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Multilevel fiscal coordination for sustainable growth

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Outline

- **Typical coordination focus:**
  - ***Macroeconomic stability***
    - Apportionment of limits
    - Links with desirable directions of clean/sustainable growth, overall employment and inequality
  - ***Fiscal equalization***
    - Ensuring that all jurisdictions have access to similar levels of service at similar levels of tax effort
    - Largely for current spending, and overlaps with special purpose transfers (Ahmad and Searle, 2006)
- ***Preconditions* for accountability: Coordination on**
  - Information flows especially on liabilities: local balance sheets, GFSM/IPSAS standards (Ahmad, 2016)
  - Own-source revenues at margin (Ambrosanio and Bordignon, 2015)
- **New areas for coordination**:
  - ***Public investment and infrastructure***—where to place and finance growth hubs?
  - ***Tax policy and administration*** interlinkages
    - Incentives to cheat and information flows (local and national taxes)
    - Block chain options—closer integration of administrations at different levels, also between revenue and treasury circuits

Multilevel Coordination for Macro-fiscal rules

Typical focus of policy makers and IFIs

Multilevel fiscal sustainability

- Typical focus on debt stock and deficit limits for general government
- Some countries in difficulty at debt/GDP ratios below the benchmarks (60% debt stock and 3% deficits)
  - Argentina in 2000 (with debt stock under 50%)
  - Spain and Ireland with debt/GDP ratio well below Maastricht levels pre-2008,
  - Germany and France above, but the former group was more vulnerable (see Ahmad, Bordignon, Brosio, 2016, *Multilevel Finance and the Eurocrisis*, Elgar)
- Is an arbitrary limit appropriate and apply to all levels of government? Dynamic issues critical, particularly link with investment and growth.
  - Should limits be relaxed for growing regions?
  - How to ensure that jurisdictions do not cheat?
- Important role for coordination—but in a broader context

Coordination for sustainable growth

- **Sustainability**, linked to new clean urban “hubs”, to enhance overall production possibility frontier
  - Investment, including cross-border connectivity to raise overall potential, and better utilization of comparative advantages
  - Dynamic effects as sustainable growth rises, so does the potential to finance additional infrastructure (formally, the Simonsen conditions)
- **Public investment cornerstone of sustainable development agenda, SDGs and COP22**
  - Critical in the international context, e.g., in China and the EU, and best case scenario: “Chile” (WB)
  - But investment and connectivity not always sufficient e.g., EU (Ahmad, Bordignon and Brosio, 2016)
- **Must focus on income distribution** as well as environmental considerations

Connectivity and growth coordination

Connectivity necessary but not sufficient

- Judicious choice of additional public investments, at national and subnational levels, including in education and public services
- Ensure that there are adequate domestic resources to meet public service requirements and to anchor access to credit at different levels of government
- Complex institutional and organizational challenges
- Use of appropriate models and economy-wide shadow prices to generate clean ”urban hubs” for green growth
- **Package approach is critical**

Coordination for equalization transfers

- Equalization systems should be based on generating the ability to provide similar levels of services at similar levels of tax effort
  - Generally rely on estimating disability factors for assigned spending and own-revenues, outside the control of the recipient jurisdictions
  - Typically, restricted to current spending—we examine the case of investments separately
  - Independent Grants Commissions (e.g., Australia) often are charged with the estimation of the relativities on which the transfers are made
  - As, these should be outside the control of the recipient jurisdictions, they are effectively lump-sum, with minimal disincentive effects
- Often transfers based on actual spending or revenues are used, in which case they are not “lump sum”, and can severely damage incentives to spend or raise revenues efficiently

Coordination for special purpose transfers

- In many countries, special purpose transfers (SPT) are used, e.g., for health care or education
- The overall multilevel system can be jeopardized if the recipient jurisdictions can divert the SPTs to other uses—e.g., of more political relevance to local officials
  - Damages yardstick competition and accountability, besides resulting in below par outcomes
- This is generally only possible if there is incomplete information on the economic and functional spending categories (perhaps linked to outcomes) at the sub-national level
  - We examine the PFM preconditions for the efficiency of SPTs in the following sub-section

Need for coordination

- **Considerable game-play between and across levels of government**
  - Hiding of liabilities, especially at the sub-national level
  - Problems with implementing special purpose transfers and poorly designed equalization systems
  - Facilitated by poor accounting and reporting standards, asymmetric information, especially with PPPs, but also SPTs
  - **Leads to game-play with liabilities, and potentially unproductive investments and spending, perhaps rent-seeking behaviour**
- **Cheating by firms and households**
  - Importance of cross-checking information on value added with activity levels and asset holdings
  - Requires interface between VAT, Income Taxes and Property taxes
  - Block chain could be used effectively, but will require new levels of coordination and streamlined tax administration functions
    - Common registration, data exchange and audits
    - Also streamlined flow of funds (revenue and treasury circuits)
    - More work needed, despite some welcome experimentation in Eastern Europe and some developing countries

Coordination for improved governance and accountability

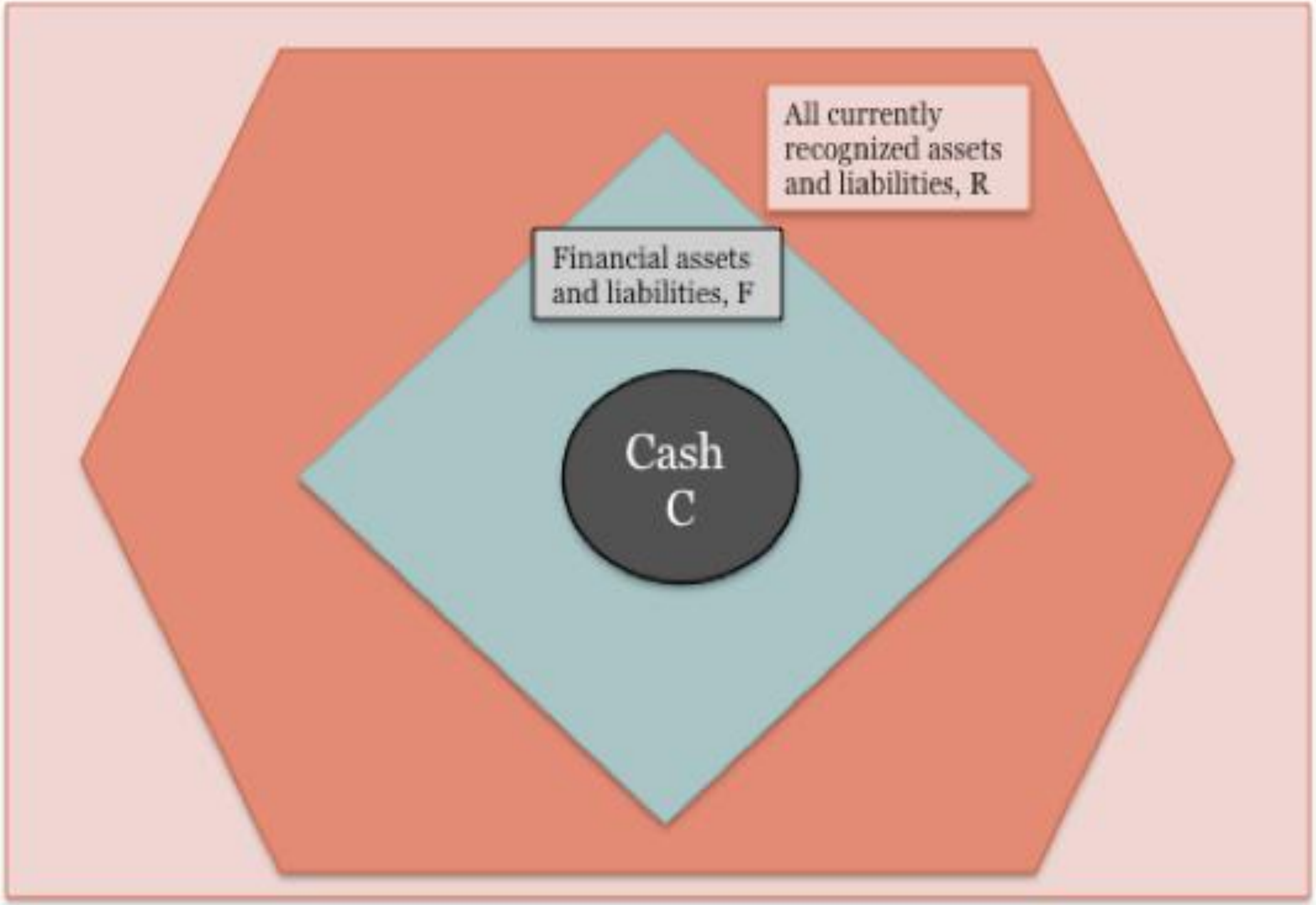
Imperfect information, Game-play and Political economy

- Imperfect information
  - Leads to “game play” across levels of government
    - And between government and private contractors (leverage to re-contract, especially in high profile cases)
  - Hiding or non-recognition of liabilities
- In extreme cases, private debt could result in public assumption of the liabilities
  - Ireland and Spain, recent crisis; and Mexican roads in the 90s
- Could result in poor decision making and cost-overruns

Credibility of the State and Accountability

- Follow spending by <u>all levels of government</u>
  - Institutions, economic classification, functions, projects, programs, outputs and outcomes
  - Manage liabilities, PPPs and standardized balance sheets
  - ***Track using common standards: lesson from EU failures***
    - ***France just moved to requiring PPPs reflected in local government balance sheets***
- Essential to know what was spent by <u>each</u> level,
  - before ascribing results to local "participatory or performance budgeting" in countries with overlapping responsibilities, earmarking
- Essential also to know extent of liabilities (also securitization of revenues, with single term mayors)
- Plus track the cash, to prevent cheating and leakages
- Harder to address "clientelism", although "capture" is easier to detect

Rights and obligations associated with all future cash flows, E



PPPs—kicking the can down the road?

- Very easy to use as a means of postponing reckoning and avoiding debt limits, especially at lower levels
- Pass the buck also to future administrations
  - Also other jurisdictions
  - The Center carries the can if there are no “own-source revenues”
- Tightening of IPSAS rules (IPSAS 32)
  - Who owns the assets—should guide provisioning
  - Resisted in some EU countries, as it would add to deficits and debt

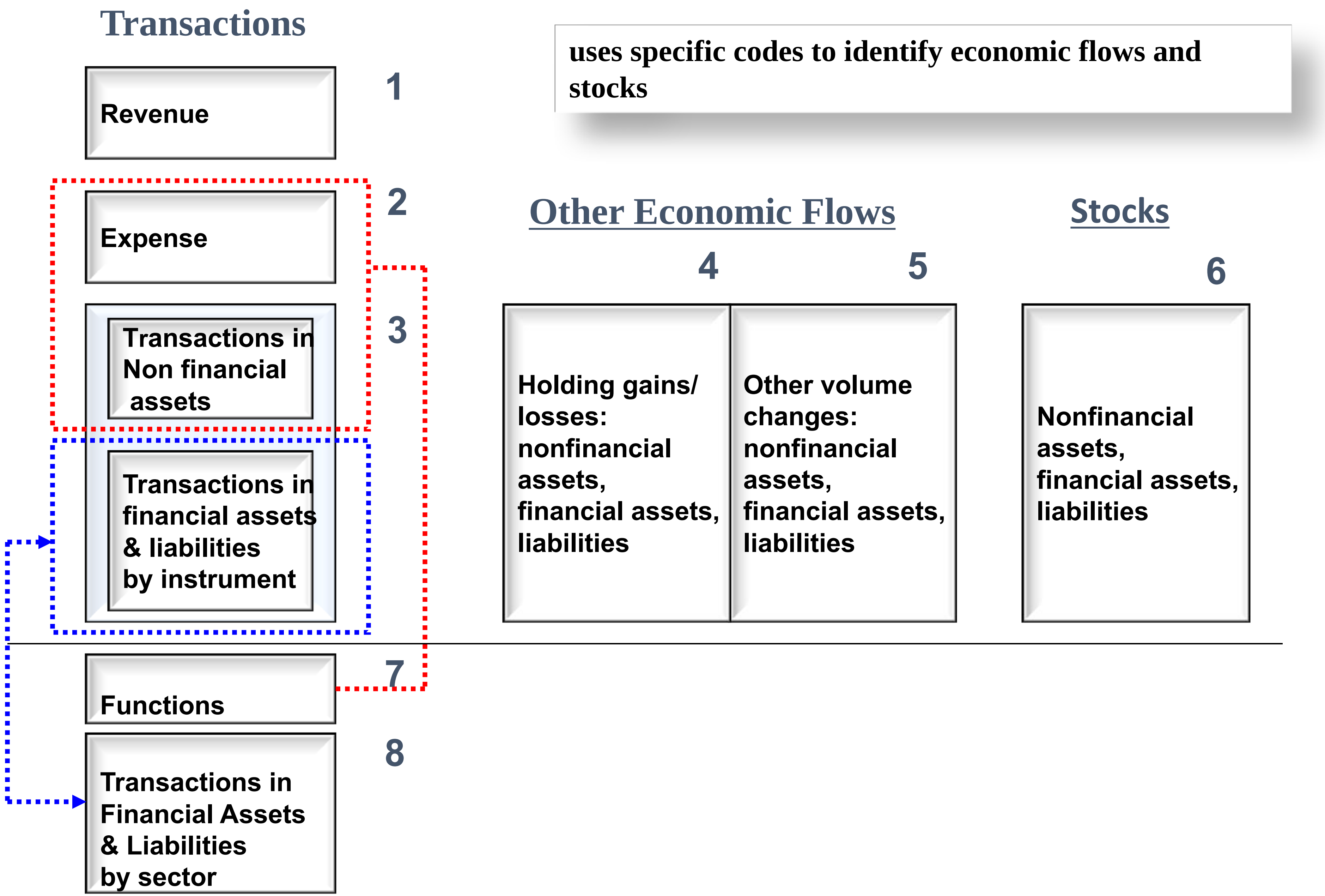
Credibility and Risk Mitigation

- Impartial arbiters between firms and national/sub-national governments
  - Incentives to renege and renegotiate contracts
  - Asymmetric information
  - Political power with high profile projects (possible rent-seeking as well)
- Sub-national overnments also cannot be trusted without adequate own-source revenues
- **Scope for coordination and independent certification?**

Incentives and transfer design

- Central transfers in spheres of sub-national jurisdiction have a debilitating effect
- Badly design equalization systems or gap filling can negate the incentives to use “own-source revenues”
- In effect, can lead to poor investment decisions, and build-up of unproductive assets and liabilities
- It’s all about incentives and the interactions between instruments
- Information is critical
  - GFSM2014 standards—not for reporting to IMF but for domestic management of liabilities <u>at all levels of government</u>
    - Big projects in Egypt: PR China; Saudi Arabia; needed elsewhere including in Europe….

IMF/OECD/UN GFSM2014 methodology for all levels of government, linked to SNA



GFSM: Balance sheet

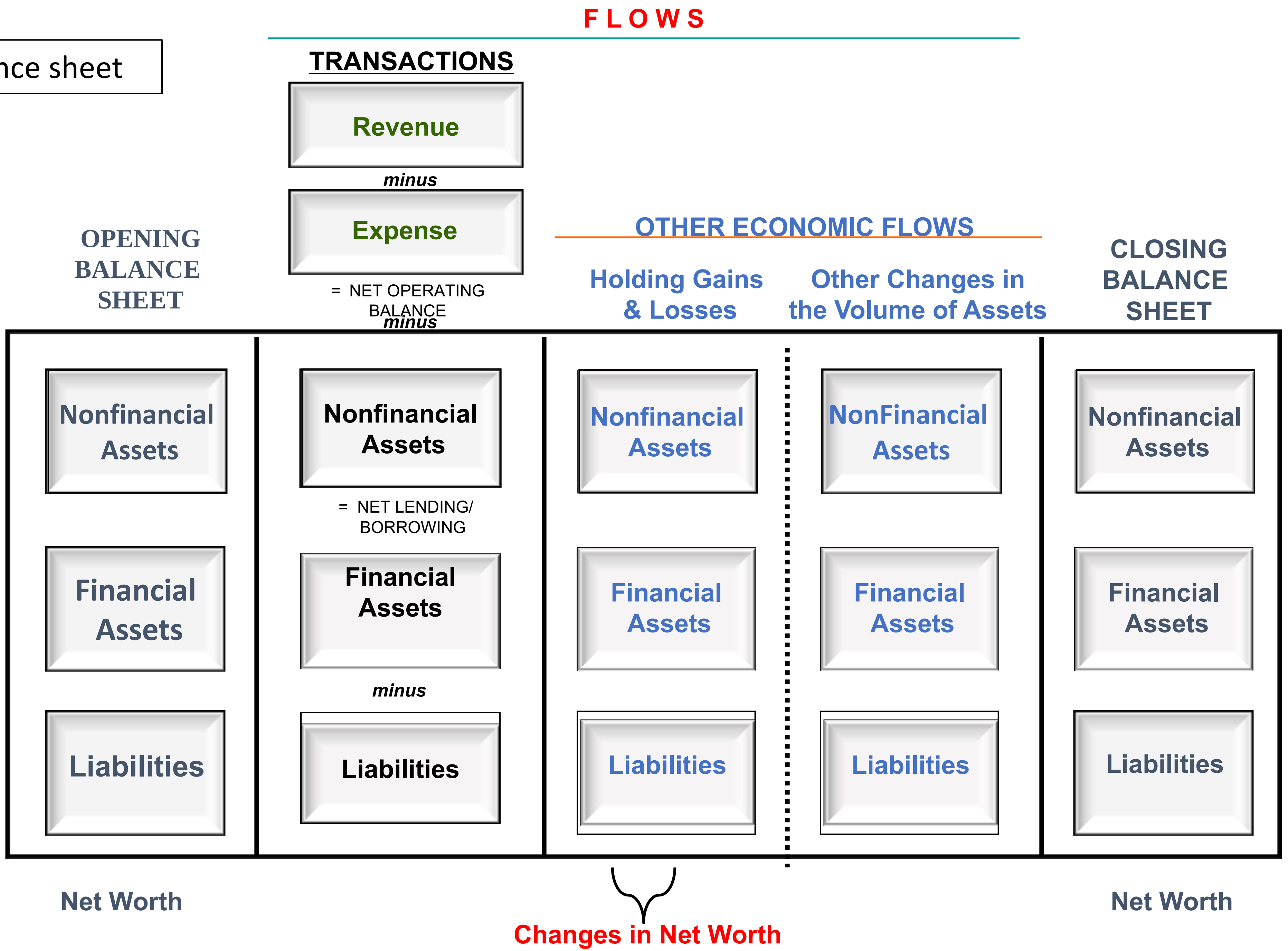


Chart Of Accounts (COA)

- Logical framework for recording and reporting financial information
- Modern systems include GFSM2014 fully in COA
  - Accommodate progressive move to accrual accounting
  - Program and performance budgeting
  - Asset and liability accounts in addition to revenue and expense accounts
  - Forms core of the information to be generated and tracked in IFMISs at center and subnational levels
- Must be common across levels of government
  - Not always followed, with great difficulty in tracking spending or liabilities
  - Can be quite problematic

Illustrative Chart of Accounts (COA) - Segments

No.	Segment	Size	Description
1.	Institutional Entity	2	Economic Entity – e.g. General Government Sector, Other Economic Entities
2.	Source of Funds	2	Funding Sources
3.	Functional Classification	8	UN/OECD COFOG
4.	Administrative Classification	6	Ministries, departments, agencies
5.	Program / Sub Program Classification	6	Outcomes
6.	Activities / Projects	6	Achieving Outputs
7.	Geographic	6	Region, District
8.	Economic Classification	8	GFSM2014 Revenue, Expense, Assets and Liabilities
9.	Real variables	6	Including for possible performance indicators/Outputs

Coordination of sub-national liabilities

- Need information to make the process more transparent and accountable
  - Better linked to local priorities
    - Avoid exclusive emphasis on physical infrastructure
    - Balanced with o/m and human capital needs
- Essential to have own-source revenues at margin; ensure hard-budget constraints
- Coordination needed to provide information to market, as well as monitoring for all levels of government
  - Critical for the operation of yardstick competition

Spending can be managed with a decentralized IFMIS infrastructure—if the COA is common

- As with the tax administration, a common infrastructure can be used (both for the TSA as well as IFMIS)
  - Replicated at the regional level
  - With local administrations using on an agency basis
- Decentralized spending can be tracked/ IFMIS
  - But a common data base is critical
  - Essential ingredient is the COA
  - Mappings to the GFSM2014 are not adequate (commonly used, e.g., in Latin America)

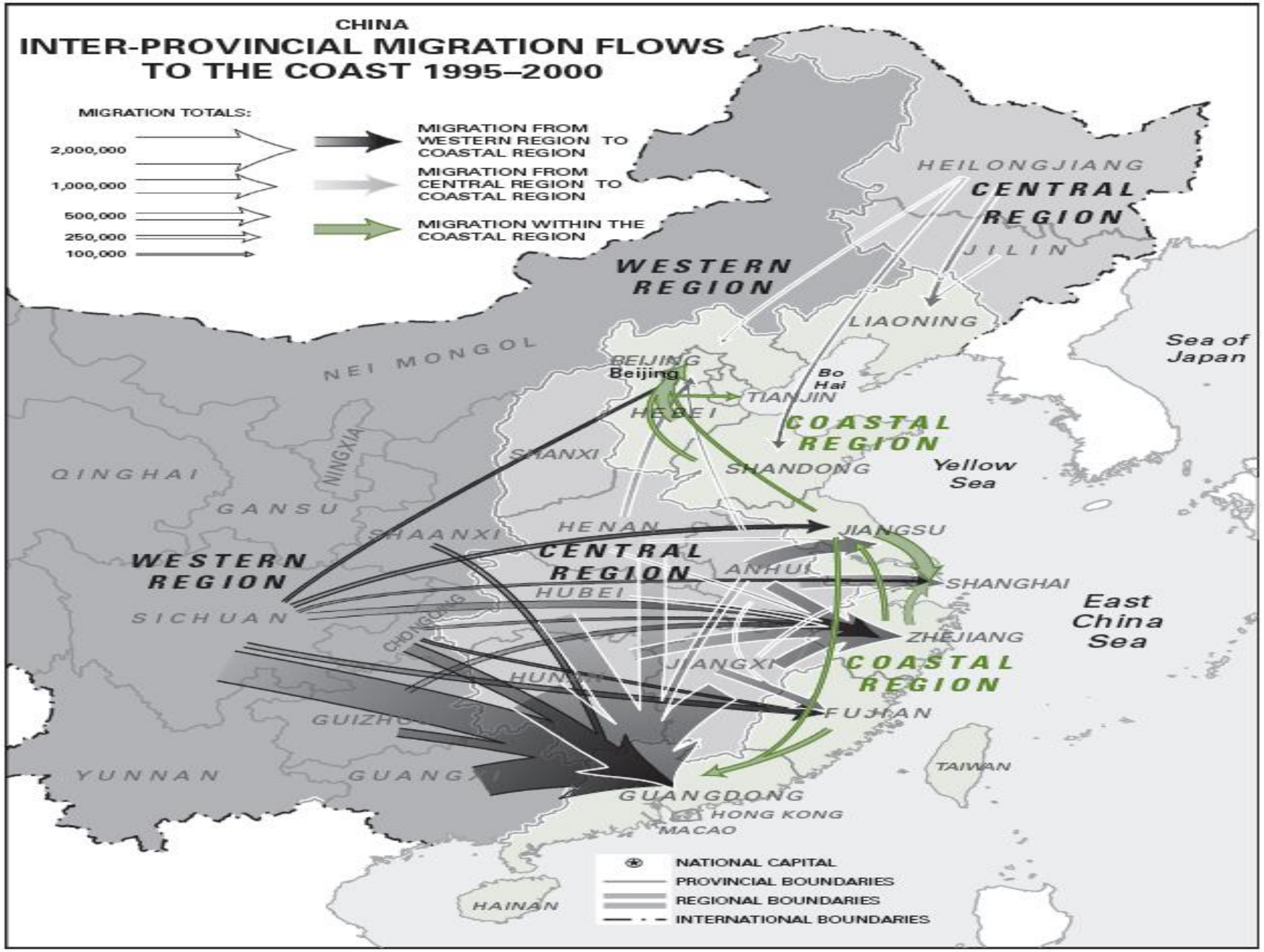
Coordinating investments for sustainable growth

Critical for multi-level countries

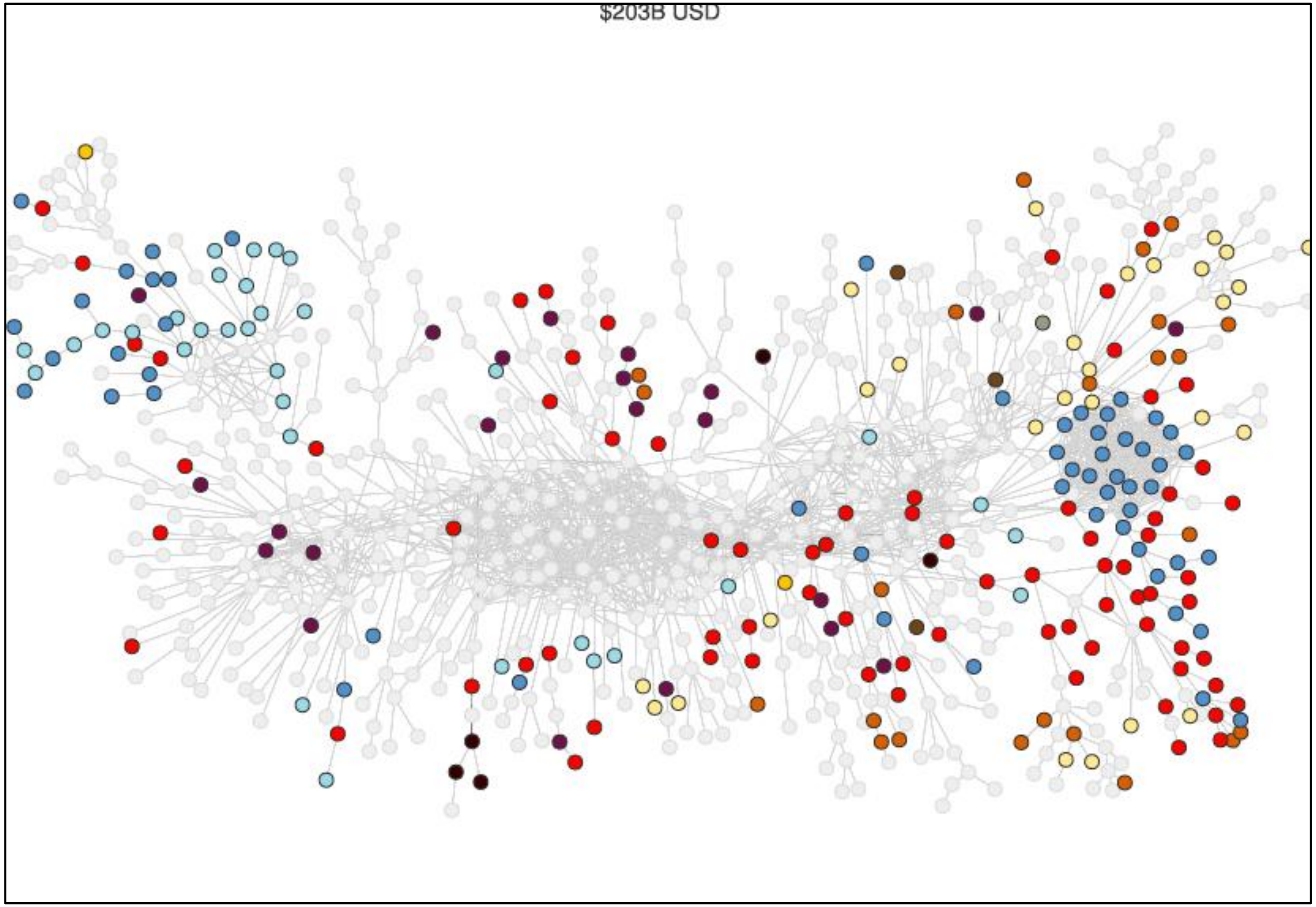
Coordinating investment and sustainable growth

- **National rebalancing and investment to generate sustained employment and growth, with an improved quality of life**
  - Address interpersonal and inter-regional inequalities, as well as **congestion and pollution (Santiago, Karachi, Delhi, Guangzhou/Shenzhen)**
  - Better utilization of both **domestic and external linkages—motorways and high speed trains connecting N and S Italy**
- **Huge growth potential with improved connectivity—cross-border, national and sub-national**
    - Coastal hubs strategy in China—problems of success (as in Chile)
    - Sustainable new “hubs”—moving investment to new technologies, better use of labour and comparative advantage—not trivial
    - Tapping into unrealized potential with global value chains: physical connectivity (Chile vs China)

China: Migration to "coastal urban hubs"

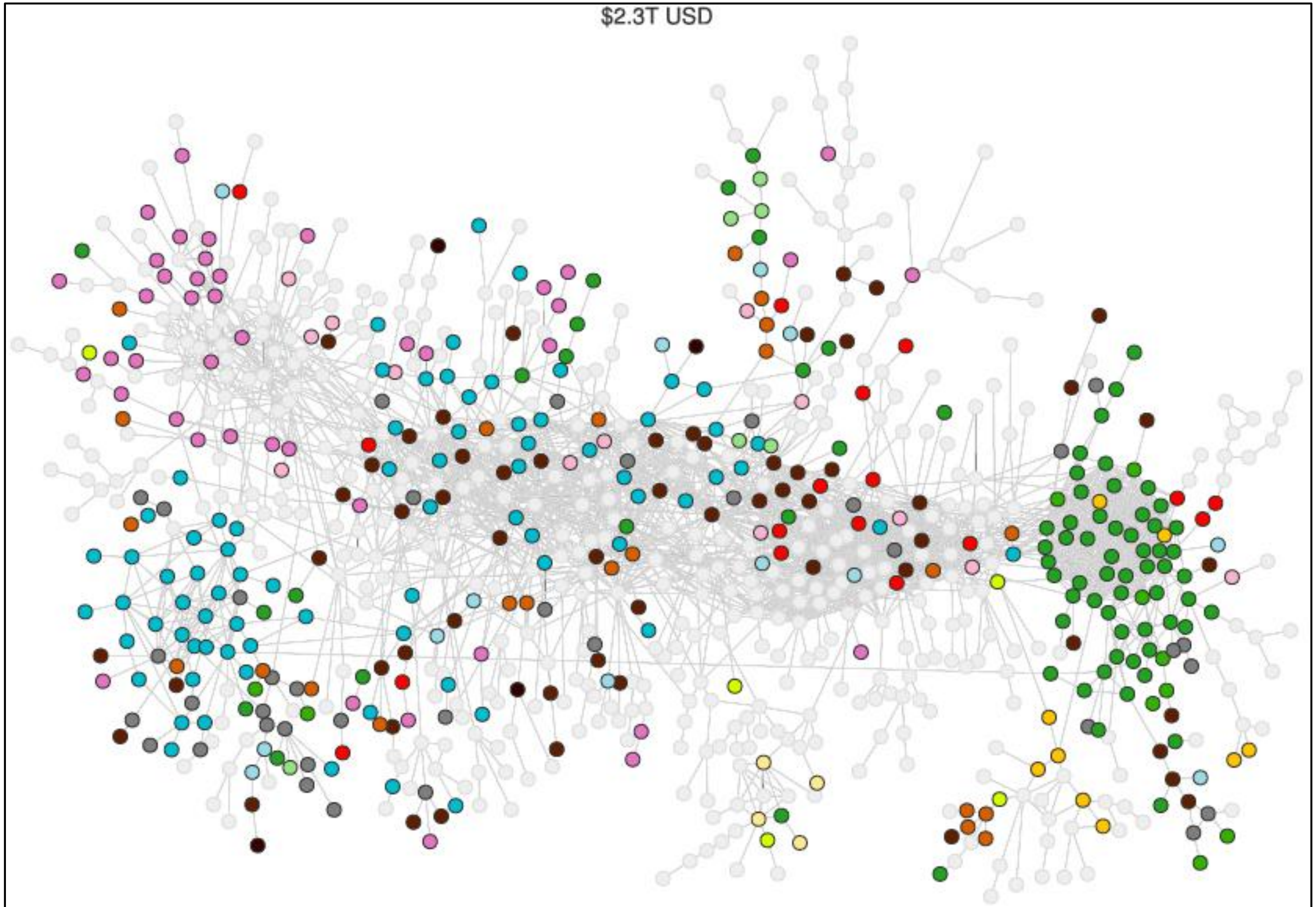


CHINA1995: Structure of exports, complexity



Source: Atlas of Economic Complexity, Harvard University

CHINA 2014: structure of exports, complexity



Logic for new domestic hubs—expand production possibility frontier and reduce environmental risks

- **Better utilize the existing production and factor endowment structures**
- **Relatively little additional connectivity possible with existing hubs**
    - Congestion and pollution raise effective costs of production
    - Extensions based on domestic “distance” better utilization of the interior provinces
- **Silk Route/B&R cross-border investment assumes that external linkages would also provide additional elements to raise the aggregate production possibility frontier**
    - Utilizing the considerable “space” in the production frontiers of neighboring countries,
    - In addition to opening up say the Western region, and providing shorter (and safer) access to markets in the Middle East and Europe and critical supplies of raw materials
    - Permits cleaner activities in existing mega-metropolitan areas, and more efficient and green activities in the new “hubs”
- Requires coordination of the national, regional/provincial and local growth strategies and investments
    - See Ahmad, Niu and Xiao (2017) for a discussion of China

Rebalancing or “sustainable urban hubs”

Connectivity investments in Italy

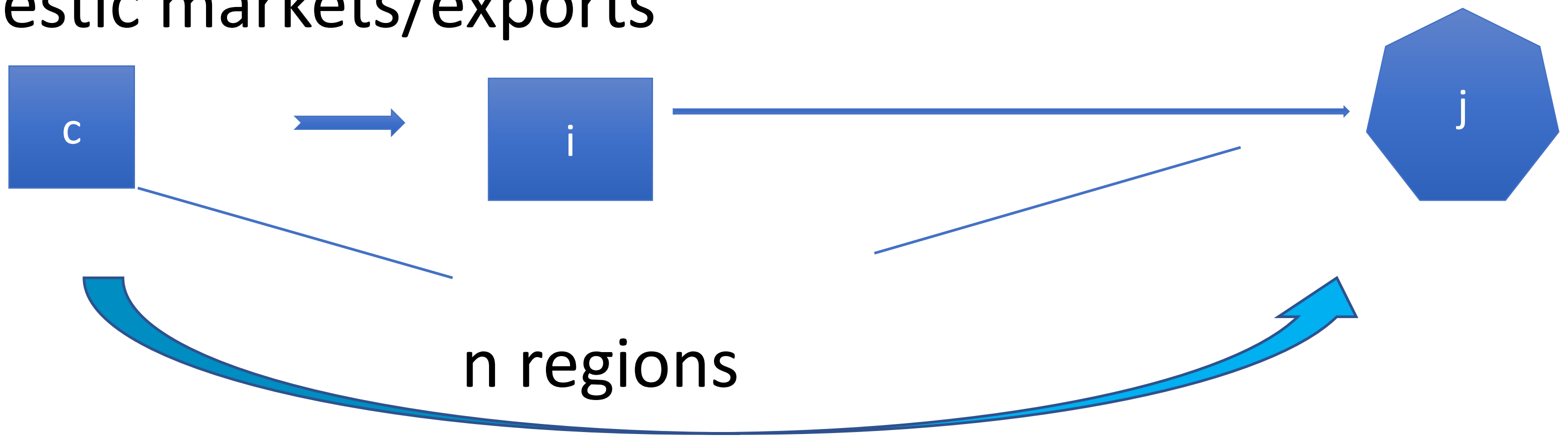
- **Major emphasis on public investment for connectivity in the EU—structural funds**
- **Mixed results for lagging regions** (Ahmad, Bordignon and Brosio, 2016)
- **Inability to generate new sustainable "hubs"** or generate private investment
  - High speed trains within and between countries
    - Italy: Turin-Milan-Rome-Naples high speed train
      - Unable to revive declining industries in Turin
      - Unable to provide a boost to lagging economy of Southern Italy
      - Make it more attractive to commute to ***existing hubs***: Milan or Rome
- **Difficulty with complementary local investments and public services** needed to create attractive locations for private firms and workers—serious governance issues in Southern Italy

Dynamic incentives for concentration

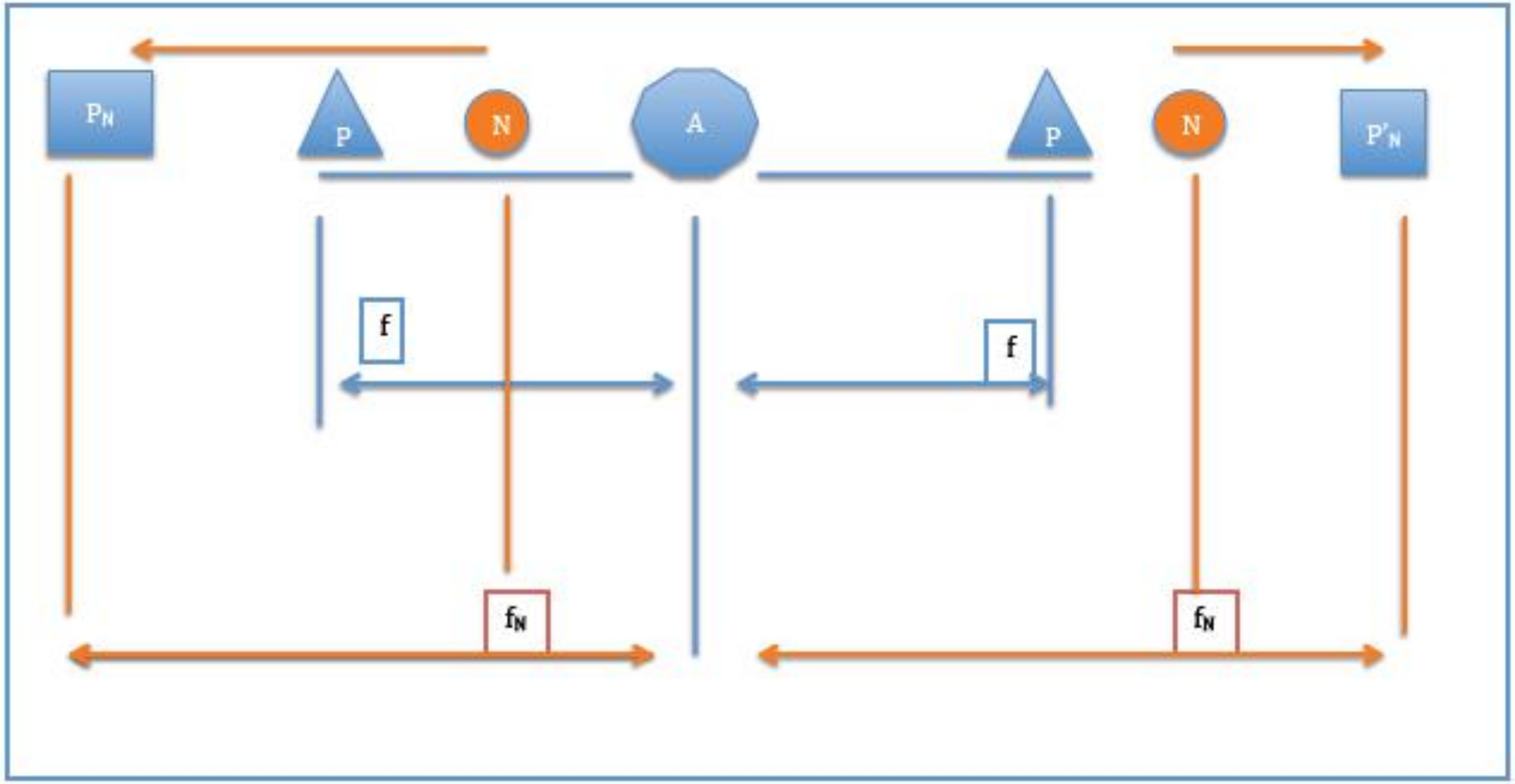
- **Firms in remote regions face higher costs of production and getting goods to the market** (external and domestic)
  - Partly issue of availability of the right skills and labour force
  - Agglomeration/supply chain and transportation issues
- **But simply addressing connectivity in isolation can make matters worse**
  - Torino-Milan-Naples —merely improved the capabilities of existing "hubs" Rome and Milan thereby increasing inequalities
  - Same story in Chile, with the N-S Highway, but project selection based on commercial profit motives
  - Have to include focus on local investments and service delivery, to generate new regional "hubs"
- **Thus, the equalization systems come into play as a supplement to a sustainable investment strategy**

Example of transportation infrastructure

- Effectively shortens economic distance (j representing new export hub, Gwadar, Khorgos)
- Reduces economic costs in Chinese interior regions (i)
- To the benefit of both rebalanced Chinese coastal (c) and interior (i) regions
- Generates shifts in production structure—closer to both domestic markets/exports



Hubs and periphery



The blue figures represent existing market structure, with A as the market/export, and P the maximum reach. P_N is the excluded periphery. New hubs, N, bring these into play, and may often be between P and P_N but in other cases, could be closer to A (Querétaro example).

Conclusions

Coordination needs to extend beyond monitoring fiscal rules

- Major issues involved in
  - Fiscal design and tracking systems to be achieved in common across jurisdictions
  - Facilitating agreement on information sharing on taxes and new open source technologies used for both revenue-collection and spending
  - Will permit a simplification of institutional arrangements, with greater confidence across jurisdictions
- Equalization systems also require cross-jurisdictional cooperation
- More importantly, cooperation is needed with respect to national, regional and local investments for sustainable growth
  - Major area of research following Paris and COP22 as well as the SDG goals

Some lessons

- Not all hubs have to be in remote sparsely populated regions,; but **there have to be sufficient “spokes” connecting to the hub**
- Implications for additional **investment financing to be met from regional, local sources**
- As seen with success in Barcelona (Brosio, Piperno and Suarez Pandiello, 2016), and EU in general, **the own-source revenue constraints are likely to be binding**
  - Critical for access to credit for local investments and “spokes” linked to “hubs”
  - Governance and provision of local public services

Coordination of investment strategy with sustainable growth

Investment strategy:

Appropriate AR for K and L
Inequality aversion (Atkinson index)
Intersectoral analysis
Appropriate cost of public funds (discount rate)

- Tax reforms structural reforms (at national and local levels)
- Avoid "Middle income trap".
- Economic and social convergence.
- Diversification.
- Pollution and congestion.

Improvement of local public service delivery

(Accountability through local own-source revenues and equalization transfers)

Sustainable urban hubs

take into account inter-related nature of public investments

Coordination of policies across levels of governments and economic sectors