

Improving subnational governments' resilience post-Covid19

Presentation by Teresa Ter-Minassian and Luiz de Mello at the 18th Annual Meeting of the Network on Fiscal Relations across Levels of Government

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Outline of presentation

- ▶ **Motivation: why focus on SNGs' resilience to shocks?**
- ▶ **Three key aspects of subnational resilience**
 - ▶ Robustness of the subnational finances to exogenous shocks
 - ▶ SNGs' ability to ensure continuity in the provision of the key public goods and services under their responsibility during crises
 - ▶ SNGs' capacity to foresee future shocks, take preventive steps to the extent possible and mitigate their impact when they materialise
- ▶ **Policy options to strengthen subnational resilience**
- ▶ **Focus of presentation is on OECD countries**



Motivation



Why does subnational resilience matter? Lessons from Covid19

- ▶ The extent of Covid19's social and economic damage has been influenced in particular by:
 - ▶ The **fiscal space** that governments had to support households and businesses affected by the mobility restrictions required by the pandemic
 - ▶ Their ability to quickly design and implement the **public health measures** to contain the spread of the pandemic and provide adequate health care to the affected individuals; and
 - ▶ Their ability to ensure a degree of continuity in the **provision of essential public services, especially education.**
- ▶ Subnational governments play important roles in the provision of such services in most countries



Key aspects of subnational resilience



Robustness of the subnational finances

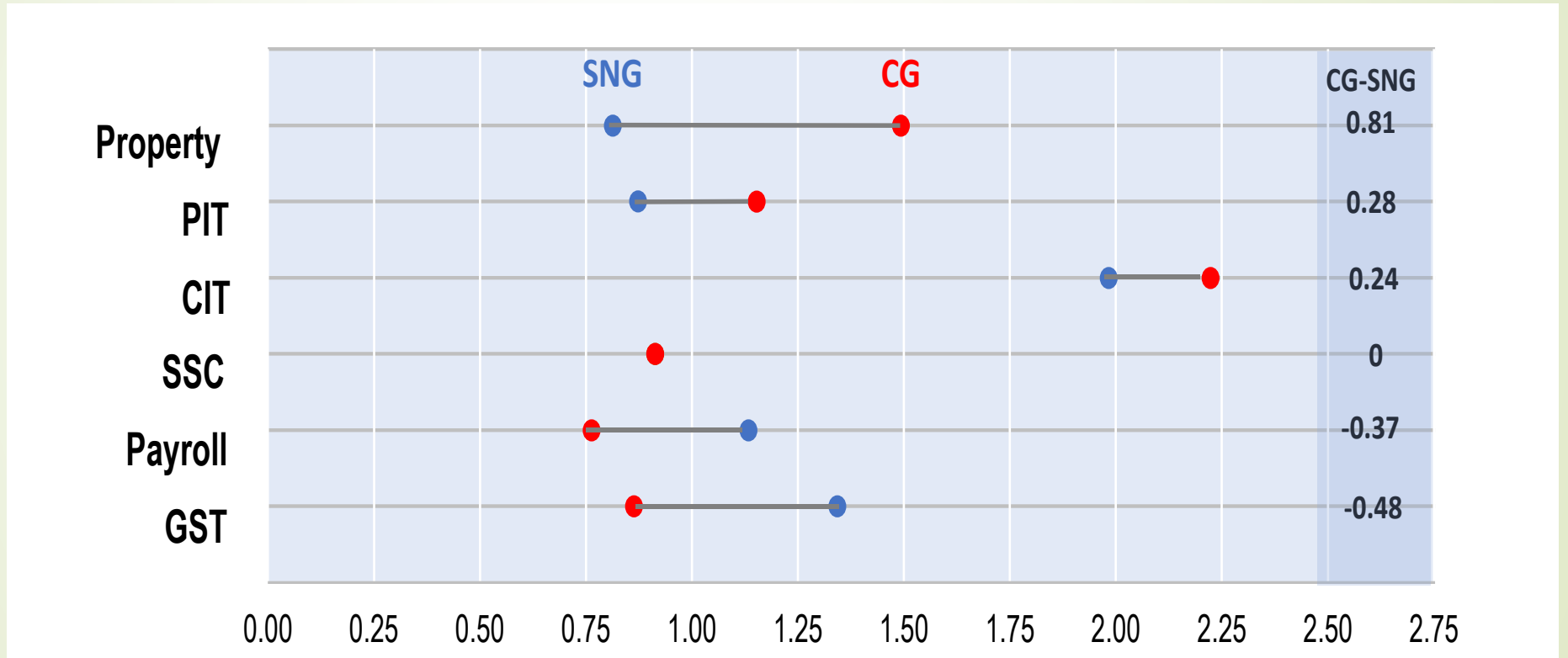
- ▶ **Key determinants of subnational fiscal robustness and resilience**
 - ▶ The **sensitivity** of SNGs' revenues and assigned spending responsibilities **to the business cycle and other shocks**; and
 - ▶ The **extent of their fiscal buffers** (in terms of budget balances and debt) both at the outset of the shock and in its wake
- ▶ Both are largely shaped to by the characteristics of countries' intergovernmental fiscal relations systems.




Subnational finances are less cyclically sensitive than national ones

- ▶ The types of taxes prevalent in subnational **own revenues** tend to have lower buoyancies than national ones.
- ▶ **Shared taxes and intergovernmental grants** are typically more cyclically sensitive than own revenues. This creates a case for smoothing mechanisms in the design of intergovernmental transfers.
- ▶ Since unemployment insurance is generally a national responsibility, **subnational spending** tends to be less cyclically sensitive than the national one.
- ▶ However, since financing constraints tend to be tighter at the subnational level, **SNGs' investments** tend to be more procyclical than national ones

Tax buoyancy across levels of government

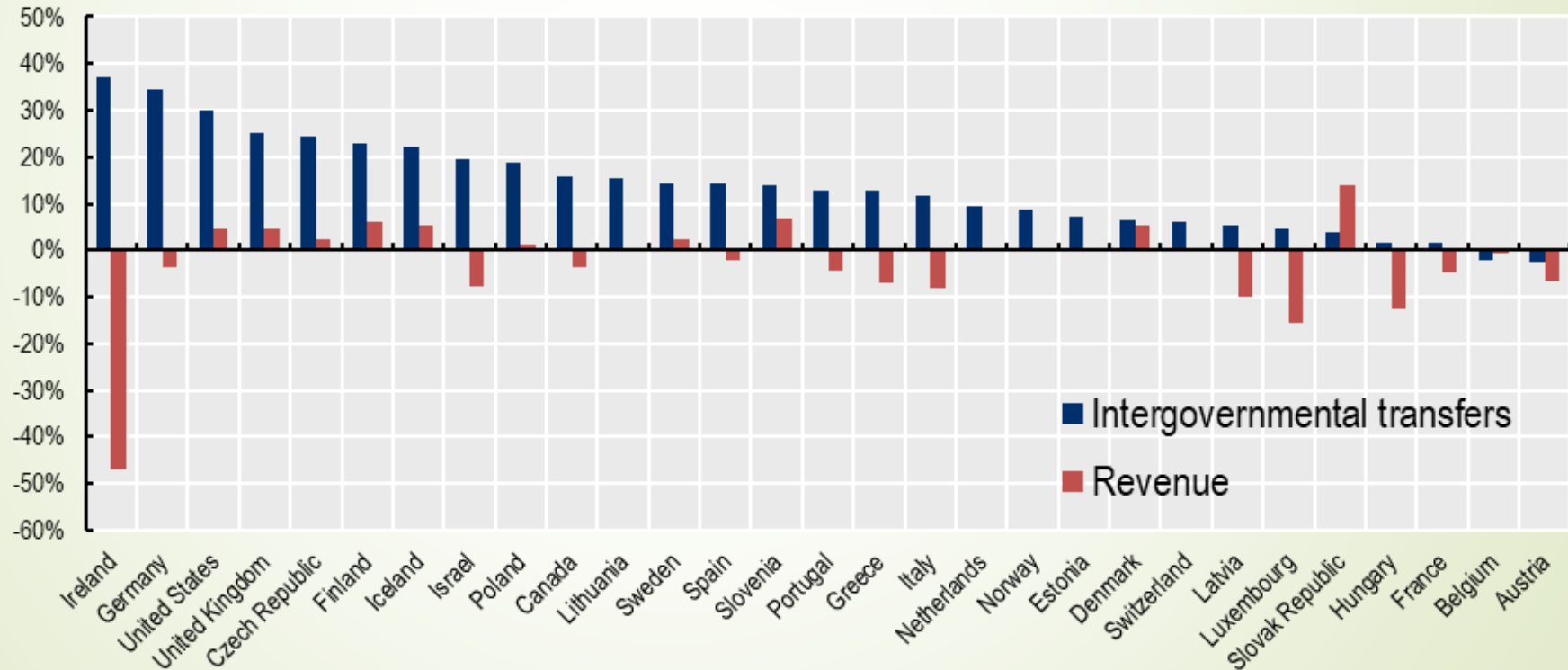





National governments (NGs) have taken the fiscal brunt of the pandemic

- ▶ Preliminary data suggest that **declines in subnational tax revenues in 2020 were on average relatively small**, and smaller than those experienced by the NGs, albeit with significant variation across countries.
- ▶ **Spending increased at all levels of government but significantly more so at the national one**
- ▶ In most OECD countries, **the NGs stepped up intergovernmental grants** to mitigate the impact of the crisis on subnational finances.

Changes in intergovernmental grants and subnational tax revenues during the pandemic

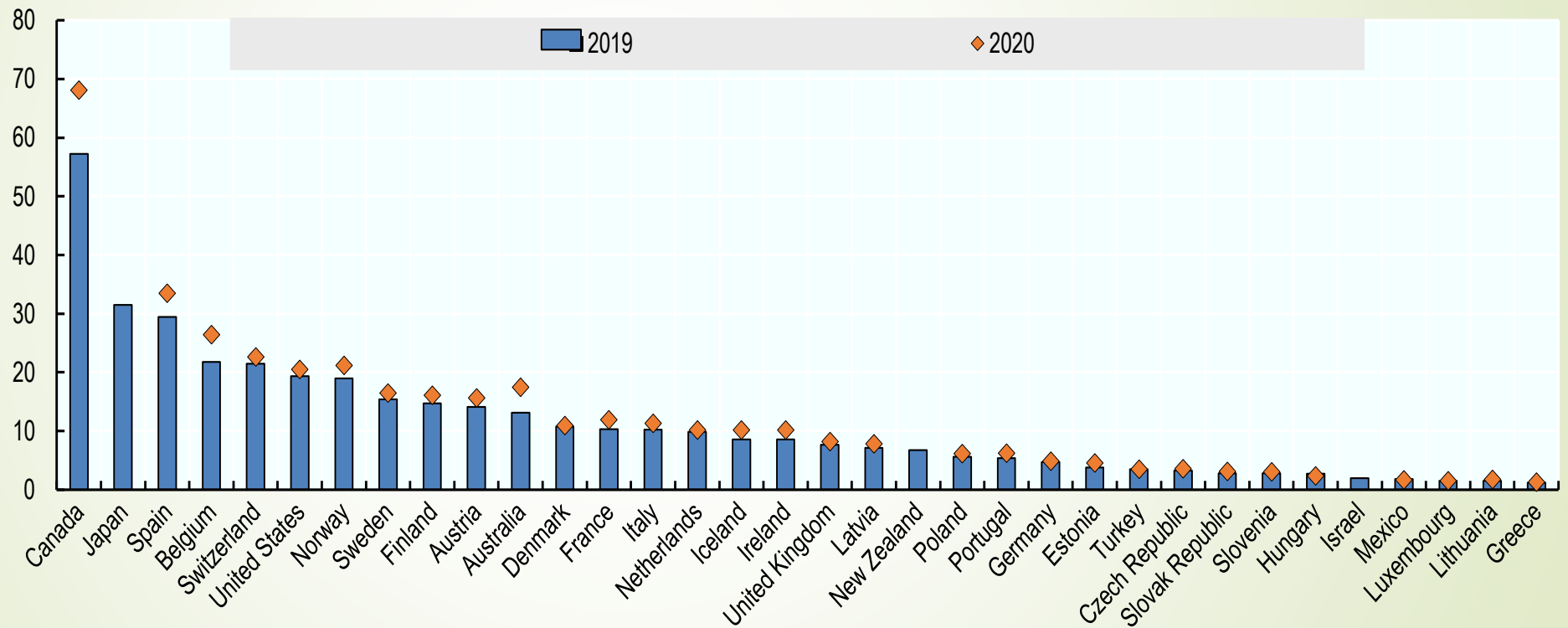




NGs have taken the fiscal brunt of the pandemic (cont'd)

- ▶ **Subnational balances** deteriorated in 16 and improved in 13 OECD countries between 2019 and 2020. In most countries, deterioration was less than 1% of GDP.
- ▶ **Increases in subnational debt** were also relatively small on average, except in some federations.
- ▶ The increases in debt were facilitated by the fact that, in many OECD countries that constrain subnational borrowing through numerical fiscal rules, these **rules were suspended during the pandemic**.

Changes in subnational debt to GDP ratios during the pandemic



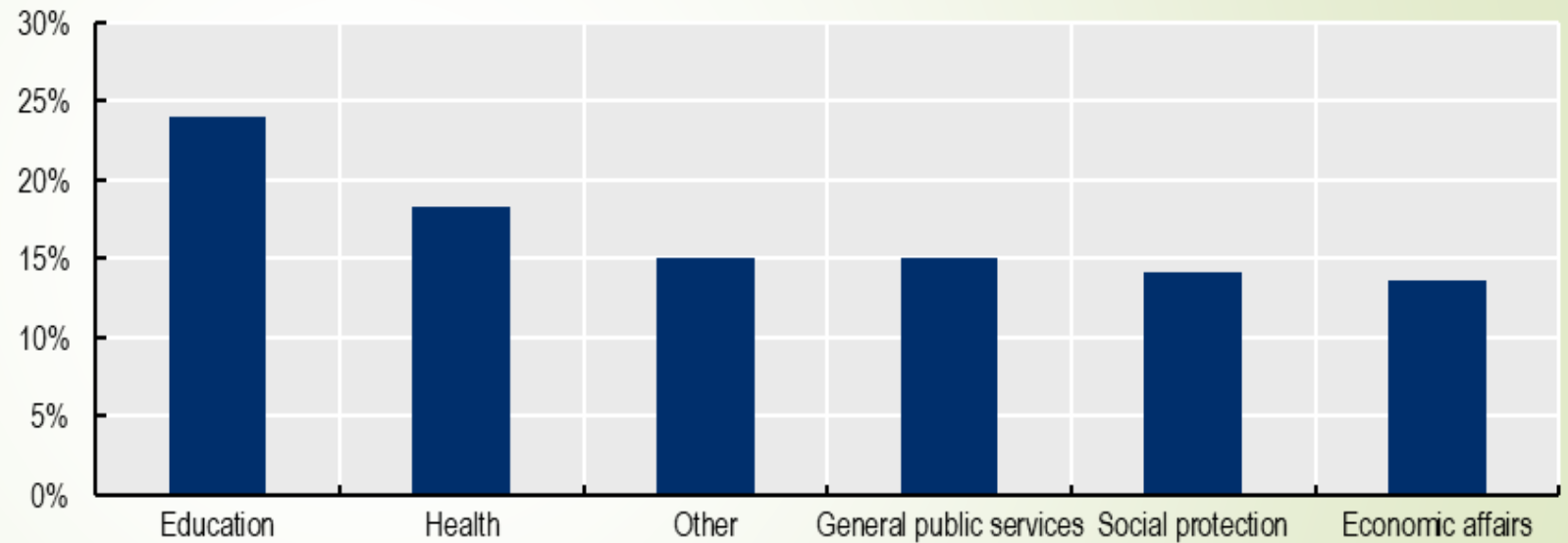


Ensuring continuity in subnational services during the pandemic

- ▶ Shared responsibilities in the key public services affected by the pandemic required an unprecedented degree of **intergovernmental coordination**
- ▶ **The effectiveness of coordination mechanisms varied greatly in the initial phases of the pandemic but was subsequently strengthened in most countries**
- ▶ The pandemic has highlighted **substantial disparities**, both across and within countries, **in the capacity of SNGs to provide adequate health care and on-line education services**
- ▶ It has also underscored the **need to better exploit the power of digitalisation** in the provision of subnational public services and in the operation of subnational administrations

SNGs' spending on essential public services

Subnational spending by selected functions in OECD countries
(as % of total subnational spending, 2019)





Subnational capacities to anticipate and prepare for shocks are crucial for resilience

- ▶ **SNGs are vulnerable to a range of macroeconomic shocks**, including some stemming from long-term structural trends, such as aging and especially climate change, **but often lack the capacity and incentives to anticipate them and mitigate their impact.**
- ▶ **SNGs have on average spent little so far to mitigate and adapt to climate change.**
- ▶ Also, most of them **do not adequately exploit their regulatory powers** in this area.
- ▶ But they need to be at the forefront of **disaster management** when climate-induced risks materialize.



Policy options to strengthen subnational resilience



Strengthening subnational fiscal buffers - Fiscal frameworks

- ▶ There is a need to **ensure that SNG fiscal buffers are adequate going forward**, especially given the now more limited fiscal space of NGs.
- ▶ **Sound subnational medium-term fiscal frameworks** are crucial for this purpose, including **fiscal rules** that safeguard debt sustainability, prevent pro-cyclicality, and promote allocative efficiency in spending; strengthened **enforcement and scrutiny mechanisms**; and improved **PFM and PIM** systems.
- ▶ **SNGs can mobilize own revenues** (national tax surcharges, green taxes, etc.) and **NGs can support subnational own revenues mobilization** (cooperation in tax administration, incentives through hard budget constraints, etc.).



Rationalising subnational spending and maintaining service delivery during shocks

- ▶ Ensuring adequate fiscal buffers requires complementary **efforts to improve the allocative and technical efficiency of spending. Key tools for this purposes:**
 - ▶ MTEFs
 - ▶ Spending reviews
- ▶ Actions to **maintain service delivery during shocks:**
 - ▶ Securing the availability of inputs in the presence of supply chain disruptions
 - ▶ Adapting modalities of services delivery
 - ▶ Ensuring the functioning of the public administration itself; and
 - ▶ Providing support for vulnerable social groups
- ▶ **Key role of strengthened institutional mechanisms for intergovernmental coordination and cooperation**



Strengthening SNG capacity to deal with future shocks: the case of climate change

- ▶ OECD countries currently differ significantly in the **respective roles of the NG and the SNGs in mitigation and adaptation policies.**
- ▶ There is **a strong case for involvement of both**, with the NG setting minimum nationwide standards and SNGs adopting higher ones in reflection of local preferences. Under any model, well-functioning intergovernmental coordination mechanisms are key.
- ▶ **SNGs have an important role in adaptation policies** (e.g., land use regulations to minimise risks of flooding; investing in infrastructure less vulnerable to climate change-induced disasters; and preparing contingency plans to respond to such disasters).
- ▶ **NGs can support SNGs in adaptation efforts** through special-purpose earmarked grants, low-cost and long-maturity loans to finance subnational climate-related investments, and/or partial guarantees or tax advantages to subnational “green bonds”.



Thank you!