Debt Sustainability Analysis at Subnational Level Training

Fiscal Rules at Subnational Level

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Outline

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   why they are needed
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• Designing issues and “pros and cons” of fiscal rules
• Empirical use of fiscal rules
• Applied fiscal rules: the case of State of Alagoas
• Main references
Fiscal Rules

• **Definition**: it as an incentive scheme or mechanism which introduces for a certain period of time (medium- to long-term) constraints on main fiscal variables (revenues, expenditures, new indebtedness) using quantitative limits.

• Therefore **a fiscal rule must have**:
  - A quantitative (numerical) target or ceiling which is translated in a fiscal indicator, e.g. “a maximum debt-to-GDP rate of X”,
  - A clear procedure to monitor or enforce the implementation of the rule, and
  - An explicit cost to be incurred to the policymaker if the target is not achieved.
Why fiscal rules are needed?

- High risk that “no fiscal rules world” (unconstrained fiscal policy) would systematically deviate from desirable policies. Reasons? Coordination failures in fiscal federalism, common pool problem, time inconsistency, and myopia in politics.

- A fiscal rule should be simple, transparent, coherent with the objective, but also mindful with other goals of public policy such as not discouraging structural reforms, allowing for cyclical adjustment and avoiding “bad” adjustments, e.g. undue tax hikes and strong cuts in quality spending.

- In a decentralized context, fiscal rules need a clear definition of intergovernmental relationships [Kopits, 2001; Sutherland et al. 2005; Ter-Minassian, 2007] and are more needed when higher vertical imbalances are in place [Eichengreen and von Hagen, 1996].
Types of subnational fiscal rules

- Rules on budget balances,
- Expenditure caps,
- Ceilings on own-revenue of sub-national entities,
- Limits on the stock of debt or on the issuance of new debt,
- Restrictions on the type of expenditure that can be financed with debt (golden rule),
- Limits on the debt linked to the cost of debt service or indicators of the ability to service the debt
• In several countries, political and legal difficulties to implement fiscal rules that apply to all level of governments and the need to reestablish macroeconomic stability have given birth to some kind of SNGs debt rescheduling, usually linked to a “fiscal adjustment program”.
• It is called “contractual approach” and they have made more effective the use of fiscal rules;
• In Latin America, Argentina, Brazil and Mexico are good examples.
Step 1: Debt crisis

- Initial situation → serious debt crisis at sub-national level. The trigger for the crisis can be a lack of fiscal control at sub-national level, low level of inter-governamental transfers, high interest rates, etc. The crisis jeopardizes debt sustainability, macroeconomic stability (given the high level of public deficit) and/or provision of basic services which are allocated to sub-national level.

Step 2: Pressures mounts → fiscal adjustment and bailout

- Macroeconomic impact of SNG finances + pressing need for a fiscal adjustment drives the bailout scheme.

Step 3: Debt rescheduling becomes an option

- Bailout scheme: SNGs are allowed and/or encouraged to adhere benefiting from a debt rescheduling. This process is achieved through a formal contract; SNGs agree with some fiscal rules.
Step 4: **Conditionality and fiscal adjustment program**

- Medium- to long term-term fiscal adjustment program, including a combination of (a) reduction of expenditures; (b) increase of tax revenues and efficiency on tax collection; (c) selling of government financial and physical assets (privatization). These are fiscal rules with limits to future indebtedness and for certain items of expenditures (debt service, wage bill, etc.).

**Step 5: Agreement (contract) is signed**

- Finally, an agreement or contract is signed between the central and the SNGs. Therefore, the implementation of the fiscal adjustment or achieving of the fiscal targets becomes “contractual”. 
Fiscal Rules: Design Issues—two key trade-offs

- **Credibility-flexibility:** allowing for greater responsiveness to shocks could undermine credibility of attaining the final goal.

- **Flexibility-simplicity:** combinations of rules can relax somewhat the credibility-flexibility trade-off, at the cost of simplicity and transparency.

➔ The devil is in the details...
Fiscal Rules: Design Issues

- **Coverage** of the government sector,
- Policy coordination in federal and highly decentralized systems,
- **Legal foundation** (effectively constraining parliament’s discretion requires Constitutional amendments or qualified-majority acts),
- Possible impact of the rule on the quality of public finances (“forced” adjustments may be of lower quality).
- PFM pre-conditions:
  - Good forecasting and planning capacities (otherwise link between rule and outcome is fuzzy).
  - Accounting requirements (e.g. separate current and capital budgets if implementing a golden rule, cyclical adjustment methodology if CAB rule,...)
  - **Budgetary procedures** conducive to the rule’s smooth operation (e.g. delegation vs. commitment models of budget centralization).
  - Transparency and truthful reporting (**creative accounting if** no underlying commitment to fiscal discipline).

Based on Debrun, Xavier, and M. S. Kumar [2009].
Balanced budget rules and overall deficit limits

**Pros:**
- Overall balance pins down asymptotic properties of debt;
- Focus on indicators most relevant for short-term macroeconomic management; directly address the deficit bias.
- Can be simple and transparent (unless cyclical considerations, escape clauses, etc).

**Cons:**
- Nominal budget balance rules are procyclical by nature unless expressed in cyclically adjusted terms or “over the cycle”;
- Silent on quality of adjustment → Possible collateral damage in terms of the quality of government finances → golden rules... but golden rules complicate implementation, open door to manipulations, and do not guarantee debt sustainability.
Pros and cons of fiscal rules (II)

Debt Rules
• Place an upper limit on gross or net public debt or set a desirable debt path.
• Pros:
  – Directly tackle debt sustainability;
  – Can be transparent and simple;
  – Can accommodate large shocks if debt is comfortably below the ceiling.
• Cons:
  – Lack of controllability;
  – Can force procyclicality and undesirable responses to interest rate and exchange rate shocks if debt is close to the limit.
• Borrowing constraints generally applied at regional and local levels.
Pros and cons of fiscal rules (III)

Fiscal Rules on Expenditures
• Expenditure ceilings (nominal, % of GDP); limits on growth (nominal or real).

Pros:
– Expenditure rule tackles deficit bias at one of its main sources (remember common pool and time consistency problems);
– Translates directly into budget preparation;
– Risk of procyclicality is minimal or absent (if cyclically sensitive expenditures such as unemployment benefits are excluded from the ceiling);
– Make sense in a medium-term context (otherwise no difference with the budget itself) → foster medium-term planning.

• Cons:
– Could prevent government to target an appropriate size of PS;
– Discretion on the revenue side is not constrained → sustainability?
– Collateral damage in terms of low-quality, spending cuts;
– Lack of resilience to expenditure shocks;
– Create incentive to bias revenue projections;
– Complex to design (nominal vs. real ceilings, exclusions,...)
Pros and cons of fiscal rules (IV)

Fiscal Rules on Revenues

• Rules imposing limits on revenues with a view to:
  – Contain size of the public sector / tax burden;
  – Allocate ex-ante revenue windfalls (e.g. due to surprisingly high growth).

• Pros:
  – Can play a key role in a “starve the beast” strategy,
  – Can reduce procyclicality in good times.

• Cons:
  – Limited impact on deficit bias if not coupled with other rules,
  – Can be procyclical in case the rule targets a given revenue-to-GDP ratio (due to the progresssivity of the tax system).
Figure 1a. Number of Countries with Fiscal Rules

- All rules
- National rules

Sources: IMF fiscal rules database; and staff calculations.

Figure 1b. Number of Countries with Fiscal Rules by Type of Country Group

- Advanced
- Emerging
- Low-income

Sources: IMF fiscal rules database; and staff calculations.
Figure 2. Number of Countries with at Least one Fiscal Rule by Type of Rule, 2009

Sources: IMF fiscal rules database; and staff calculations.
Figure 4. Fiscal Rule Features by Type of Country, 2009

Sources: IMF fiscal rules database; and staff calculations.
1/ Share in country group.
2/ Index ranging from zero to one capturing the coverage of the fiscal aggregate and the strength of the enforcement mechanism.
Until the late 1990s, expansionary fiscal policies by Brazilian states, and a lack of effective controls over their borrowing practices resulted in frequent debt crises.

On three occasions—1989, 1993, and 1997—, the Federal Government had to assume and reschedule debts of several important states.

The largest operation took place in 1997, when the Federal Government restructured R$ 200 billion—about 12% of national GDP—in debts owed by 25 states, including Alagoas.
The 1997 refinancing operation refinanced Alagoas debts for 30 years.

Refinanced debt—“intra-limite” debt—carries a real interest rate of 6%, with the nominal value rising with inflation (i.e., inflation-indexed debt).

Debt service is capped at 13% of NCR; anything above that is recapitalized and added to the “intra-limite” stock. At the end of the contracts in 2028, if there are residual debt balances, the State must pay off the remainder within 10 years.

The bailout resulted in three-year rolling Programs of Fiscal Adjustment (PAFs), which set annual targets for indebtedness, primary balances, personnel spending, tax revenue, and public investment, and included structural reforms such as privatization and other public sector modernization initiatives.

The 2008-2010 PAF included the following targets:

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<tr>
<th>PAF Targets</th>
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<tbody>
<tr>
<td>Debt / NCR</td>
<td>&lt;238%</td>
</tr>
<tr>
<td>Primary Balance</td>
<td>R$ 2.1 B</td>
</tr>
<tr>
<td>Personnel Expenditures / NCR</td>
<td>&lt;60%</td>
</tr>
<tr>
<td>Revenue Collection</td>
<td>R$ 21 B</td>
</tr>
<tr>
<td>Current Expenditures / NCR</td>
<td>&lt;36%</td>
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</tbody>
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In 2000, a Fiscal Responsibility Law was enacted, enshrining hard budget constraints, and explicitly prohibiting refinancing operations between levels of government to address moral hazard created by frequent bailouts in the past.

The FRL includes the following key limits:

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<th>FRL Limits</th>
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<tr>
<td>Personnel Expenditures</td>
<td>&lt;60% NCR</td>
</tr>
<tr>
<td>Net Consolidated Debt</td>
<td>&lt;200% NCR</td>
</tr>
<tr>
<td>Debt Service</td>
<td>&lt;11.5% NCR</td>
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A multi-step approach was used to develop the sustainability analysis:

i. Assess fiscal and debt sustainably under a baseline scenario (w.r.t. FRL indicators).

ii. Assess fiscal and debt sustainably (w.r.t. FRL) under alternative reform scenarios, assuming the implementation of the WB operation and associated reform program (e.g., impact on revenues, personnel expenditures, overall fiscal outturns).

iii. Consider the impact of potential shocks to macroeconomic variables.
Policy Reform Scenario

• The sustainability analysis considers the impact of the WB operation under both the baseline and policy reform scenario.

• The objectives of reforms targeted by the operation include:
  ➢ Increasing efficiency of tax collection
  ➢ Changing pension fund policy (reducing benefits)
  ➢ Improving control of payroll outlays
  ➢ Imposing a rule to discipline salary increases
  ➢ Improving the efficiency of public investment
Alagoas: Fiscal and Debt Sustainability Analysis

Impact of Reforms → local tax revenue (relative to the baseline scenario)
Impact of Reforms → payroll expenditures (relative to the baseline scenario)
Debt Sustainability

- Sustainability (under the FRL) with and without reforms, and WB operation.

Net Consolidated Debt / NCR

- No Reform, Without WB loan
- No Reform, With WB loan
- Reform, With WB loan
- FRL LIMIT


