HOW WILL THE GLOBAL FINANCIAL CRISIS AFFECT FISCAL POLICY AT THE SUBNATIONAL LEVEL?

RELEVANT ISSUES FOR DEVELOPING COUNTRIES

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INTRODUCTION: THE CURRENT GLOBAL FINANCIAL CRISIS AND DEVELOPING COUNTRIES

THE IMPACT OF THE CURRENT GLOBAL FINANCIAL crisis at the individual country level will depend largely on pre-existing conditions. Countries with high current account deficits; heavy dependence on capital inflows, FDI, and remittances; small debt headroom; short-term debt maturity lags; and strong reliance on foreign aid will be highly vulnerable.

In addition, the expected impact in the near future will be linked to the magnitude and frequency of the shocks that may occur coupled to events at the national level affecting their food, fuel, and financial sector, as well as other exogenous changes that may happen, such as price decreases in the main commodities that they export as a result of lower international demand, changes in weather conditions affecting agriculture export commodities, and natural disasters.

Without any exception, developing countries need to adjust to a high volatility and uncertainty environment, as global demand declines, export commodity prices fluctuate, international real interest rates remain largely unpredictable, and remittance flows become a less reliable source of income. Overall growth in developing countries is projected at 4.5 percent in 2009 down from the 6.4 percent original forecast, global trade is expected to fall in 2009 for the first time since 1982, the food and fuel crises have already pushed about 100 million people into poverty,[1] and 28 developing countries are already fiscally highly vulnerable due to the twin shocks of food and oil.

In such circumstances, adjusting fiscal targets cyclically may prove to be more challenging than ever. Similarly, countercyclical interventions may not be feasible in practice during times of crisis as many countries lack the fiscal space necessary to intervene without jeopardizing fiscal sustainability.[2]

MACROECONOMIC VULNERABILITIES AND FISCAL BEHAVIOR AT THE SUBNATIONAL LEVEL

The conduct of fiscal policy at the subnational level is particularly challenging since the option of seignoirage financing does not exist and provincial and local governments cannot issue their own currencies. In addition, they are subject to risks of national currency depreciation and even currency crises, with limited leverage to influence exchange rate management policies at the national level.

Subnational governments also operate under the country's overall institutional set up and existing legal framework, difficult to amend in times of crises, and are subject to national investment climate perceptions, which affect external debt headroom at subnational levels too. They also may have an additional layer of vulnerability as they are affected by the volatility and unpredictability of official loans and grants with a subnational component.

Regarding their margin for maneuvering for the conduct of fiscal policy in times of crisis, on the revenue side subnational governments face constraints for increasing their own tax collections mainly because of pre-existing legal agreements and previous, often weak, tax effort levels. They also depend on central government transfers which may be vulnerable as central government devolution may decrease during times of crisis. On the expenditure side, the obligation to satisfy certain spending categories, such as salaries, pensions, and debt service payments could squeeze investments, maintenance, and social spending, and therefore jeopardize service delivery unless development priorities are well established and maintained despite the crisis.

With respect to fiscal behavior, subnational governments will have an incentive to increase subnational debt only if a national guarantee perception prevails. Similarly, subnational banks and subnational corporations may keep hidden liabilities, creating an implicit risk/threat of subnational debt crisis, which could aggravate the impact of the global financial crisis at the national level.

The degree of enforcement of subnational fiscal discipline is closely linked to central government policies to deal with emerging subnational income disparities while preserving debt sustainability at the national level. However, uneven political pressures may emerge from different subnational governments on both revenues and spending.

RESPONSE TO THE CRISIS: PROACTIVE FISCAL MEASURES, STIMULUS PLANS, AND SAFETY NETS

Most of the examples from previous crises illustrate their effects at the national level or by population groups, with fewer lessons drawn at the subnational level. For instance, in Indonesia (1998) geographically uneven poverty increases are observed due to the uneven extent of the shocks and different initial conditions, with the rural poor being less affected.[3] On the contrary, in Thailand (1998), the rural poor were the most affected due to their greater integration with the urban economy and the lack of specific safety nets targeting them.[4] In many low-income countries (such as Cote d'Ivoire, Ethiopia, Malawi, Tanzania, and Zimbabwe) it has been observed that the effects of the crises are felt at the sector level, with health and education outcomes deteriorating the most.[5]

As a counter example, it is worth noticing that in Chile (90s), structural reforms in tax structures, subsidies, and benefits acted as a safety blanket against inequality in most of the country.[6] Specific safety net with successful results include food subsidies in Tunisia, which were considered cost-effective as they switched to inferior food items and different packaging, the conditional cash transfers in Mexico (*Oportunidades*) introduced right after the 1994 Tequila crisis with remarkable results on education enrollment rates and nutrition, and some workfare programs in East Asia (Indonesia and Korea) following the 1998 crisis.

At the subnational level, it is worth mentioning the labor intensive public works that were introduced under the Employment Guarantee Scheme (EGS) in Maharashtra, financed by raising taxes on richer population segments, and were later scaled up nationally in India,. They provide up to 100 days of unskilled manual labor per family at the statutory minimum wage for agriculture labor to anyone who wants it.

Most recently, the example of the fiscal stimulus plan introduced in China in 2008 allocates additional province and local counterparts to foreign financed subnational investments, focusing on infrastructure, health, and education for the provinces and communities most devastated by the March 2008 earthquake.

The overall question remains: how could subnational governments be proactive in the design of fiscal policy taking into account the intricacies of subnational behavior, local vulnerabilities, and available subnational fiscal policy tools? Although the support from central government is always required for effective implementation, a few proactive measures could be undertaken by subnational governments to position themselves better when anticipating/facing crises.

First of all, just avoid spending contraction could act as a safety net against poverty increases.[7] This may entail negotiations with the central government with respect to transfers and devolution ratios. Second, improving spending efficiency may be more critical than ever. As subnational governments are generally closer to beneficiaries, the crisis could become an opportunity to favor cost-efficient local options, using local inputs, and relying more on local sources of employment.

Similarly, spending reallocations in favor of productive expenses, with impact both on short and long term growth, may translate into immediate benefits. However, the concept of productivity of expenses may vary depending on the level of government being considered. For example, reallocating spending towards certain infrastructures may well contribute to creating employment and stimulate growth at the national level but not necessarily benefit all subnational (regional or local) governments the same say. In the end national governments need to balance their economic stimulus goals with subnational equity considerations. At the same time, subnational governments need to be prepared to suggest growth-promoting programs and safety nets to satisfy their emerging needs at province and local levels.

It is also possible to envisage the creation, pre-crisis, of subnational contingency funds for education and health, since those sectors are more critical to the poor and tend to suffer the most in times of crises.

Regarding tax revenues, while changes to certain consumption tax rates (alcohol, basic food) may need to be agreed upon at national levels, subnational governments may have more flexibility with

local taxes. It becomes critical that they manage them taking into account tax capacity and effort levels in their own regions/local communities while respecting criteria of national tax harmonization.

Finally, increased accountability by tracking spending in a transparent way, avoiding leakages, involving the civil society, and improving communications about budget execution at subnational levels may result not only into higher efficiency but also act as a safety blanket against fiscal disequilibria in times of crises.

Final Remarks

Different decentralization models around the world will shape differently the impact of the current global crisis at the sub-national level. Subnational public finances will be affected by the way the central government handles the crisis at the national level knowing that debt sustainability risks emerging at subnational levels may jeopardize the country's capacity of response to the crisis.

At the same time, preventing public spending decreases and/or fiscal revenue devolution at subnational levels can act as a safety net against the crisis while preventing further disparities in the country. In addition, specific proactive fiscal measures and safety nets can be implemented at the subnational level to give income opportunities, protect, and empower the most vulnerable, while preserving the quality of fiscal adjustment.

Notes

1 World Bank (2008).
2 Easterly and Serven (2003).
3 Ferreina, Leite, and Ravallion (2007).
4 Friedman (2002); Bresciani (2002).
5 Schady, 2004.
6 Ferreira and Paes de Barros, 1999.
7 Example: Russia 1998 (Ravaillon and Lokshin, 1999).

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