

Fiscal Rules at Subnational Levels: International Experiences

by
Sanjeev Gupta,
Deputy Director, Fiscal Affairs Department, IMF
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1. Why constrain subnational governments

2. How to constrain subnational governments

3. Subnational fiscal rules : various facets

4. Impact and effectiveness of subnational fiscal rules

5. Lessons for effective subnational rules

1. Why to constrain SNGs?

1. Why Constrain Subnational Governments

- To Eliminate **Deficit Bias** at subnational level from
 - Bailout expectations
 - Transfer dependency that arises from common pool problem
- To Minimize **Coordination Failure with/Negative Spillovers to**
 - CGs (Vertical) : Macroeconomic stability/fiscal adjustment efforts at general government level compromised
 - Other SNGs (Horizontal): Lower taxes, higher borrowing costs

2. How to constrain SNGs?

2. How to constrain: typology

Arrangements to Constrain Subnational Fiscal Policy

Less sub-national autonomy

More autonomy

Institutional arrangements

No formal coordination

Direct controls by the center

Imposed by center

Self-imposed/
Negotiated

Cooperative arrangements

Pure Market discipline

2. How to constrain: selected evidence

Institutional Constraints on Subnational Governments: Types and Number

	Fiscal rule	Direct control	Cooperative approach
Argentina	3	...	...
Australia	3	...	1
Austria	1	...	1
Belgium	1	...	1
Brazil	3	...	...
Canada	3	1	...
Germany	3	...	...
India	4	1	...
Mexico	2	...	...
South Africa	2	...	...
Spain	6	...	...
Switzerland	5	...	...
United States	5	...	...

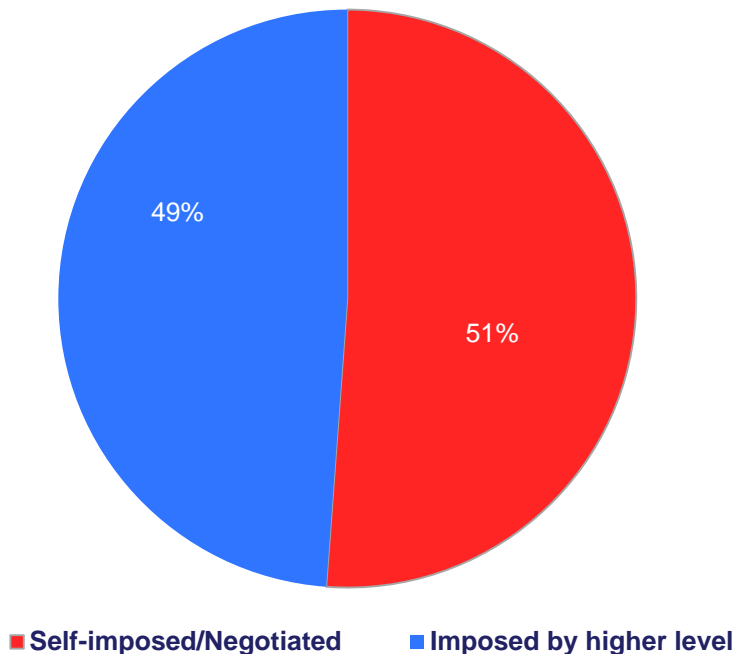
3.Subnational Fiscal Rules : Various facets

3. Subnational fiscal rules : origin

Fiscal Constitution matters

- Self-imposed in competitive federations (U.S., Switzerland)
- Imposed by the higher level in cooperative federations (E.U.), unitary countries (Joumard and Kongsrud, 2003; Sutherland et al., 2005)

Origin of Fiscal Rules on Subnational Governments



3. Subnational fiscal rules: definition

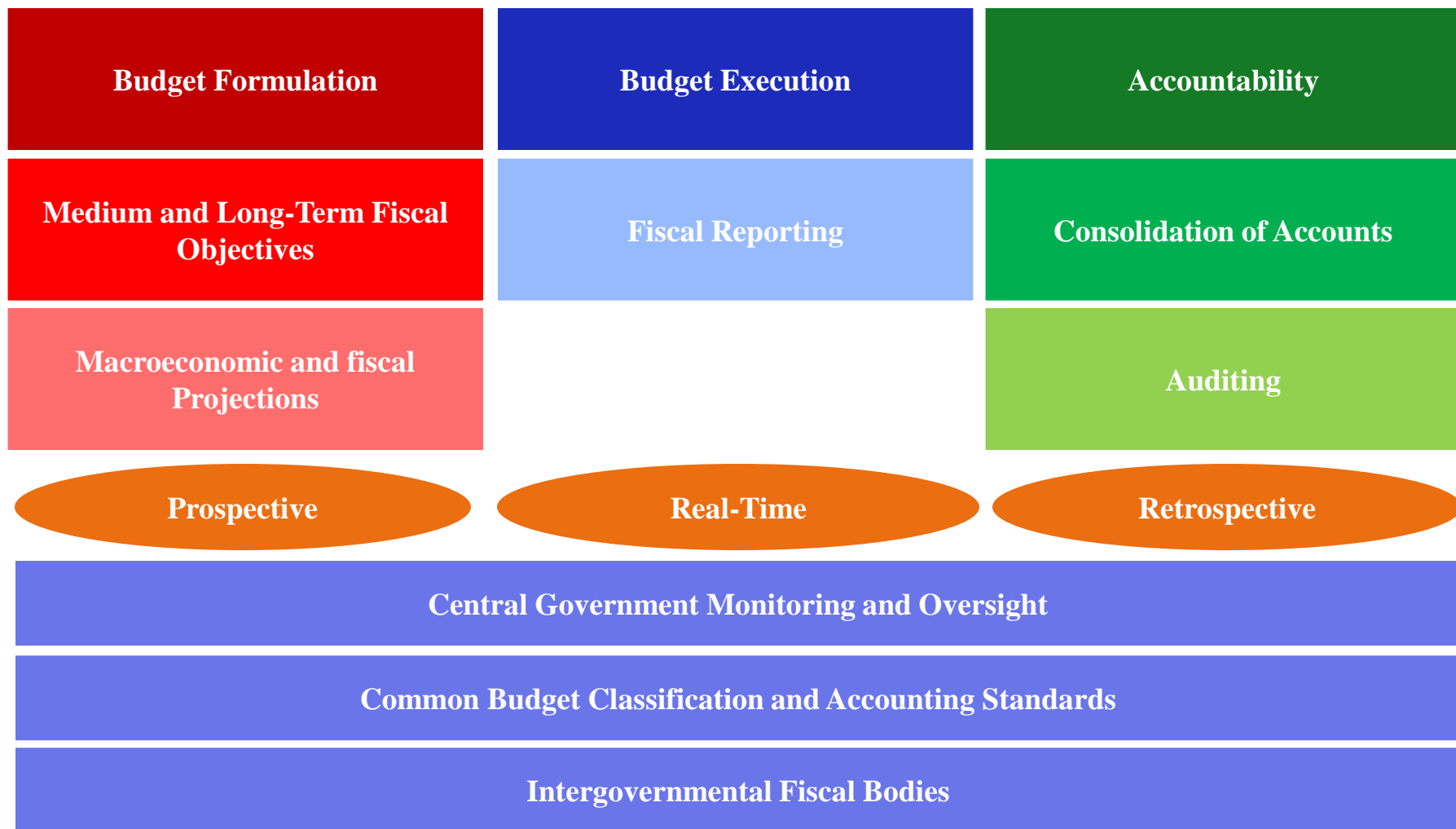
A fiscal rule imposes a long-lasting constraint on fiscal policy through numerical limits on budgetary aggregates

- **Fiscal Rules**

- **Limit discretion** of policymakers in the collective decision-making process and contain pressures to overspend
- **Signaling device** to anchor expectations about fiscal policy
 - Powerful communication tool to assure public that future policy will be responsible and consistent with targets defined by fiscal rules, thereby reducing uncertainty

3. Subnational fiscal rules: pre-requisites

Features of Sound Fiscal Management and Oversight in Federations



3. Subnational fiscal rules: pros and cons of different rules

DEBT RULES

Set an explicit limit for public debt

- + Direct link to debt sustainability
- + Easy to communicate and monitor
- No clear short-term guidance
- Can lead to pro-cyclicality

BUDGET BALANCE RULES

Constrain the evolution of the debt ratio

- + Clear operational guidance
 - + Easy to communicate and monitor
 - Can lead to pro-cyclicality
- But: Structural budget balance rule**
- More complicated, less transparent
 - Difficult to implement at subnational level

EXPENDITURE RULES

Limit total / primary / current spending

- + Clear operational guidance
- + Allows for economic stabilization
- + Rel. easy to communicate / monitor
- No direct link to debt sustainability
- Could lead to changes in composition

REVENUE RULES

Set ceilings or floors on revenues

- + Steers the size of government
- + Can improve revenue policy and admin.
- No direct link to debt sustainability
- Can lead to pro-cyclicality

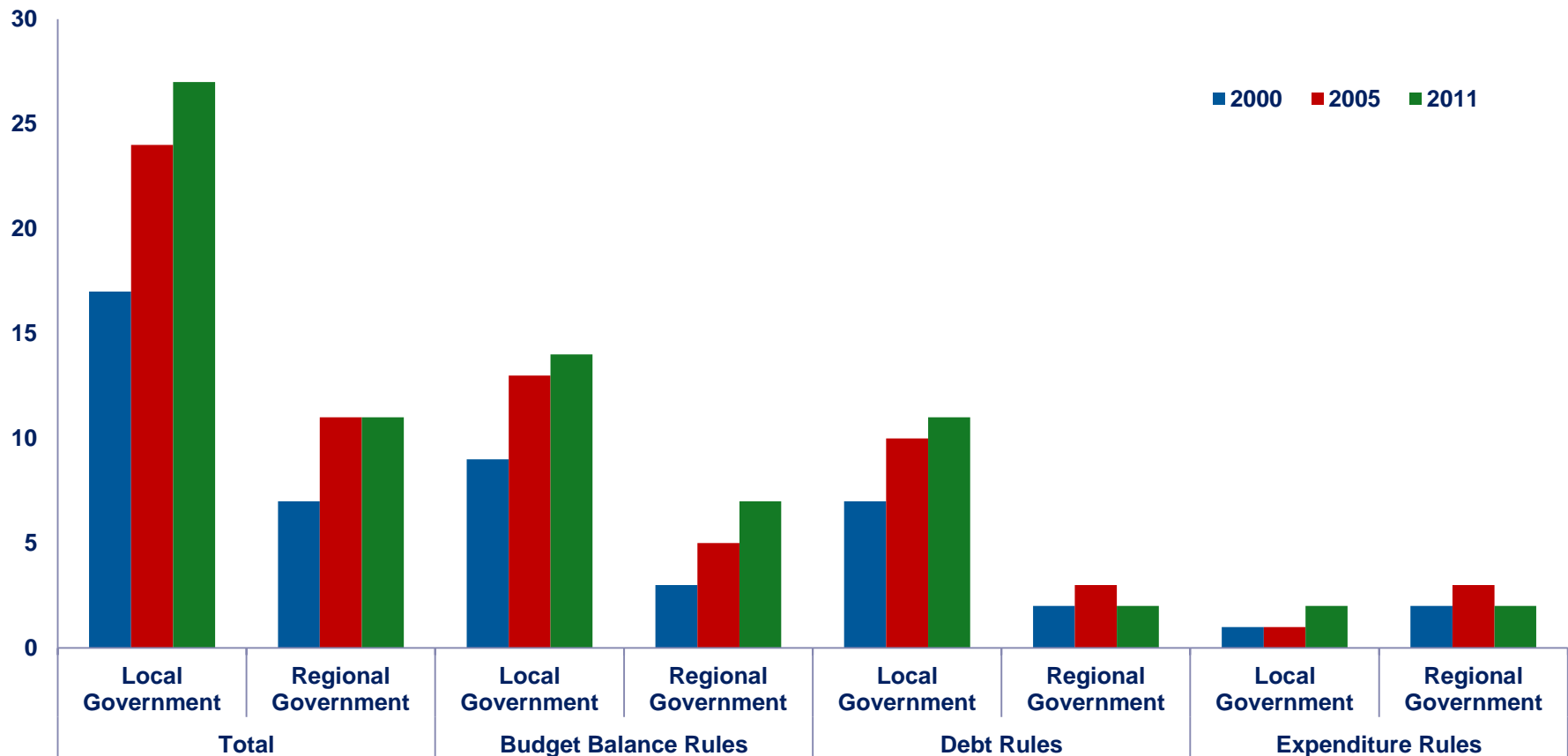
3. Subnational fiscal Rules: selected evidence from Federations

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

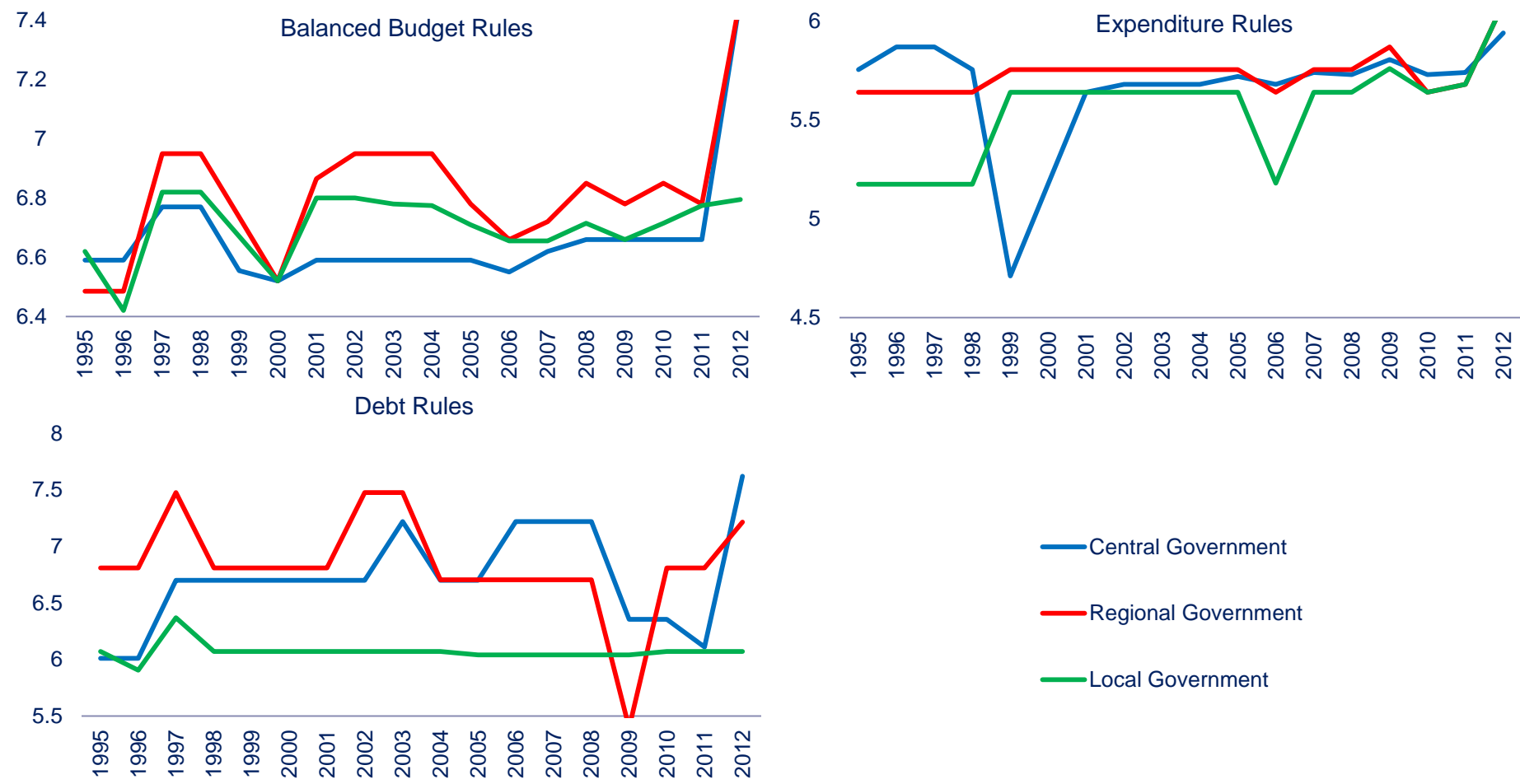
3. Subnational fiscal rules in the EU:2000-2011

Subnational Fiscal Rules in EU Member States



3. Subnational fiscal rules in the EU since the crisis

**EU: Subnational Fiscal Rules Strictness Index
Median across Countries**



4. Impact and Effectiveness of Subnational Fiscal Rules

4. Impact and Effectiveness of fiscal rules

- Evidence mostly limited to country cases : hard to identify positive impact on fiscal discipline given
 - Generally a short history, except for a few countries
 - Reverse causality: Countries facing a fiscal crisis likely to strengthen rules
 - Simultaneity: Rules introduced together with other reforms

- US, Switzerland : Vast literature with positive impact on fiscal performance and market discipline (US: Poterba 1996, Strauch and Von Hagen 2001 for U.S States; Feld et al, 2011 for Swiss Cantons)

- EU: Growing literature with mixed results. Recent findings show little impact (Escolano and others, 2012); others positive in unitary systems (Foremny, 2014)

- Emerging markets (Brazil): Inconclusive. Rules introduced during debt crisis jointly or preceded by other reforms (Liu and Webb, 2011)

4. Impact and Effectiveness of fiscal rules

- **Their design matters: budget coverage**
 - Failure to include sub-central public enterprises (Spanish regions) or special funds (U.S. states) as part of a balanced budget rule led SNGs to rely on these sources for additional funding
 - Golden rules can be circumvented if investment is not well defined (Mexico states)

- **Flexibility**
 - Rainy day funds improved flexibility and smoothed spending (U.S states)

- **Enforcement :Legal basis and Oversight**
 - Balanced budget rules, enshrined in the constitution (US states) and enforced by independent courts or independent fiscal (US states, EU countries) led to lower deficits

4. Impact and Effectiveness of fiscal rules

- **Sound Public Financial Management**
 - The adoption of common standards of financial reporting increases their effectiveness (advanced and emerging economies; Plekanov and Singh, 2006)
 - SNGs poor budget execution, fiscal reporting, and oversight compromised monitoring of and compliance with fiscal rules (Indonesia provinces, Portuguese municipalities)
 - Uniform budget procedures, and strong sanctions for non-compliance have been associated with improvements in subnational fiscal performance in Brazil in the 2000s

4. Impact and Effectiveness of fiscal rules

- **Rules ineffective if fiscal decentralization framework characterized by low subnational revenue autonomy/transfer dependency leads to large vertical fiscal imbalance and bailout expectations (Spain, EU federations, emerging market economies)**
- **U.S non-bailout history key for credibility of subnational fiscal rules**

5. Lessons for Effective Subnational Rules

5. Lessons for Effective subnational rules

- **Rules with a comprehensive budget coverage ,flexible, and enforceable are more likely to be effective**
 - **Coverage:** rules should apply to all budget categories (current and capital spending) and to sub-central public enterprises
 - **Flexibility** : rules should adapt to economic and fiscal conditions
 - While the jury is still out on whether structural budget balances at the subnational level will work, stabilization funds (U.S. Rainy Day Funds) have shown to be a feasible option
 - **Enforcement:** strong legal basis and independent oversight help, although there is some evidence that they work better in advanced economies if self imposed

5. Lessons for Effective subnational rules

- **Subnational governments should follow sound PFM practices....**
 - Reliance on realistic macroeconomic outlook consistent with central government
 - Common accounting frameworks; harmonized with central government
 - Statistical reporting should be timely, transparent
 - Annual reports should be independently audited

5. Lessons for Effective subnational rules

- Subnational rules will not be effective if there are fundamental flaws in the fiscal decentralization framework

Fiscal Affairs Department

Ambrogio Lorenzetti; The Effects of Good Government on the City Life; Fresco; Palazzo Pubblico, Siena (Italy)

Thank you for your attention!

