Comments on Fiscal risk management and Fiscal decentralization

Motohiro Sato
Hitotsubashi University
Issues and Challenges
What is challenge?

- How to reconcile fiscal risk management to secure fiscal sustainability and fiscal decentralization that grants more autonomy of policy decisions to local level government?

  ✓ Attention cannot be paid only to the central budget to fulfill fiscal sustainability given that intergovernmental transfers create close linkage between the central and local budget

- Intergovernmental transfers as risk sharing or as soft budget

- Fiscal decentralization generates own benefit (known as the decentralization theorem) but can make fiscal risk management difficult as local governments may pursue different objectives than the central government.

- Fiscal decentralization increasing the number of stakeholders/policy decision makers as a source of coordination failure?

  ✓ Local governments may act to undermine the central fiscal management effort by overspending and/or borrowing
## Intergovernmental Fiscal Relation in Japan

Fund flow from the central to local government in Japan (2012)

<table>
<thead>
<tr>
<th>Central General Account (trillion yen)</th>
<th>Special Account for LAT (trillion yen)</th>
<th>Local Public Finance Program (trillion yen)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Revenue</strong> (90.3)</td>
<td><strong>Revenue</strong> (81.9)</td>
<td><strong>Revenue</strong> (81.9)</td>
</tr>
<tr>
<td><strong>Expenditure</strong> (90.3)</td>
<td><strong>Expenditure</strong></td>
<td><strong>Expenditure</strong></td>
</tr>
<tr>
<td><strong>Revenue</strong></td>
<td><strong>Revenue</strong></td>
<td><strong>Local Taxes</strong> (33.7)</td>
</tr>
<tr>
<td><strong>Expenditure</strong></td>
<td><strong>Expenditure</strong></td>
<td><strong>Labor Cost</strong> (21.0)</td>
</tr>
<tr>
<td>National Taxes (42.3)</td>
<td>National Debt Service Payments (21.9)</td>
<td>Local Transfer Tax etc (2.3)</td>
</tr>
<tr>
<td>Local Allocation Tax (16.6)</td>
<td>Special Accounts (16.6)</td>
<td>Other Current Expenditure (31.1)</td>
</tr>
<tr>
<td>General Expenditure (51.8)</td>
<td>Local Allocation Tax (17.5)</td>
<td><strong>Local Allocation Tax</strong> (17.5)</td>
</tr>
<tr>
<td>National Bond (44.2)</td>
<td>Special Grants (0.1)</td>
<td>Local Debt Service Payment (13.4)</td>
</tr>
<tr>
<td>Others (3.7)</td>
<td></td>
<td><strong>National Subsidies</strong> (11.8)</td>
</tr>
<tr>
<td><strong>General Expenditure</strong></td>
<td></td>
<td><strong>Local Bond</strong> (11.2)</td>
</tr>
<tr>
<td><strong>Central General Account</strong></td>
<td></td>
<td><strong>Others</strong> (5.4)</td>
</tr>
<tr>
<td><strong>Special Account</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Local Bond Program</strong></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

The central and local budgets are closely related.
Macro and micro of fiscal risk management

- Fiscal risk management is to assure fiscal sustainability of “consolidated government budget” that encompasses both the central and local budgets.

- Macro=Overall expenses must be contained and tax efforts must be enhanced
- How to secure inter-governmental coordination for fiscal risk management?
- Micro=Scarce financial resources need to be devoted to must valued use.
- Fiscal decentralization can improve micro-efficiency of budgetary allocation to make it more suitable to residents’ needs.
  - economize use of financial resources which in turn works to ease fiscal consolidation/ risk management.

- Fiscal decentralization can be supplementary to fiscal consolidation at the macro level
Fiscal Consolidation and Fiscal Decentralization

Transfer cut
As a part of fiscal consolidation

Decentralization theorem
= Local governments are more capable to allocate scarce budget to make it suitable to local needs/preference.

Post consolidation budgetary allocation
Under the centralization

initial budgetary allocation
Under the centralization

Fiscal decentralization

Central mandate

Local residents’ Well-being

$X = Health care

$Y = Public Projects

0
Fiscal decentralization; curse or cure?

- Fiscal decentralization work as Cutting-edge
  - Role and consequence of intergovernmental transfers

- Intergovernmental transfers can be used (i) as spending power to enhance intergovernmental policy coordination and (ii) as risk sharing device to secure equitable provisions of public services.

- Intergovernmental transfers may soften local budget bailing out indebted local governments.
  - Local debt as contingent fiscal liability of the central government
  - The central government as last resort

⇒ In anticipation of such bailout, local governments will over-spend and over-borrow, which undermines fiscal management effort.
Formal versus informal authority

- In the context of developing economies, distinction should be made between formal/de jure and real/de facto authority.

- In formal or legal arrangement, local borrowing is regulated or prohibited in many countries.

- De facto, local governments find loophole to circumvent the central regulation through special account or related/affiliated companies.

  - Ex: Local off/extra budget in China

  - Focus should be on real power of local governments in borrowing rather than statutory statement.

- Local borrowing may be hidden and accumulated over times which once being revealed, lead to macro economic turmoil.
Policy implication
Coordination of fiscal risk management/consolidation

- There needs the central initiative to establish intergovernmental coordination of fiscal risk management/consolidation.
  
  - Numerical target on consolidated (primary) fiscal balance and requirements on local governments to make their budgets consistent with such target.
  
  - Effective monitoring to assure compliance on the target.

- Local budgets should be balanced or golden rule should be on local borrowing, i.e., no deficit financing bond.

- Intergovernmental transfers should be adequate and stable to secure standard local spending so that local governments do not have to rely on borrowings.
Hard budget

- Local government should face hard budget
  - Transfers need to be formula based to minimize the central discretion on ex post allocation of the transfers.
  - The central government may retain transfers to indebted local government and force the transfers to direct their debt repayment.
  - The expectation for the ex post bailout must be removed.
- Local governments should possess tax autonomy and responsibility to raise tax rate on own tax bases such as property tax to finance own discretionary spending more than the national standard
  ⇒ Fiscal responsibility on margin
  ✓ Example: UK council tax
Fiscal consolidation/risk management rule?

- Ex post bailing out can be made rule based.
  - Ex. Sovereign debt reschedule rule
- The central government sets **guideline/standard** to rescue local governments that include mandatory expenditure cut and local tax increase as condition of fiscal rescue.
- There can be in place **objective/numerical thresholds** on fiscal deficit/accumulated debt relative to local own revenue/debt repayment cost that trigger the central intervention.
  - **Early warning**/ yellow card scheme as part of fiscal rule
- Prior to the central intervention stage, there can be early warning on fiscally troubled local governments according to the certain thresholds to request fiscal consolidation effort including consolidation plan and report on its implementation
  - Rx: Japan local government fiscal consolidation act
Information collection and disclosure

- Local governments may hide their (de facto) borrowing in off/extra budgetary accounts and/or in special/affiliated companies.

- Scope of the central regulation and monitoring on local debt should be extended to these accounts and companies.
  - Establishing consolidated accounting.
  - Both explicit and implicit/contingent local debt liability need to be accounted for.
  - Reform of local accounting system to recognize contingent liability as future pension payments to own officials may be necessary.
  - Attention should be on both (i) flow=deficit and (ii) stock= accumulated local debt liability.
  - Debt hangover and trigger of fiscal crisis.

- Data on consolidated debt of local government should be published on timely basis.
<table>
<thead>
<tr>
<th>Early warning limit</th>
<th>Prefecture</th>
<th>Municipalities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real deficit ratio</td>
<td>3.75%</td>
<td>11.25〜15% (depending on fiscal size)</td>
</tr>
<tr>
<td>Consolidated real deficit ratio</td>
<td>8.75%</td>
<td>16.25〜20% (depending on fiscal size)</td>
</tr>
<tr>
<td>Real debt payment ratio</td>
<td>25%</td>
<td>25%</td>
</tr>
<tr>
<td>Future burden ratio</td>
<td>400%</td>
<td>350% (government-designated cities: 400%)</td>
</tr>
</tbody>
</table>
Comments on the papers....