

Coordinating Fiscal Consolidation in Decentralized Countries : Capacity, Incentives, and Frameworks

Victor Lledó

**Senior Economist, Fiscal Affairs Department
International Monetary Fund**

***“Fiscal Governance in Decentralized Countries:
AIReF-UIMP Seminar, Santander, September 11, 2017***

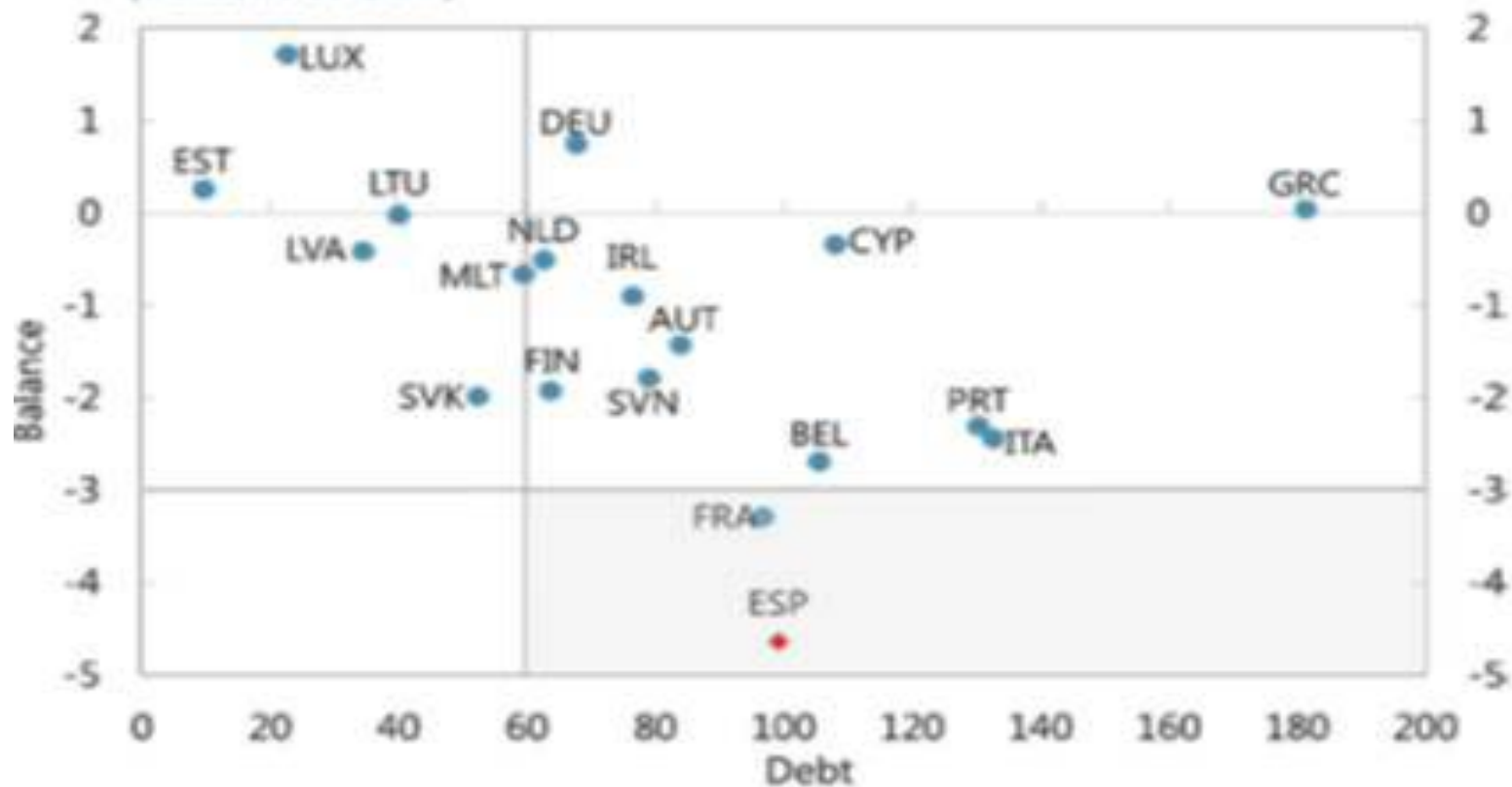


Fiscal consolidation remains a priority in Spain



General Government Balance and Debt, 2016

(Percent of GDP)

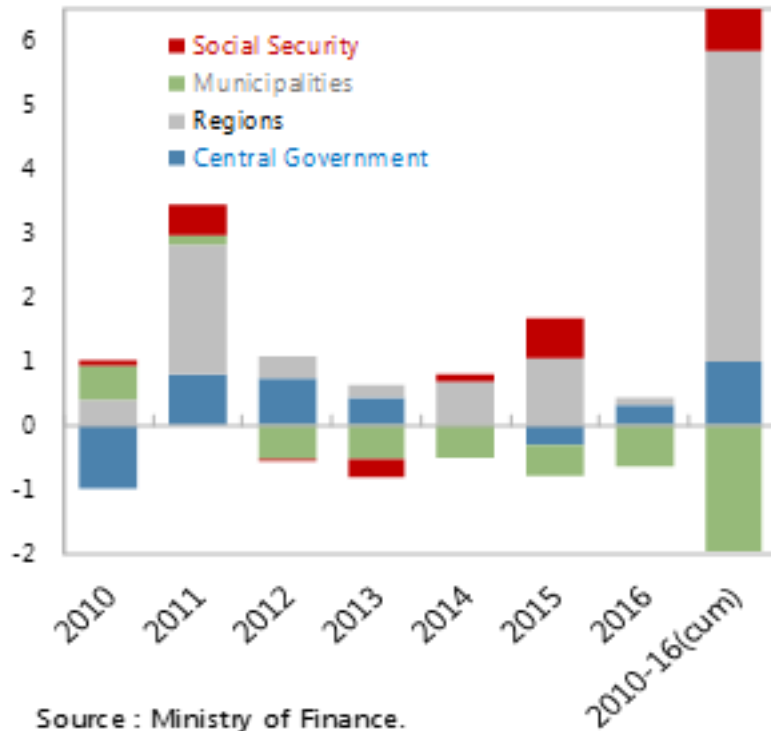


Sources: Eurostat; and IMF *World Economic Outlook*.

Concerted fiscal efforts across governments critical



Fiscal deficit deviations by sector 1/
(Percent of GDP)

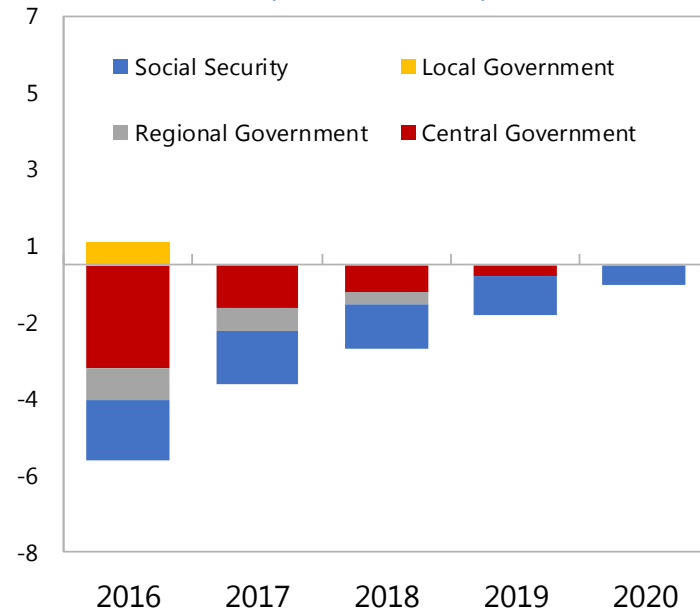


Source : Ministry of Finance.

1/ Positive deviations : non-compliance.

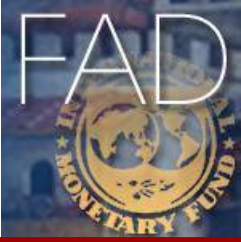
Negative deviations : over-compliance.

Fiscal deficit by sector 1/
(Percent of GDP)



Source : Ministry of Finance.

Coordination failures in decentralized countries



Proximate : SNGs with no capacity or incentives to adjust

- **Capacity : Instruments, Mandates, Shocks, Targets**
- **Incentives: Common Pool + Moral Hazard = Soft Budgets**

Deep: Gaps in SNG Fiscal Framework

- ❖ **Fiscal Autonomy**
- ❖ **Fiscal Governance**
- ❖ **Fiscal Resilience**

Fiscal Autonomy Gaps



- Limited taxing powers/ control over tax rates and bases
- Large vertical fiscal imbalances
- Unfunded mandates
- Unbalanced fiscal equalization systems
- Spending discretion limited by minimum service standards, revenue earmarking

Large VFI undermine Fiscal Discipline

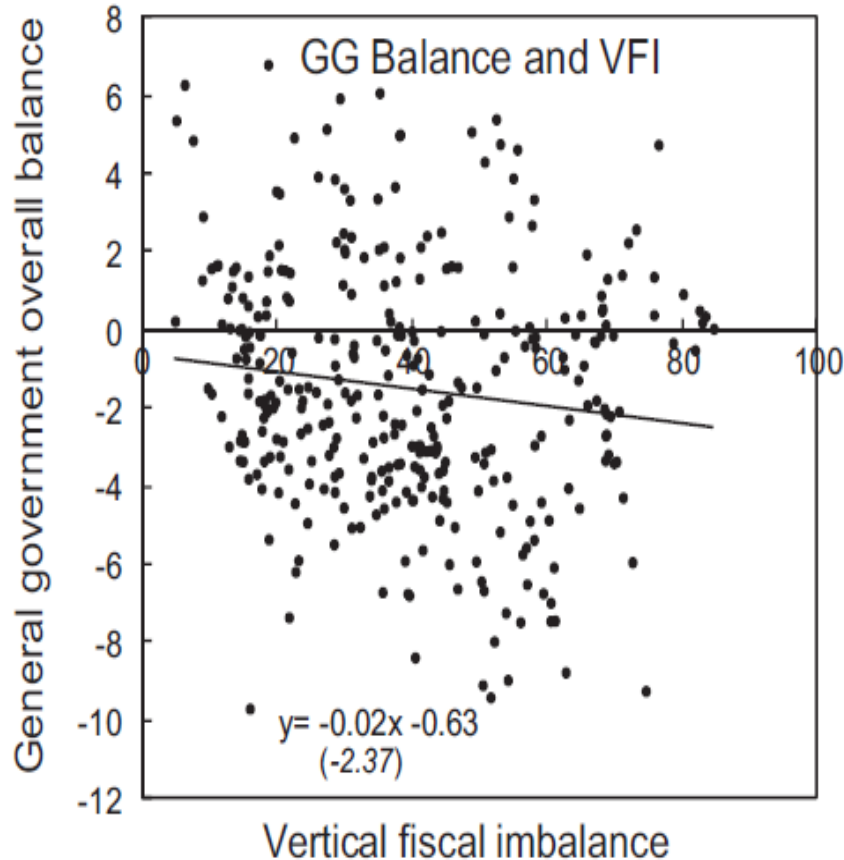


Table 1

Main regression results (dependent variable: general government primary balance, percent of GDP).

	(1)	(2)	(3)
VFI	-0.15*** (-6.35)	-0.12*** (-3.06)	-0.17 (-1.33)
Expenditure decentralization	0.21*** (3.24)	0.22*** (3.49)	0.21** (2.51)
Lag debt-to-GDP ratio		0.06*** (4.56)	0.06*** (4.51)
Lag of output gap		0.20* (1.97)	0.20* (1.97)
Rule of law		5.89*** (5.67)	5.72*** (5.48)
VFI squared			0.00 (0.43)
Overall R^2	0.10	0.22	0.22
Within R^2	0.48	0.54	0.54
Number of observations	485	273	273
Number of countries	28	25	25

Source : Eyraud and Lusinyan (2013)

Fiscal Governance Gaps



- Weak administrative controls; fiscal rules and targets
 - selection, design, calibration, monitoring and enforcement

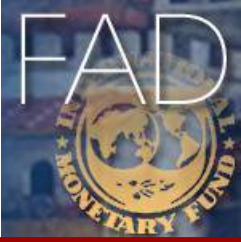
- Lack of preconditions for market discipline
 - Lax prudential requirements on SNG lending
 - SNG access to non-competitive sources
 - Lack of transparent and comprehensive SNG fiscal accounts

Fiscal Resilience Gaps



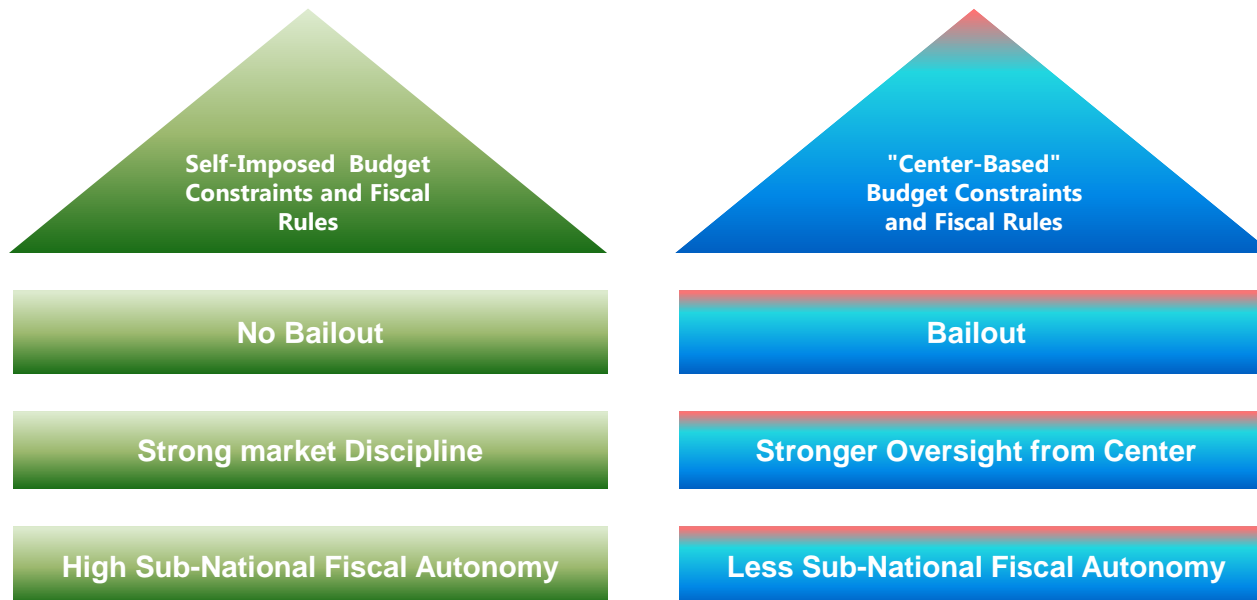
- ❑ Dependency on volatile taxes (PIT, VAT)
- ❑ Transfers from the center are pro-cyclical
- ❑ Limited access to borrowing during downturns
- ❑ Inability to appropriate and save surpluses
- ❑ Absence of risk-sharing mechanisms, stabilization funds

Fiscal Frameworks : Fiscal Autonomy and Governance



- Fiscal frameworks close fiscal autonomy and governance gaps to different degrees

Stylized Set up for Hard Budget Constraints



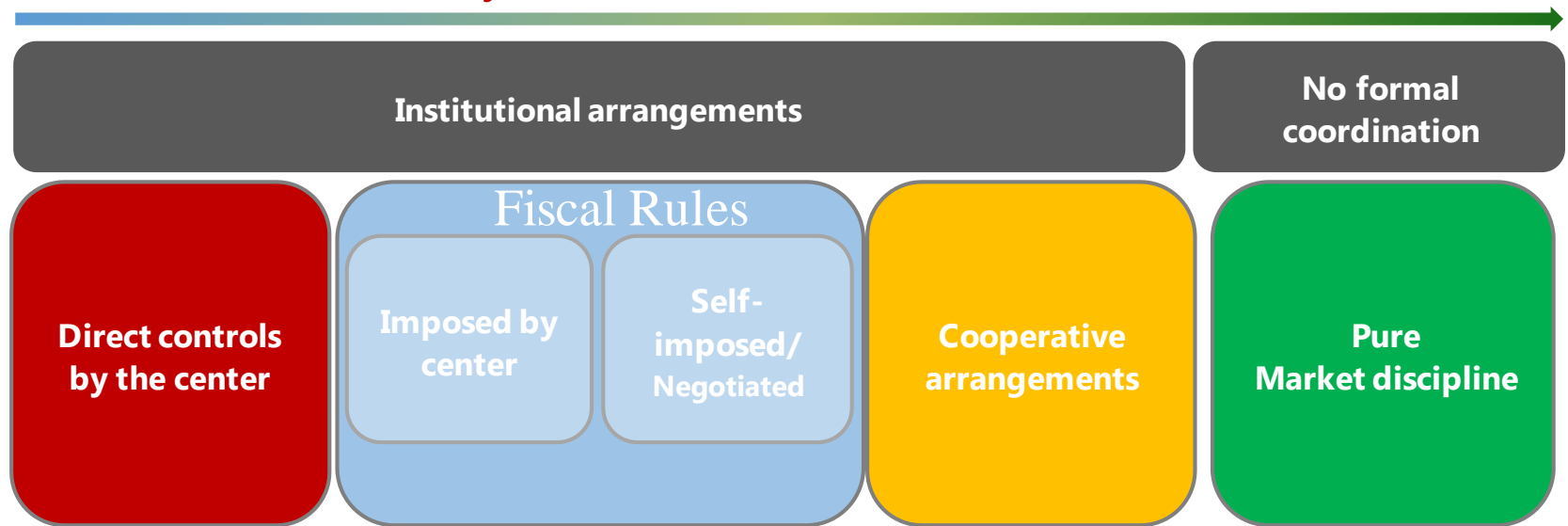
Less is Fiscal Autonomy; Tighter are Fiscal Constraints



Arrangements to constrain Subnational Fiscal Policy

Less sub-national autonomy

More autonomy



Subnational Fiscal Rules: Selected Evidence from Federations

Fiscal Indicator Targeted by the Institutional Constraint

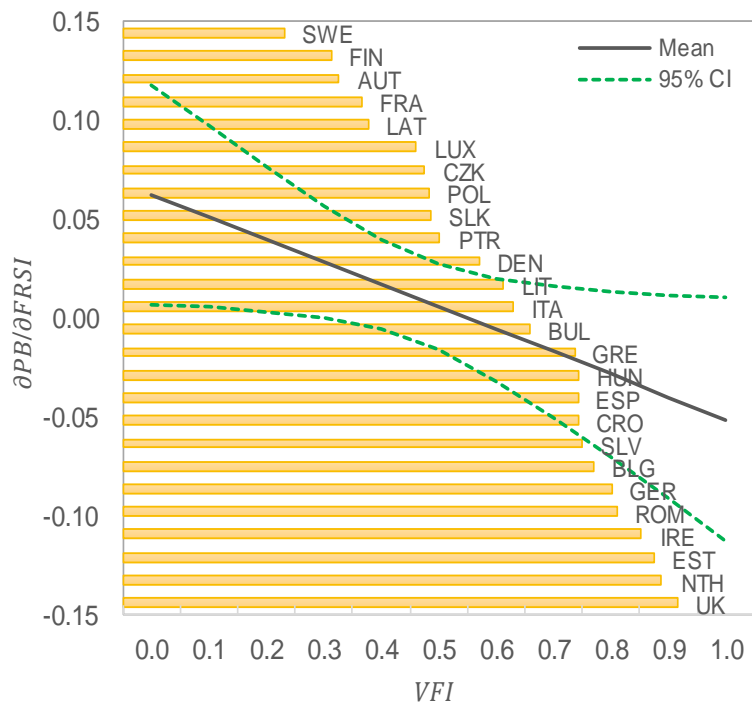
Fiscal Rule **Cooperative Arrangements** **Direct Control from a Higher Government Level**

	Fiscal Balance			Borrowing	Debt		Expenditure		Revenue
	Overall balance	Golden rule	Structural balance		Debt stock	Debt service	Aggregate	Subcomponent	Tax ceiling
Argentina		Green				Green	Green		
Australia	Green			Yellow	Green		Green		
Austria	Yellow	Green							
Belgium	Yellow	Green							
Brazil				Green	Green			Green	
Canada	Green			Red	Green		Green		
Germany	Green		Green	Green					
India	Green			Red	Green	Green			
Mexico				Green					
South Africa	Green			Green					
Spain	Green		Green		Green	Green	Green		
Switzerland	Green	Green	Green				Green		
United States		Green		Green	Green	Green	Green		Green

Fiscal Governance and Autonomy Must Both be Tackled



VFI Impact on Fiscal Rule Effectiveness



Source : Lledó and Kotia (2016)

FD GMM Estimates of the Impact VFI on the Effectiveness of SNG Fiscal Rules
(Dependent Variable: Sub National Primary Balance)

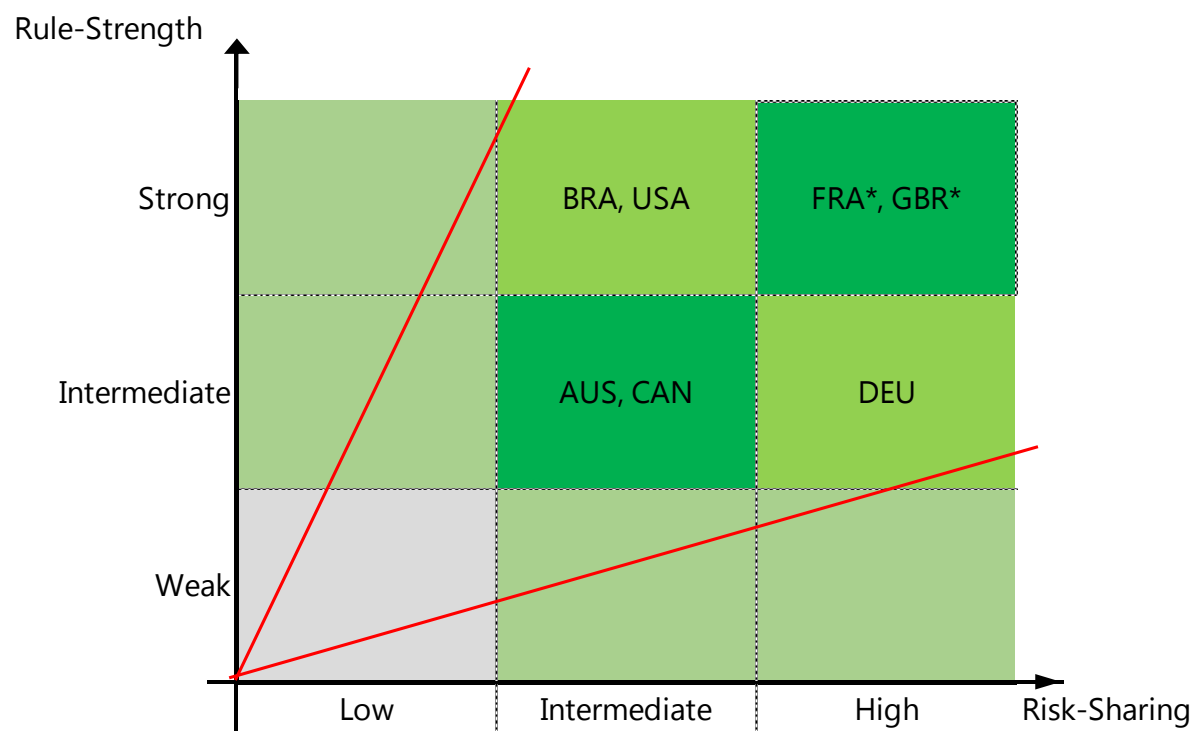
Lagged Dependent Variable	0.108	0.112	0.118	0.099	0.109	0.075
Overall	(0.09)	0.064** (0.10)	(0.09)	(0.08)	0.064** (0.10)	(0.08)
Overall*VFI						
Statutory Base		0.072** (0.03)				
Statutory Base*VFI		-0.143** (0.07)				
Monitoring and Enforcement			0.056** (0.03)			
Monitoring and Enforcement*VFI			-0.104* (0.06)			
Non Compliance				0.087** (0.03)		
Non Compliance*VFI				-0.136* (0.07)		
Media Visibility					0.062** (0.03)	
Media Visibility*VFI					-0.111* (0.06)	
Flexibility						0.076** (0.04)
Flexibility*VFI						-0.130** (0.06)
VFI	0.026 (0.02)	0.027* (0.01)	0.026 (0.02)	0.031* (0.02)	0.021 (0.02)	0.021 (0.02)
Output Gap	-0.001*** (0.00)	-0.001*** (0.00)	-0.001*** (0.00)	-0.001** (0.00)	-0.001** (0.00)	-0.001*** (0.00)
Population > 65	0.006 (0.00)	0.003 (0.01)	0.007 (0.01)	0.009** (0.00)	0.007 (0.00)	0.008* (0.00)
Number of Observations	321	321	321	321	321	321
m1	-2.42	-2.44	-2.4	-2.5	-2.19	-2.2
m2	-0.43	-0.61	-0.46	0.1	-0.39	-0.42
Instruments	30	30	30	30	30	30
Hansen	3.35	1.9	3.12	4.41	3.09	4.14

Fiscal Frameworks : Fiscal Resilience and Governance



- Stronger risk-sharing and stronger governance typically go hand in hand.

Nexus between risk sharing and governance



Note: The risk-sharing classification is based on estimates from the literature of the share of income shocks to subnational entities that are absorbed by central transfers. The rule strength classification is based on a review of each country's codified rules and an assessment of their effectiveness in constraining sub-national budgets.

Source: Allard and others (2013)



Muchas Gracias!