Fiscal Decentralization and Macroeconomic Performance

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Key Issues

- Are there greater risks of macroeconomic mismanagement and instability with decentralized fiscal systems (federal vs unitary countries)?
- What has been the experience to-date in macroeconomic management in federal vs unitary countries? Or What has been the impact of decentralization on fiscal discipline and macro stability?
Fiscal Dec and Fiscal Performance: Outline of Presentation

• Institutional Framework for Monetary Policy
  – Industrial countries
  – Brazil
  – China
  – Empirical evidence

• Institutional Framework for Fiscal Policy
  – Industrial Countries
  – Brazil
  – China
  – Empirical evidence

• Securing an Economic Union
• Conclusions and Lessons
Institutional Framework for Monetary Policy and Review of Country Experiences

• Consensus on monetary policy as a central function but practices vary
• Independent central bank with focus on price stability
• Arms length relationship between governments and the financial sector
• Brazil – monetary discipline and price stability
• China: still muddling through
Fiscal dec and monetary management – empirical evidence

- Positive and significant association with central bank independence
- Positive but insignificant association with growth of money supply
- Negative but insignificant association with inflation
- Positive but insignificant association with management of inflation and macroeconomic imbalances.
Institutional Framework for Prudent Fiscal Management

• Clarity in roles of various orders of government
• Tax decentralization and no passing the buck and pork-barrel transfers
• Institutional arrangements for IGFR
• Fiscal rules and “gate-keeping” institution
• Direct democracy checks. Societal conservatism.
• Integrity and independence of financial sector
• Financial consequences of own decisions. No bailouts
Fiscal Federalism As a Bane for Fiscal Prudence

• Agency problems with incomplete contracts and undefined property rights (taxing, spending and regulation)

• Intergovernmental bargaining with high transaction costs.

• Tragedy of commons with universalism and pork-barrel politics
Fiscal federalism as a boon for fiscal prudence

• Federal policy as an insurance against asymmetric regional shocks.
• Non-cooperative collusive behavior not in regional interest
• Variety of federal instruments and Institutions of IGFR
• Regional stabilization with “rainy day umbrellas”
• Federal systems – better adapted to deal with universalism
Fiscal Policy Coordination in Mature Federations

• Institutions of IGFR: executive and/or legislative federalism

• Diversity of coordinating mechanisms and experiences – Australia, Canada and Germany

• Formal (constitutional or legislated) and informal fiscal rules
## Fiscal Rules at a Glance

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<tr>
<th>Country</th>
<th>Budget</th>
<th>Debt</th>
<th>Tax/exp</th>
<th>Ref</th>
<th>Penalties</th>
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<td>India - States</td>
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Lessons on Fiscal Rules

- Fiscal rules are neither necessary nor sufficient for fiscal discipline.
- Fiscal rules can be useful for fiscal retrenchment under multi-party coalitions but not required for successful consolidation under a single party majority rule (Canada, UK, Australia).
- Fiscal rules may impede countercyclical fiscal policy.
- Fiscal rules should apply to budgetary outcomes and not projections.
- Fiscal rules more appropriate for local governments.
- Enforcement by an independent body desirable.
Brazilian Federation – A Case Study

• 1988-1995: Teething problems with fiscal policy coordination under new federalism
• 1995 Senate fiscal rules on new debt and debt service
• 1997: Debt restructuring and state banks privatization initiative
• 2000. Fiscal Responsibility Law: ceilings on debt, deficit and personnel spending for all orders; sanctions including prison terms
• Impact: all re wage exp limits; 22/27 on debt; 92% municip. for debt; primary surplus by all.
Unitary China: unmet challenge

- Lack of clarity in roles and limited tax decentralization and abolition of agricultural income tax and rural fees and charges in 2002.
- Unfunded mandates – fees for service – lack of access to social services by rural poor
- Prohibition on local government borrowing – large hidden debts of local governments through SOEs.
Fiscal Dec and fiscal management – empirical evidence

<table>
<thead>
<tr>
<th>Fiscal performance</th>
<th>Impact of Fiscal Dec</th>
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<tr>
<td>Quality of debt manag.</td>
<td>Positive but insignificant</td>
</tr>
<tr>
<td>Quality of FP and Inst.</td>
<td>Positive significant</td>
</tr>
<tr>
<td>Eff. Revenue Collection</td>
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<tr>
<td>Prudent use of taxes</td>
<td>Positive significant</td>
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<tr>
<td>Growth of public exp.</td>
<td>Negative but insig.</td>
</tr>
<tr>
<td>Control of deficit</td>
<td>Negative but insig.</td>
</tr>
<tr>
<td>Growth of public debt</td>
<td>Positive but insig.</td>
</tr>
<tr>
<td>PSM</td>
<td>Positive but significant</td>
</tr>
<tr>
<td>GDP growth</td>
<td>Positive but insig.</td>
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</table>
Securing an economic union

• Preservation of internal common market
• Tax harmonization and coordination
• Transfer payments and social insurance
• Intergovernmental fiscal transfers
• Regional fiscal equity
• Conclusion: Federal countries do better and decentralized federal countries best performing.
Figure 3.1: Regional disparities within industrial countries

- France (1995-97)
- Italy (1995-97)
- Spain (1995-97)
- Former West Germany (1995-97)
- United Kingdom (1995-97)
- Canada (1998)
- United States (1997)

Inequality measure

- Theil index
- Weighted gini index (Gw)
- Relative mean Deviation (Rw)
- Weighted coefficient of variation (Cvw)
Figure 3.2: Regional disparities within non-industrial countries

[Diagram showing inequality measures for various countries]
Conclusions on Regional Equity

• Evidence questions claim that centralization reduces regional disparity
• Regional disparity more pronounced in countries with interventionist regional policies
• Subnational political autonomy creates political pressures against inequitable development
• Regional convergence largely attributable to removing distortions in economy
Fiscal Decentralization and Fiscal Performance – Some Conclusions

- Fiscal federalism – deeper thinking on institutional design and development
- Greater clarity in roles and responsibilities
- Greater emphasis on rules of the game and fair play
- Greater emphasis on bottom-up accountability through citizen empowerment.
- Decentralized fiscal systems better record of fiscal management than centralized fiscal systems.