

Intergovernmental Fiscal Outlook for 2024 and 2025

This document is prepared semi-annually to set the stage for discussions at the OECD Network on Fiscal Relations across Levels of Government annual and interim meetings. It presents an overview of the economic outlook and how it translates into the prospective fiscal scenario across levels of government. It also includes a discussion on relevant themes that impact subnational governments' (SNGs) fiscal sustainability and their impacts on central and general government.

Key Messages

1. GDP growth estimates have been revised slightly upwards and projected inflation shows a trend towards targets, but interest rates should remain elevated.¹
2. Subnational government (SNG) revenues are projected to grow around 1.4% in 2024, and 2.1% in 2025, despite some negative revisions for 2024.
3. However, with higher interest rates, SNGs will likely face important challenges in managing their debt.
4. Six countries have SNG debt-to-revenues above 250%, and another four above 200%.
5. SNGs' debt in most countries is highly vulnerable to interest rate movements, with a 56% average share of bank loans and short-term bonds.
6. Using portfolio characteristics and some scenarios for rates, interest spending may increase between 0.4 and 1.0% of GDP, or 4 and 11% of SNG revenues.

1. INTRODUCTION

The global macroeconomic outlook has improved further, with growth showing some resilience and inflation falling a bit faster than expected. But activity remains subdued and important geopolitical risks keep uncertainty high. Headline inflation is already pointing towards targets in most countries, which gives some space for a slow monetary policy easing. But inflation is still above targets and real rates

thus will remain above neutral levels in most countries for the near future.

Drawing on the projection tools developed by the OECD Network of Fiscal Relations (OECD, 2023c) and based on economic developments across OECD and G20 economies captured in the *OECD Interim Economic Outlook* published in February 2024 (OECD, 2024a), this note updates the intergovernmental fiscal outlook from

¹ Projections are based on the OECD *Interim Economic Outlook* (OECD, 2024a). This note was prepared by Acauã Brochado, collaborator to the Network on Fiscal Relations, with inputs from Pietrangelo de Biase, under the supervision of Sean Dougherty, Head of the Network Secretariat. We are grateful for comments on the document from delegates of the Network as well as OECD colleagues Boris Cournède and Sébastien Turban of the Economics Department.

November 2023 (OECD, 2023a) and discusses its main implications. The note also refers to a recent paper on debt profiles and risks for SNGs (OECD, 2024b), especially to the estimates of higher interest spending in the current environment of heightened inflation and policy rates.

The following sections show that revenue forecasts are growing at a slightly slower pace, with some stronger negative surprises. Expenditure pressures are still mounting, and the debt exposure to interest rate movements is

raising financing costs and interest payments. The fiscal balances of SNGs in the OECD may move to negative territory due to a surge in borrowing costs. Those are unevenly distributed across countries and jurisdictions, depending on their fiscal deficits and debt portfolios (maturity and interest rate profiles). Central governments would benefit from closer monitoring of subnational finances and debt portfolios to avoid having to support them in times of needed fiscal consolidation.

2. ECONOMIC CONTEXT

2.1. GDP growth estimates have been revised slightly upwards, while projected inflation has declined but remains pressured amid heightened interest rates

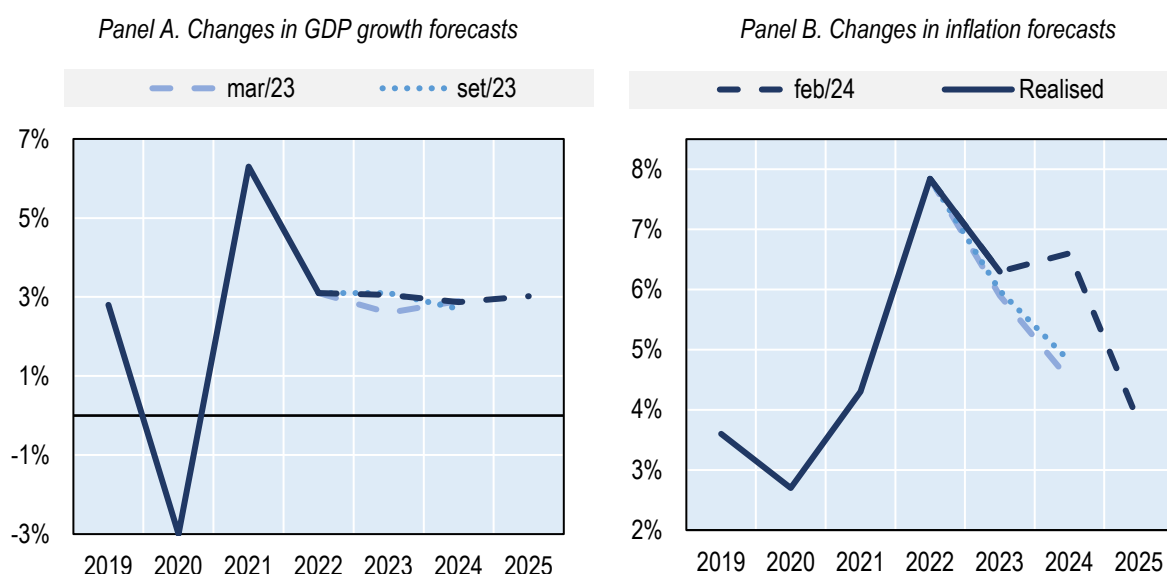
The macroeconomic outlook has improved further, with growth showing some resilience in 2023. Inflation declined faster than anticipated and energy support schemes helped to preserve households purchasing power. Excess savings from pandemic years are still not exhausted helping to sustain consumption. Government spending also remains strong. In Europe, growth weakened somewhat, mostly because of cooling bank financing. In some emerging markets, especially where the monetary cycle started earlier or where governments keep investing in infrastructure, growth remains strong. The exception is China, with slowing consumer demand and contraction in the housing and construction sector weighing on growth.

But activity remains subdued, below past decades' average, and important geopolitical risks keep uncertainty high. The conflict in the Middle East and the attacks on ships in the Red Sea keep supply chains stretched and energy markets tense.

Headline inflation is already pointing towards targets in most countries, which gives some space for a slow monetary policy easing. But

underlying (core) inflation is still pressured, mostly by tight labour markets, and monetary policy should remain tight, keeping real rates above neutral levels in most countries. The risk that a longer period of higher interest rates may trigger financial vulnerabilities built up in a long period of very low rates and rising indebtedness is also still very present (OECD, 2023b).

Against this backdrop, projections of growth and inflation were moderately revised since the previous Intergovernmental Fiscal Outlook (and IEO). For the G20, projected GDP growth is now 2.9% for the year 2024, compared to 2.7% projected in Sep/23. For 2025, GDP growth is expected to reach 3.0% (Figure 1, Panel A). Inflation in the G20 ended 2023 at 6.3%, slightly above the 6.0% projected in Sep/2023. For 2024, projections for the aggregate G20 were revised upwards to 6.6%, from 4.8% in the previous Outlook (Figure 1, Panel B). This number is, however, distorted by figures for Argentina and Turkey. Not considering these two countries, the rest-of-G20 inflation should decline from 3.6% in 2023 to 2.6% in 2024 and 2.4% in 2025.

Figure 1. Growth and inflation outlook for the G20

Notes: Inflation for 2024 is distorted by data for Turkey and Argentina. Without those, for the rest-of-G20, average inflation forecasts for 2024 remained very close to last figures.

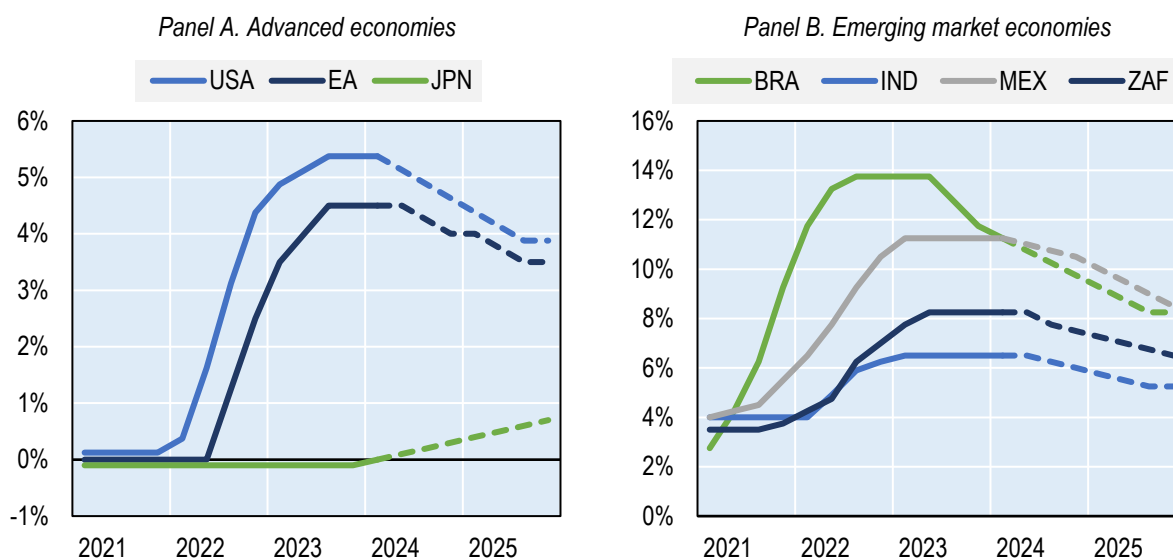
Source: OECD Quarterly National Accounts (Database), OECD Economic Outlook Interim Report (February 2024), OECD Economic Outlook, Interim Report (September 2023) and OECD Economic Outlook, Interim Report (March 2023).

2.2. High inflation still calls for heightened interest rates, which can trigger financial vulnerabilities

While headline inflation is forecasted to ease further towards targets, underlying (core) inflation still must show stronger easing trends. Additionally, geopolitical risks for energy prices and supply chain disruptions continue to be tilted to the upside. On top of that, although growth remains subdued, labour markets still have not shown clear signs of easing by the usual measures, like unemployment rates. Thus, risks for the inflation forecasts continue to be towards the upside.

Some countries however are already slowly lowering rates, others are expected to start some time in 2024. Easing will nonetheless be mild, with most central banks still willing to keep monetary policy in a restrictive stance.

Forecasts indicate that rates will gradually fall until the end of 2025 but remain (significantly) above levels observed before 2022. 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 (February 2024).

Therefore, there is still the risk that a longer period of heightened interest rates may trigger financial vulnerabilities built up during the long period of extremely low rates (OECD, 2023b). In particular, as will be discussed below, subnational governments' debt is, in some cases,

highly exposed to interest rate movements. Together with the fact that SNGs in general also face liquidity and borrowing constraints, they are particularly vulnerable and may struggle to keep debt payments on schedule without major fiscal rearrangements.

3. THE UPDATED SUBNATIONAL FISCAL OUTLOOK

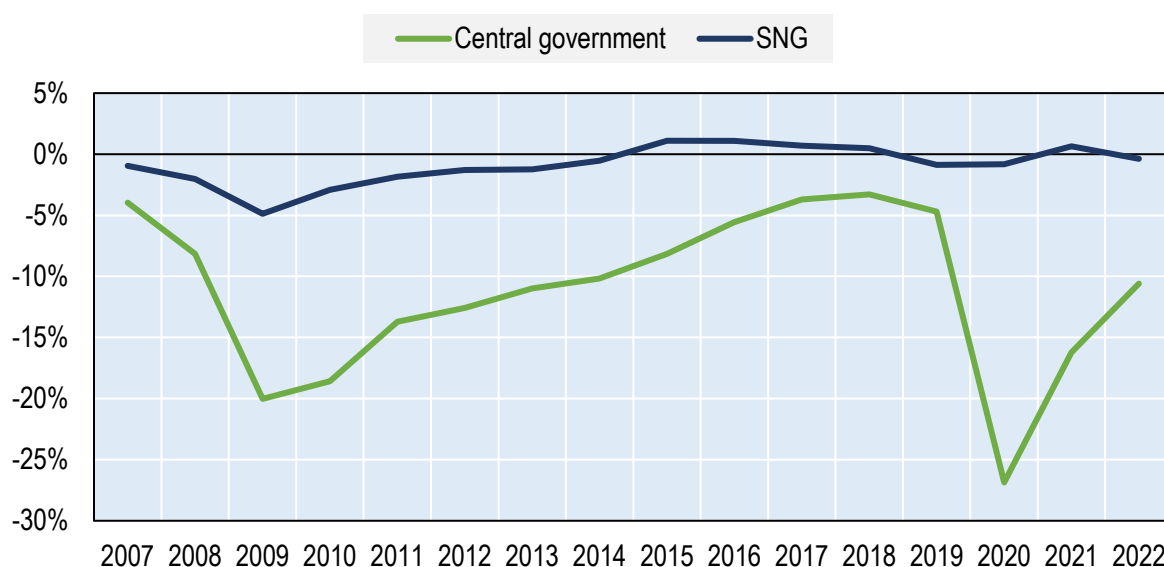
3.1. Preliminary data for 2023 indicate resilience, but financing risks are starting to appear

In contrast to central governments, who absorbed most of the shock caused by COVID-19, the finances of SNGs in general improved in the aftermath of the pandemic (Figure 3), in great part supported by transfers from central governments, but also because of changes in consumption patterns which, in some cases, benefited SNG tax collections. Beginning in 2022, however, the trend reversed because of the shock in energy prices and migration caused by the invasion of Ukraine by Russia. Revenue forecasts have been revised downwards, and expenditure and financial pressures persist.

Despite the overall relatively good shape of SNGs' budget balances, it is worth noting that general government debt levels are still not far from their historical highs in 2020 (OECD, 2023b).

This has important implications for SNGs. First, it implies that central governments have little fiscal space to provide additional help (if need be) to SNGs. Second, highly indebted SNGs might be asked to help contribute to the overall reduction in general government debt, as is currently happening in China.

Lastly, in this scenario of high government debt and inflation, a long period of heightened interest rates can become a serious threat to highly indebted SNGs, depending on their debt profiles, in terms of maturity and indexation. The analysis below benefits from a recent study (OECD, 2024b), which assesses these characteristics to estimate changes in SNG interest spending for the next couple of years.

Figure 3. Fiscal balances of central governments and SNGs as a share of revenues

Note: Median of OECD countries is shown.

Source: OECD – System of National Accounts, Table 12 – Net lending (+) / Net borrowing (-).

3.2. Projections for revenue in 2024 were revised downwards but for 2025 they are positive

Despite the current good shape of SNG finances, looking forward, more modest economic growth will directly affect SNG revenues. Taking estimated tax buoyancies² (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 project SNG revenues for the present and near future. Figure 4 shows the current revenue growth estimates, compared to estimates from the last Intergovernmental Fiscal Outlook in November 2023 (OECD, 2023a). For 2023 there are still no final data available, and the current estimates are very close to the previous ones (Figure 4, Panel A).³

² 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 an analysis of SNGs' short-term buoyancies see (Dougherty & de Biase, 2021).

Regarding 2024, projections for half of the countries did not move substantially, but for the others there were some relevant changes. For US SNGs, there was a positive change of around one percentage point, with revenues expected to now see real growth of more than 2%. This is corroborated, for example, by the very positive tone of the analysis for the United States (Volcker Alliance, 2024), which showed surprisingly positive fiscal expectations for US states despite reductions in tax rates in the aftermath of the pandemic. On the other hand, the buoyancy-based projections of real revenue growth for SNGs in Spain,⁴ Canada, France and Germany fell,

³ The preliminary updated projections for GDP growth still do not cover all OECD countries (only G20), so this analysis focuses on those available in the February 2024 OECD Economic Outlook Interim Report (OECD, 2024a).

⁴ Note that for Spain, 2024 AIREF medium-term projections appear to be relatively stable relative to GDP (AIREF, 2024).

by up to almost 1 p.p. in the case of Germany, as illustrated in Figure 4, Panel B.

For 2025 (Figure 4, Panel C), SNG revenues are projected to grow in real terms by around 2% in

most countries, while for France, Germany, Italy and the United Kingdom, growth should be around 1%.

Figure 4. SNGs own revenues' annual growth in real terms



Note: Blue hollow dots represent estimates using September 2023 Interim Economic Outlook. Green and red arrows represent current estimates using February 2024 Interim Economic Outlook (OECD, 2024a), with positive and negative changes, respectively. For 2025 solid blue dots represent current projections. Uses consolidated revenues. Projections used the mean group estimator for each type of tax revenue from Dougherty & de Biase (2021). SNGs' own revenues refer to total revenues minus transfers received from other levels of government – they therefore include own tax and non-tax revenues, such as user fees and charges.

Source: Authors' calculations based on OECD (2024a), OECD System of National Accounts and OECD Fiscal Decentralisation database.

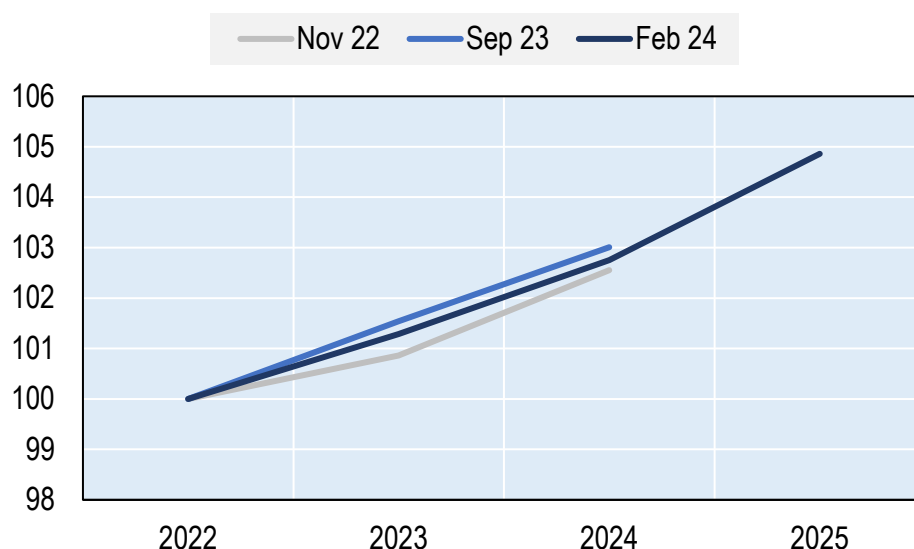
To get a better sense of the overall movement, looking at the median of projections for the countries listed above, current estimates for 2023 and 2024 still show moderate growth, though marginally below the last forecasts. On the other hand, projections for 2025 show a slight acceleration of growth for revenues. In Figure 5, it is possible to see that the most recent figures foresee a catch-up towards the trend of the previous projections, and even go slightly beyond them. Using the median estimates, SNGs revenues are expected to grow 1.4% in 2024, and 2.1% in 2025.

We see two main risks to these projections. Firstly, on the positive side, many SNGs have a

sizeable share of their revenues coming from taxes on services, and the services sector, both in real and in nominal terms, has been outperforming the goods sector since the end of the pandemic (OECD, 2023b). The estimates discussed above, produced using the OECD buoyancy framework, however, do not consider the detailed forecasts for goods and services sectors. Therefore, there is a chance of some positive surprises for revenues in countries where SNGs significantly tax services. On the negative side, however, rising interest rates are eroding one of the most important tax bases for subnational governments, as property values fail to keep pace with inflation in many OECD countries.

Figure 5. Trends in forecasted SNG's revenues

Median trajectory of SNG's revenues from 2022 to 2025, expected at current and previous outlooks



Note: Index is set to 100 in 2022. 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 (September 2023), OECD Economic Outlook – Interim Report (February 2024), OECD System of National Accounts and OECD Fiscal Decentralisation Database.

3.3. On the expenditure side, there are still little signs of easing, while interest payments could increase by up to 1% of GDP

After the first generally positive impact of inflation on the nominal value of tax collections, it may now negatively affect public budgets through higher prices of goods and services that they buy to fulfil their mandates. The rise in wages, for example, will probably impact SNGs directly.⁵ Also, the intense migration, especially in Europe, still puts pressure on SNGs' expenditures.

Moreover, in this scenario of high general government debt and high inflation, interest rate hikes, either by monetary policy tightening or by higher risk aversion overall, can become a serious threat to highly indebted SNGs. While at first inflation can help reduce debt-to-revenues

ratios,⁶ when debt is large and interest rates rise, the overall result might be higher debt.

Six countries (Mexico, Netherlands, Ireland, Austria, Estonia and Spain) have aggregate SNG debt-to-revenues above 250% (OECD, 2024b) as of 2022.⁷ With such a debt level, in a hypothetical stress scenario, should interest rates on the whole outstanding stock rise by 5 p.p. (close to what has been observed for monetary policy rates), annual spending for debt service would grow by 12.5 p.p. of revenues, potentially causing major fiscal challenges.

However, the degree and speed at which rate increases will translate into higher debt service

⁵ See, for example, the frequent strikes from local and regional public servants in Germany (Tagesschau, 2023).

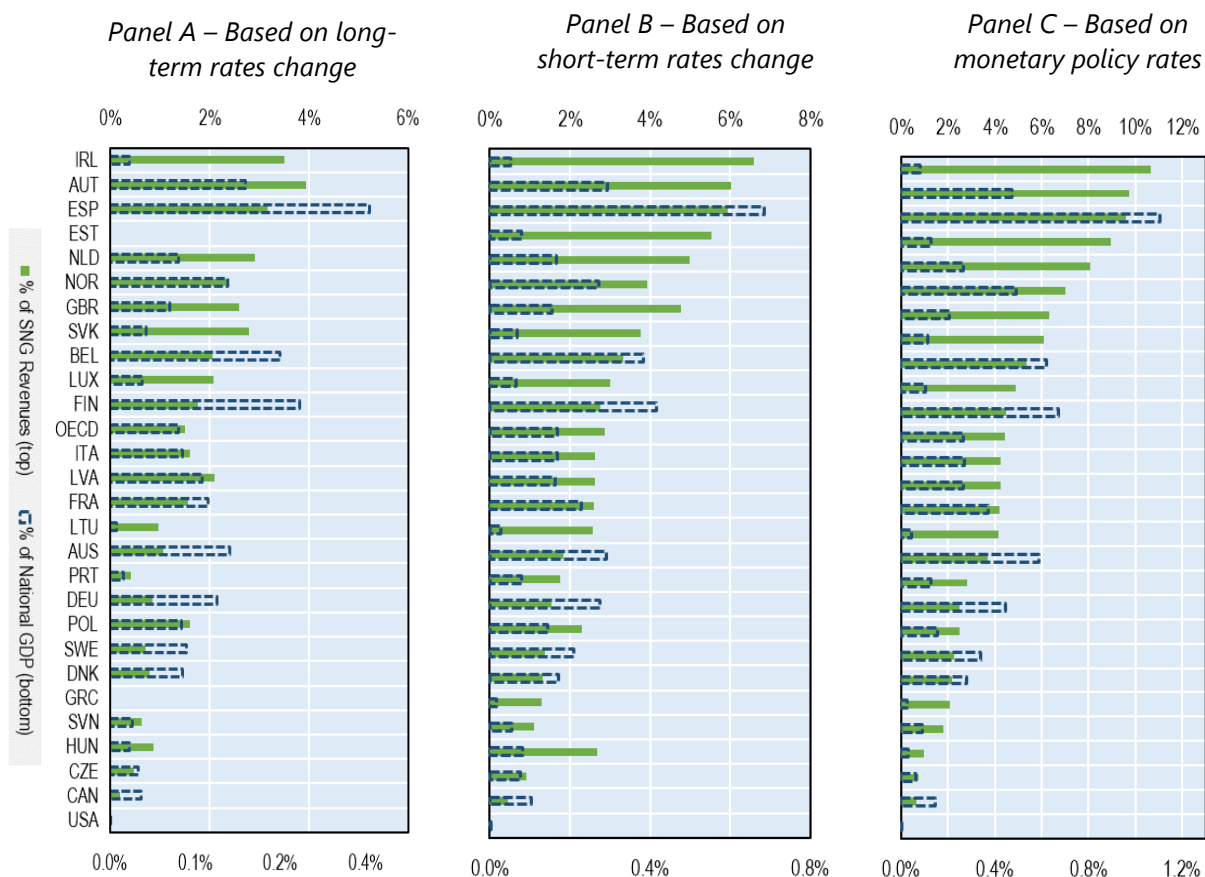
⁶ Provided debt is not mainly inflation linked.

⁷ Also, the United Kingdom, Canada, Norway and Belgium show numbers above 200% (OECD, 2024b).

accrual and payments depends crucially on SNGs' debt profile in terms of maturity and indexation, which varies significantly across countries and

between jurisdictions. Some of these characteristics are assessed below, together with three borrowing cost assumptions.

Figure 6. Estimated growth in annual interest expenses: three scenarios



Note: Bars represent estimated growth in interest expenditures, in percentage points of SNG revenues (green) & national GDP (blue dashed). Source: OECD (2024b).

Figure 6 shows some estimates of the growth in SNGs' expenditures with interest payments for three different scenarios (OECD, 2024b). Since systematic information on actual past and current borrowing costs for SNGs is scarce, the exercise focuses on the changes (not levels) of sovereign short and long-term rates for each country.⁸ The idea is to capture the change from a low-interest rate environment to the current high rates scenario. For this, the calculations use the

difference between the average rates observed in the period 2015 to 2020, and the average between 2022-2023, for short and long-term rates, in each country. A stress scenario also looks at a hypothetical change of 5 percentage points in borrowing costs for all countries.⁹

The calculations consider the shares of floating and short-term debt, as well as the shares of debt-to-GDP and debt-to-revenues. The United States and Canada, even as highly decentralised

⁸ Implicitly the assumption is that spreads between SNG and sovereign borrowing costs remain constant in this period, or fluctuate less than rates in absolute terms.

⁹ Consistent with the movements in monetary policy rates seen in 2022-2023 in most OECD economies.

federations, show low risk, mainly because of the low share of short-term and floating rates bonds. They are followed by Czechia, Hungary, Slovenia and Greece. With high bars both in relation to SNGs' revenues and to national GDP, Spain,

Ireland, Austria, Estonia stand out as having more vulnerable SNGs, with high estimates in relation to SNG revenues, and Finland, Belgium, Australia and Austria (again), with high numbers in relation to national GDP.

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