

Fiscal Institutions for a Currency Union

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Motivation

- There appears to be general agreement that
 - The European Union, in particular the Euro area, needs fiscal rules
 - Existing rules under the Stability and Growth Pact have not been sufficient and need further amendment to fulfill this need
- Bailout of Greece and impending fiscal crises in other Euro area members is the most salient recent evidence

Motivation

- The history of the SGP suggests that it is hard to fashion effective fiscal rules for a currency union
 - If too restrictive, will be ignored
 - Hard to target the things that matter, particularly if accounting practices and financial engineering make reported fiscal aggregates less meaningful
- The question: can the rules be designed to work better?

Is This the Right Question?

- Should we try to design better fiscal rules for the Euro area, or would a different approach be preferable?
- Possible Alternatives:
 - No rules, possibly combined with new regulations on private behavior to make the absence of rules work
 - Independent fiscal authorities, to provide better information and evaluation of country situations

An Alternative Reality

- United States, also, is a currency union
- States do have strong budget restrictions – stronger than those of the SGP
- But these budget restrictions were self-imposed
- If the US doesn't need centrally imposed budget rules, why does Europe?

Budget Rules and Currency Unions

Why should budget rules and currency unions go together? Several potential explanations, but they generally don't help in this case:

1. Without independent monetary policies, countries need to coordinate fiscal policies as well
2. To avert the Samaritan's dilemma
3. To protect countries with cross-border exposure

Avoiding Fiscal Shocks

- Depends on the strength of interdependency
 - If countries' economies are relatively independent, then who cares about another country's macroeconomic developments?
 - An empirical question; answer using simple VAR:

$$(1) \quad X_t = \Pi X_{t-1} + u_t$$

where X is a vector of log changes in output for different countries; restrict off-diagonal elements of Π based on countries' size or trade connections

Interdependence: Eurozone vs. US

- Measure effects of unit shocks in individual Euro area countries on aggregate Euro area output, and effects of individual US states on aggregate US output, using impulse response functions
- Focus on “problem” countries and states:
 - Greece, Ireland, Spain, Portugal
 - California, Nevada, New Jersey, Texas

Results

- For Europe, Spain and Portugal more important than Ireland or Greece
- But all of US states more important for US than any of European countries are for Europe
 - The smallest of the four US states (Nevada) more important than the largest of the four Euro area countries (Spain), even though a much smaller share of aggregate GDP
 - Reflects greater economic integration of US

Implications

- So why isn't the US more concerned?
 - Because US states have smaller budgets?
 - But budget gaps and spending/tax adjustments are large
- Even if want to limit spillovers,
 - Why focus only on fiscal policy, when shocks have many sources?
 - Why focus on budget deficits, when these aren't especially good proxies for fiscal shocks?

The Samaritan's Dilemma

- The story: Europe requires budget control, because it knows it will feel compelled to bail out those in need, even if the need has a strategic origin
- A logical story, if membership in a currency union reflects common interests and social integration
- But, does this describe better Germany and Greece or New York and New Jersey?

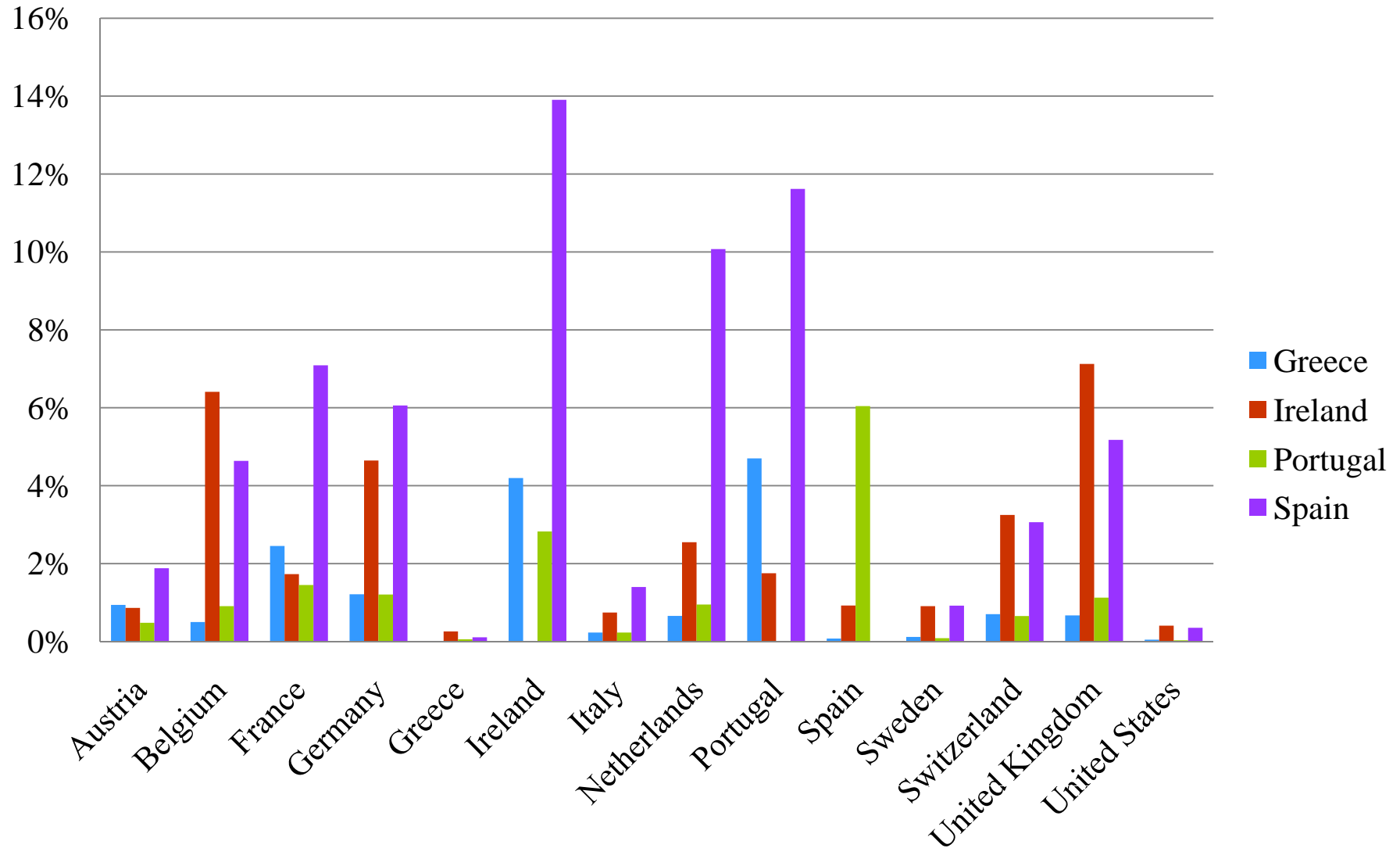
The Samaritan's Dilemma

- It is true that US has much stronger central tax and spending mechanisms programs to cushion effects of regional shocks, which lessen the pressure to aid those in need
- But doesn't the lack of programs in Europe tell us something about social cohesion there?
 - Why isn't there a progressive income tax that redistributes from Germany to Greece, the way there is from New York to Alabama?

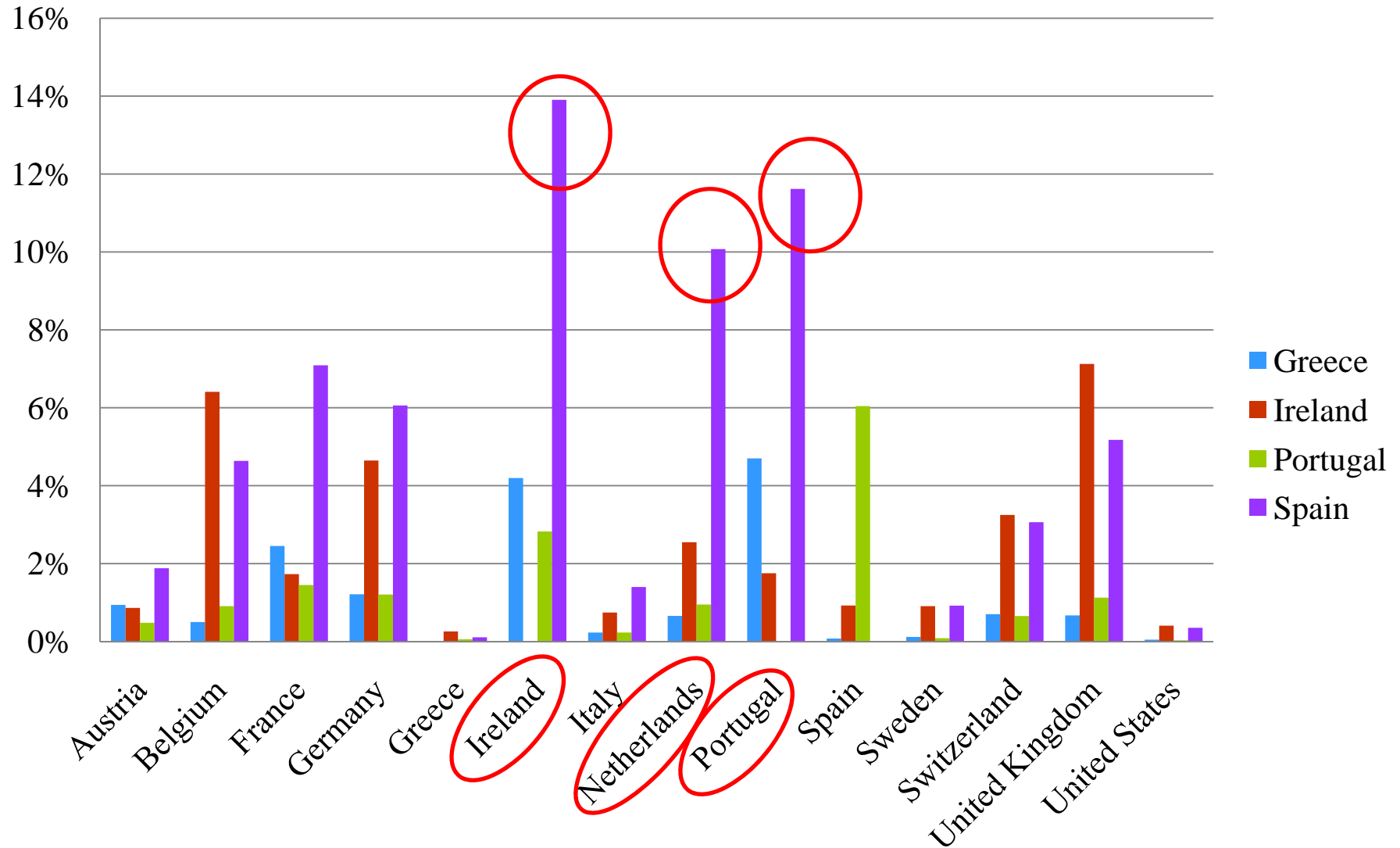
Cross-Border Financial Exposure

- An issue in the bailout of Greece and the concerns about other countries in distress
 - Public sector failure, which can also spread to the private sector, can have serious effects on those with major cross-border holdings
- Exposure in Europe is significant, so these concerns are rational

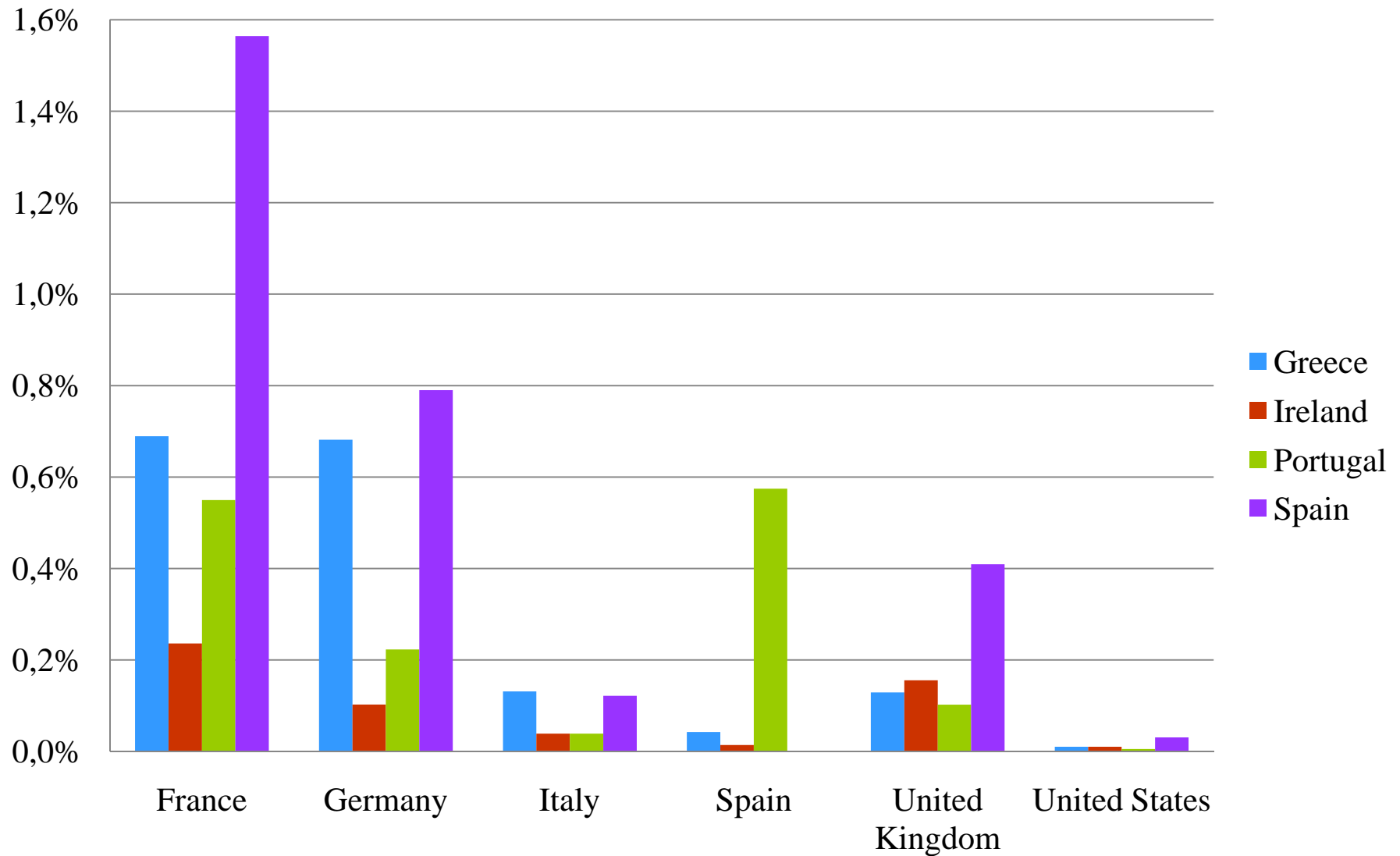
Total Exposure, Relative to GDP



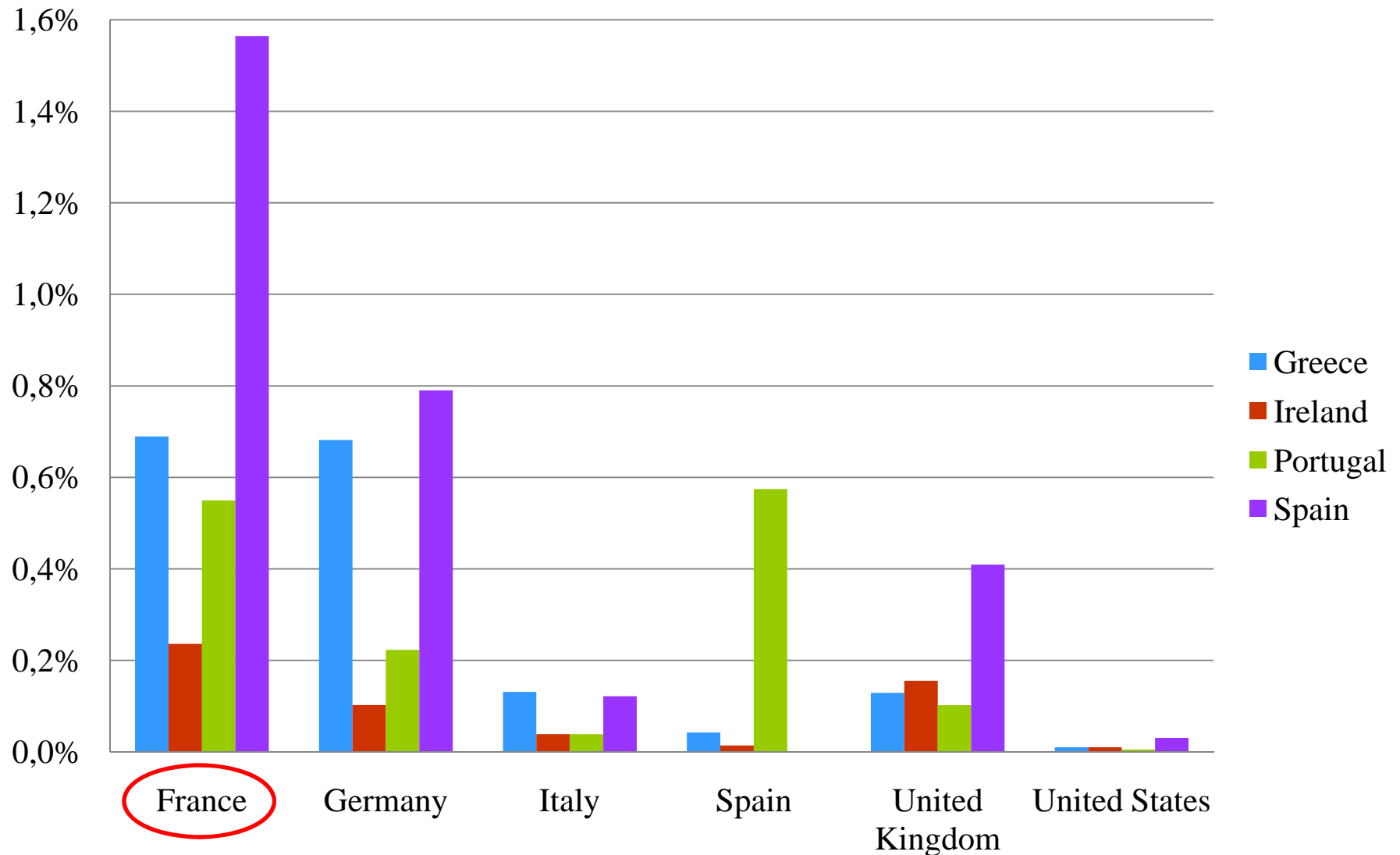
Total Exposure, Relative to GDP



Public Exposure, Relative to GDP



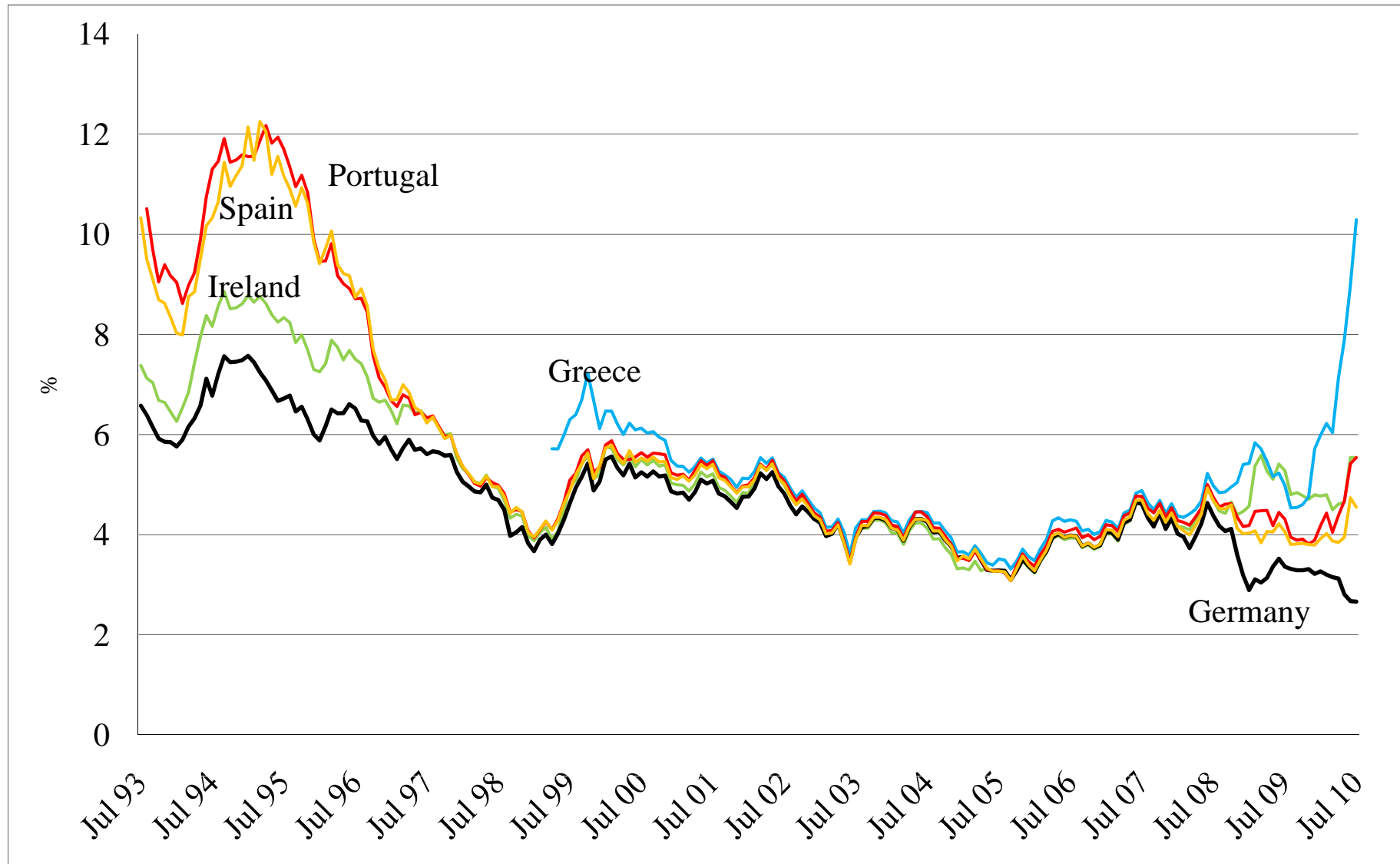
Public Exposure, Relative to GDP



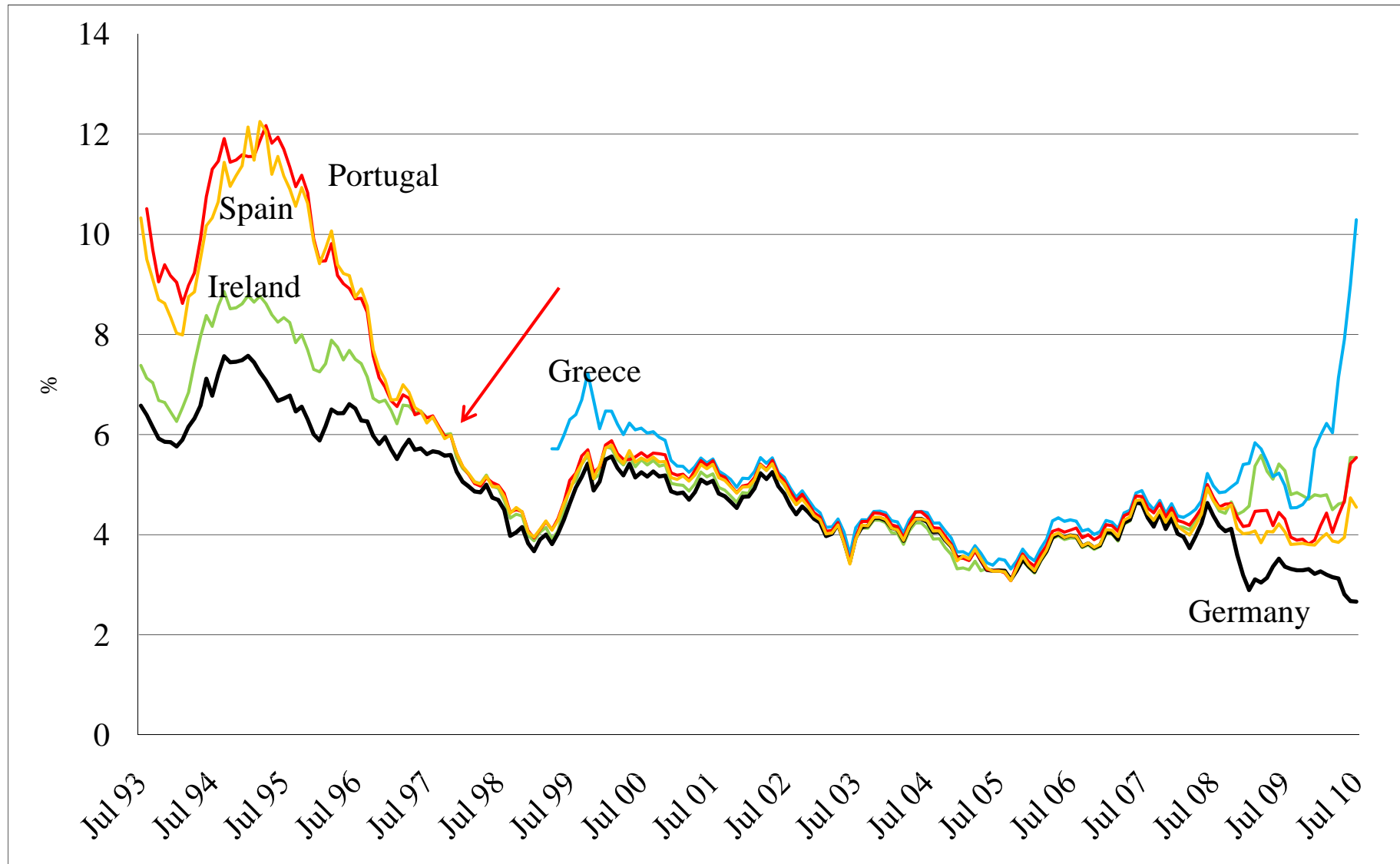
Why So Much Exposure?

- If there are implicit guarantees associated with membership in a currency union, then there is little risk

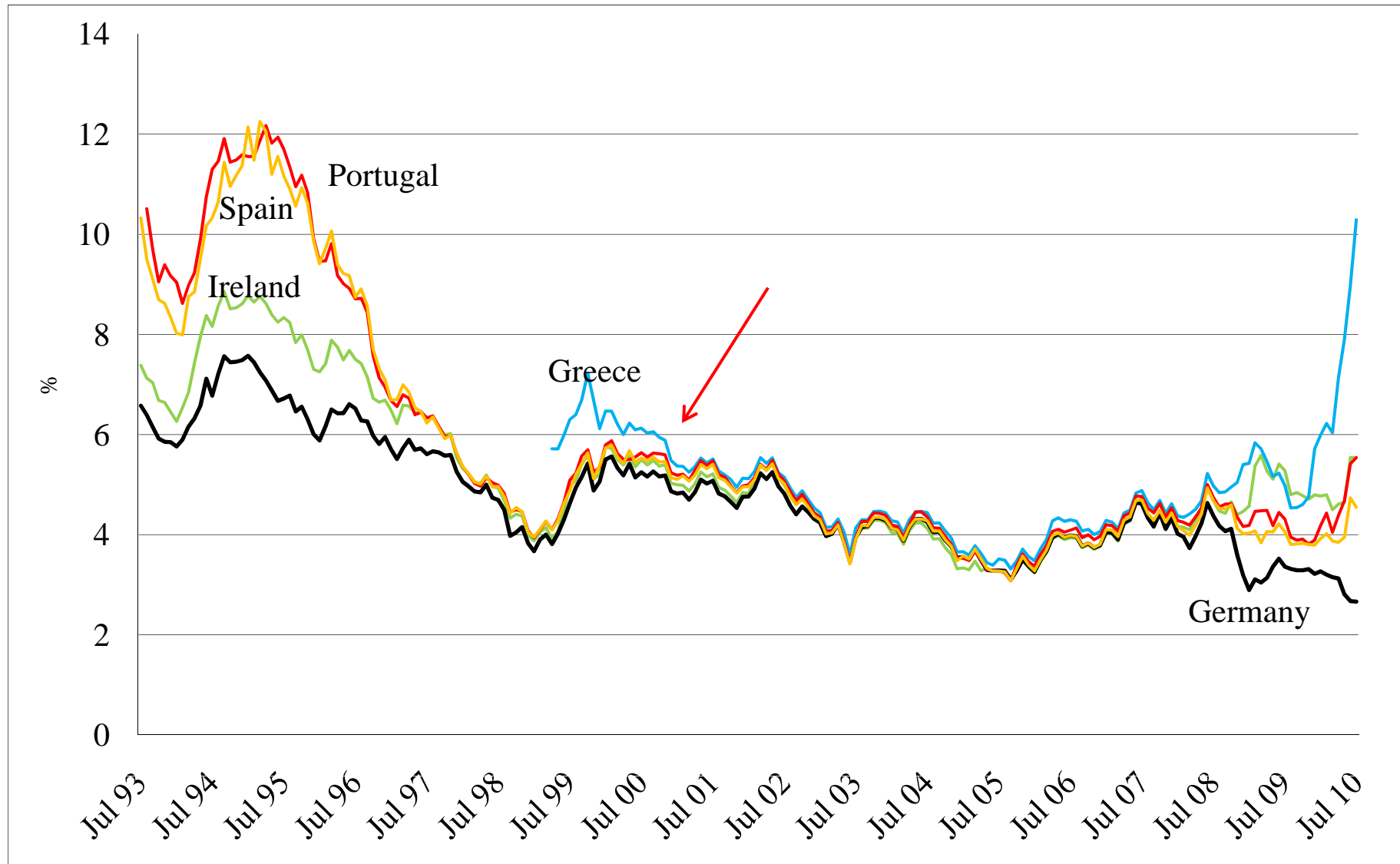
Benchmark 10-Year Yields



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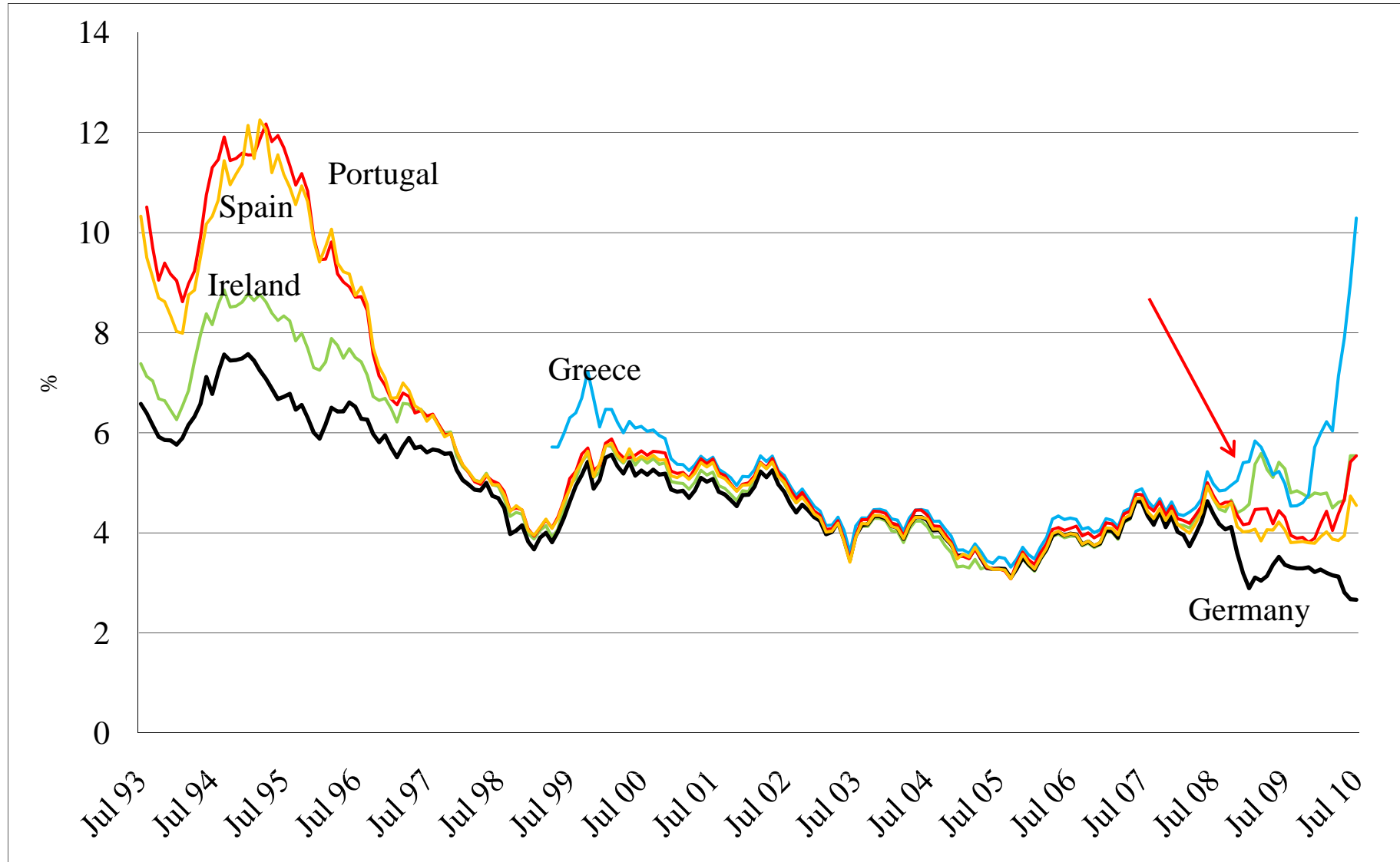
Benchmark 10-Year Yields



Why So Much Exposure?

- If there are implicit guarantees associated with membership in a currency union, then there is little risk
- Until the guarantees are questioned

Benchmark 10-Year Yields



There Still are Puzzles

- Why were guarantees assumed?
- Why did relief take the form of country bailouts, rather than domestic creditor bailouts?
- But, whatever, the answers, why impose restrictions on budgets, rather than on cross-border exposure?

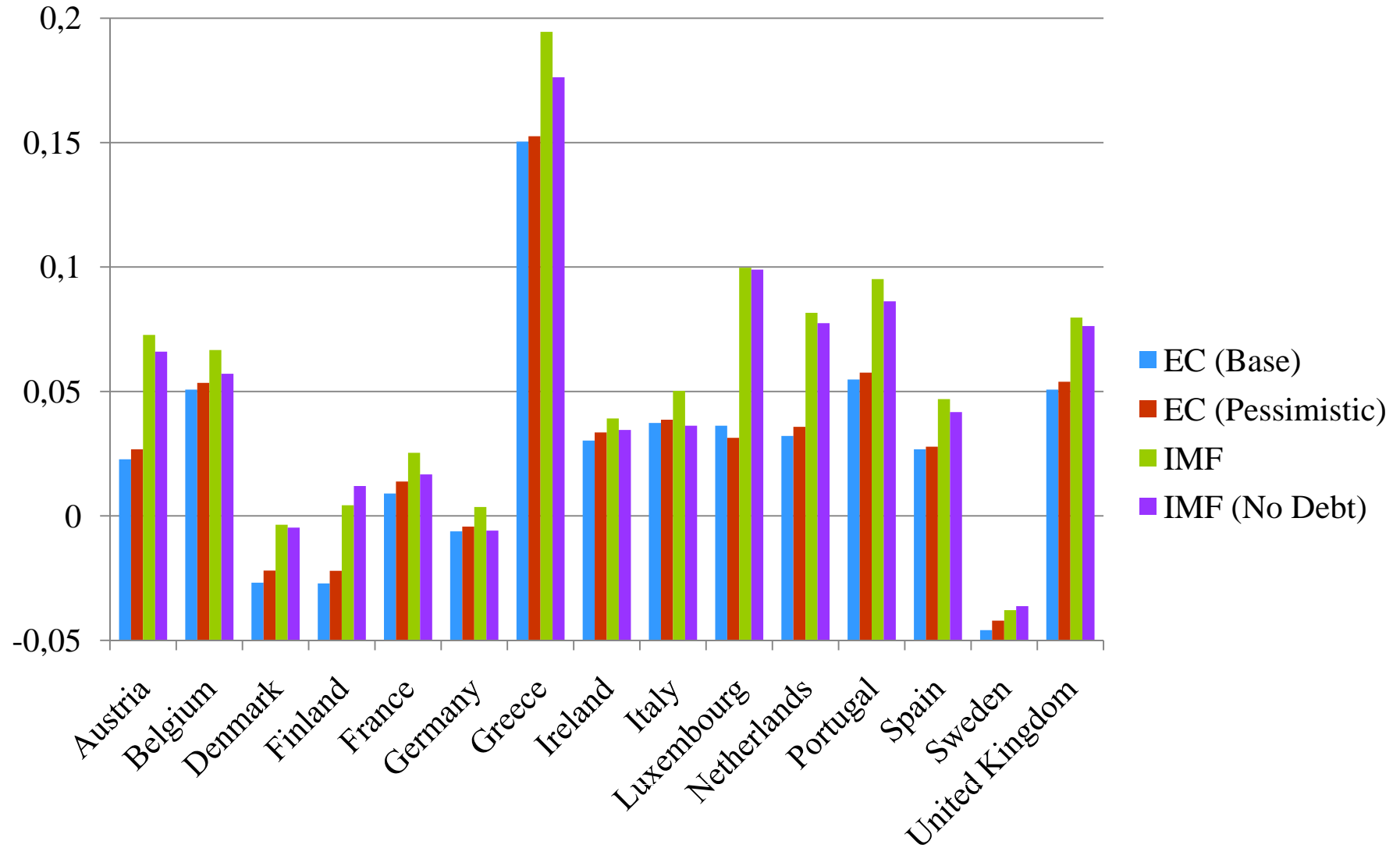
Further Issues

- Debt and deficits vs. fiscal sustainability
- Fiscal restrictions vs. tax policy coordination

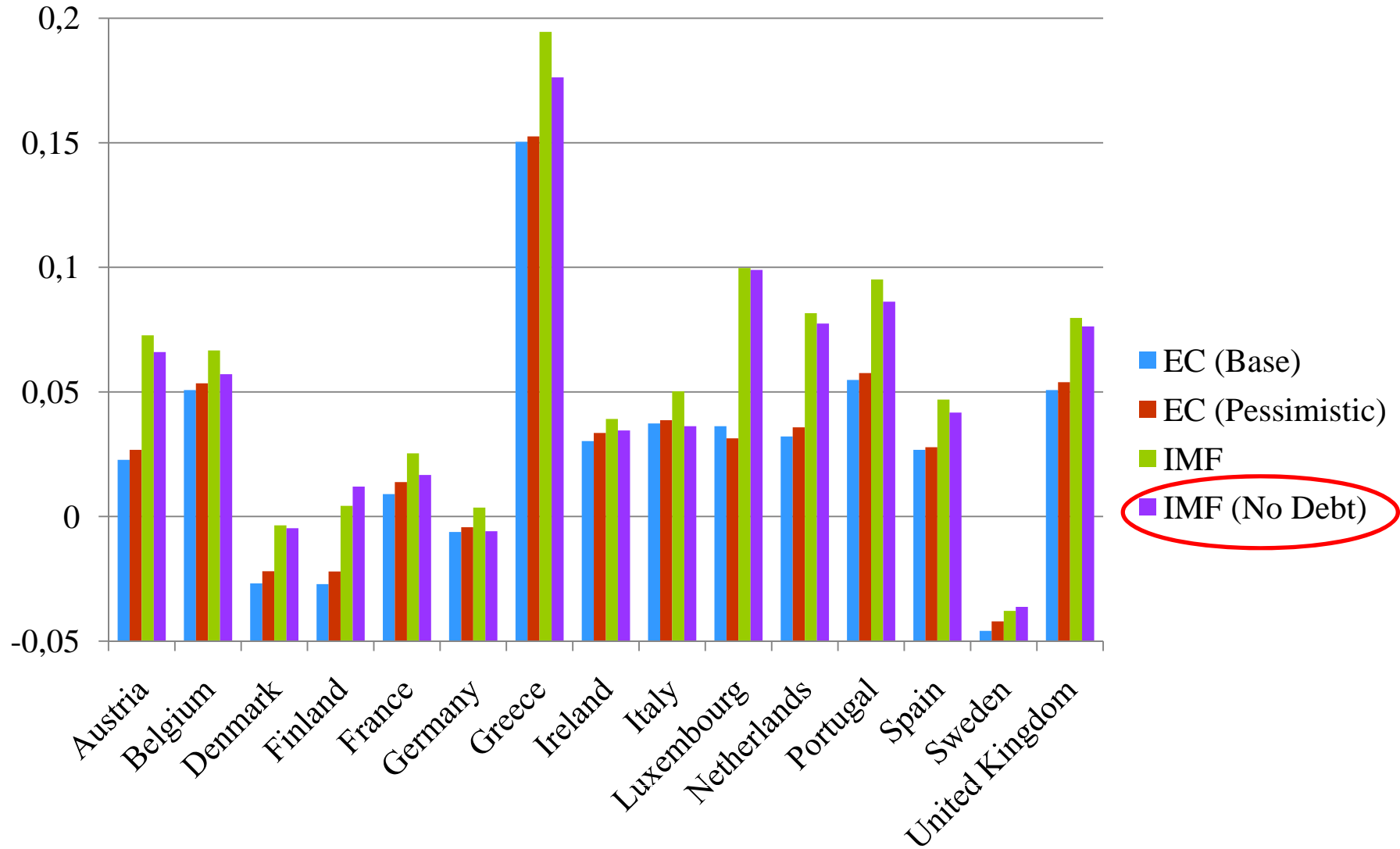
Fiscal Sustainability

- Does control of debt and deficits ensure fiscal sustainability?
- Calculate fiscal gaps to determine how much need to add to primary surplus to maintain debt-GDP ratio for next 50 years

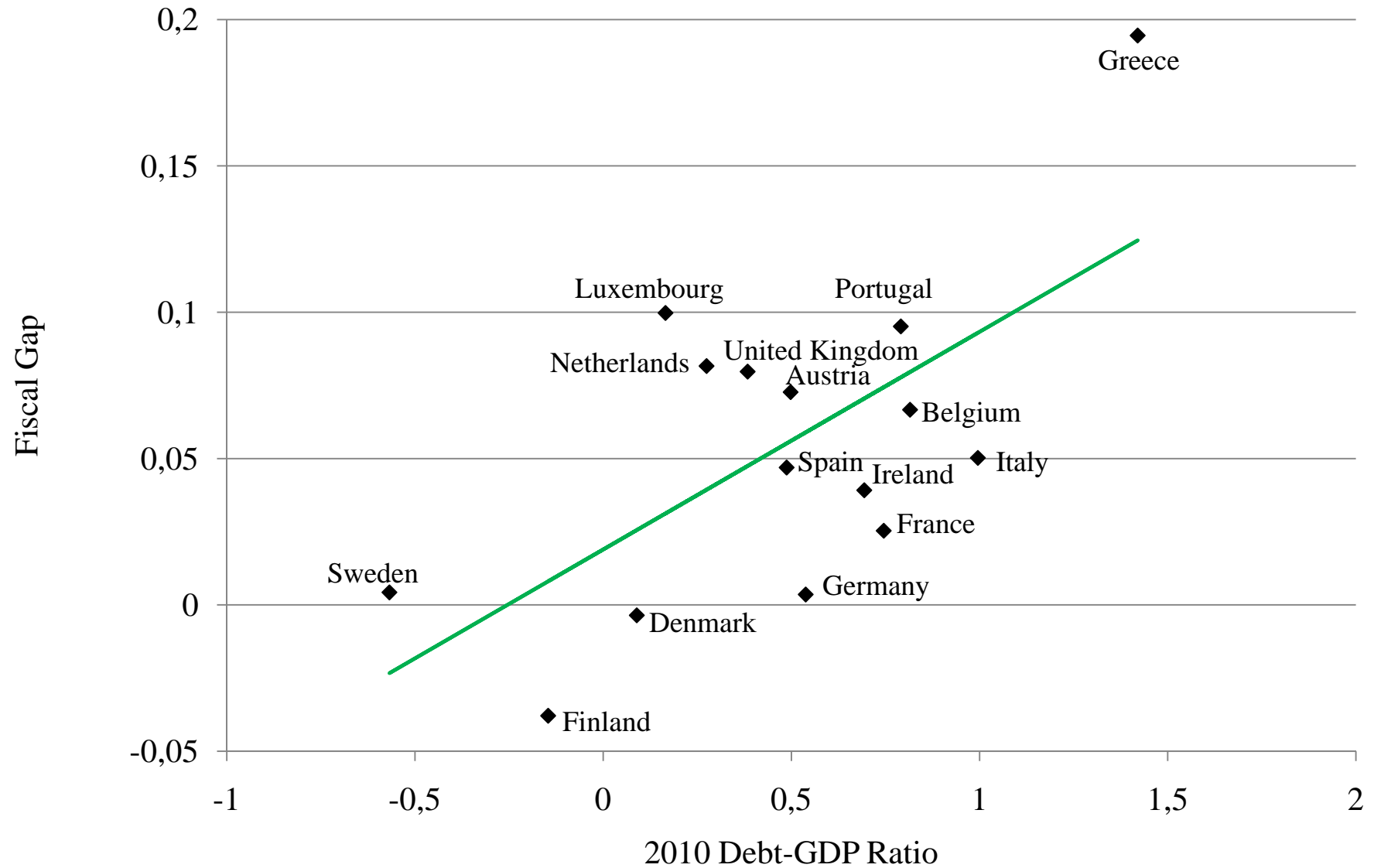
50-Year Fiscal Gaps



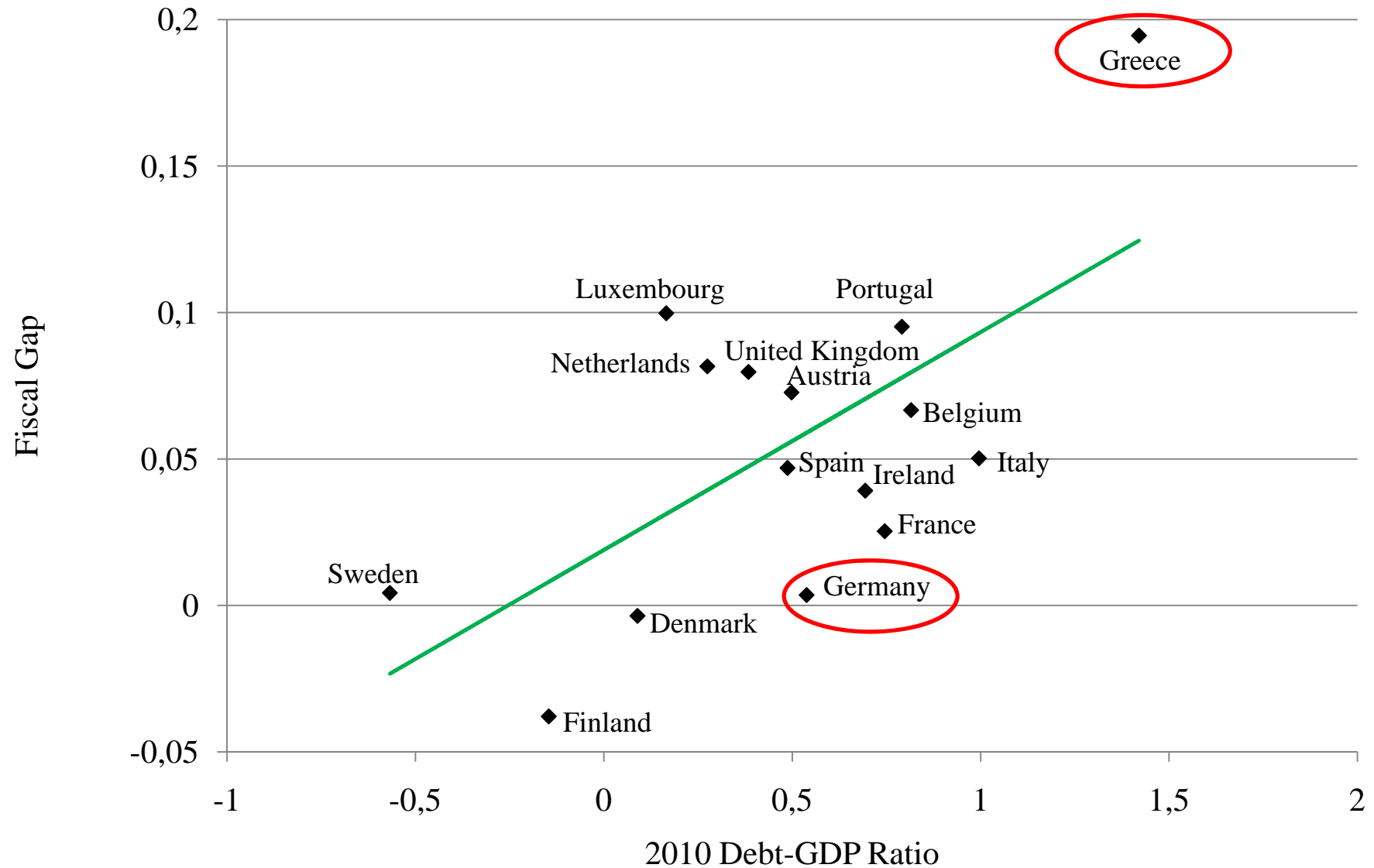
50-Year Fiscal Gaps



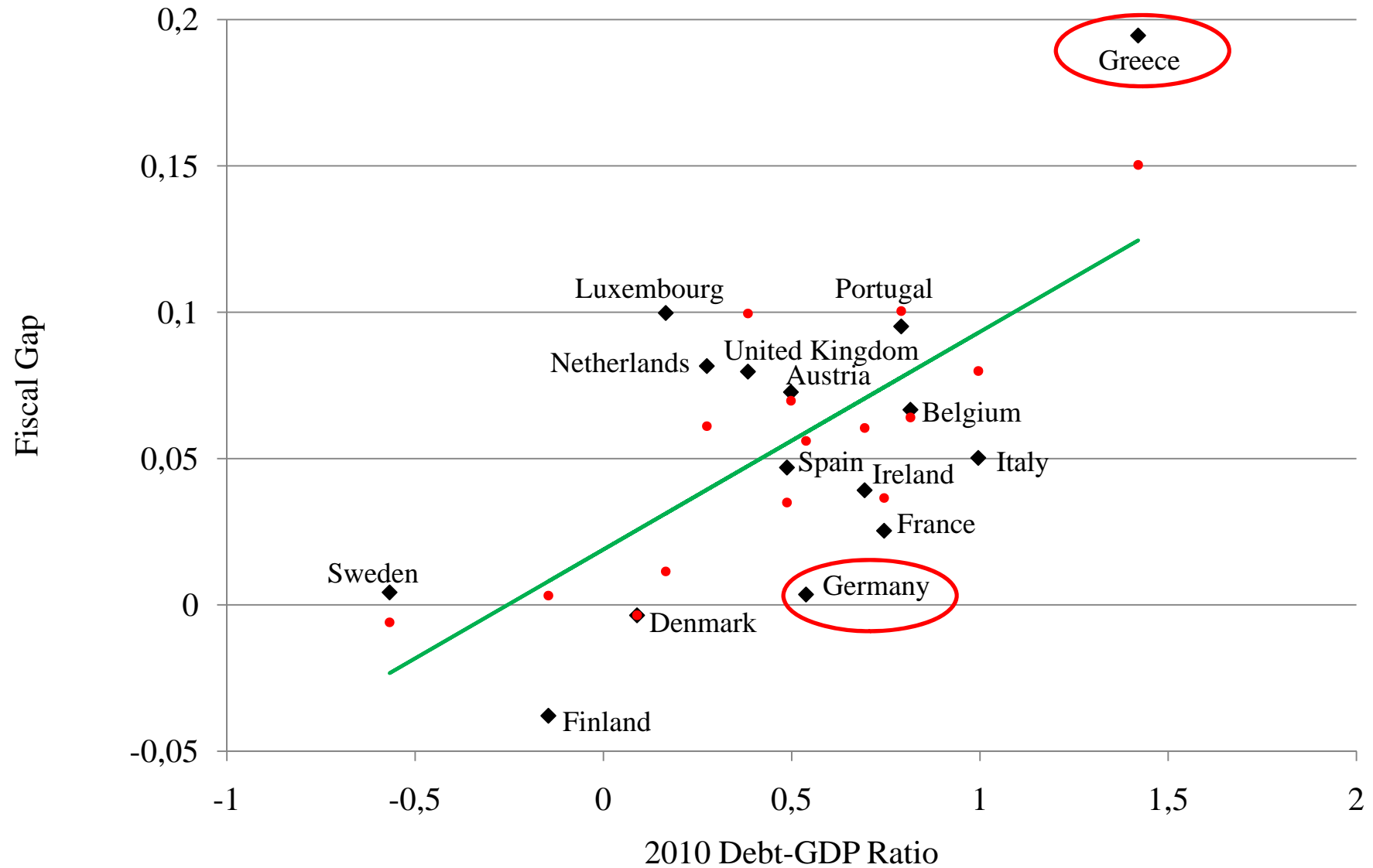
Fiscal Gaps and Debt-GDP Ratios



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Fiscal Gaps and Debt-GDP Ratios



Tax Policy

- An important source of spillovers, too, so coordination would be useful
- Some coordination within the EU
 - Limits on trade barriers
 - Minimum VAT rate
 - Recent CCCTB initiative

Tax Policy

- But very hard to do so, as experience in Europe has suggested
- Examples
 - Extensive litigation between countries and taxpayers at ECJ
 - tariff limits but ability to reduce taxes on production and raise VAT
 - CCCTB: institutionalizing the wrong corporate tax system?

Summary and Implications

- Fiscal rules in a currency union: an answer in search of a question, especially for Europe
 - Not an obvious solution to dealing with spillovers
 - The Samaritan's dilemma doesn't seem relevant
 - The wrong solution for dealing with cross-border exposure
- So, why have them at all?
 - One possibility: as an aid in self-discipline, perhaps like free-trade agreements

Enforcing Self Discipline

- But, if self-discipline is the objective, then existing restrictions on debt and deficits still aren't the right answer
 - Don't account for richness of fiscal policy and the importance of long-term commitments
 - But long-term commitments are very hard to deal with in a rules-based regime; depend on quality of forecasts and evaluation of strength of explicit and implicit commitments

Enforcing Self Discipline

- An alternative is independent fiscal bodies, to assess and evaluate fiscal performance
 - Use own projections and judgment
 - An auditing function, but can help provide information to markets