentina; Brazil

Introduction

In an oft-cited *World Politics*' article on macroeconomic management in multi-tiered systems, Jonathan Rodden and Erik Wibbels claim that "federalism good (or alternatively bad) reputation should actually attributed to underlying incentives built into the particular institutions of each country" (Rodden and Wibbels 2002: 496). Their concern with the prospects of fiscal federalism is understandable, as fiscal decentralisation has been associated with decreases in government macroeconomic effectiveness and increases of government budgets afar welfare criteria in developing countries (Davoodi and Zou 1998; Kwoon 2003). Still, beyond the point whether federalism has intrinsically a "market-preserving" nature (Weingast 1995), their conclusion invites us to ponder about the institutional roots of the fiscal effects of federalism and thus the sources of institutional variation that account for the wide divergence in the responses of federations to economic and fiscal crises. This analytical challenge has predominantly drawn attention to lessons to be learned from developed federations such the US for its entrenched hard-budget constraints (Inman 2003; Sbragia 1996) and its lower levels of corruption (Fishman and Gatti 2002) as well as other developed OECD countries (Rodden et al. 2003).

However, whilst these academic voices acclaimed the virtues of federal fiscal designs, the fiscal full moon that benefited the developed world in the 1990s began to eclipse. The US has inaugurated the new century with budget gaps and shortfalls that prompted Ray Scheppach, executive director of National Governors Association, to calls this "the worst fiscal situation since the Second World War" (Wright 2003: 10). The European Union, so far a sort of poster child of fiscal integration, has entered the last part of the decade on the verge of fiscal meltdown as a result the Global Recession of 2008 and subsequent sovereign debt crisis in Greece in the Spring of 2010. In fact, perhaps no region has been more impaired than the European Union. The most pervasive explanations to this circumstance is that monetary unification led to bail out expectations, which in turn resulted in soft budget constraints and over-borrowing. This context of fiscal flagrancy transpires in the creation of the European Financial

Stability Facility and the European Financial Stabilisation Mechanism to channel resources to EU countries that face the danger of sovereign default (Baskaran and Hessami 2011). Hence, trading off austerity measures and stimuli packages, Europe has unavoidably come to the conclusion that supranational fiscal coordination is necessary, jogging the memory and mindsets of politicians and pundits not only about the fact that institutions matter but that probably institutions matter more than ever before.

In parallel, the market reforms of the 1980s and 1990s, combined with a few years of commodity-driven prosperity, have unleashed confidence in the ability of Latin American capitals to withstand the tensions affecting the world economy. *The Economist*`s special reports on the region resorting to headlines such as “A Latin American Decade?” or “Brazil Takes Off” in the 2009 and 2010 are vivid illustrations of the optimist views of world markets in Latin American prospects. The consolidation of Latin American multinationals, on the one hand, and the strengthening of progressive social policies to tackle inequality in Brazil, on the other hand, bred something a forward-looking mood in the region. In fact, besides the exceptional case of sustained growth in Chile, developments in Brazil and Mexico, and to a lesser extent Argentina, suggested that perhaps, and after all, federal dynamics are not inherently economically-regressive and that the political quality of federalism often affects a country’s macro-economic policies and outcomes negatively (Wibbels 2005) is something at the least to be taken with a dose of salt. What is more, for students of Latin American political economy, accustomed to the import of policy and institutional paradigms from the developed world (Weyland 2009), this shaking of federal responses in the North and some relative advances in the South offers a significant theoretical and analytical challenge to look inwardly to assess the institutional sources of such progress.

That said, in their journey toward economic progress, Latin American countries were confronted in the late 1990s with the outbreak of an international financial turmoil triggered by the South East Asian financial crisis and, more acutely, Russia’s 1998 debt default. Although these international developments affected the entire region, their effects were particularly distressing for the two big federal Southern Cone neighbours, Argentina and Brazil. While the *Plan Real* generated confidence among

international investors in Brazil's economy through a crawling peg which permitted the currency to depreciate at a controlled rate against the US dollar and the International Monetary Fund provided a $41.5 billion loan in 1998 to help Brazil defend its currency, the central bank decided to devalue the *real* by 8% in January 1999. By the end of the month, the *real* depreciated 66% against the U.S. dollar. This financial meltdown has immediately made itself blatant in Argentina, which was struggling against the same international financial challenges and the effects of the currency devaluation in its most important export market whilst maintaining its overvalued *peso* pegged to the US dollar. From this inauspicious starting point for both countries, Brazil has managed to balance its financial health and regain the confidence of the IMF and World Bank, whereas things in Argentina went from bad to worse, as the government, between December 2001 and January 2002, abandoned the currency Convertibility Plan and defaulted on its foreign debts, amounting to the world's largest debt default.

Argentina and Brazil are high middle income countries and the largest emerging markets in the South America. Having both struggled with high inflation through the 1970s and 1980s, they embarked upon ambitious plans of macroeconomic stabilization that kept international markets unruffled at the eve of the 1990s. Juxtaposed to these economic troubles and concomitant remedies is the political significance of federalism in both countries that had turned subnational administrations into king-makers in fiscal policymaking. In fact, federalism has played a strikingly similar role in the fiscal troubles of both countries. Moreover, Argentina and Brazil stand out as the two most fiscally decentralized countries in their region, conferring considerable policy responsibilities to their respective local levels. In this respect, this comparison conforms to the "most similar systems" design characterization (Peters 1998: 36-41). That having been said, the superior strength of Brazilian fiscal federalism becomes apparent when looking at some key figures. For example, it is the only Latin American country in which the share of both total government tax revenue and expenditure are higher at the sub-national level than at the central one (Garman, Haggard and Willis 2001). Adding to these higher levels of subnational fiscal assignments is a party system that despite sharing its subnationally-oriented character with that of Argentina, has maintained a fluid and flexible nature that allowed Brazilian presidents to marshal support subnational support in times of fiscal emergency. In this vein, while President

Fernando Henrique Cardoso in Brazil enjoyed similar constitutional support to resort to executive decrees to launch and maintain his stabilization plan to that of Presidents Carlos Menem and Fernando de la Rua in Argentina[1], he opted for and succeeded in luring incumbent and opposition governors to bear support to subnational spending cuts and significant reduction of bailouts for state over spenders.

In examining the experiences of Argentina and Brazil in their quest to overcome severe fiscal predicaments, it is important to stress that the importance of these experiences extends far beyond these two cases. Highly decentralized countries such as Argentina and Brazil are regularly assessed in terms of the institutions of federalism; these institutions explain why fiscal power and resources flow to subnational levels. While some unitary countries like Denmark and Japan also exhibit high levels of fiscal decentralization, the findings of this study are more germane to federal countries structuring their central government and state relations as a matter of fiscal federalism. This notion is based on the idea that the end product is more than the sum of its parts: "Fiscal federalism, then, is in many ways a function of the national political economy and it serves to highlight several fundamental features of federation that are worth more than a moment´s glance" (Burgess 2006: 148). In other words, fiscal federal arrangements are not simply technical adjustments but ultimately driven by politics. Herein lays the Achilles' heel of existing fiscal federal arrangements and their concomitant dilemmas to enforce fiscal discipline in conditions whereby the centre cannot unilaterally impose itself on subnational governments. Especially is this case for federations whose institutional arrangements stem from original constitutional bargains where the states were signatories and must be consulted for any amendment, hindering restrictions to the access of said states to deficit finance. In view of episodes of fiscal squeeze in the Germany of the late 1990s and ongoing debates on sovereign debt crises in the European Union, the lessons from the contrasting Argentine and Brazilian experiences are worth considering.

This article advances an institutionalist perspective to address a subset of issues that led to the relative success of Brazil and the absolute failure of Argentine in

confronting the financial crisis of 1999. It focuses on one aspect of fiscal institutional design aimed at tackling the soft-budget constraints lurking underneath said financial crisis. The political significance of soft-budget constraints stems from its potential for politicians in their quest to muster support under circumstances of suboptimal economic decision-making. Originally alluding to a situation in which state firms deemed to fail survive thanks to interventionist financial aid (Kornai 1980), the soft-budget constraint revolves around the recurring practice of several developing economies to provide public employment beyond the fiscal limits of the state to offset the lack of private investment for job creation. In Latin America, the conspicuous lack of fully-fledged market institutions has lurked underneath this predicament, which has been exacerbated in countries with decentralized systems of job creation and salary hikes such as Argentina and Brazil due to the federal empowerment of subnational administrations. Said shortage of mechanisms for enforcing fiscal responsibility has brought the debate about the enactment of Fiscal Responsibility Laws to the forefront of the academic and specialist debate on pathways to contain mushrooming fiscal leniency and patronage (Tommasi and Velasco 1996).

In this spirit, I use the analysis of the adoption of Fiscal Responsibility Laws (henceforth, FRLs) to put forth some tentative hypotheses of general interest to the literature on the political economy of federalism and decentralisation, especially on the territorial underpinnings of fiscal crises. In so doing this paper seeks to contribute the burgeoning literature on the institutional foundations of fiscal behaviour, zooming in on an instrument extolled by international financial institutions as necessary to bolster accountability and transparency of fiscal policy intentions. The article proceeds as follows: First, the conceptual and theoretical discussion about the territorial underpinnings of fiscal crises is introduced. Second, it outlines the context of the fiscal emergency in the late 1990s in Argentina and Brazil and discusses the suitability of FRLs as an instrument for federal fiscal systems where multiple players find it difficult to coordinate fiscal adjustment. Third, it presents two alternative theses drawn from the comparative political economy and institutionalist literature related to the obstacles of multitiered polities to confront fiscal crises. We then discuss theses for

elucidating the contrasting Argentine and Brazilian experiences with their respective FRL. Conclusions ensue in the final section.

The Role of (Sub) Nationally-induced Fiscal Crises: Theory and Related Literature

What is a fiscal crisis? How do we know when such crisis starts and ends? In what ways is it possible to unravel types of crises? Extant research on fiscal crises has generated multiple insights into the implications and impact of financial crises on political processes and institutions, be it in terms of political leadership (Posner and Blondall 2012), public dissatisfaction (Keeler 1993), policy responses (Gourevitch 1986) and even bureaucratic responses to fiscal crises (Lodge and Hood 2012; Peters 2011). Illustrative and helpful as these studies are, they have for the most part messily referred to crisis to indicate the range of economic phenomena of their choosing. Let alone that notions such as global financial crisis, banking crisis, economic crisis and fiscal crises have been often used interchangeably and using a myriad of complementary yet often not clearly interconnected empirical indicators (Roberts and Wibbels 2010).

Useful as these bodies of research are in highlighting the political conditions and policy options, they have conspicuously fallen short of paying heed to subnational and intergovernmental politics. As a result, most researchers have neglected the fact that subnational politicians, attuned to their own political survival, have often fiscal policy priorities that diverge from national-level officials, complicating the coordination of fiscal policy changes. As federalism usually affords some significant latitude in the conduct of fiscal affairs to subnational elected officials, no theory of fiscal crises is complete unless the intergovernmental dimension is taken into account.

No widely accepted theory of fiscal crisis exists. Well up the ladder of abstraction, crisis necessarily entails circumstances that have far-reaching, if not traumatic, consequences that transcend economic dynamics in “normal” times. However, if crises relate to more specific and identifiable phenomena, the responses to them shall focus on coordination mechanisms, especially those linked with far-reaching policy and institutional changes typically couched as economic and fiscal reforms. In dealing with this dimension, the scholarship on this subject has for the most part fallen short of providing solid theoretical accounts. As a remedy, Roberts and Wibbels (2010: 384-85)

urge scholars to unravel economic crises from the adoption of economic reforms for avoiding research based on misleading findings; they claim that "previous scholarship tends to conflate crisis and reform, reasoning tautologically that major reforms provide prima facie evidence of a severe crisis, while the absence of reform is taken as an indicator of non-crisis". A possible fix to this theoretical deficiency is to identify the necessary and sufficient conditions for fiscal reforms. For instance, macroeconomic challenges such as inflation, recession and, currency depreciation and trade deficits must be tackled at the national level. Yet, multi-tiered polities based on federal principles empower subnational officials to use their institutional prerogatives and concomitant strategic leeway to block or sabotage national-level reform initiatives when these dent their regional interests. By the same token, subnational indebtedness may only turn into a fiscal crisis when the national government lacks the means (or will) to enforce fiscal discipline across the board and cannot impede subnational borrowing in international markets or subnational financing institutions.

Herein lay the costs and opportunities rendered by fiscal federalism institutional designs and the institutional resources that national governments can resort to centralise fiscal authority in times of crisis. This, of course, begets the assumption that fiscal rules are devices to ensure subnational fiscal discipline. In the absence of market discipline, fiscal rules, a national-level governance instrument *par excellence,* lay intrinsically blame on the subnational-level processes for the mushrooming of the national debt leading to fiscal crisis. This perspective is championed by Rodden (2006) and related public choice approaches, still one may wonder whether it is always the case that the federal government is responsible and reliable in the handling of its debt yearnings, especially when the budget cycle encourages spending. Let alone that when international capital markets are within reach both federal and subnational levels may well attempt to borrow as much as they can (i.e. Petrodollars age, especially in the case of Argentina). Leaving normative assumptions and preferences aside, the Gordian knot of fiscal stability in multi-tiered polities is then the balance of power between both levels of government and how intergovernmental political practices reflect such balance.

Last, this discussion on the politics of fiscal federalism brings the question about the endogenous nature of fiscal institutions to mind. In this study, we conceive FRLs as

dependent variables whose nature and design are part and parcel of other institutional features such as presidential control and party politics. Yet a cautionary caveat is necessary: fiscal institutional rules work only in a context. That is to say, these rules shape subsequent fiscal parameters on which presidents decide courses of action as much as political parties choose the limits of programmatic viable options for fiscal policies and reform. Let alone that various fiscal institutions interact with one another in complex ways. For instance, in analyzing the principal fiscal institutions in the U.S., Strauch and Von Hagen (2012: 168) found that "strict balanced budget requirements may not matter in states with so-called rainy days funds (reserves to be spent in lieu of issuing debt). Similarly, state-level tax limitations may encourage state to mandate local-level expenditures and may only affect statewide expenditures when combined with prohibitions on such unfunded mandates". This concern with multiple interactions among fiscal institutions has challenged methodologists to devise approaches to cope with endogenous and conditional effects such as fixed-effects and instrumental variables estimation. Nevertheless, considering there is relatively little intertemporal variation in either the institutions themselves or in the exogenous state parameters, alternative in-depth case study analyses are necessary to disentangle omitted variable biases and policy endogeneity. This article seeks to provide case study evidence contribute to this theoretical and empirical debate.

The Financial Crisis of 1999: External Shocks and Subnational Indebtedness

For most of the 1990, Argentina was regarded as a sort of paragon for "Washington consensus" economists and policymakers. Its success in ending the hyperinflation of the late 1980s and its strengthening and globalization of its banking sector (Perry and Serven 2003) insured a steady flow of foreign cash inflows, even as lenders withdrew their financing in East Asia in 1997. However, by the end of 1990s, Argentina suffered an external blow of an unusual nature. The country's situation worsened because its main trading partners, namely Europe and South America, depreciated their currencies. With the peso pegged rigidly to the U.S. dollar, there was no way to offset competitive depreciations. On the expenditure side, increasing indebtedness related to mushrooming public employment. As the government was a large employer, it found hard, for political reasons, to cut down its wage bill. More dramatically, the central

government could not dissuade provincial governments to slim down their own wage bill, finally having to assume their liabilities.

Concomitant to this problem, the Russian currency crisis of 1998 intensified the hesitations of investors in developed countries about investing in developing countries. Brazil, Argentina's largest trading partner, withstood a currency crisis in 1998 by allowing its currency to float freely, thus making the Argentine peso much less competitive. This predicament was further exacerbated by the uncertainty about the growing public debt, leading to very sharp increases in the returns investors demanded to hold Argentine government bonds. In turn, massive deposit withdrawals followed suit, pushing Argentina to suspend payments of its external debt, which amounted to the world's largest debt default. The government decided to freeze deposit withdrawals and force those with dollars to convert their accounts into devalued pesos, the so called *corralito* (fence).

Facing similar concerns about the lethal political costs of inflation to those confronted by Argentina, Brazil has adopted the Real Plan, initiated under the government of Fernando Henrique Cardoso in 1994 to stabilise the economy by means of fixing the Brazilian Real to the US Dollar on an equal base in the vein to what occurred in its neighbour country a bit earlier. Within a few years, it became clear that the Real was tremendously overvalued, making Brazilian exports less competitive and thus creating a balance of payments deficit. In turn, in the eve of 1998 Brazil's financial markets were soaring and the country had to increasingly rely on foreign direct investment to offset said deficit.

Partly as a result of the closure of international markets for credit after the Russian crisis in 1998 and also due to the announcement of Itamar Franco, former president of Brazil and governor of Minas Gerais, that his state would default on its federal debt, Cardoso allowed the Real to float freely. Albeit unavoidable, such move increased capital flight and panic in the international and domestic financial community, draining Brazil's hard currency reserve significantly. This dramatic scenario was further exacerbated by the swelling growth of subnational governments' debt, which was owed to the central government. Said debt loomed large as a legacy of the 1988

Constitution that increased the subnational share in total revenue, widening the indebtedness at the end of the decade to such an extent that the central government has been the only player able to assume and refinance states' external debts.

The above-mentioned devastating interaction between domestic monetary supply and foreign factors notwithstanding, there is a wide consensus both from national and international analysts that the most dramatic deficit, and the one that ultimately made Argentine and Brazilian acclaimed economic models of the 1990s unsustainable, is the one brought about by the demand side of the equation, especially that of political origin (Afonso 2005; Arretche 2007; Buscaglia 2004; Krueger 2002; Pastor and Wise 2001). The difficulty of enforcing fiscal discipline transpired as the central parameter, resulting from the inability or unwillingness of controlling deficits and limiting subnational indebtedness. Ranking already as the most fiscally decentralised nation of Latin America, Brazil had experienced an expansion of state's autonomy as a result of the enacting of the 1988 Constitution. However, as Alston, Melo, Mueller and Pereira (Alston et al. 2009: 78) claim, problems with intergovernmental fiscal relations were already endemic before 1988 and although several initiatives to control spiralling subnational debts were attempted, the permissiveness with debt rollovers and a record of bailouts of state debts have severely thwarted meaningful measures. Likewise, Argentina, historically seen as a basket case of decay amidst populist macroeconomic policies and abusive expansion of state capacities (Dornbusch and Edwards 1991), has noticeably maintained subnational patronage networks that underpinned the varying capacities of provincial governments to adjust their public finances at will (Remmer and Wibbels 2000).

These comparable troubling federal fiscal scenarios have been addressed by the passing of Fiscal Responsibility Laws (FRLs) in both countries. Still, the outcomes of such passing have diverged dramatically. In Argentina, the results were disappointing because the FRL related to the late 1990s crisis was promoted mainly to give positive signs overseas, fulfilling the commitments made with the IMF, get better credit ratings and restore credibility in the markets. But its implementation in the early 2000s coincided with the doomed efforts to prevent the collapse of the convertibility regime, which was ultimately abandoned in late 2001 in the midst of a deep political, economic

and social crisis. Contrastingly, Brazil's FRL has been commended as a meaningful step in reforming fiscal federalism in that country and became the poster child of subnational fiscal discipline not only in Latin America (Webb and Liu 2011) but also has been recommended as a plausible solution for the bailouts dilemmas faced by the European Union to confront its fiscal crises (Hallerberg 2010) and even considered for Nigeria (Ezeabasili and Herbert 2013). The differences between Argentina and Brazil as their governments confronted the financial crisis of 1999, however, are neither principally functions of the nation's levels of development nor reflect olden times of fiscal efficacy. Then, what accounts for these contrasting responses to the crisis of the late 1990s?

The Adoption of FRLs: Theory and Practice

The debate on the emergence and suitability of FRLs is central to grasp the institutional roadmap that scores of countries have adopted to circumvent fiscal populism and its economic effects. At a minimum, FRLs belong to the family of budgetary rules aimed at enhancing the credibility, predictability and transparency of fiscal policy. Concretely, FRLs are laws intended to provide a comprehensive framework based on rules and procedures related to the budget system, including budget authority, common pooling of revenues, the specificity of spending, budget unity and performance (Lienert and Fainboim 2010). Alike stand-alone fiscal rules, FRLs contain procedural rules that typically require the government to commit up front to a monitorable fiscal policy strategy, usually for a multi-year period, and to routinely report and publish fiscal outcomes and strategy changes. Beyond stand-alone fiscal rules, FRLs include numerical rules related to quantitative targets such as ceiling for debts and debt ratios (Ter-Minnasian 2007). However, FRLs vary across countries and optional features abound. The first pioneering experience with an FRL had not taken place in a fiscally-collapsing developing country but, rather, in least-likely New Zealand, which adopted in 1994 a FRL that set the tone for subsequent experiences. In this country, short-term political motivations led fiscal policy to support the stabilisation of aggregate demand, bolstering excessive pro-cyclical spending and concomitant fiscal distress. In less than ten years, and despite an electoral reform that fostered coalitional, clientelistic-ridden, rather single-party rule, New Zealand succeeded in limiting deficits (Lienert 2010: 15).

While celebrated and replicated in OECD federal countries such as Australia and Canada, this FRL had no numeric rules thus it is hardly a useful case for developing countries with very loose fiscal restraints. What is more, as the emphasis in New Zealand was on deficits rather spending discipline, savvy governments can use increased revenue from economic growth for pork-barrelling spending without being punished by such FRL.

From the standpoint of territorial interests, it is pertinent to ask whether FRLs are necessarily a centralising institutional arrangement or vice versa. In fact, the analysis of FRLs highlights the horizontal and vertical dilemmas that federations face in confronting fiscal distress. For instance, horizontally speaking, it is important to pay heed to whether FRL is an encompassing comprehensive framework based on administrative guidelines of legal sanctions that sidesteps legislative oversight or otherwise. Vertically, we should look to the territorial and functional scope of FRL, insofar it may affect only the subnational level or be binding for all entities of the public sector at ALL levels of government (inclusive of the federal level).

Furthermore, the institutional effect question remains: Can a country impose fiscal responsibility by law? As a vast number of fiscally-troubled developing countries have adopted FRLs, the prevailing paradigm based on the *fiscal institutions cum fiscal performance* dictum (Alesina et al. 1999) is apparently substantiated. Still, pressure and conditionality from the international community to address fiscal weakness may be at stake or some sort of policy replication to those countries that pioneered the use of FRLs, as occurred in Latin America. Yet, as the number of developing countries adopting FRLs is exponentially higher than those of advanced economies[2], this evidence may lead to a trap of endogenous reasoning because developing countries are per se more fiscally troubled thus more potentially susceptible to resort to FRLs. In this regard, the Indian experience is a case in point. Hausmann and Purfield (2004: 3) argue that its adoption of the FRL has met the resistance of society and politicians because of the apparent absence of symptoms of economic illness; in fact, interest rates remained low and international capital inflows large at the time of its adoption. This raises the spectrum to the more difficult-to-sell-to-voters scenario that countries may resort to FRL *ex ante* for preventing rather than confronting crisis.

Nevertheless, the adoption of FRLs is not prima facie evidence of commitment to fiscal federalism principles to endorse prudent fiscal policy for addressing economic distress. Above we have discussed the rationale of FRLs as a tool to motivate fiscal sustainability and debt controls in countries where the subnational level is not significantly empowered; neither to sustain long-standing enclaves of debt spending nor to export its liabilities to the national government. Strikingly different is the case of Argentina and Brazil where subnational governments have strong constitutional rights amid severe fiscal vertical imbalances due to the mismatch between expenditure and revenue assignments. The ensuing common pool problem insert an additional layer of complexity for FRLs as it becomes necessary to restrain the free-rider incentives of territorial actors with veto player credentials in the political game. Once the effects of high levels of legislative malapportionment are added to this, a complex picture emerges. Overrepresented jurisdictions, often poorer and with lower levels of political competition and thus virtual overspending "rentier subnational fiefdoms" (Gervasoni 2010; Hagopian 1996), can bring into play their representational advantages to attract shares of federal transfers beyond social welfare criteria (Gordin 2006). Even admitting that fiscal vertical imbalances in Argentina are higher than in Brazil (Ter-Minnasian 1997), the 1988 Constitution in Brazil gave states residual powers in policy domains that included the single most important tax, the ICMS (*imposto sobre circulação de mercadorias e prestação de services,* tantamount to a subnational value added tax), which accounts for approximately 30 percent of all revenues. By the same token, while central government retained primary responsibility for transfers to individuals (80 per cent of the total) and public debt interest payments (90 per cent of the total), subnational units accounted for 68 per cent of active civil servants and other current expenditures, and 80 per cent of fixed investments (Serra and Afonso, 2002). A putative implication of the above is that any attempt to confront economic troubles in these two countries should pay critical attention to the hardening of territorially-bounded budget constraints.

Given the similarities in some fundamental fiscal federal conditions in Argentina and Brazil preceding the late 1990s crisis, and that both countries resorted to FRLs in about the same timing, I propose two explanations that raise the political and institutional impediments and opportunities experienced in both countries in their attempts to

restrain the fiscal behaviour of the individual subnational governments but also restrain the behaviour of the federal government.

The FRLs as a Means to Overcome (Sub)National Fiscal Predation and Federal Commitment Problems: Two Likely Correlates

Soft-budget constraints intertwined with the broader common-pool problem engender a culture of fiscal ransoms that troubled the economic sustainability of federalism and Argentina and Brazil (Rodden et al. 2003; Tommasi 2006). This means that subnational officials are aware that overspending confers them political benefits, especially when they can nationalise the costs of fiscal profligacy through central bailouts. This routine was relatively sustainable in Argentina until the effects of the Convertibility Law turned wicked insofar the national government could not resort to devaluate the Peso, while facing imminent bankruptcy in several provincial administrations. In Brazil, the syndrome “too-big-to-fail” made itself apparent when Brasilia deterred other states from mimicking Itamar Franco, the then governor of Minas Gerais who defaulted on the debt service agreement signed his predecessor. Still, and despite the international credibility of the then President Fernando Henrique Cardoso, the ghost of Minas default sparked a speculative crash that led to a currency fall by a third of its value. The tolerance toward repeated bailouts that had led to chronic and increasing central deficits in the past petered out amidst said fiscal critical junctures in both countries. On the national-level side, a different picture emerged. Despite Menem`s relative success in the early 1990s to contain chronic hyperinflation in Argentina, it proved unsustainable towards the end of the decade. Conversely, the Plan Real of 1994 amounted to a watershed in fiscal terms as the national government exposed the financial use that state governors were making of inflation (Schneider 2006: 17). The ensuing reputational and political clout of the national executive made itself evident in the institutional engineering of the FRLs in both countries. As we will see in the next section, institutional choice was not merely procedural or mechanical. Rather it reflected the political resources available to each level of government prior to the legislative process to approve and pass the FRL. Accordingly, as follows two axes of variation are identified: Centralisation and Political Competition.

1) Centralisation: Argentina's *Bottom-up* deceptive decentralising course and Brazil's *Top-down* self-enforcing fiscal centralisation

Proposition: *The recent resolution of an economic crisis and its concomitant presidential political capital are associated with FRLs whose centralising drift reduces subnational fiscal powers*

While the phenomenon of decentralisation has captured most of the normative and scholarly attention, there is no shortage of research on the desirability of centralising and recentralising changes at the face of economic crises (Eaton and Dickovick 2004; Grindle 1996; Haggard and Kaufmann 1995). This scholarship draws attention to the quintessential *bête noire* of fiscal policies, fragmentation. Albeit helpful as this research is in highlighting the leverage crisis give to central governments, we are left a bit on the dark with regards what dimension of crisis is the decisive one. In this vein, Dickovic (2011: 10) proposes focusing on the resolution rather the mere existence of a crisis as the ultimate empowering factor. From this, it is plausible to infer that the political capital accrued by Cardoso may have underpinned fiscal centralisation and the opposite for the case of Argentina. Related to this is the allocation of responsibilities and liabilities of the FRLs. In turn, the provisions for subnational governments can be adopted either with a top-down or a bottom-up approach. In a top-down approach, FRL are national laws that also apply to subnational levels of government. In a bottom-up approach, the national government passes a FRL only for itself, setting incentives for subnational governments to follow.

In Argentina, the bottom-up approach was adopted. The Fiscal Solvency Law of 1999, also known as the "fiscal convertibility law", did not include formal obligations for subnational governments but invited subnational governments to pass their own fiscal responsibility legislation. Several provinces followed suit, although it is of essence to underline that while the majority of provinces responded positively, such decentralising approach reflected something of an institutional façade. First, only 5 out of the 11 provinces that imposed fiscal restraint actually fulfilled it in practice; let alone that for the most successful ones of these 5, Cordoba and Tucuman, the observed

performance has been similar to that of the period preceding the introduction of the FRL, reflecting thus the resilience of pre-existing political agreements. Second, when we look at the provinces that rejected the deal, the city of Buenos Aires and three of the four large provinces (Buenos Aires, Entre Rios and Santa Fe), they encompass more than half of Argentine economy, diminishing the actual fiscal restraining effect of the FRL initiative (Braun and Tomassi 2003).

Brazil has contrastingly embraced a top-down approach, thus the FRL extends equally to all levels of government. The adoption of the FRL in 2000 (*Lei de Responsabilidade Fiscal e Finanças Publicas Municipais*) loomed large a key milestone in the fiscal history of Brazil, let alone that encouraged the acceptance of mechanisms of intergovernmental relations for dealing with economic crises (Alston et al. 2009). Namely, fiscal federalism, often seen as the cancer of the country's economy, began to be seen as a solution. Being a complementary law (almost constitutional level), this *lei* requires a qualified majority of two thirds for approval and modification, and it is binding for all entities of the public sector at all levels of government, including the municipal level. Quantitatively, the financial balance of the public sector fluctuated from a deficit of a 1% of the GDP in 1997 to a surplus of 4.5% of the GDP in 2004, a fiscal improvement seldom matched in other federal countries for that short a period (Corbacho and Schwatz 2007). More crucially, in systematising, reinforcing restrictions on and criminally penalising excesses in personnel spending, it has mashed the flesh and blood of political clientelism in Brazil, the doling out of jobs in the public sector. Leoni and Renno (2006) go that far as arguing that the most politically visible unintended consequence of the FRL is the framing of fiscal governance issues in terms of responsible government, especially in the public discourses and media.

2) Political Competition: Argentina's Deadlocked Peripheralism and Brazil's Coalescing Party Rebooting

Proposition: *The increasing fluidity of party systems and its related openness to interparty compromises are associated with FRLs whose centralising drift reduces subnational fiscal powers*

Lest passed through an executive decree, the enacting of FRLs demands something of a "coming-together" spirit to prevent fissiparous forces embedded in free-riding and common pool problems from sabotaging the cooperative game and concomitant agreement. The structure of incentives underlying such agreement is part and parcel of the structure of party systems and the resulting cooperation between levels of government or lack thereof (Riker 1964; Wibbels 2005). The outcome of the federal bargain, the argument goes, is contingent on whether the party system gives dominance to national or regional elites or some balancing between them. This being the case, both Argentina and Brazil are sort of textbook cases of subnationally-oriented political parties (Calvo and Escolar 2005; De Luca, Jones and Tula 2002; Abrucio 1998; Samuels 2003). Beyond the point that Brazilian party system is considered weaker and more fragmented due to its open-list proportional system (Ames, 2001; Mainwaring, 1999), the executive in both countries often resorts to massive payouts to gain support for policy reforms and even ordinary policymaking. This suggests that any consensus for a fiscal restraining legislation must be sufficiently appealing for subnational elites inasmuch as this agreement would necessarily cut down pork-barrelling. Hence, what party-level developments account for a full-blown FRL in Brazil and Argentina's unfortunate experience?

In many respects, Argentina embodies the best and worst faces of the politics of the periphery. The best, seen from a normative federal and power dispersion perspective, three governors of four peripheral provinces, Carlos Menem (La Rioja), Alberto Rodriguez Saa (San Luis) and Nestor Kirchner (Santa Cruz) became presidents. The worst, and the more relevant from the vantage point of this paper, these governors represent provinces with no limits of the incumbent executive re-election, and happen to be Peronist, who had controlled provincial governorships without significant challengers (Calvo and Murillo 2004). These uncompetitive milieus, which Gervasoni (2010) conceptualises as sort of overspending authoritarian enclaves, have prompted a federal political dynamics whereby peripheral kingpins somewhat fetch something of a stick and carrot temper into national politics. These parameters transpired in the period following the adoption of the FRL. First, in view of the recessionary trend a Fiscal Countercyclical Fund was established, to be financed out of privatisation leftovers, special funds and a set percentage of tax revenues. This fund not only was

never satisfactorily financed, expectedly in times of recession, but also was opposed by most subnational administrations (Melamud 2010). More critically, following the adoption of the FRL and when tax revenues declined dramatically at the eve of 2001, Peronist governors opposed a last resource measure of the then President De La Rua of reducing revenue transfers to preclude national debt default. What is more, not only said governors rejected such reduction but also they demanded the President to release U$S 250 millions in back transfers (Eaton and Dickovick 2004: 102). The world's largest debt default followed suit.

Since its return to democracy in the mid-1980s, Brazil has embarked itself upon decentralising progression that reached its apex with the 1988 Constitution. This peripheralisation consisted in the recognition of significant competencies to be held by states as well as municipalities, which are also constituent members of the federation. In political terms, this process intensified the incentives of politicians to cultivate local followings and the weakening of the presidency vis a vis state governors (Mainwaring, 1997). This weakness was further exacerbated by the persistence of weak presidential coattails sparked by a disintegrated party system (Ames 2001; Samuels 2003). Moreover, the most significant advances in intergovernmental fiscal relations such as the creation of the State Participation Fund (FPE) and the Municipal Participation Fund (FPM) in the early 1990s were triggered by weak partisan presidential powers (Mainwaring and Shugart 1997) and the fall of the then ruling coalition around the Partido do Movimento Democratico Brasileiro (PMDB). While some evidence against this ostensible disorganised party universe and the putative undisciplined behaviour in Congress is offered (Amorin Neto 2002; Figuereido and Limongi 2000), the conspicuous absence of mechanisms to coxswain centrifugal subnational political dynamics amounted to formation of coalitions around particularistic benefits. The aftermath of Collor presidency and the hyperinflation legacy precipitated the ascendancy of Cardoso and his plan of economic stabilization, later to become the Plano Real. Alike neighbouring Argentina, Cardoso set out the hyperinflationary spiral. Unlike his Argentine counterparts, he identified the subnational origins of Brazil's inflationary crisis.

The popularity of the Plano Real has boosted Cardoso's credentials among governors of key states such as Sao Paulo, Rio de Janeiro, Minas Gerais and Rio Grande

do Sul, enabling the formation of broad coalition of the PMDB and Cardoso's Partido da Social Democracia Brasileira (PSDB). The spectre of Lula da Silva had cemented a reformist agenda that had increasingly revolved around issues of fiscal responsibility. The 1999 flotation of the real and the Minas Gerais' debt moratorium had further intensified the recognition among governors that they had more to gain from delegating fiscal authority to Brasilia than from adhering to Franco's moves. The FRL, in turn, could not emerge in better political and tactical conditions.

Conclusion

This paper adds to the literature on the politics of fiscal federalism documenting that fiscal crises prompt policy responses whose effects are mediated by institutional choice and the broader political dynamics and the incentives both generate. By analysing the adoption of FRLs in two federal polities that had been challenged by similar financial and territorially-induced constraints, it tentatively shows that success in containing subnational fiscal profligacy, which has been causally related to the national overall financial weakness to confront the late 1990s crises, is contingent upon the internalisation of the value of fiscal responsibility by subnational administrations. This has been the case of Brazilian approach to FRL and more generally to the critical junctures faced by this country since the early 1990s troubles with hyperinflation. Conversely, the political dynamics shaping Argentina's adoption of its FRL revealed an intergovernmental gap in the management of the late 1990s crisis, whereby subnational governments had not taken meaningful steps to avoid fiscal collapse, preferring to pass on the national government the bitter pill. This tit for tat game has been the preamble of one of the worst chapters in Argentine economic history, a problem that still lies at the centre stage of current debates about the ongoing conflict with international lenders and hedge funds investors.

There are some further implications. Prevailing views on structural economic reforms have characterized the role of party politics in the reform process in a different way to that described above for the Brazilian case. Haggard and Kaufman (1995) assert that political parties play a key role in reform consolidation and that such partisan centrality is contingent on a two-party or dominant party dynamics rather than a fragmented make-up. The success of Cardoso's scheme amidst multipartism

based on relatively weak and pork-barreling oriented parties flies in the face of the contention that a fragmented party system is an impediment for the success and consolidation of fiscal policies. Further, and equally important, it highlights the role of strategic factors, insofar as the ghost of Lula's social democratic options boosted cooperation among the hitherto conflicting PMDB and PSDB .

Regarding the extent to which international financial institutions played a decisive role in advancing the enactment and success of FRLs, the evidence presented in this study indicates that external pressure varied significantly across our two cases. In Argentina, international conditionality had exerted something of a damaging influence insofar as the adoption of the FRL related to the late 1990s crisis amounted to a window-dressing exercise promoted mainly to give positive signs overseas. In fact, neither the International Monetary Fund nor the World Bank had sponsored any substantive initiative to aid the central government to withstand fierce subnational pressure to maintain bailouts. What is more, international borrowing to subnational governments, albeit restricted, was kept in place. Conversely, international pressure on Brazil had not impinged decisively on decisions to centralise for restoring fiscal order. As shown above, both Cardoso's reputation and the details of the FRL, mostly its clear punishment mechanism, superseded external influences in containing subnational profligacy. By rendering the link between intergovernmental fiscal troubles and macroeconomic instability, Cardoso's Real Plan set the ground for one of the world most successful FRLs, which criminalize rent-seeking fiscal behavior. Hence, decisions about containing federal overspending in Brazil were more rooted in domestic power and institutional design than in international imperatives.

In closing, further research is necessary for conceptualising the reciprocal and causal complex connections between economic crises and intergovernmental politics. The conventional wisdom has so far depicted subnational actors as debt-hungry and passive spectators of fiscal policies for which national governments had taken full responsibility. More detailed inquiry into the political and institutional differences across subnational units may shed light on diverging trajectories as well as unexpected outcomes. This paper reflects only preliminary thinking on the subject, hoping that more mid-range theorizing and concepts will be developed to address this source of fiscally-induced political stress.

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Notes

[1] President Menem issued more decrees than all previous Argentine presidents since 1816 and he also dominated the judiciary to make sure that his decrees were not reversed (Rubio and Goretti 1998; Jones 1997).

[2] According to Lienert (2010: 4), only Australia and United Kingdom have a FRL currently in operation and most of the other OECD countries had at best sporadic episodes of FRL or even FRL-like stand alone fiscal rules.

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