

Fiscal Decentralization and Macroeconomic Performance

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Decentralization for Economic Development

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Key Issues

- Are there greater risks of macro economic 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

Country	Budget	Debt	Tax/exp	Ref	Penalties
• EU- GSP	Yes	Yes			Yes
• US States	48	41	30	3	yes
• Canada - Provinces	8	3	2	4	yes
• Germany	Yes				
• New Zealand	Yes				
• Sweden			Yes		
• Switzerland	Yes	Yes	Yes	Yes	
• Brazil, 2000- Yes	Yes	Yes	Yes		prison
• Argentina, 2004-	Yes	Yes	Yes		
• Argentina -provinces	17	17	17		
• India, 2003-	Yes	Yes			
• India - States	Yes	Yes			

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

Fiscal performance	Impact of Fiscal Dec
Quality of debt manag.	Positive but insignificant
Quality of FP and Inst.	Positive significant
Eff. Revenue Collection	Mixed but insignificant
Prudent use of taxes	Positive significant
Growth of public exp.	Negative but insig.
Control of deficit	Negative but insig.
Growth of public debt	Positive but insig.
PSM	Positive but significant
GDP growth	Positive but insig.

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

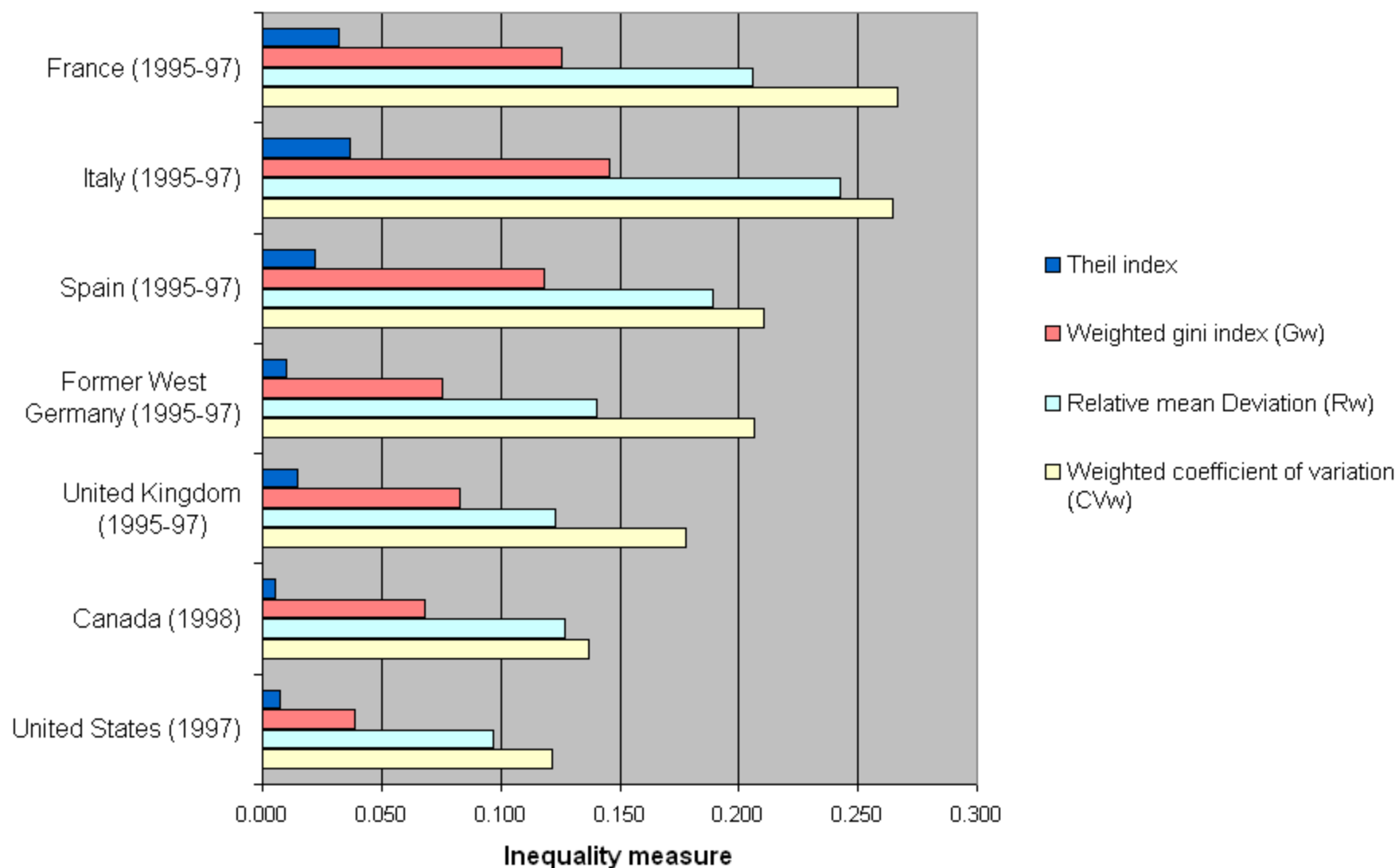
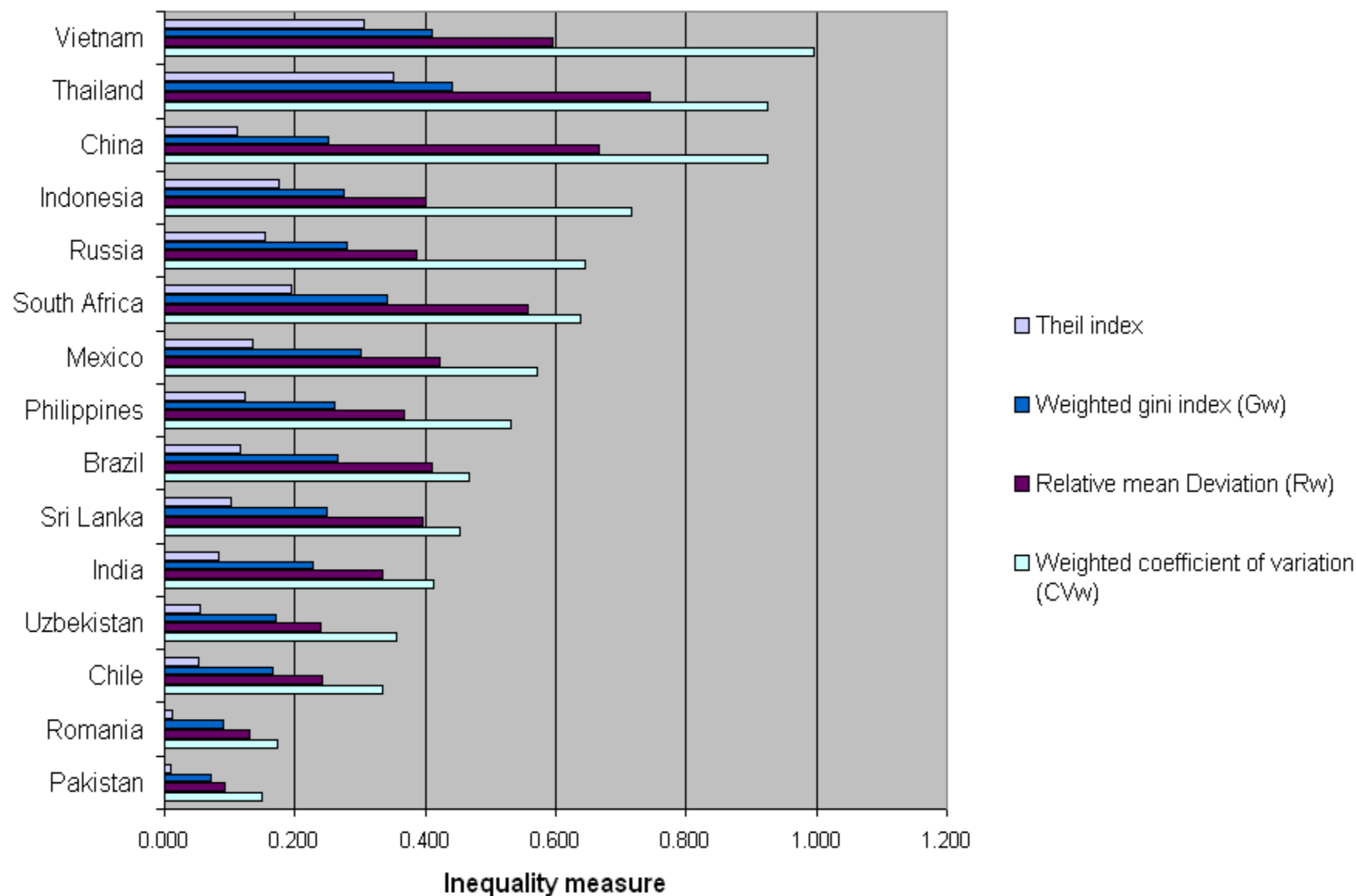


Figure 3.2: Regional disparities within non-industrial countries



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.