Discussion of:

Intergovernmental Fiscal Cooperation – International Experiences and Possible Lessons for Brazil; By: Teresa Ter-Minassian and Luiz de Mello

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a. Introduction

The paper examines intergovernmental relations in a broad set of countries and identifies common conflicts and coordination problems that evolve in multi-layered governments. Based on worldwide policy experiences and some theoretical studies, the authors highlight the potential positive role of vertical cooperation and coordination fora among the various levels of government and of horizontal ones between subnational governments. Based on this analysis they also draw policy recommendations for Brazil, where intergovernmental relations hamper the conduct of fiscal policy.

The survey of intergovernmental relations and institutions provided in this paper is an excellent starting point for scholars wishing to study policy design for multi-layered governments. As in their previous work, the authors take a comprehensive approach and use their personal experience to highlight many issues that concern policy-makers across the globe when designing fiscal systems and mechanisms of intergovernmental relations.

In contrast to the comprehensive review of country experiences and policy issues, the theoretical analysis in this paper is somewhat too simplified, as the authors seem to ignore significant institutional and political obstacles to the implementation of the policy-making mechanism they recommend. It is difficult to oppose the desirability of a mechanism in which all the relevant institutions and interest holders cooperate and coordinate (C&C) – horizontally and vertically - for a mutual benefit. Nevertheless, the paper pretty much ignores the key question: why aren't these bodies already collaborating in the proposed manner and how should the incentives be designed to overcome the barriers to cooperation? There are substantial obstacles to establish and effectively operate the proposed institutions, and the political economy literature offers a wide discussion of this issue. Accordingly, the key question is how to bring the various players to take part in the proposed fora, rather than whether the C&C fora specifically, and institutions that facilitate joint discussions and settlements in generally, are beneficial.

b. Rules versus discretion

A key theoretical issue that seems to be directly related to the proposed C&C fora is the topic of rules-based versus discretion-based fiscal systems. The concept is not mentioned explicitly in the paper, but is at the heart of the recommendations. The intergovernmental fiscal cooperation (IFC) idea is based on a belief that if policy-makers from the various levels of government were provided with a mechanism to seat together and negotiate policy design they would come out with better results than in a system that is subjected to rules set (probably) by the central government. However, this outcome is conditional on the presumption that the intergovernmental fora will be able to agree on policies in a manner that overcomes conflicts of interest that the central government was unable to bridge or to enforce an efficient solution for. As discussed below, this is not a trivial presumption, and definitely one that requires a comprehensive discussion of the ways to establish the mechanism.

The authors provide an example for the difficulties that the creation of such fora may face when they explain that "For IFC to work effectively to prevent predatory tax competition, it is essential that participants agree to abide by clear rules". Of course, the heart of the issue is to get everyone to agree to such rules, or to be able to enforce them. If the form of these rules is clear, the question turns out to be one of implementation in the face of contradicting interests and preferences. This is typically where theory and past experience tell us that the first best solutions of mutual decisions – i.e. discretion – are often difficult to achieve and authoritative rules may provide the feasible "second best" solution. In the setting discussed by the current paper the horizontal conflicts of interests between various sub-national governments, and the conflicts between them and other levels of government, may turn the IFC fora into a floor of endless negotiations with little progress, since some parties are likely to benefit from a standstill. In such circumstances, setting the "rules of the game" in a way that prevents a standstill is in many cases equivalent to determining the final outcome, so the same forces that prevent enforcement of direct policy decisions – e.g. on income redistribution - will likely block these procedural rules – e.g., on veto players – as well.

c. Policy constraints and the ability to overcome them

A key topic that the paper is not very clear about is depicting the available space that policy-makers have for institutional design. In several points along the article the authors seem to argue that politically the proposed C&C fora are in fact the only feasible option. Of course, if this is the case, then the economic discussion is redundant. Nevertheless, the authors still need to come up with an explanation why such fora were not established yet under such circumstances. The same argument applies if the appropriate rules for launching such fora are already in place and do not have to be adopted by the political institutions. As discussed above, it is likely that there are reasons why the rules for C&C are not preset, and in such a political and legal environment it is not clear that attempting to establish a cooperative system is preferable to a more authoritative one.

Two missing pieces in the analytical discussion that would help making the paper more relevant for policy design are 1. How to construct incentives that will move the system towards the desired equilibrium? 2. What should we treat as "Given"? The multiplicity of institutional structures across countries indicates that different fundamentals lead to different settings of C&C; the authors could use these data to identify the relevant characteristics that led to effective institutional designs. They could also track the development of these institutions more systematically to explore the role of country fundamentals relative to incentive mechanisms in reaching the desired outcomes.

The question which institutional features should be treated as "given" and which should be targeted for change is also critical. For example, in countries in which the provinces have strong representation in the national parliament it is difficult to change procedures without cooperation. Such a system typically reflects an original gap in interests, for example due to differences in the economic structure or income levels of the provinces/states. Therefore, it is unlikely that bypassing this mechanism by establishing a C&C forum via rules that generate a different distribution of power will go through uncontested. Moreover, if it can go through than possibly the balance of power can be changed directly "at the source". In a political economy setting, it is also important to account for the likelihood that one-sided moves will backfire in a later date, given that policy is set in a "repeated game" environment; dictating a rule change is likely to make the achievement of future cooperation more difficult. Therefore changing the rules should be used sparingly; opportunistic moves should be avoided unless the underlying circumstances are deemed to have changed.

Similar policy design issues arise with respect to concurrent spending responsibilities and cost-sharing. Where such mechanisms exist, they are a potential source for a myriad of moral hazard incentives and conflicts. While these certainly require more coordination, the first question in such circumstances should be whether there is an opportunity to remove the overlap. In many cases such expenditure mechanisms are a reflection of social and political circumstances and the reviewed examples in the paper show that indeed more cooperation is found where it is "needed" in terms of the magnitude of expenditure responsibilities duplicity. It is not clear that these cases should be viewed as the examples to learn from, rather than as episodes where the core problem of concurrent expenditures was bypassed or mitigated. In terms of the policy recipe, when it is deemed impossible to agree on disentangling the policies, coordination may also not be politically feasible and vice versa; when effective coordination can be implemented it may well be possible and desirable remove the duplicity altogether.

d. Incentives for C&C and the case of Israel

The potential obstacles to C&C stress the important role of designing appropriate incentives for collaboration in improving IFC. Clearly, the opposition to change varies significantly across countries and periods, but if reform seekers manage to reshape the external forces that affect SNGs in a way that mobilizes internal support for C&C this may be an effective mechanism. Such changes might be politically feasible because many local politicians are more concerned with micro issues – such as freedom to run their local administration (their power base) than with macro issues. Accordingly, it may be easier to agree first on macro frameworks – the removal of some inter-regional trade and labor-mobility barriers; deficit and debt levels. These can make distortions such as cascading taxes, tax competition, expenditure overlaps and fiscal migration visible to the public – and mobilize local internal forces that would lead to efficiency gains through micro C&C.

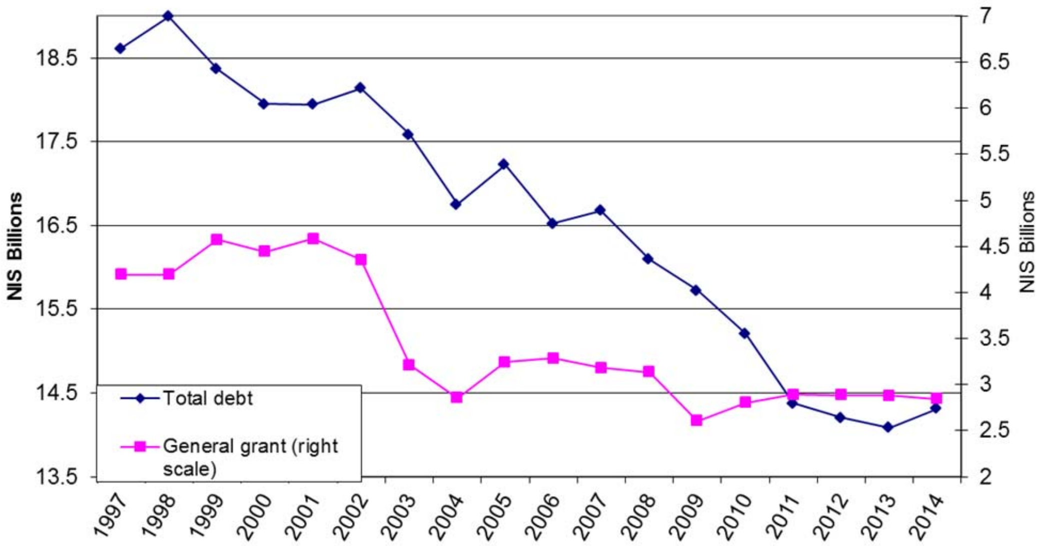
In most cases, the success of policy reforms that relate to SNGs is preconditioned on the implementation of a hard budget constraint. Without it policy-makers and their electorates will likely prefer to avoid the concessions that are needed to promote C&C and would expect the costs of inaction to be shared with the rest of the country. The basic features of hard budget constraint are no, or only partial, bailouts of failing SNGs (examples for it in the paper are Canada and the US); transfers that are formula based, and not subject to negotiations; maintaining the marginal cost of policy at the local level, even if equalization grants are generous; and reducing or eliminating the size-based transfers to small localities – thus enhancing the motivation to cooperate in order to utilize returns to scale. The paper also provides some useful examples how financial incentives were used to smooth the implementation of such measures.

Mobilizing internal political forces requires, in addition to changes in the fiscal design of incentives, improvements in transparency and in the accessibility of information to the public. Measures in this category include the adoption of unified accounting standards, broad reporting and the activation of effective information dissemination mechanisms. These were for example an important focus in the Australian SNG reform. Transparency and accountability can also be enhanced by clear separation of responsibilities between different levels of government.

One successful example for the use of the proposed measures to mobilize domestic voters and promote significant changes in intergovernmental relations and improvements in local government performance is the case of the Israeli reforms in the 1990s. These mechanisms had a substantial impact on the electoral process, on SNG fiscal outcomes and on efficiency. These reforms were launched at the time the country faced the enormous task of absorbing 1 million immigrants from the FSU (20% of the population at that time), with a considerable associated fiscal burden. The reforms included introduction of formula-based equalization grants, reduced compensation for small municipalities, the adoption of unified accounting standards, the employment of external accountants nominated by the Ministry of the Interior to audit all the municipalities on an annual basis, publication to the public of the results of the audits in a unified format that allowed easy comparisons, the adoption of formal tough criteria for bailouts - including effective conditionality for the aid component - and the initiation of annual wage reports on local authorities by the Ministry of Finance. These policy measures were importantly supported by the emergence of local media that focused on local and regional issues, hence delivering the newly generated data to the relevant public.

As reported in Brender (2003)[1] the reforms had important outcomes, in line with the policy targets outlined above. These included a disconnection between local and national parties, with voters beginning to focus on fiscal management. Starting in the 1998 elections, voters began to punish inefficient performance and non-prudent fiscal behavior. As a result, mayors began to increasingly engage in C&C programs between LAs in order to utilize economic advantages and returns to scale. These new policies were also reflected in a continuous improvement of fiscal prudence as evident in the following chart.

LAs Debt and the General Grant (2014 prices)



[1]Brender, A., 2003. "The effect of fiscal performance on local government election results in Israel: 1989-1998." *J. Pub. Econ. 87*, 2187–2205.

e. Brazil

Following their general policy analysis and recommendations, the authors present Brazil as a case study to which they apply their conclusions. They begin with a characterization of prevalent problems in Brazil's intergovernmental relations which include a "Tax war" that leads to inefficiency and revenue loss. However, as some states are bound to lose from tax harmonization there are lingering difficulties in resolving the conflicts. Additionally, Brazil's fiscal system is characterized by a vertical overlap of expenditures that leads to waste and inefficiency, and the equalization grants' system is outdated. Accordingly, the high transfers diminish the motivation of SNGs to collect taxes, and the discretionary authorization to borrow reduces the drive of politicians to expedite the resolution of fiscal imbalances. While I am no expert on the specifics of the Brazilian political and fiscal systems, it appears that these problems require much deeper solutions than simply developing fora to discuss fiscal issues between the different levels of government. I would therefore recommend a deeper analysis of the roots of the Brazilian intergovernmental C&C problems, to identify the sources of the existing caveats, before concluding the IFC fora are a feasible and/or desirable solution for this substantial policy challenge. If it is still viewed as the way to go, much effort should be placed on designing the appropriate incentives that will overcome the forces that shape the existing system.