Background Note: Intergovernmental Fiscal Outlook for 2023 and 2024 [1]

Key Messages

1. In a slightly improved scenario for the G20, projected GDP growth is now expected to be 2.6% in 2023 and 2.9% in 2024, compared to 2.2% and 2.7%, respectively, as of November. Inflation was revised slightly downwards to 5.9% for 2023 and, even more in 2024, to 4.5%, compared to 6.0% and 5.4% previously.[2]
2. Preliminary data for 2022 on subnational governments' (SNGs) finances show a reversion from the stellar SNG fiscal results observed in 2020 and 2021.
3. Expected SNG revenues for 2023 and 2024 were revised both up and down, but projections remain much lower than at the beginning of 2022. Projected revenues for 2023, for instance, are around 3% lower than what was expected a year ago.
4. On top of higher prices of goods and services paid by SNGs, where inflation is already biting, especially for Europe, there is also ongoing pressure for increases in expenditures triggered by the inflows of refugees and the energy crisis. In this area, a review of untargeted fiscal support measures will be necessary.
5. Due to high inflation, monetary policy has tightened, raising borrowing costs significantly. SNGs that have short-term financing needs and those that have a large share of outstanding debt with floating rates will come under stress.
6. To avoid an overcorrection, SNGs should re-evaluate untargeted fiscal support, carefully restore fiscal rules and engage in necessary structural reforms to boost productivity and improve fiscal sustainability.

[1] This document was discussed at the 2023 Annual Meeting of the Network on Fiscal Relations across Levels of Government on 20-21 April. It was prepared by Pietrangelo de Biase, advisor to the Network, with inputs from Acauã Brochado, under the supervision of Sean Dougherty, Head of Network Secretariat. A special thanks to Boris Cournède (Economics Department) and Alexander Pick (Centre for Tax Policy and administration) for their comments.

[2] Current forecasts from OECD *Interim Economic Outlook* of 17 March 2023 (OECD, 2023b).

Background Note: Intergovernmental Fiscal Outlook for 2023 & 2024

1. Introduction

The global economic outlook has slightly improved over the past three months but remains fragile. Against a backdrop of downside risks in the geopolitical, global trade and macroeconomic fronts, inflation prospects were slightly revised down while growth improved a bit compared with the economic outlook of November 2022 (OECD, 2023a). The scenario is nonetheless much worse than what was expected at the beginning of last year. Drawing on the projection tools developed by the Network of Fiscal Relations and based on recent economic developments across OECD countries and on the most up-to-date projections from the OECD *Interim Economic Outlook* of March 2023 (OECD, 2023b), this background note updates the intergovernmental fiscal outlook shared in November 2022, before discussing its main implications. Revenues are expected to grow at a slower pace, expenditures are under pressure, and borrowing costs are rising. But central and subnational governments should avoid an over-correction. A re-evaluation of the generous untargeted fiscal measures offered to counteract the energy crisis is necessary, and a careful reinstatement of fiscal rules would help ensure a sustainable path forward while strengthening buffers to improve resilience against future crises.

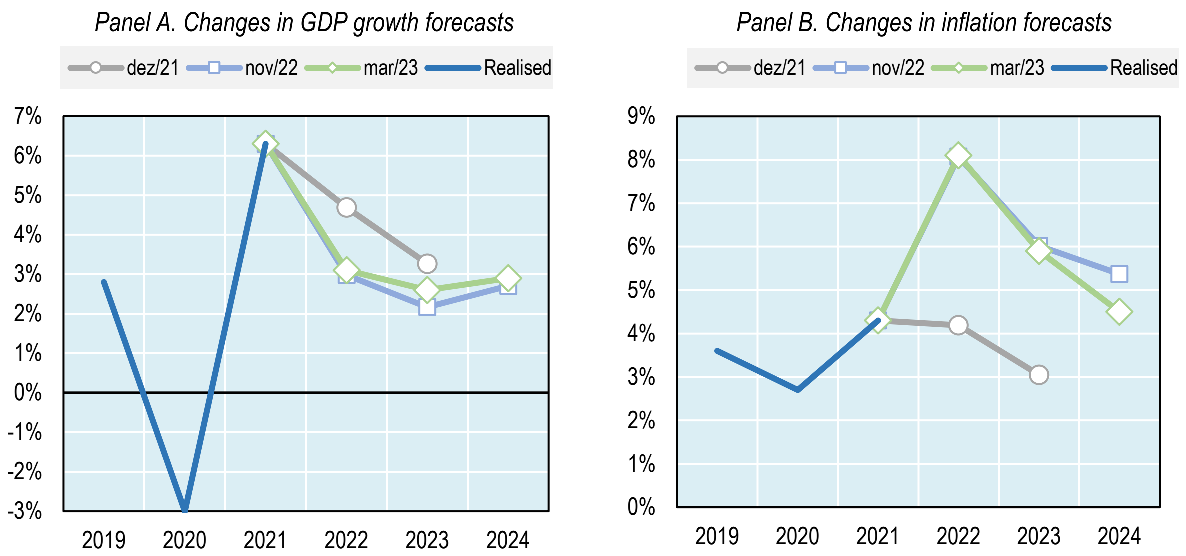
2. Economic context

GDP growth estimates have been revised slightly upwards while projected inflation remains high against rising interest rates

The current challenging scenario has not changed dramatically from the one described in the last intergovernmental fiscal outlook (OECD, 2023a), although there has been a slight upward revision in growth forecasts, and an expected reduction in the pace of monetary tightening and inflation. Growth performed above expectations in the final half of 2022 in major emerging markets and many developed countries. China's reopening after COVID-related shutdowns has helped with the recovery, through household dis-saving of resources accumulated during the pandemic and more broadly higher-than-expected fiscal support on top of still-low unemployment, which has kept consumption and investment strong. For inflation, a milder-than-expected winter in Europe and a faster transition to alternative energy sources contributed to bringing energy prices back down and avoiding even higher inflation. But this reduction was not enough to bring inflation back to targets, and in many countries underlying inflation is still trending upwards and the peak is not yet evident (OECD, 2023b).

Against this backdrop, projections of growth and inflation were revised towards a less pessimistic scenario (OECD, 2023b). For the G20, projected GDP growth is now 2.6% for 2023 and 2.9% for 2024, compared to 2.2% and 2.7% respectively in November (Figure 1, Panel A). The inflation forecast was revised slightly downwards to 5.9% for 2023 and even more, to 4.5% for 2024, compared to 6.0% and 5.4% (Figure 1, Panel B) in the last OECD Economic Outlook (OECD, 2022). Nevertheless, growth prospects are still below what was projected in December 2021, before Russia's illegal, unprovoked and unjustifiable war of aggression against Ukraine. Similarly, despite the recent moderation of projected inflation, the new inflation forecast for 2023 is nearly two times higher – 3 percentage points – than was expected at end-2021. For this reason, the outlook improved only moderately, and the challenge remains the same as in November 2022: dealing with a scenario of falling purchasing power due to higher inflation and slower growth.

Figure 1. Growth and inflation outlook for the G20

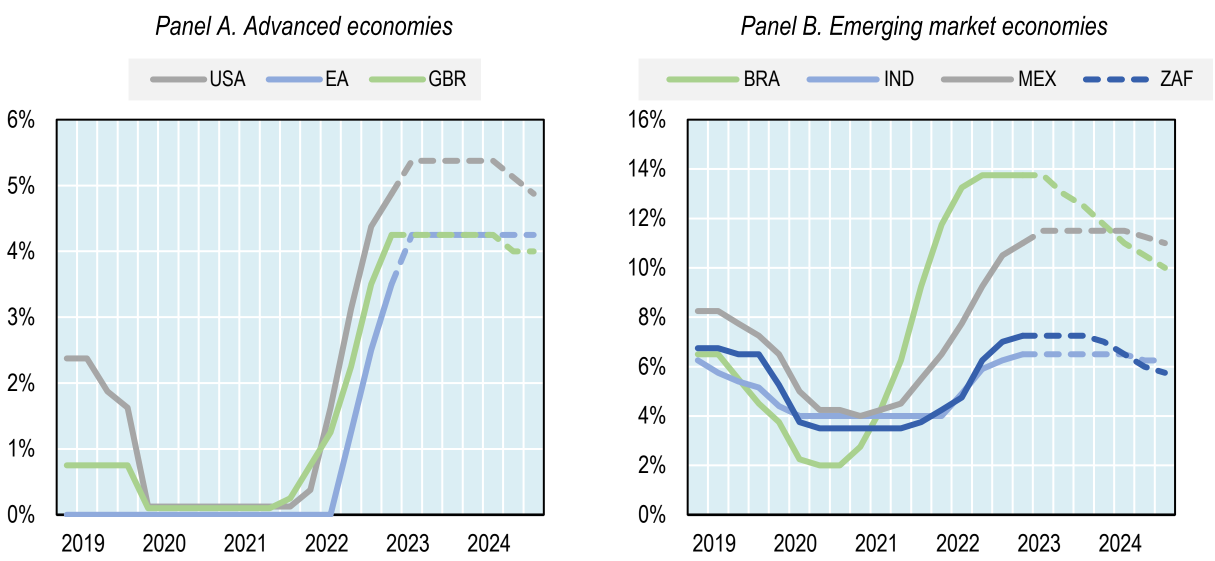


Source: OECD Quarterly National Accounts (Database), OECD Economic Outlook of n° 110 (December 2021), n°112 (November 2022), and OECD Economic Outlook, Interim Report (March 2023).

High inflation still calls for elevated interest rates

With high inflation, central banks will continue tightening. Although updated inflation projections are slightly lower than in the previous outlook, they are still very high. For 2023, projected inflation for the G20 is two times what was expected in early 2022 (Figure 1, Panel B), and, more importantly, well above the targets of almost all countries that set nominal references. In this scenario, central banks have been raising interest rates and, with few exceptions, are expected to either maintain an already contractionary monetary policy or to tighten further, even if at a slower pace. With a few exceptions, rates may start to fall only in 2024 (OECD, 2023b). Figure 2 shows recent and expected movements in monetary policy rates for selected countries.

Figure 2. Policy interest rates in the major economies



Note: Main refinancing rate for the euro area.
Source: OECD Economic Outlook, Interim Report (March 2023).

3. The updated SNGs fiscal outlook

Preliminary data for 2022 indicate resilience, but downward trends are starting to appear

The finances of SNGs in OECD and G20 countries improved strongly following the peak of the pandemic, with the OECD fiscal balances going from a deficit of 0.04% of GDP to a surplus of 0.08% of GDP, second only to the surpluses experienced in 2015 and 2016 over the past fifteen years. However, a reversal of this trend has begun. As noted in the previous intergovernmental fiscal outlook (OECD, 2023a), subnational finances improved during the pandemic due to generous transfers provided by central governments in 2020 and 2021, and to a somewhat lesser extent from their relatively buoyant tax revenues.

In 2022, the reversal of these dynamics started to become clearer and preliminary data for SNG fiscal accounts are starting to confirm this. In Brazil, for instance, primary balances for states and municipalities were still positive, but much below the record highs observed in 2021 (Banco Central do Brasil, 2023). In contrast, the German state and local governments, which had less generous support from the central government, were showing a higher surplus in the third quarter of 2022 compared to the same period in 2021 (Destatis, 2023). In the United States, data for the fiscal year 2022 shows a record-high accumulation of funds (rainy day funds and total balances), while preliminary data for FY 2023 show a substantial reduction, albeit from a high level, and this is seen throughout the vast majority of states (White, 2023).

Despite the overall good shape of SNGs' budget balances, however, it is worth noting that debt levels, while down, are not far from the historical highs observed in 2020, of 12.5% of GDP, on average. This imposes substantial risks, especially for those with financing needs in the coming months, as discussed in the next section. The strong balances that many SNGs had at the end of 2021 might have already been partially depleted or in some cases reversed, raising some concerns about potential future financing needs.

Estimates for 2022 and forecasts for 2023 were revised

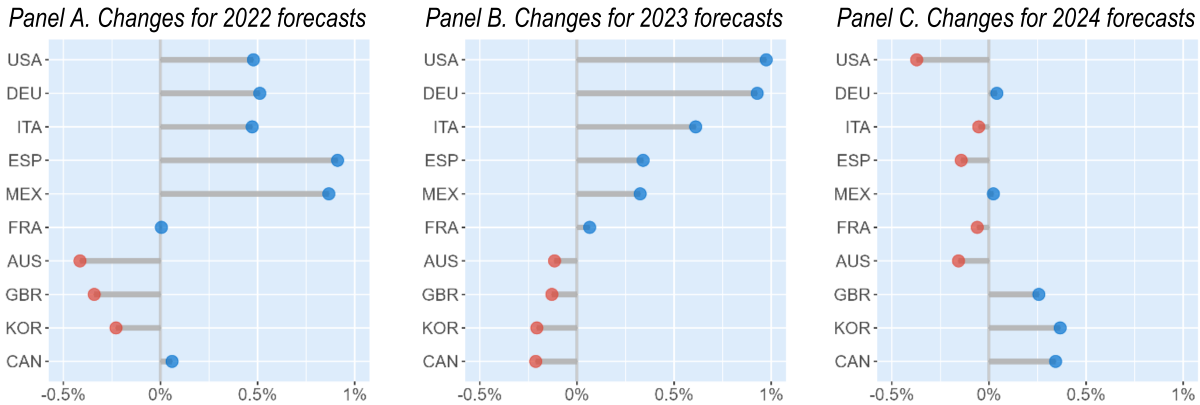
Despite the current good shape of SNGs finances, looking forward, more modest economic growth will directly affect SNGs' revenues. Taking estimated tax buoyancies[3] (i.e. sensitivity of government revenues to economic activity) for each country, as well as OECD projections for real GDP growth in G20 countries, it is possible to forecast SNGs revenues for the near-term future. Figure 3 shows the differences in current revenue growth estimates in relation to the estimates from November 2022 (OECD, 2023a).[4]

With this updated G20 economic outlook, SNG revenues are expected to show, in general, mildly stronger growth than expected in the previous note (OECD, 2023a), but for a few countries, the opposite is true, with a downward revision. Estimates for 2022 real growth in SNG's revenues were revised upwards by almost 1 percentage point (p.p.) in the case of Mexico and Spain. There were upward revisions of about ½ p.p. also for Germany, Italy and the United States. A downward revision of less than ½ p.p. was observed for Australia, Korea and the United Kingdom. Forecasts for France and Canada remain mostly unchanged.

[3] Buoyancy captures the sensitivity of government revenues to economic activity (i.e. GDP) based on historical data. Buoyancy coefficients capture both the tax elasticity with respect to economic activity and the changes in the tax system made in the past. A buoyancy of 1.1 means that when GDP increases by one per cent, revenues should increase by 1.1%. For a detailed discussion of SNGs' long-term buoyancies see (Dougherty, de Biase, et al., 2022) and for an analysis of SNGs short-term buoyancies see (Dougherty & de Biase, 2021).

[4] The preliminary updated projections for GDP growth still do not cover all OECD countries (only G20), so this analysis focuses only on the countries with new forecasts.

Figure 3. Changes in projected SNGs own revenues growth in real terms



Note: Uses consolidated revenues. Projections used the mean group estimator for each type of tax revenues from Dougherty & de Biase (2021). SNGs' own revenues refer to total revenues minus transfers received from other levels of government – they thus include their own tax and non-tax revenues, such as user fees and charges.

Source: Authors' calculations based on OECD Economic Outlook of n° 112 (November 2022), OECD Economic Outlook – Interim Report (March 2023), OECD System of National Accounts and OECD Fiscal Decentralisation database.

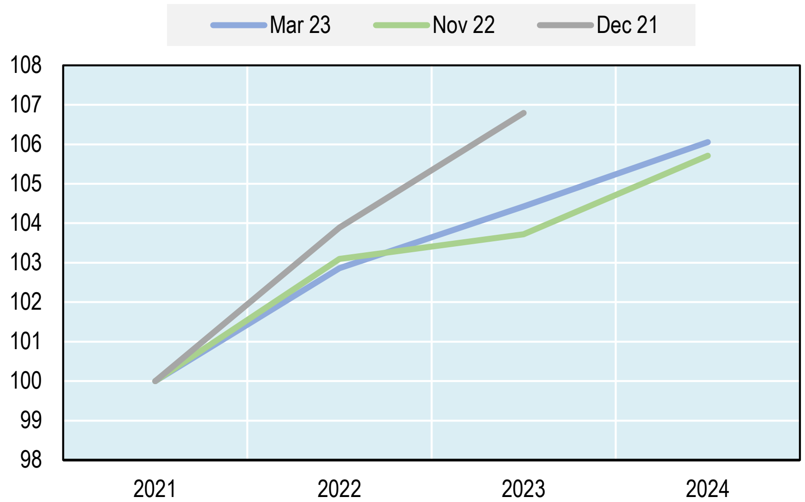
For 2023, the revenue revisions were somewhat more pronounced on the upside, but some negative revisions are also present. Forecasts for real growth in SNG's revenues in 2023 were revised upwards by almost one percentage point for Germany and the United States. For Italy, Mexico and Spain, the improvement was around ½ p.p. Again, for Australia, Korea and the United Kingdom, now joined by Canada, the updates were on the downside, with changes of 0.1 to 0.2 p.p. The forecast for France was stable. In the case of forecasts for 2024, changes were less pronounced, although in some cases, opposite to the changes for 2022 and 2023. Projections for the United States fell by almost ½ p.p. For Canada, Korea and the United Kingdom, projections rose by around 0.3 p.p.

Current forecasts for 2023 and 2024 are much worse than at the beginning of last year

Though GDP growth and, correspondingly, SNG revenues were revised upwards for certain countries (DEU, ESP, ITA, MEX and USA), for others the current forecasts are even worse than at the end of 2022 (AUS, GBR, KOR and CAN). Moreover, the aggregate situation is certainly much worse than what was expected at the end of 2021. Figure 4 depicts the expected trajectories of SNG's revenues between 2021 and 2024, using median estimates produced in different forecast vintages. While compared to the estimates made in November 2022, there was a slight improvement in current projections, it is clear that the forecasts are much lower than the estimates derived from the Economic Outlook in December 2021. For 2023, median forecasted revenues are almost 3% below those former estimates.

Figure 4. Trends in forecasted SNG's revenues

Median trajectory of SNG's revenues in 2022, 2023 and 2024, expected at current and previous outlooks



Note: Index is set to 100 in 2021. Median estimates for each year. Uses consolidated revenues. Projections used the mean group estimator for each type of tax revenues from Dougherty & De Biase (2021). SNGs' own revenues refer to total revenues minus transfers received from other levels of government – they therefore include their own tax and non-tax revenues, such as user fees and charges.

Source: Authors' calculations based on OECD Economic Outlook of n° 112 (November 2022), OECD Economic Outlook – Interim Report (March 2023), OECD System of National Accounts and OECD Fiscal Decentralisation Database.

On the expenditure side, there are also no signs of easing

After the initially broadly positive impact of inflation on the nominal value of taxes collected, it may now negatively affect public budgets through higher prices of goods and services that they buy to fulfil their mandates. Strikes from public worker categories demanding higher pay are a particularly important example of how this is starting to happen and they are happening throughout the world, for example in Germany (BR24, 2023), South Africa (eNCA, 2023), and in the United Kingdom (BBC, 2023).

The current crisis also brings high pressures for an active increase in expenditures. Especially in Europe, there is still a very high demand for public services caused by the record inflow of refugees. And the energy crisis is pressing both to compensate highly impacted households and to achieve a faster transition away from Russia's fossil-fuel supply and towards cleaner sources (OECD, 2023a).

In this scenario, it is especially important to re-think the untargeted support measures that were offered to households and firms over the past year and focus on more efficient targeted measures (OECD, 2023a; OECD 2023b).

4. Inflation and higher interest rates will be a challenge for SNG's financing

Rising interest rates pose a serious threat to highly indebted SNGs

At the end of 2022 and the beginning of 2023, central banks reinforced their commitment to swiftly fight inflation. The tightening of the monetary stance, together with the slightly lower perceived geopolitical risk, significantly affected the yield curves, with short and medium-term rates rising, but long-term rates falling compared with what was observed in mid-2022 (IMF, 2023; US Department of the Treasury, 2023).

This could mean both worse and better prospects for subnationals' debt financing, depending on specific situations. SNGs that expect higher financing and liquidity needs in the short term, or those who only manage to borrow at shorter maturities, are now in a worse situation. On the other hand, those subnationals that have liquidity cushions can postpone investment plans and/or are able to borrow in longer maturities, are in slightly a better situation than what was expected at the time of the last report (OECD, 2023a).

In some countries, like Canada and Australia, with high debt and expected deficits, high borrowing costs will put further pressure on public budgets. In other countries, such as Israel and Sweden, reliance on short-term and floating rate issuances imposes a relevant risk, but lower debt and deficits mitigate this significantly. On the other hand, in Europe, most SNGs are less exposed to short-term interest rates, as they mostly rely on fixed-rate bond issuance and are estimated to have only around 10% of refinancing needs per year (S&P, 2023).

Rising interest rates, despite increasing the cost of borrowing, may not necessarily mean lower access to financing, though. In the United States, for example, market liquidity was ample in 2022, and there was a record-high number of trades in municipal bonds (Bagley & Vieira, 2023).

5. Managing the challenges

SNGs should gradually restore fiscal rules and engage in structural reforms

Though the present scenario is challenging, subnational and central governments alike should avoid an overcorrection. This pause is warranted because of the contrasting approaches observed during the Global Financial Crisis (GFC) in 2008-09 and during the COVID-19 pandemic in 2020-2021. During the GFC, governments were probably too conservative and waited too long to provide fiscal liquidity to subnationals, and the delay may have contributed to deepening the economic slump. During COVID-19, central governments likely overcorrected and transferred considerable fiscal resources to subnationals, which turned out to be excessive in many cases, resulting in SNGs having stellar positive fiscal results in 2020 and 2021.

To prepare for challenging times ahead, ensuring fiscal rules are appropriately and carefully put back into action, after the exceptions made during the pandemic, may be a good start. Finally, as is usual in hard times, engaging in structural reforms directed towards productivity growth and fiscal sustainability will be key to avoid fiscal distress in SNGs, especially for those with weak access to credit markets.

Contact for more information:

Sean Dougherty, Head of Secretariat, OECD Network on Fiscal Relations

Email: Sean.Dougherty@oecd.org

Tel: +33 1 45 24 82 91

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