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
Introduction: how multi-level finance has contributed to the crisis and is affected by it
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PART I MANAGING SUB-NATIONAL LIABILITIES IN EUROPE

1 Promoting stabilizing and sustainable sub-national fiscal policies in the Euro area
Teresa Ter-Minassian

2 Political economy of information generation and financial management for sub-national governments: some lessons from international experience
Ehtisham Ahmad

3 History of the constitutional debt limits in Germany and the new ‘debt brake’: experiences and critique
Georg Milbradt

PART II INCIPIENT PROBLEMS IN THE BIGGEST COUNTRIES IN EUROPE

4 Multi-level finance and the Euro crisis: the German experience
Paul Bernd Spahn

5 French sub-national public finances: on the difficulty of being a decentralized unitary state
Pierre Garezzo
PART III  THE TROUBLED COUNTRIES OF SOUTHERN EUROPE

6  Economics and politics of local Greek government  
   Georgios Chortareas and Vassiletos E. Logothetis  
   133

7  Portugal’s multi-level finance adjustments within the sovereign debt and Euro crises  
   Mário Fortuna  
   148

8  Multi-level finance and governance in Spain: the impact of the Euro crisis  
   Santiago Lago-Peñas and Alberto Solé-Ollé  
   175

9  Economic crisis and fiscal federalism in Italy  
   Maria Flavia Ambrosanio, Paolo Balduzzi and Massimo Bordignon  
   212

PART IV  CITIES, THE OLYMPICS AND GROWTH

10  A tale of two cities: the Olympics in Barcelona and Turin  
    Giorgio Brosio, Stefano Piperno and Javier Suarez Pandiello  
    249

PART V  ACCESSION STATES

11  The impact of the global crisis on Macedonian local governments  
    Marjan Nikolov  
    277

PART VI  SOME GENERAL LESSONS

12  Clientelistic politics and multi-level finance: some implications for regional inequality and growth  
    Alex Mourmouras and Peter Rangazas  
    299

13  Incentives facing local governments in the absence of credible enforcement  
    Leo Fulvio Minervini and Annalisa Vinella  
    326
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 (Briosio, 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)
• 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.
• **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
• **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