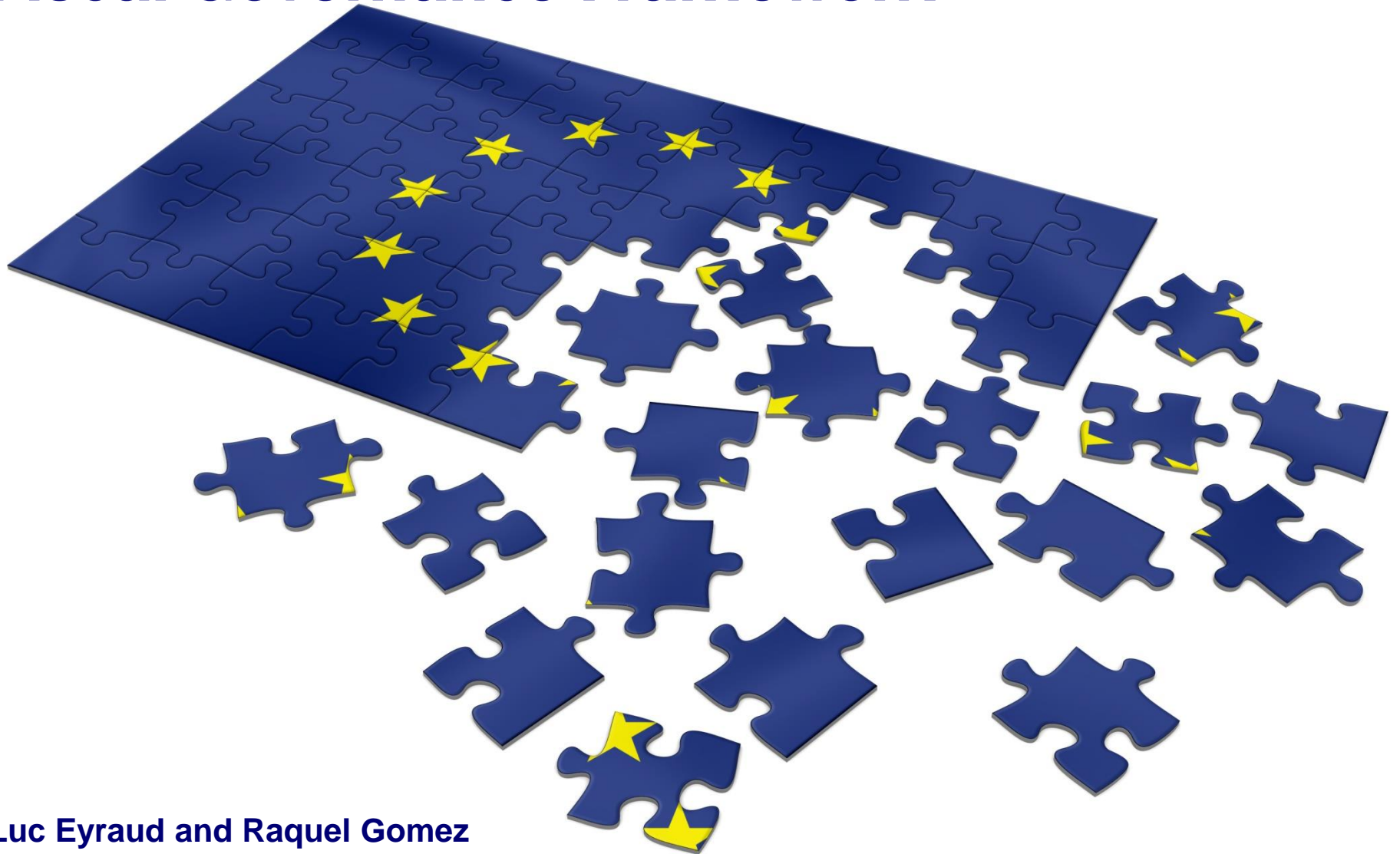


# A Comparative Perspective on the European Fiscal Governance Framework



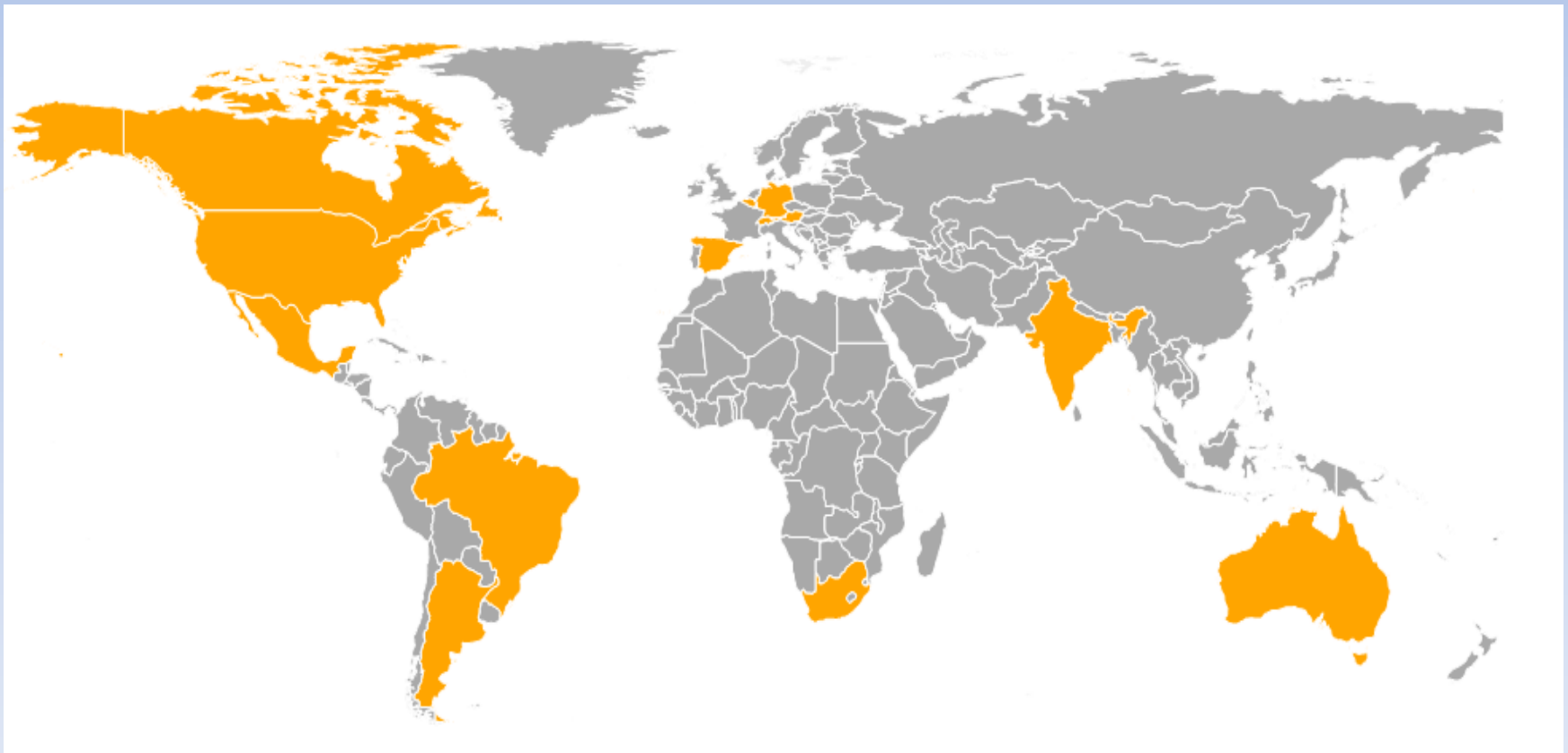
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May 24, 2013

# Introduction (1)

- IMF is preparing comprehensive study on **the functioning of federations**. All dimensions covered: tax & spending assignments, transfers, subnational borrowing, crisis resolution...
- **Lessons for Europe** and fiscal union
- This presentation focuses on fiscal governance: **constraints imposed on subnational fiscal targets** in federations ( $\neq$  procedures)

## Introduction (2)

- Analysis of **13 federations**: ARG, AUS, AUT, BEL, BRA, CAN, DEU, IND, MEX, ZAF, ESP, CHE, USA
- Comparison with EU fiscal governance framework

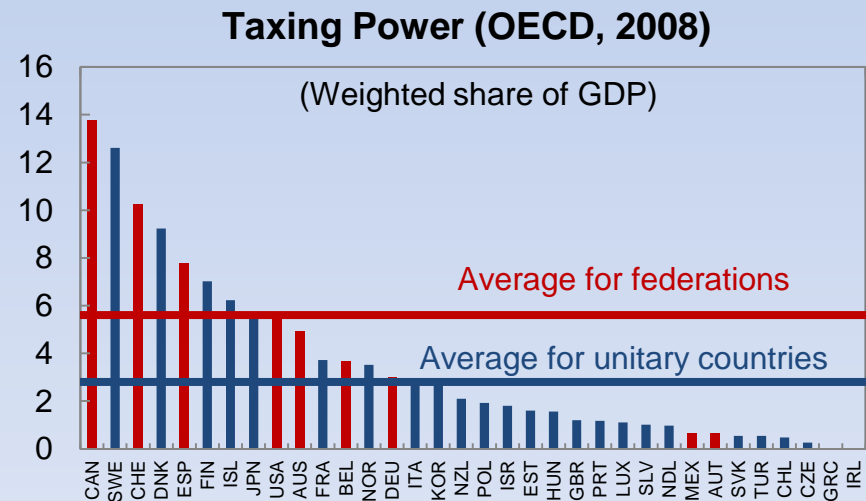
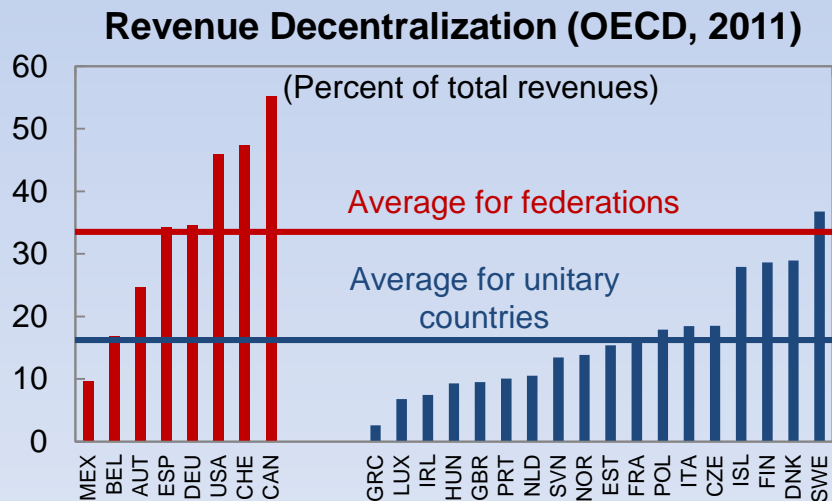


# Overview

- I. Rationale and typology of subnational constraints
- II. Analysis of constraints in 13 federations
- III. Comparison with EU governance framework
- IV. Lessons

# Rationale for SNG Constraints in Federations (1)

- SNG have greater spending and tax powers in federal than unitary countries...
  - Account for larger share of GG
  - Have more control over tax and expenditure
  - SNG autonomy is at the heart of the federal contract



# Rationale for SNG Constraints in Federations (2)

- ...and SNG autonomy may be detrimental to GG performance:
  - Deficit bias: soft budget constraint & common pool
  - Coordination failure
  - Probably more acute in federations
- → Constraints have mainly two objectives
  - Enforce and signal fiscal discipline
  - Strengthen coordination across government levels

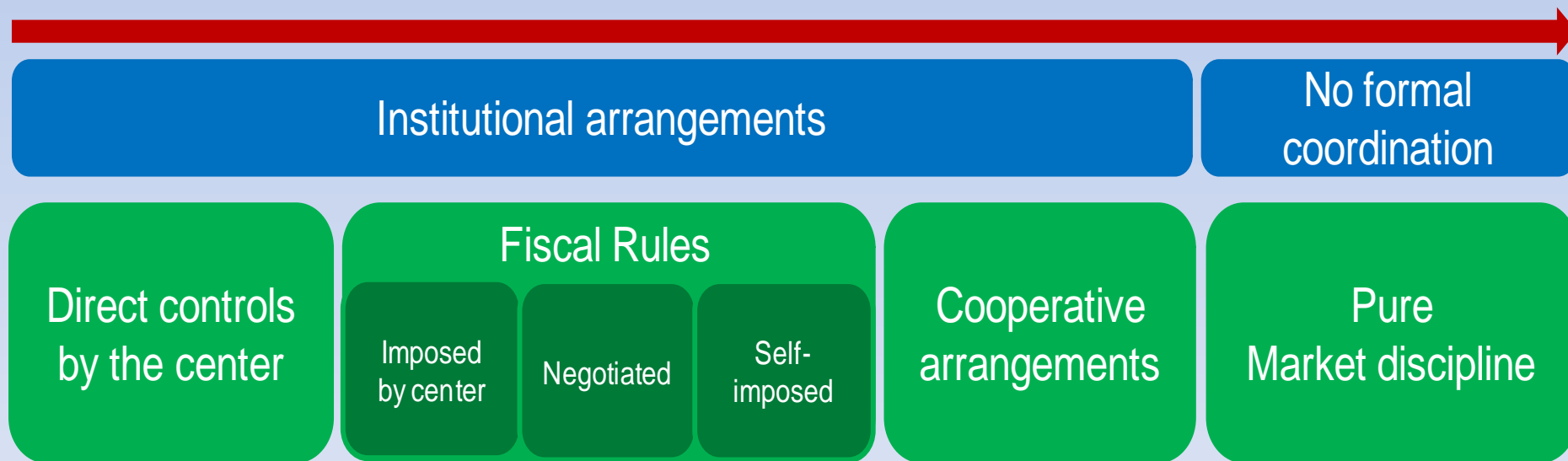
# Rationale for SNG Constraints in Federations

## (3)

- **Typology** of arrangements to constrain subnational fiscal policy

Less sub-national autonomy

More autonomy



# 13 Federations: Type of Constraint (1)

- **Fiscal rules** are the most common constraint; **cooperative approaches** seem to loose ground; **direct controls** are rare

**Institutional Arrangements: Types and Number**

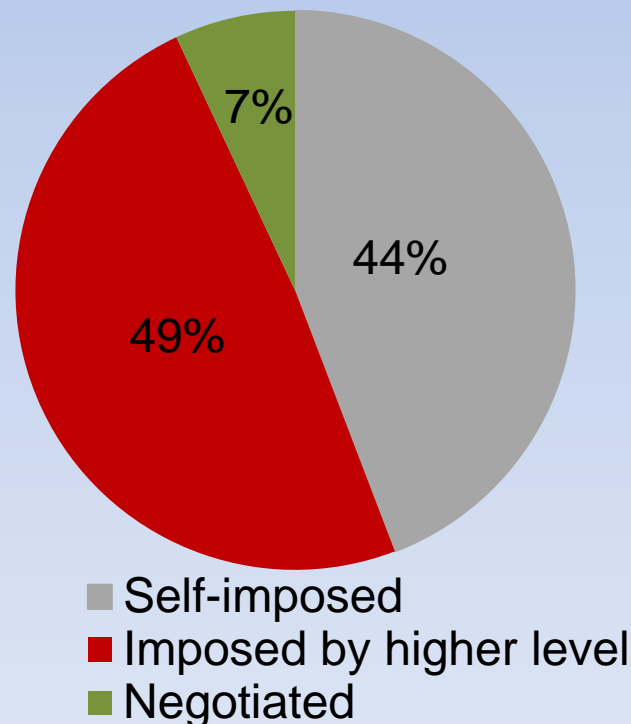
	Fiscal rule	Direct control	Cooperative approach
Argentina	3	...	...
Australia	3	...	1
Austria	1	...	1
Belgium	1	...	1
Brazil	3	...	...
Canada	3	1	...
Germany	3	...	...
India	4	1	...
Mexico	2	...	...
South Africa	2	...	...
Spain	6	...	...
Switzerland	5	...	...
United States	5	...	...



## 13 Federations: Type of Constraint (2)

- About half of the **rules** are **self-imposed** by SNG

### Origin of Fiscal Rules on Subnational Governments



## 13 Federations: Type of Constraint (3)

- **Market discipline** is somewhat **different** from institutional constraints
  - More difficult to quantify
  - Broader scope
  - Additional to other constraints
- Purely market-based discipline remains atypical.  
**Coexistence of market and institutional controls**  
(also in emerging countries)

# 13 Federations: Fiscal Aggregate (4)

- Constraints on **budget balance** more prevalent and growing, including cyclically-adjusted
- Constraints on **debt** and **borrowing** also common

## Fiscal Indicator Targeted by the Institutional Arrangement

	Fiscal Balance			Borrowing	Debt		Expenditure		Revenue
	Overall balance	Golden rule	Structural balance		Debt stock	Debt service	Aggregate	Subcomponent	Tax ceiling
Argentina		x				x	x		
Australia	x			▲	x		x		
Austria	▲	x							
Belgium	▲/x								
Brazil				x	x			x	
Canada	x			o	x		x		
Germany	x		x	x					
India	x			o	x	x			
Mexico				x					
South Africa	x			x					
Spain	x		x		x	x	x		
Switzerland	x	x	x				x		
United States		x		x	x	x	x		x

# 13 Federations: Sanctions/Corrective Actions (5)

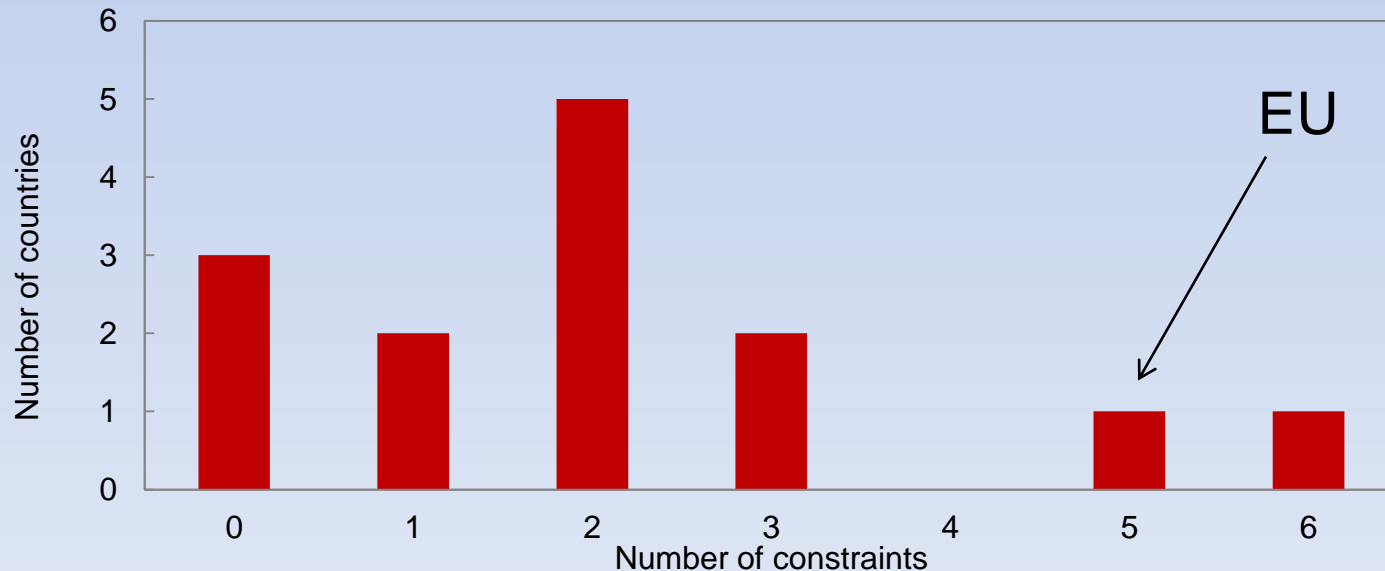
- Mechanisms to deal with **non-compliance**:
  - **Escape clauses** for exceptional events (macro shocks, emergency, natural disasters)
  - Financial and administrative **sanctions**
  - Range of **corrective actions**: from justification (Australia) to borrowing restrictions (Belgium, India), rebalancing plans (Germany) and possibility to take regions under central administration (Spain)

# EU Supranational Rules (1)

Main **differences**:

(1) Federations tend to impose a **smaller set of rules**: 5 rules in Europe (deficit, debt, expenditure, MTO, structural BBR) vs. 2 on average in federations

**Number of Countries with Federal Constraints on Subnational Governments**



# EU Supranational Rules (2)

## (2) Multi-step approach of EU rules

### Multi-step Approach with EU Fiscal Rules

Stage 1	Stage 2		Stage 3	
(Main rule)	(If noncompliance with main rule)		(If insufficient effort to correct the breach)	
	Sanctions	Corrective Actions	Sanctions	Corrective Actions
Overall deficit of the general government below 3% of GDP	→ Non-interest bearing deposit	EDP with annual fiscal effort of at least 0.5 percent of GDP in structural terms	→ Fines	
Country specific MTO in structural terms	→	Annual efforts of at least 0.5 percent of GDP to reach MTO	→ Interest-bearing deposit if significant deviation	
Annual growth of general government primary expenditure below potential GDP growth	→ Interest-bearing deposit if significant deviation			
Financial debt of the general government below 60% of GDP	→	1/20 <sup>th</sup> debt rule (starting 3 years after EDP)	→ Interest-bearing deposit	An EDP can be opened

Balanced budget rule

Medium-term objective

Expenditure benchmark

Debt rule

## EU Supranational Rules (3)

- (3) Supranational requirements enshrined in **national legislation**
- (4) **Subsidiarity** principle: EU rules apply to GG, with countries responsible for distributing the target internally
- (5) Less stringent **enforcement mechanisms**
- Sanctions only apply to euro-area member states
  - Sanctions are mild compared to federations
  - Corrective actions are weaker; no direct controls

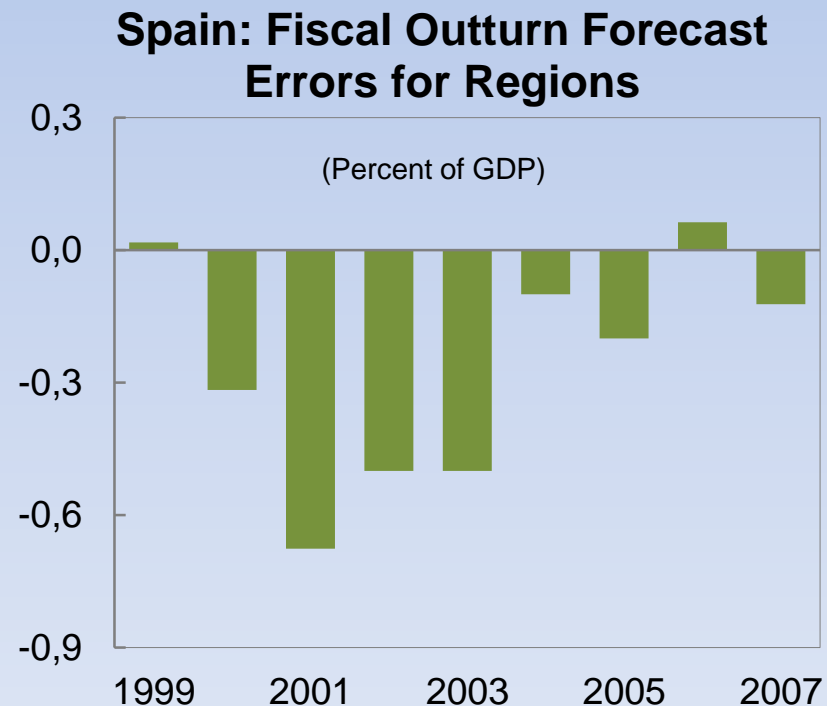
# Effectiveness of SNG Constraints (1)

- **Institutional constraints do work!**
  - Literature mostly on the US
  - Methodological hurdles
  - Large evidence that fiscal constraints on US states are effective
  - Does it apply to other federations?
- And they have a positive **impact on market perceptions**
  - Bond market reaction to state deficit smaller if states have BBR
  - Are fiscal institutions and market discipline substitutes? Or fiscal institutions have only signaling effect of commitment to fiscal prudence?



## Effectiveness of SNG Constraints (2)

- But subnational constraints **cannot substitute for properly designed system of intergovernmental fiscal relations**



## Effectiveness of SNG Constraints (3)

- Constraints necessitate a **clear commitment from the central government to enforce them** (no bailout expectations)
- Eliminating bailout expectations is not an easy task

# Conclusions

- EU vs. 13 federations
- Some similarities: **reliance on fiscal rules**
- **Important differences**: larger set of constraints; subsidiarity; sanctions and corrective actions are weaker
- Based on historical evidence, **fiscal federations seem to rely on strong enforcement mechanisms** rather than large number of rules