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Fiscal Federalism & Fiscal Policy: Bane or Boon?

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Bane:

Evidence from early developing and transition countries: Arg., Bra., Russia
(see Tanzi, Prud'homme, Ter-Minassian, Treisman,...):

- Sub-central governments don't take into account national welfare:
Common pool problems: Soft-budget constraints and Bail-outs.
Fiscal policy spillovers: insufficient stimulus, excessive austerity.
- Fiscal Federalism hinders the conduct of Fiscal Policy over the cycle:
Voracity effect: grants contribute to pro-cyclicality during the boom.
Fiscal perversity: pro-cyclical sub-central fiscal policy during busts.
- Central government also behaves opportunistically:
Politics of grants: pork-barrel and rent-seeking.
Burden shifting and Recentralization during busts.

Boon:

Evidence from recent successful reforms: Brazil, China (Shah):

- Same problems plague unitary countries.
- But federal countries more successful in reforming institutions.

Depends:

Both 1st and 2nd Generation of Fiscal Federalism:

- Problems will be mitigated by institutions:
 - Tax autonomy (Weingast, Rodden).
 - Smart assignment of taxes and responsibilities (Inman).
 - Smart grant design and debt regulation (Inman).
 - Fiscal rules & fiscal institutions (Foremny & von Hagen, Rodden & Wibbels).
- It is a problem of accountability and institutional quality (Shah, Mookherjee).

Fiscal Federalism and Pro-cyclicality: Existing evidence

1) Pro-cyclicality in federations (Rodden & Wibbels):

Sub-central expenditures are pro-cyclical

Sub-central own revenues are pro-cyclical

Inter-governmental grants are pro-cyclical:

- Rent-seeking pressures during booms (discretionary and formula)

- Central government burden-shifting during busts

- Equalization grants deal only with asymmetric shocks

- Revenue sharing linked to total tax revenues

Subnational surplus is a-cyclical, especially during booms (so higher deficits)

Federal policy is counter-cyclical or at least a-cyclical.

Fiscal Federalism and Pro-cyclicality: Existing evidence (& 2)

2) Institutional differences (Foremny & von Hagen, Sorensen, Rodden)

Unitary v. federal (EU-15):

Grants provide insurance in unitary but not in federal (EU15).

Expenditure more pro-cyclical in unitary, but grants help (EU15)

Tax autonomy:

No effects in EU-15 (but lower deficits in federal countries).

Federations of sovereigns less pro-cyclical (US, Can., Aust. v. Brazil, Arg).

Fiscal limits:

US States: fiscal policy more pro-cyclical (trade off with lower deficits).

EU-15: the same in the case of federations (no effect on the deficit), no effect in unitary countries (but effect on the deficit).

Intuition: Fiscal limits bite more in recessions than during booms.

Fiscal Federalism and Pro-cyclicality: Existing evidence (& 3)

2) Institutional differences (& 2)

Revenue volatility (Sorensen):

Sales & Property taxes less pro-cyclical / Income & Business more

Volatility makes overall fiscal policy pro-cyclical

Expenditure responsibilities (Sorensen):

Welfare: downward rigidity, less pro-cyclical in crisis.

Capital spending: easy to adjust, highly pro-cyclical.

Intergovernmental cooperation (Rodden, Shah):

Coordination of national and sub-national debt: less pro-cyclical.

Transparency and accountability: less pro-cyclical (no much evidence).

Independent grant's commission / Fiscal councils / Good government.

Case of study:

Construction revenues in Spanish local governments

Huge housing boom (Ireland, Spain): 1997-2007 (stronger 2003-2007)

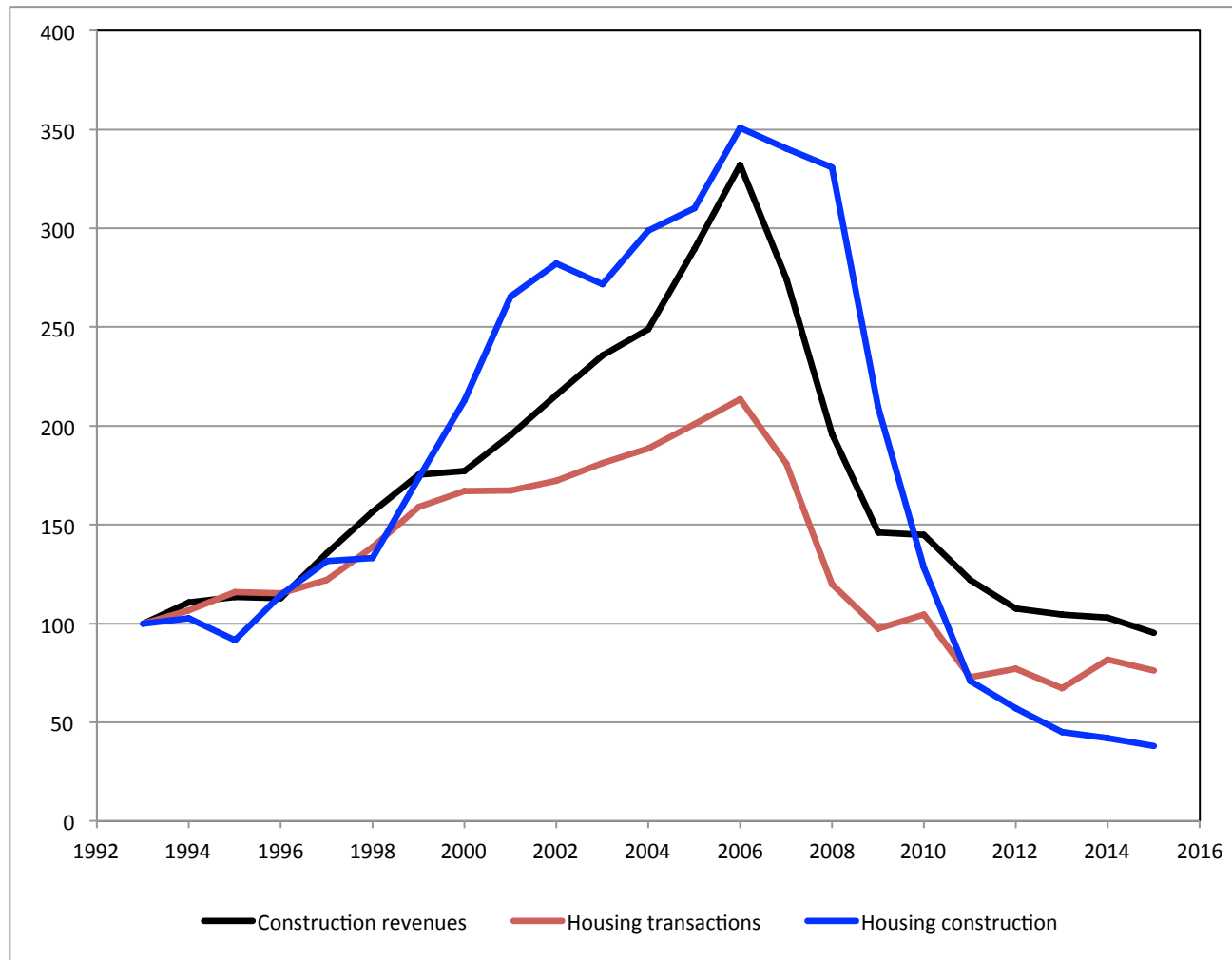
Over-reliance on taxes related to housing construction & transactions:

- VAT, Stamp duties, Land transactions, Developers' fees, Land sales
- Very volatile: receipts x 4 in 1995-2007 and vanished in 2008-11
- All layers of government affected: Central, Regional, Local

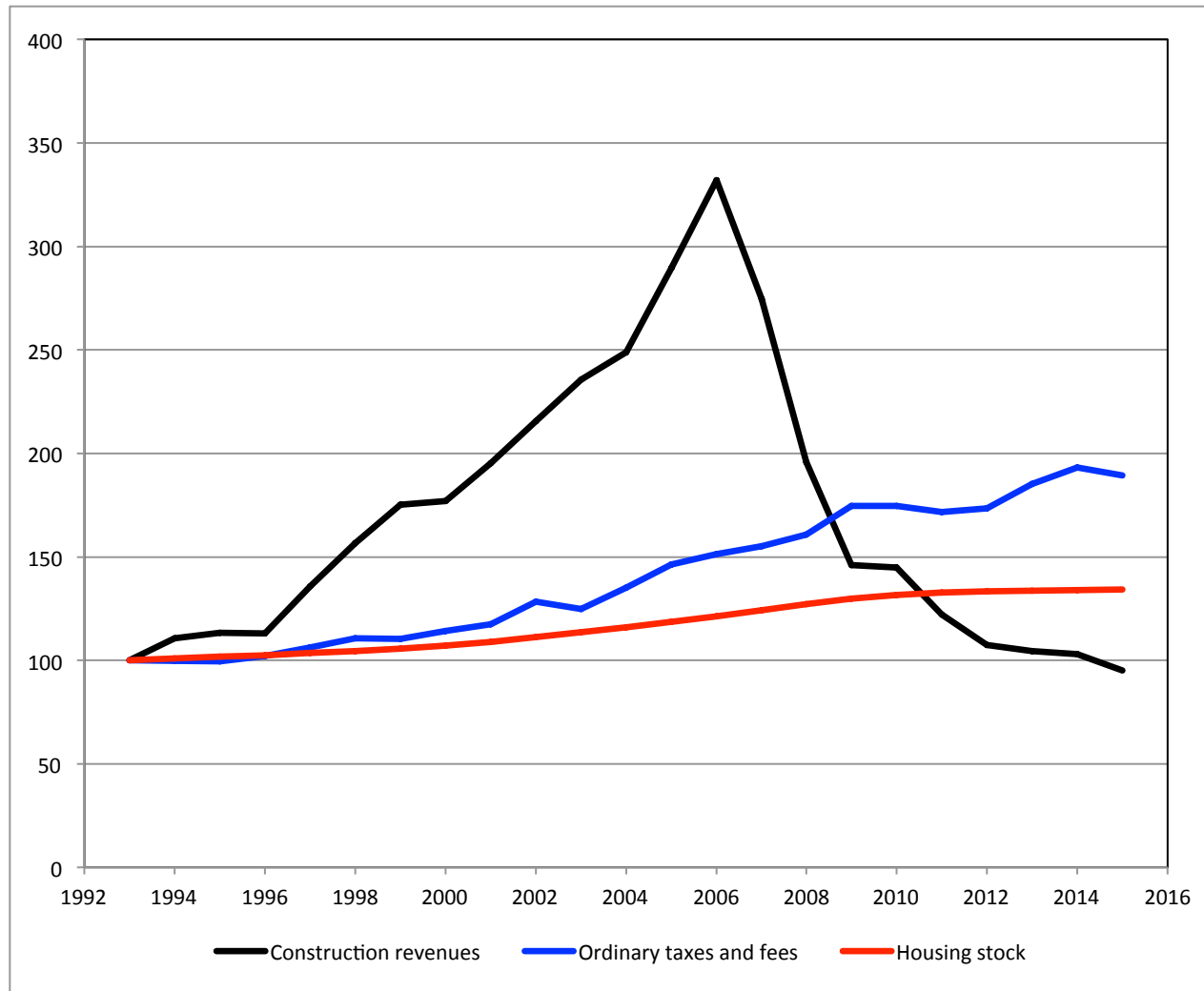
Consequences:

- Management of these revenues requires prudence:
Temporary: they should be saved or invested wisely
- Instead: over-spending during boom, painful adjustment during bust
- Solution: stabilization fund, improve transparency & accountability

Volatility of local construction-related revenues



Stability of ordinary taxes and fees



Case of study (& 2)

Effect of construction windfalls, 495 municipalities, 50 urban areas:

Results for the boom period (1995-2007), response to a 100 euro Δ :

| | Panel (a): <i>Spending</i> | | | | | |
|---------------------------|---------------------------------------|---|---------------------------------------|-----------------------------|----------------------------------|--------------------------------|
| | Δ <i>Spending</i> | Δ <i>Current</i> | Δ <i>Capital</i> | Δ <i>Wages</i> | Δ <i>Purchases</i> | Δ <i>Transfers</i> |
| <i>Windfall rev. p.c.</i> | 63.72 (2.72) ^{***} | 17.06 (1.96) ^{**} | 40.35 (2.80) ^{***} | 4.33 (1.75) [*] | 14.09 (2.12) ^{**} | 1.14 (0.21) |
| | Panel (b): <i>Revenues</i> | | | | | |
| | Δ <i>Revenues</i> | Δ <i>Taxes</i> | Δ <i>Grants</i> | Δ <i>Deficit</i> | Δ <i>Property tax</i> | Δ <i>Other taxes</i> |
| <i>Windfall rev. p.c.</i> | -37.90 (-1.96) [*] | -23.61 (-3.02) ^{***} | 1.10 (0.21) | -14.05 (-1.50) | -13.94 (-4.31) ^{***} | -7.12 (-2.05) ^{**} |

No savings: fully pro-cyclical policy during the boom (a-cyclical surplus)

Increase spending (capital: white elephants), Cut taxes (voracity?)

Case of study (& 3)

Results for the bust period (2008-11):

| | Panel (a): <i>Spending</i> | | | | | |
|---------------------------|-----------------------------------|---------------------------------|------------------------------------|---------------------------------|------------------------------|-----------------------------|
| | Δ <i>Spending</i> | Δ <i>Current</i> | Δ <i>Capital</i> | Δ <i>Wages</i> | Δ <i>Purchases</i> | Δ <i>Transfers</i> |
| <i>Windfall rev. p.c.</i> | -83.17 (-2.34)** | -4.55 (-1.50) | -78.60 (-3.15)*** | 10.63 (1.02) | -15.62 (-1.77)* | -4.60 (-1.42) |
| | Panel (b): <i>Revenues</i> | | | | | |
| | Δ <i>Revenues</i> | Δ <i>Taxes</i> | Δ <i>Grants</i> | Δ <i>Deficit</i> | Δ <i>Property tax</i> | Δ <i>Other taxes</i> |
| <i>Windfall rev. p.c.</i> | 39.58 (1.66)* | 11.93 (1.96)** | 2.43 (0.54) | 25.28 (2.26)** | 9.63 (2.14)** | 4.44 (1.92)* |

Deficit: so, policy less pro-cyclical in the bust (but difficult adjustment).

Cut spending (only capital: effect on stimulus), Raise taxes.

No insurance, No bail-outs (different for regional governments).

Case of study (& 2)

Good v. Bad government and windfalls during the **boom**:

| | Δ Spending | Δ Current | Δ Capital | Δ Taxes | Δ Deficit |
|---|----------------------------------|-------------------|--------------------|------------------------------------|-----------------------------------|
| Windfalls \times <i>Low corruption</i> | 41.70 (0.64) | 12.83 (0.15) | 18.94 (0.70) | -10.48 (-0.47) | -52.86 (-2.19)** |
| Windfalls \times <i>High corruption</i> | 81.82 (3.64)*** | 24.10 (1.98)** | 57.70 (3.20)*** | -18.41 (-3.68)*** | 1.27 (0.47) |
| χ^2 Test High-Low = 0 | 2.65 (0.10) | 2.10 (0.14) | 2.90 (0.09) | 2.91 (0.09) | 3.33 (0.06) |

Pro-cyclicality only wit bad governments

Bad government = high prevalence of corruption in the area, also low political competition, low press circulation

Similar effects in the bust.

Summary & conclusions

- Fiscal Federalism tends to have an effect on Fiscal Policy.
- The results might be: higher deficits/debt and/or more volatility.
- The devil is in the details: effects depend on many things.
 - (1) Tax base volatility, (2) Expenditure rigidities.
 - (3) Tax autonomy, (4) Fiscal limits.
 - (5) Grant design: insurance properties, transparency.
 - (6) Inter-governmental co-operation, & (7) Accountability.
- Best results: Autonomy &/or Co-operation (truly federal countries)
- Reminder: Decentralization \neq Federalism (Federalism protects Dec.)
- Good results: Unitary countries, but lose benefits of decentralization
- And perhaps at the end all depends on (7).