Developments of Fiscal Responsibility Rules in Federations

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Focus of the Project

- Fiscal Responsibility:
  - Sustainable Public Finances
  - Responsible Spending
- Fiscal Accountability:
  - Political Accountability
  - Relations between tiers of government
- Fiscal Transparency:
  - Information flows and proper management
- Importance regarding an underlying notion of fiscal exchange, i.e., tax honesty affected by what taxpayers get in exchange.

Origin of this Project

- Recent changes in federations intended to improve fiscal outcomes along these three lines.
- Germany: Federalism Reform II with the introduction of a new debt regime.
- Switzerland: Debt brakes and reform of fiscal federalism.
- Brasil: Fiscal Responsibility Law
- Nigeria: Fiscal Responsibility Act

Outline of the Presentation

- The German Case
- The Swiss Case
- The Brazilian Case
- The Nigerian Case
- Where Do We Go from Here?

The German Case 1

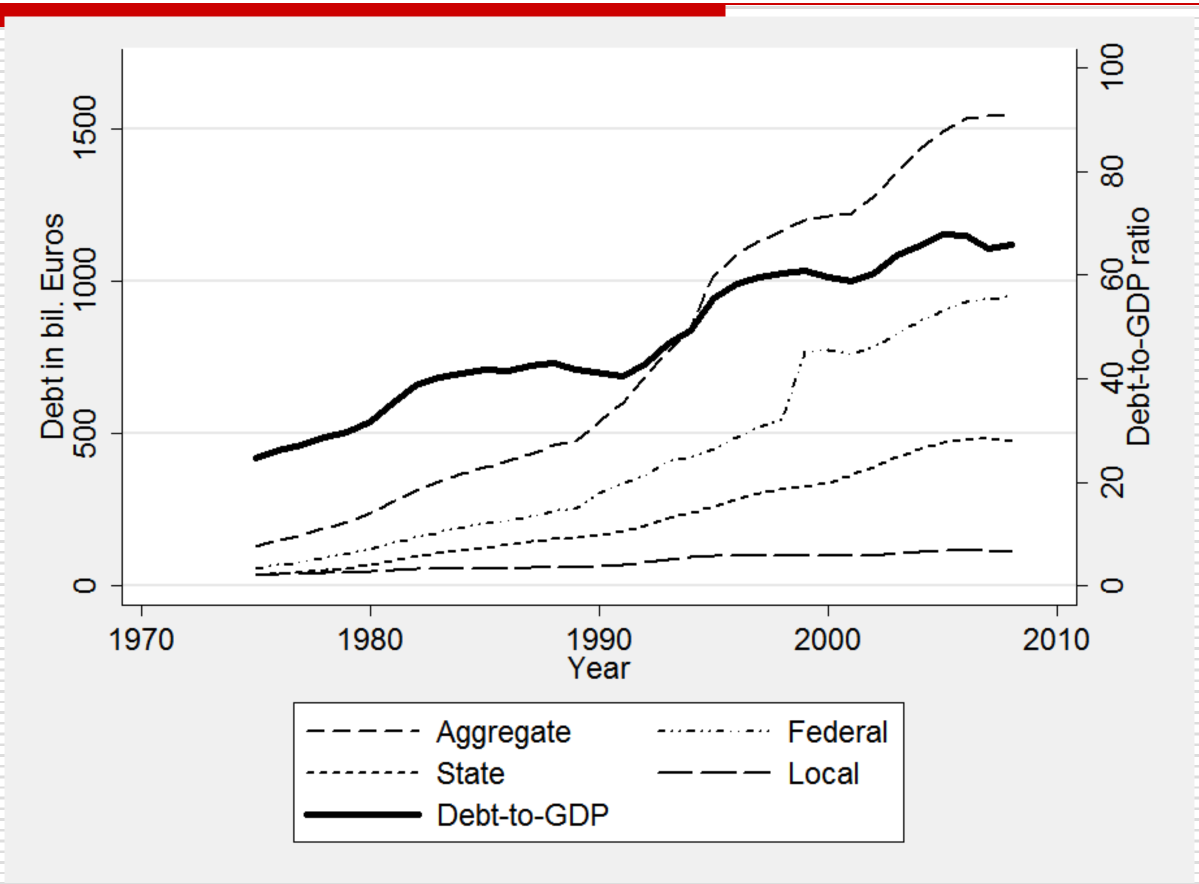

Figure 1: Government Debt in Germany, 1975 – 2008

The German Case 2

- Current expectations after the financial crisis
  - Deficits to GDP Ratios (in % of GDP)
    - 2009: -3,0 %
    - 2010: -5,0 %
    - 2011: -4,7 %
    - 2012: -4,0 %
    - 2013: -3,0 %
  - Debt to GDP Ratios (in % of GDP)
    - 2009: 73,1 %,
    - 2010: 76,5 %
    - 2011: 79,5 %
    - 2012: 81,0 %
    - 2013: 82,0 %

The German Case 3

- Problems run deeper:
  - Incentive problems of the German fiscal constitution.
    - No incentives for sound fiscal policies.
    - Fiscal equalization provides no incentives to attract additional tax revenue.
    - Bailout provides incentives for excessive debt.
  - Fiscal commons problems are aggravated by this fiscal constitution.
  - German states take part in good rating of the federal government.

The German Case 4

- Explicit bail-out guarantee for excessively indebted jurisdictions (ruling of the Constitutional Court)
- Incentives:
  - The implied marginal contribution rates to the fiscal equalization system vary between 60 and 100 percent.
  - The last step in the fiscal equalization system can change the revenue rank of states such that those with an initial revenue above average are falling behind those with initial revenue below average.
  - Empirical evidence that fiscal equalization and bail-out lead to higher borrowing and spending.

The German Case 5

- New debt brake for the federal government:
  - Balanced budget over the business cycle („close to balance");
  - Procedure for cyclical adjustment;
  - Special account to synchronize budget planning and implementation;
  - Extraordinary deficits decided by a qualified majority of the members of parliament;
  - Fully implemented from 2016 onwards.

The German Case 6

- New debt brake for the Laender:
  - Balanced budget in budgetary planning with some adjustment in implementation.
- Prevention provisions for excessive debt
  - Stability council as oversight committee.
- Bail-out for highly indebted states.
- Fully implemented as of 2020.
- Further changes regarding budget (and tax) administration and procedures.

The Swiss Case 1

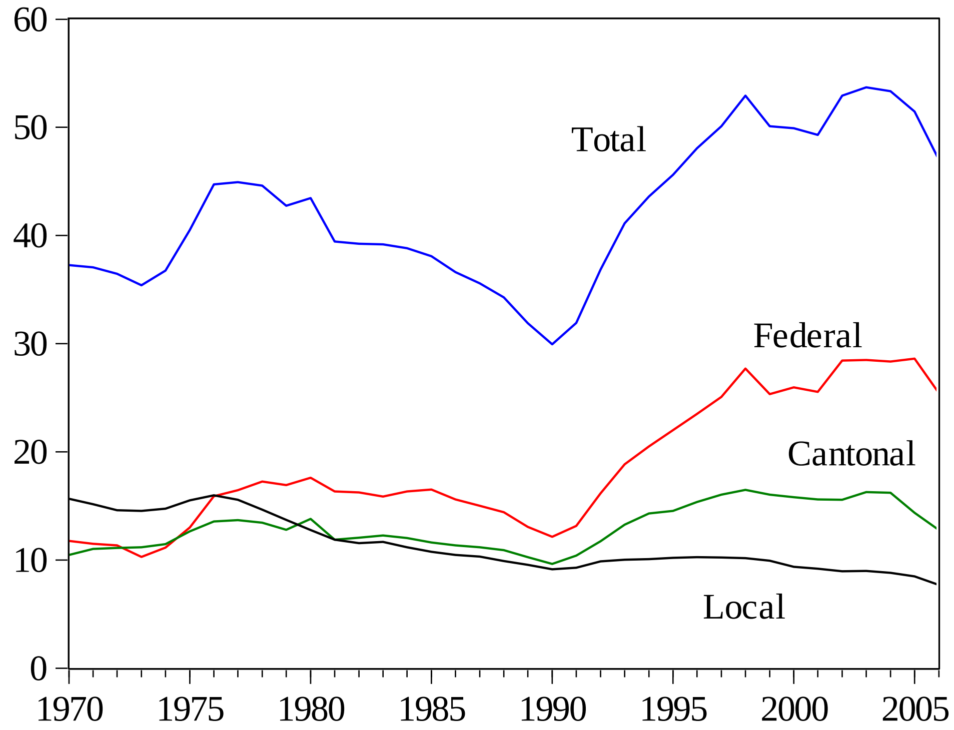

Figure 1: Debt to GDP Ratios in Switzerland, Federal, Cantonal and Local Levels, in % of GDP, 1970 - 2006

The Swiss Case 2

- Debt Brake at the Swiss Federal Level
  - (i) Forecasts of the revenue, adjustment for the impact of the business cycle,
    ⇒ estimation of ‘equilibrium’ revenue
  - (ii) Adjustment of the expenditure at the (expected) revenue (no fiscal referendum)
  - (iii) Reducing the deficit within several years (3 years for deficits of more than 6 percent of the expenditure)
  - (iv) Budget cuts by the government - proposals for the necessary law revisions to the parliament
  - (v) Possibility of extraordinary expenditure with a qualified majority

The Swiss Case 3

- Cantonal Debt Brakes
  - Introduction of 'Debt Brakes'

    St. Gallen (1994 / 1929)
    Fribourg (1994 / 1960)
    Solothurn (1995)
    Appenzell Ausserrhoden (1995)
    Graubünden (1998)
    Luzern (2001)
    Bern (2002)
    Wallis (2002) ....
- Feld and Kirchgässner (2008): Successful restraints of cantonal public debt.

The Swiss Case 4

- Tax Autonomy is very high with strong tax competition between cantons and local jurisdictions.
- Cantons and local jurisdictions are responsible for their debt.
  - Leukerbad (1998)-decision by the Federal Court (2003): No Bail-out
  - Comprehensively new assessment of default risk by the banks.
  - Küttel and Kugler (2002)
    - Spread (Treasury vs. Cantonal Bonds) varied between -0.139 % (GR) and 0.855 % (TI); GE: 0.264 %, ZH: 0.007 %.
    - Fiscal referendum important to explain spread.

The Brazilian Case 1

- Fiscal Responsibility Law as of 2000, but history and predecessors.
- Series of bail-outs from the 1970s to the beginning of the 1990s.
- State-owned banks misused for political purposes.
- 1994: State banks and states feared bankruptcy.
- Federal government launched a *last* rescue plan linking refinancing to a rigorous program of fiscal adjustment and the repayment of the debt to the National Treasury over a thirty-year period.
- Sanctions if no compliance.

The Brazilian Case 2

- 1997: Agreements between states and federal government were signed.
- Bail-out with restrictions: 30 years, 13 % of monthly net revenue, most of state banks closed or privatized.
- 2000: Fiscal Responsibility Law
  - Secures the results from agreements in a complementary law just below the constitution.
  - Comprehensive concept comprising public administration, funds, foundations and state owned enterprises: Definition of spending that is covered.

The Brazilian Case 3

- Fiscal Targets
  - Budget Balance
  - Execution of Expenditure by Function.
  - Restrictions on each of the powers and each level of government regarding personnel spending.
- Code of Good Fiscal Practices: Budgeting
- Fiscal Management
- Fiscal Transparency: Accounting and Auditing
- Penalties: Withdrawal of Transfers, Loss of Position, Arrest and Fine.

The Brazilian Case 4

- Success story:
  - Primary surplus of the states increased significantly after FRL
  - High acceptance in the public: Change of culture.
- Drawbacks:
  - Personal sanctions almost never applied.
  - Creative accounting possible because the agreements (and the FRL) focus on net debt.
  - Council of Fiscal Management has not been implemented.
  - Recent bills to amend the FRL.

The Nigerian Case 1

- Brazilian success with FRL inspired Nigerian policy-makers to pass the Fiscal Responsibility Act of 2007.
- Almost exclusively focused on federal level.
- Establishment of the Fiscal Responsibility Commission.
  - Monitoring and Enforcement
  - Standard Practices
  - Publish studies on public finances
  - Independent commission.

The Nigerian Case 2

- Assessment:
  - Not much has been achieved yet as the commission has not been very active.
  - Other challenges, like the financial crisis, or the general political situation (succession of President Yar`Adua) have occupied policy-makers
  - But: Awareness in the public has increased inducing a new dynamic.
  - Obvious constraints:
    - States are not covered.
    - Missing fiscal exchange perspective.
    - Administrative capability.

Where Do We Go from Here?

- Designing proper fiscal responsibility rules is a continuous challenge.
- Each federation finds solutions that fit its legal system and legal tradition.
- Implementation: Simple rules are better, but: how to cope with loopholes.
- Implementation: Cover all public finances of all public of quasi-public agencies with the same rules.
- Creating a culture of fiscal sustainability in the general public.
- Importance of fiscal exchange.