

Do Constitutional Side Payments Induce Subnational Bailouts ?

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Abstract

This paper analyses the effects of federal revenue sharing on subnational borrowing and debt bailouts. While federal revenue sharing could reduce subnational borrowing, it drives the demand for a bailout among politicians with subnational constituencies, as a bailout of a subnational implies a shift of taxation towards the federal tier. A pro-bailout coalition is formed by states which are over-represented in the revenue sharing fund and states with a high debt relative to their expected future tax base. The predictions of the model are consistent with the treatment of state debts by the Brazilian Senate in the 90s.

Keywords: Bailout; Brazil; Federalism; Revenue sharing; Soft budget constraints

JEL classification: D70; H73; H74; H77; O23; O54

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