



MULTILEVEL FINANCE AND THE EURO CRISIS—CAUSES AND EFFECTS

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KEY FEATURES OF THE VOLUME

- Eurozone is a veritable laboratory for multilevel finance: the political economy alternative to the US—and to positive theories of local finance
 - So how did subnational levels contribute to the crisis?
 - Sharp cuts in public services, and growing regional and interpersonal inequalities—
 - Islands of prosperity attracting migration, in a sea of decaying industrial heartlands, ineffective structural adjustment and public investment strategies
- What happens within countries as a result of a shock?
 - Fault lines exposed with respect to underlying imbalances, especially magnitude and responsibility for liabilities—what role was played by “game play” across jurisdictions?
 - Pressures of adjustment—implications for effective service delivery and political sustainability?
 - Centrifugal pressures within many countries, and now reflected within the Union—with Brexit

LESSONS

- Lessons for theory and policy in European countries:
 - subsidiarity and yardstick competition;
 - effectiveness of fiscal rules and public investment strategies;
 - importance of neglected governance preconditions
- Lessons for, and sometimes from, large multi-level countries:
 - China, Brazil, India, Indonesia, Pakistan
 - But also smaller countries/islands within the sphere of dominant powers

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WHY WAS THE EUROZONE MODEL SO ATTRACTIVE?

But some limitations

ATTRACTIVENESS OF THE EUROZONE MODEL

- Seen as an alternative to the US model (normative federalism)
- Scope for “political economy” and “positive” choices
 - Yardstick competition, bounded by the political process
 - Subsidiarity with considerable flexibility on institutional arrangements and information flow
 - Fiscal rules seen as “sufficient” to maintain overall macroeconomic stability
 - Attractive for countries seeking to join EU, or interested in learning from European success stories
- Eurozone seemed to perform better than US in the period to 2008
 - Spain often praised as a model performer, meeting Maastricht debt and deficit limits
 - Greece scored well in Fiscal ROSC pre-crisis, but in reality had a very weak system of subnational information generation and management (Chortareas and Logothesis)
- Looked at very carefully by China and in Latin America

BUT UNEVEN ADJUSTMENTS TO THE SHOCK, 2008

- US seems to have recovered faster than the Eurozone
- Within the EU, non-Eurozone countries, such as the UK, recovered faster driven by financial services, but at cost of high spatial inequalities and decaying industrial heartlands
- Counter-cyclical adjustments in 2008 opened up fissures and imbalances at the subnational levels
 - Portugal and Greece found themselves in a “hole” as true extent of liabilities emerged
 - Spain, Ireland—liabilities emerged overnight, as the banking systems needed to be bailed out by public moneys
 - Growing regional disparities within countries
 - Islands of prosperity, Barcelona, Milan (and London),
 - Spatial connectivity and structural policies (highways and high speed trains) did little for lagging regions or spatial inequalities
- 2010 application of fiscal rules at subnational level—problems with asymmetric information generation (Ahmad) plus asymmetric arrangements within countries: Barcelona and Turin (Brosio, Piperno and Suarez Pandiello)
 - Emergence of game-play, with growing employment pressures, as well as stresses on public services and social safety nets
 - Centrifugal forces, especially in some Southern European countries

INSTITUTIONAL ANTECEDENTS AND POLICY INERTIA

- **Very difficult to change assignments or numbers or levels of government**
 - Germany: Föderalismus I and II, from 2004 to 2007 did not achieve much; last minute debt brake to take effect in 2019
 - Papers by Milbradt and Spahn: impact of debt brake without own-source revenues for the Länder will be severe for investment, and incentives to push liabilities to municipalities
 - As it is, IPSAS rules for treatment of PPP liabilities were opposed by German municipalities in 2004, and not adopted EC wide
 - Millefeuille in France (Garello) and similar arrangements in Italy (Ambrosanio, Balduzzi and Bordignon), reflect medieval traditions of city states—but
- **Multiple layers do not lead to a simple assignment of responsibilities or accountability through own-source revenues**
 - Incentives to maximize hiring and political influence; without accountability
 - Greece response to Troika-driven rationalization of municipal governments—push public services and hiring to off-budget centrally supported public enterprises (Chortoreas and Logothesis)

SURVEILLANCE AND POLICY FRAMEWORKS

- **Tendency to look at separate policy areas in isolation**
 - Macrofiscal
 - Decentralized spending—yardstick competition and service delivery
 - Assignment of subnational taxes
 - Equalization transfers
 - PFM (also on a box-ticking basis)
- **Spain looked very good in 2007: had followed the normative recommendations of intergovernmental reforms; prosperity; low debts and deficits**
- What went wrong?
 - **Asymmetric arrangements** led to spiraling centrifugal tendencies, as the richer regions preferred not to share their wealth
 - Exacerbating imbalances in other parts of the country with pressures on service delivery and employment, but overall centralization trends (Lagos-Peña and Solé-Ollé), leading to greater resistance in distinct regions (Catalunya)
 - **Hidden liabilities** masked by the cajas; inordinate rent-seeking; unable to address the “fight for German tourists”
 - **Excellent example:: not enough to look at the performance of individual instruments in coming to a judgement on failure of governance; and inadequacy of connectivity investments in the face of declining public services**

GOVERNANCE FAILURES

IMPERFECT INFORMATION, GAME-PLAY AND POLITICAL ECONOMY

- Imperfect information ***generates problems within countries***, as well as for ***effective Eurozone level management***
- Within countries:
 - Leads to “game play” across levels of government
 - And, between government and private contractors (leverage to re-contract, especially in high profile cases)
 - Hiding or non-recognition of liabilities in struggle for tourists (Portugal, Madeira—chapters by Fortuna and Ahmad)
 - Or use of off-budget vehicles to provide services and employment (firms for local services paid for by the center in Greece, as a response to the troika-led rationalization of local governments)
- **In extreme cases, private debt resulted in public assumption of the liabilities**
 - Ireland and Spain, 2008 on; results of poor decision making and cost-overruns

POLITICS AND STRUCTURAL CHANGES

- Long serving President of Madeira, excessive investment in “tourist” facilities
- Generating Ponzi-like liabilities that became unsustainable with the crisis
- Facilitated by weak information flows and poor monitoring
- Despite advice by the Portuguese fiscal council, major structural reforms were not enacted
 - MOF tightening by control board arrangement without structural reforms may not be sustainable

ENHANCING CREDIBILITY OF THE STATE AND ACCOUNTABILITY

- **Structural fiscal reforms needed to follow spending by all levels of government**
 - Institutions, economic classification, functions, projects, programs, outputs and outcomes
 - Manage liabilities
 - *Track using common international standards does not imply reduction in national or subnational autonomy*
- **Essential to know what was spent by each level, before ascribing results to local actions—key for yardstick discipline**
 - Essential also to know extent of liabilities (also problems with securitization of revenues)
- **Plus track the cash**, to prevent cheating and leakages
- **Key elements of a clean and effective governance model, relevant also in countries with administrative progression, rather than yardstick competition** (China—some progress along these lines)

PPPS—KICKING THE CAN DOWN THE ROAD?

- Very easy to use as a means of postponing reckoning and avoiding debt limits
- Pass the buck also to future administrations
 - Also other jurisdictions
 - The Center carries the can if there are no “own-source revenues”, whether in Saxony, Madeira or a Chinese province
- Prior to the European crisis—tightening of IPSAS rules
 - Who owns the assets?—should guide provisioning
 - **Resisted in EU, as it would add to deficits and debt** (Germany was the main culprit)
- **Important to have uniform coverage of budget and recording of liabilities, e.g., IMF’s 2001/14 GFSM framework**
 - Does not imply subservience of subnational governments to the IMF, or even to Brussels
 - Makes judgements easier for politicians and the public

CREDIBILITY AND RISK-MITIGATION

- **Impartial arbiters between firms and governments** (lessons from failures of PPPs in the UK—e.g., London Underground)
 - Incentives to renege and renegotiate contracts around election time (Indian examples relevant for EU)
 - Asymmetric information—has to be addressed within an acceptable international standard (not just for inclusion of information in the GFS yearbook)
 - Political power with high profile projects (possible rent-seeking as well)
- **Subnational governments also cannot be trusted to finance debt without adequate own-source revenues**

MANAGEMENT OF INVESTMENT ACROSS LEVELS OF GOVERNMENT

- **The role of urban “hubs” is critical in the sustainable growth agenda**
- Interface between local governance and improved connectivity, investments by higher levels, and access to credit (research in the EU, Chile and China)
 - Major road (EU structural funds) and high-speed rail links to Southern Italy and Southern Spain did not have much impact on depressed regions
- The role of the Olympics in Barcelona and Turin (Brosio, Piperno, Pandiello):
 - Barcelona: very successful in regenerating decaying city, good linkages, access to credit facilitated by own-source revenue handles and local willingness to pay
 - Turin less successful: easier access to Milan as northern “hub”, as old industries continue to decline
- **In general, with long-term investments, important to ensure continuity, even at the cost of “loosening” the subnational fiscal rule (Minervini and Vinella)**

SOME LESSONS

Including for China, India, Pakistan, other multilevel countries,
and from China or South Asia

ISSUES WITHIN COUNTRIES AND ACROSS THE EUROZONE

- **Within country agenda remains in virtually every country**, including Germany (unfinished business from 2004-2007)
- **Macro stabilization without structural reforms unlikely to be sustainable**
 - **Make public investment more effective**
- While institutional and political arrangements will vary across countries, the **importance of standardized information is critical**
 - Yardstick competition within countries, but also across countries
 - Local government must be seen to be taking responsible decisions, and not passing the buck to the center, other countries or the EC, or future generations
- **Adopting say the GFSM2014 or IPSAS 32 does not limit autonomy**, but
 - will help with the establishment of greater local accountability, whether in Germany or Greece or China
 - But again, not enough in isolation

ARE THE ASSIGNMENTS RIGHT?

- **Spending responsibilities are often opaque and overlapping but hard to correct**
 - Very little scope for either accountability or yardstick competition
 - But disentangling spending without addressing revenue assignments risks unfunded mandates (Pakistan, 18th Amendment)
 - Rationalization of assignments in Germany failed during the period 2004-8
 - Some of the minimum social benefits cannot be handled at the lower levels (critical issue in China, with pensions)
- **Schisms with asymmetric assignments**
 - open up demands from other well-off regions, resulting in less resources for the poorer jurisdictions and
 - reduced ability of the center to ensure minimum standards of public services
 - Separatist tendencies with distinct populations, from Spain to the UK

ARE THERE TOO MANY LEVELS OF GOVERNMENT?

- **Attempts to rationalize levels of government in Spain and France have had limited success** because of the political power of the intermediate tiers
 - Some progress in Italy, given the extent of the crisis
- Numbers of municipalities in Greece were reduced under the Troika, but
 - employment was protected through the public service companies, subsidized by the center—to maintain employment even if service delivery deteriorates
- On the other hand, **creation of regional tiers to handle investments in England and Portugal failed in the past fifteen years**—may need to be revisited
- Important to **rationalize the “responsible” government levels in countries like China**, but also Chile, where the investment needs of “sustainable hubs” are critical

IMPORTANCE OF SUB-NATIONAL OWN-SOURCE REVENUES

- Critical for **accountability, but also responsible access to credit**
 - Potential problem with the German debt brake (unlike Swiss cantons, Länder lack own-source revenues, (see Milbradt, Spahn)—increasingly an issue in China)
 - Inappropriate design of intergovernmental transfers can exacerbate the disincentive effects
 - May override tax handles, should they exist
- **Appropriate sources of subnational own-source revenues a complex issue—as** revenue sharing operates like a transfer over which the jurisdiction has no control
- **Indexation of property tax could generate perverse incentive effects,** although a buoyant base is critical

IMPORTANCE OF STANDARDIZED INFORMATION FLOWS

- **This is critical for accountability**
 - Yardstick competition cannot work without full information on what was spent by whom and what are the attributable results
 - As well as for macro-economic management at both national and EC levels
- **Operations of layers of government need to be reported on a standardized basis**
- **China has gone further with adopting GFSM 2001/14 than EU countries**, but not yet accruals and full sub-national balance sheets, but progress is positive

CAN SUBNATIONAL FISCAL RULES WORK? PRECONDITIONS IMPORTANT

- **Critical preconditions** (Ter-Minassian)
 - Binding rules require own-source revenues as well as
 - Standard and timely information on government operations (spending as well as revenues and liabilities)
- **Problems with**
 - Publicly own-enterprises
 - PPPs
 - Arrears and window dressing
 - Financial derivatives (Italy, Portugal and Greece, use of derivatives severely curtailed)
- **Fiscal compact: how to handle investment without severely hampering growth** (Minervini and Vinella)
 - Structural balances are difficult to track even at the national level, almost impossible at the sub-national level
 - May damage investment and growth potential, and the future prosperity of the Euro area.

POLITICAL ECONOMY CONSTRAINTS

- **How much adjustment before there is loss of political support?**
 - Loss of benefits, as well as sharp rise in unemployment, particularly among the youth
 - Cuts in investment threaten longer term growth in jobs
 - Refugees and immigration from turbulent neighboring regions also pose challenges
- **Challenge remains to regenerate the productive potential and employment prospects of sustainable growth**
- **Search for public investment and connectivity to generate new growth hubs**
 - Can make matters worse without corresponding improvements in service delivery and effective employment generation
 - Better service delivery requires a full package of multilevel structural reforms
- **But this brings us back to the political economy constraints and feasibility of the reforms**

CONCLUSIONS

- **Macroeconomic stabilization at the country level without genuine multilevel structural reforms is only likely to paper over the cracks, or kick the can down the road**
 - Rationalization of levels and functions of government; interactions between levels for sustainable investment
 - Own-source revenues and equalization for responsible governance and creating a level playing field for investment and growth
 - While public investment and connectivity are crucial, not typically part of the “intergovernmental calculus” but needs to be included
- **Full information on budgets and liabilities, and outcomes in order to stop “game play”** and provide the basis for “yardstick competition” or effective administrative progression
 - Ironically may become easier to implement in Eurozone post-Brexit, and even more critical
- **Institutions and governance to stop cheating and rent-seeking**

CONCLUSIONS

- **Eurozone with Brexit needs strengthening**
- **The European project remains valid** in an increasingly competitive world
 - Tightening of information flows and reporting requirements does not damage national autonomy but critical in maintaining a common market/currency union
 - Political economy of institutional adjustment may have to be country-specific
 - Proper integration of investment and connectivity with “sustainable hubs” to address spatial inequalities
- **Lessons for other large multilevel countries/regional groupings:**
 - China, India, Indonesia, Pakistan and Brazil, as well as the GCC building on regional synergies
 - But also smaller countries like Cyprus, within the economic spheres of larger economic areas