Fiscal Federalism
- some thoughts

John Hassler

Swedish Fiscal Policy Council and IIES

Institute for International Economic Studies, IIES

FINANSPOLITISKA RÅDET
SWEDISH FISCAL POLICY COUNCIL

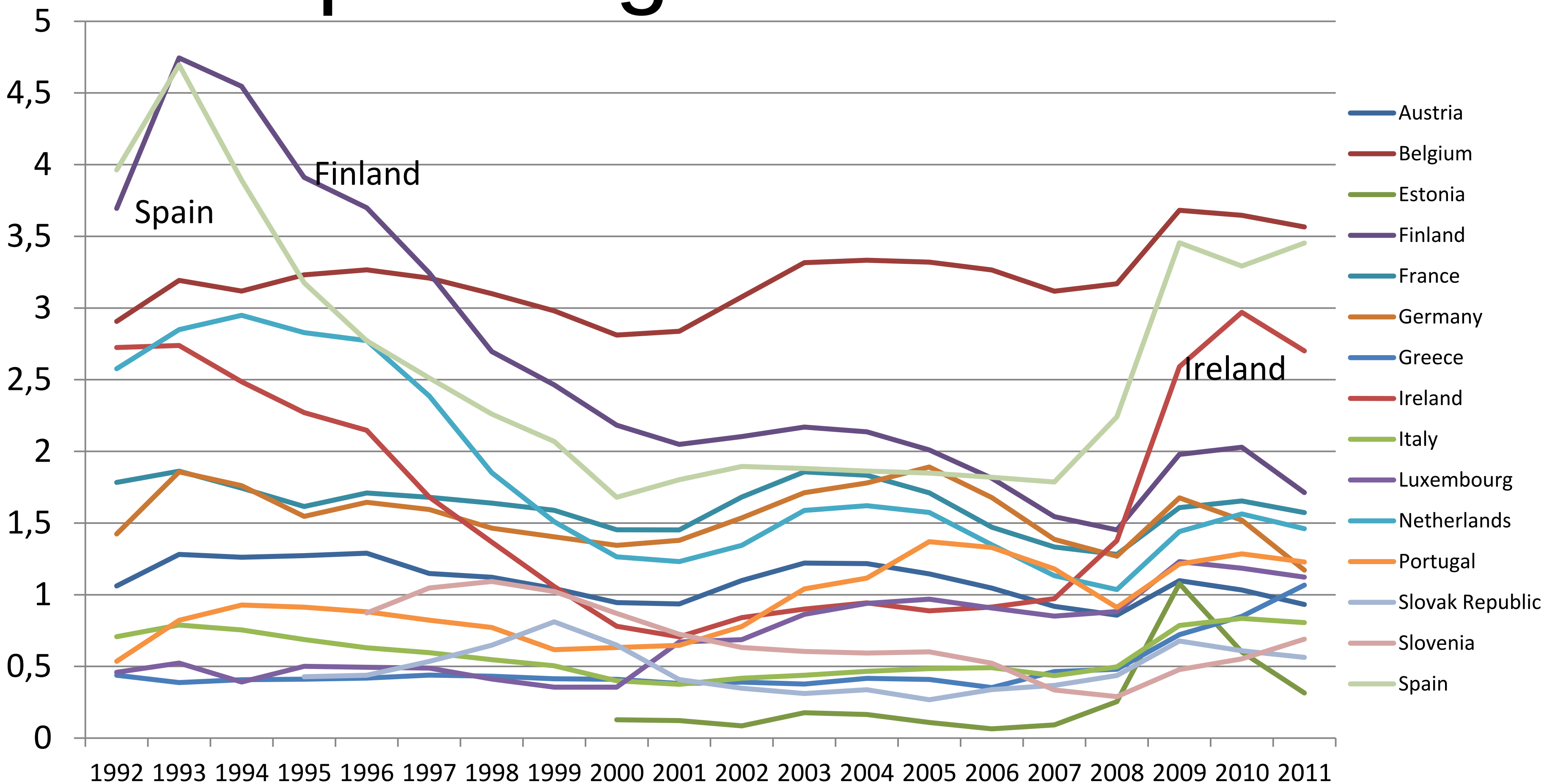
Why federal fiscal policy?

1. Financing union-wide public goods
2. Means to foster integration
3. Insurance against idiosyncratic shocks
4. Tax competition
5. Policy spillovers

3. Insurance against idiosyncratic shocks

- Theoretically a “free lunch”.
- In practice not – trade-off risk reduction and moral hazard/monitoring cost.
- Larger insurance pools:
  - more risk reduction (at decreasing rate)
  - higher costs (at increasing rate)
  - value of pooling lower if risk is correlated
  - transfer rather than insurance if average risks are different
  - $\rightarrow$ optimal size.
- Are member states too small for efficient risk sharing?
- Example: unemployment insurance.

Unemployment insurance spending share of GDP



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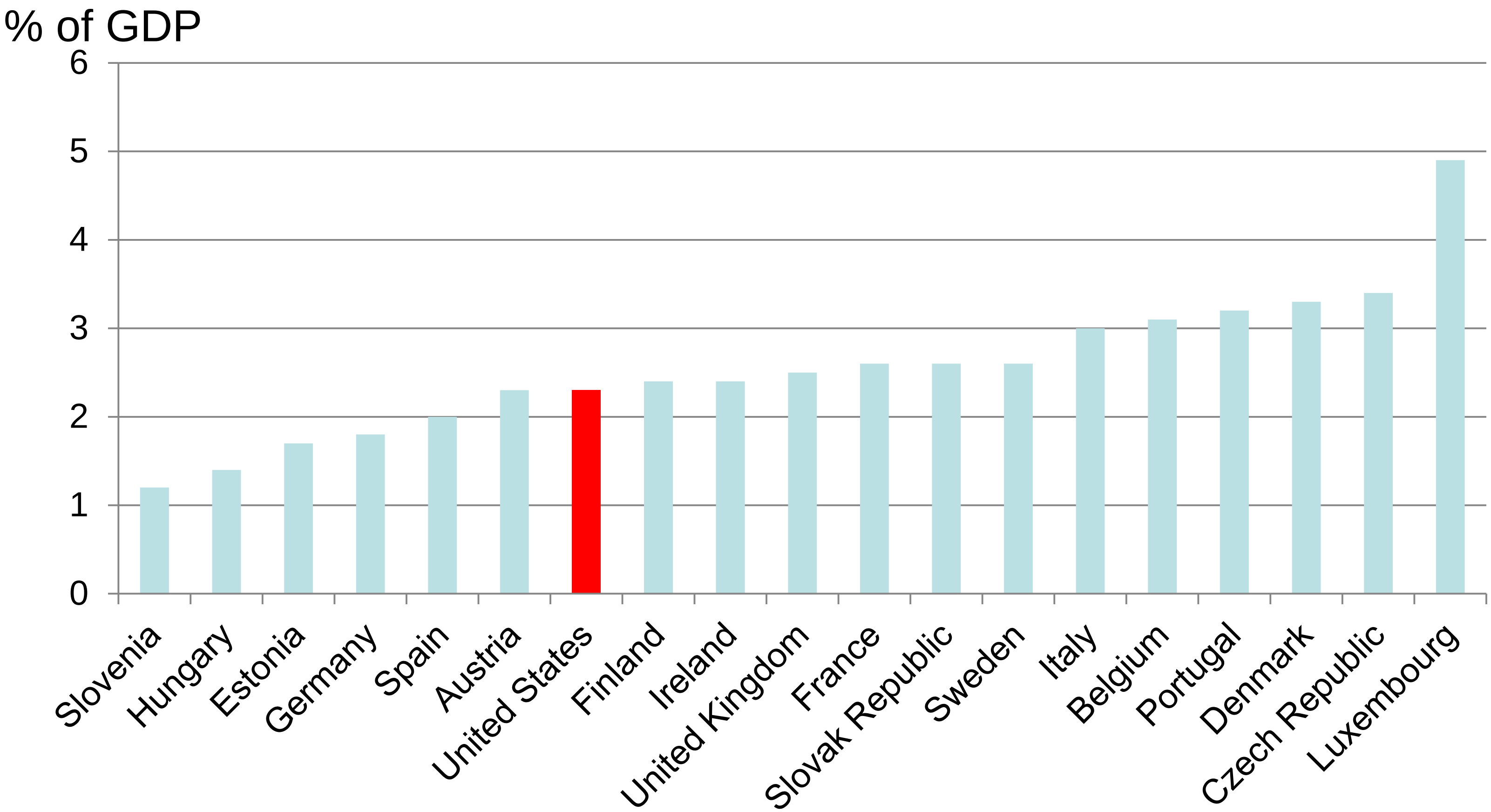
4. Tax competition

- If tax bases are mobile within EU but less to countries outside of EU, tax competition can drive down tax revenues to suboptimal levels (even zero).
- Harmonization seems largely to work.
- Example: corporate tax revenues

Revenues from tax on corporate profits 2013



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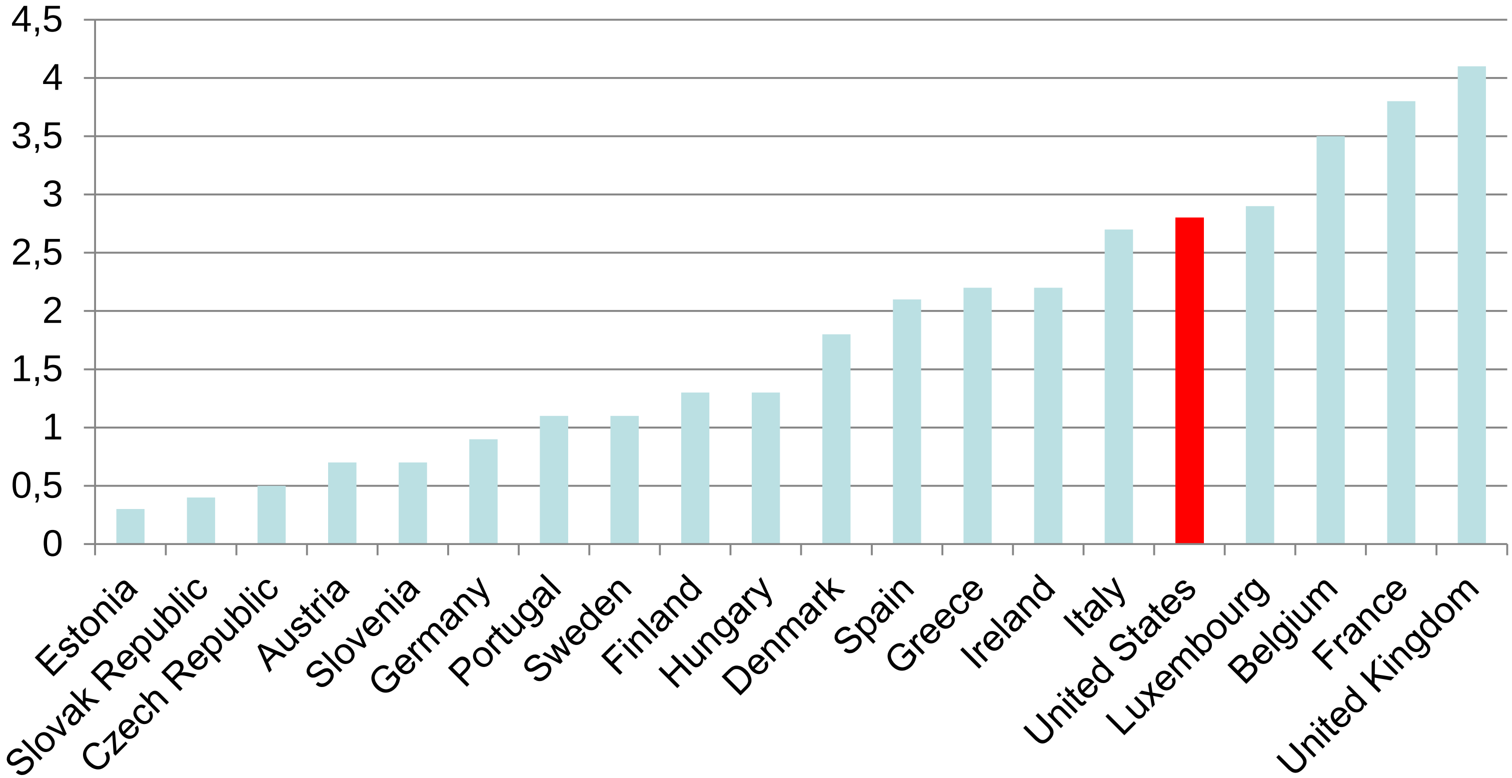
Revenues from property taxes 2013

% of GDP



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5. Policy spillovers

- In small open economies fiscal policy affects other countries – demand spillovers, exchange rates, interest rates, capital flows.
- Not necessarily taken into account by individual governments.
- Positive as well as negative spillovers – not clear if uncoordinated policy becomes too active or too passive. Example:
  - Direct demand spillover through trade $\rightarrow$ too **passive** uncoordinated stimulus against common demand shock.
  - Effect on exchange rate $\rightarrow$ too **active** uncoordinated stimulus against common demand shock. (Remember EZ has floating exchange rate implying aggregate fiscal policy is not thought so effective).
- Pre-crisis view that positive spillovers are not likely to strongly dominate. But little consensus on size of fiscal multipliers.

Updated macroeconomics

- Macroeconomic theory used to be much less useful for fiscal policymakers than for monetary. That is now changing.
- New and quite practical evidence on multipliers.
- Fiscal multipliers and spillovers may sometimes be quite high:
  - If CB does not respond; fixed exchange rate or zero lower bound.
  - Financial freezes and liquidity constraints.
- Low or negative multiplier if debt is high or spending increases permanent.
- Evidence of important positive fiscal spillovers at global scale during crisis.
- Dooms-loop increase risk of self-fulling expectations, runs and contagion.

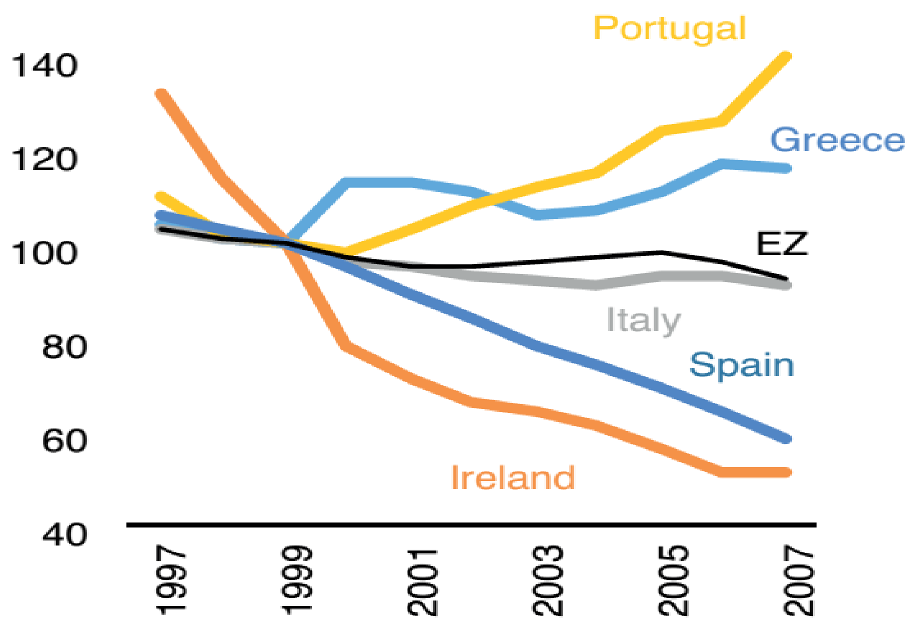
Consequences for fiscal policy

- View of reasonable practitioners and policy makers largely supported by recent findings. Timely, Targeted and Temporary remains key policy recommendation.
- Implement strong fiscal norms in normal times to:
  - allow automatic stabilizers to work, and
  - give room for discretionary policy when needed.
- Discretionary fiscal policy should target observable liquidity constraints and other market failures, not general stimulus.
- Crisis with asymmetric ability to act requires more policy coordination than during normal times. Aggregate EZ fiscal policy was destabilizing (pro-cyclical) during part of crisis.
- Fiscal norms and rules need to have popular and local political support. Learning from crisis requires a common narrative.

Fiscal Union?

- Does the crisis demonstrate the necessity of a fiscal union?
- EZ crisis not caused by excessive pre-crisis government borrowing.

Government debt % of GDP



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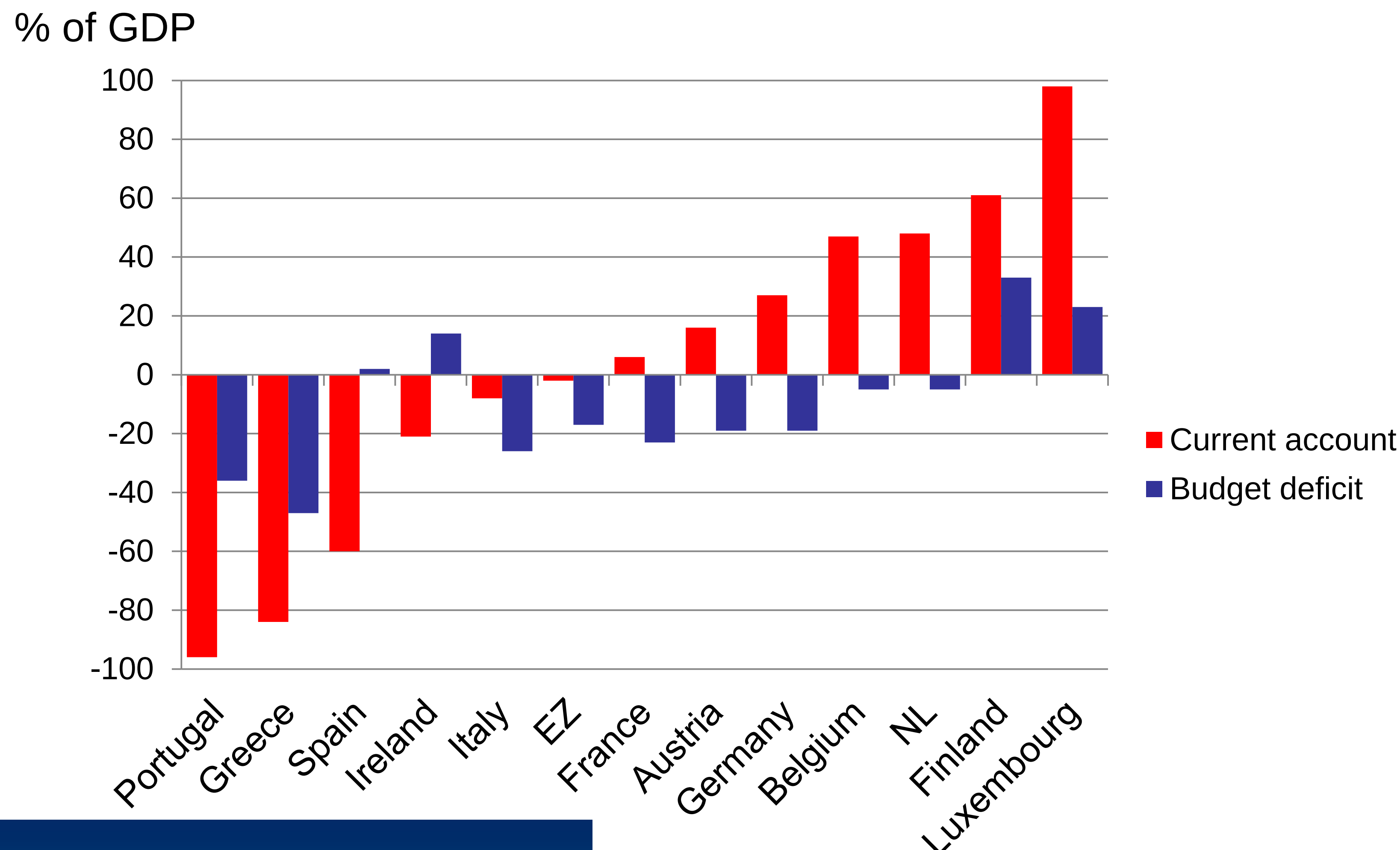
- EZ crisis not caused by excessive pre-crisis government borrowing.
- Key cause: inability to deal with
  - diverging price/wage trends,
  - large capital flows, and
  - too large undercapitalized banks.
  - Implied very late and thus very dramatic “sudden stop”.

Accumulated current account and government budget 1999-2007



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  - Too large undercapitalized banks.
  - Implied very late and thus very dramatic “sudden stop”.
- Financial markets not enough integrated to smooth shock, rather the opposite.
- Strong fiscal union would have made it easier to deal with crisis,
- but not a necessary ingredient (and not politically feasible).

Banking union

- Flaws in EZ financial system key problem. Should be part of new theory of Optimal Currency Area.
- EZ banks and sovereigns cannot live without each other. Financial system should spread risks not amplify.
- Orderly default not possible – should be.
- Contrast to the US – what would happen if state California were shut out from markets?
- Smart banking union may get popular support. Take over troubled banks rather than bail out. Requires common fiscal backing, but much less than a full-fledged fiscal union.
- Without a well designed banking union, a strong fiscal union is necessary. With a banking union, EZ can probably exist without it.