Common Pools — Why a European Fiscal Union will Make Things Worse

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The root of excessive deficits and debts is in the lack of proper governance over common pool problems of public finance (Kontopoulos and Perotti (1999), von Hagen and Harden (1995), Weingast, Shepsle, and Johnsen (1981), Wyplosz and Kostrup (2010), Hallerberg, Strauch, and von Hagen (2009)). The common pool problem of public finance is the result of financing public policies targeted at specific groups in society from a general tax fund, which creates an externality: Those enjoying the marginal benefit from an extra euro of public spending are not those bearing the marginal cost of funding it. If they did, they would choose the level of spending that equates the marginal benefit and cost of funding. But since they generally do not, those benefitting from a policy tend to ask for higher levels of spending, deficits, and debts.

This common pool problem of public finances manifests itself in a number of

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ways. The first concerns the level of public spending and taxation. Representatives of different political constituencies compete for financial resources and must reach a decision on the level of taxation and spending and the distribution of spending over a range of public policies (von Hagen and Harden (1995), Kontopoulos and Perotti (1999)). The more narrowly individual policies are targeted toward individual constituencies, the more pervasive the common pool problem becomes.[1] Cultural, ethnic, and other divides among the population aggravate the common pool problem, since each constituency pays less attention to the fiscal burdens falling on the other.

A second manifestation of the common pool problem occurs when current government spending can be financed by borrowing, since this gives today's decision makers access to future general tax funds. The result is excessive borrowing compared to a situation in which the common pool externality is fully internalized (see von Hagen and Harden (1995), Wyplosz and Kostrup (2010)).

A third manifestation concerns the financial relations between different levels of government, where the degree of vertical imbalance, i.e., the ratio of spending at the lower level to the own tax revenue collected by lower-level units, is a critical parameter. The greater the degree of vertical imbalance, the more the sub-central units depend on revenues transferred from the central government. Such transfers give the lower units the opportunity to spend taxes collected from citizens in other parts of the federation or country. They invite strategic behavior to extract more transfers from the higher-level government (see e.g. Careaga and Weingast (2000)). If the lower units can borrow from banks or capital markets, bailouts of over-indebted jurisdictions are a particularly pernicious form of vertical transfers and common pool problems (see Rodden (2003), von Hagen, Bordignon, Grewal, Peterson, and Seitz (2000)). Such bailouts have been the cause of fiscal and

[1] The classical analysis of this problem is Weingast, Shepsle, and Johnsen (1981).

currency crises in weak federations such as Argentina and Brazil in the 1980s and 1990s and a recurrent problem in Germany since the late 1980s (see von Hagen, Bordignon, Grewal, Peterson, and Seitz (2000)).

A fourth manifestation of the common pool problem is in the event of a *war of attrition* (Alesina and Drazen (1991)). This is a situation requiring a large fiscal adjustment, in which the representatives of some large constituencies in society cannot agree on the distribution of the adjustment burden, and public debt keeps increasing as no agreement is being reached. The current European debt crisis in some aspects resembles a *war of attrition* as the European governments seem unable to reach an agreement on how to distribute the cost of crisis resolution over the citizens of their countries. Northern Europeans are unwilling to accept this cost pointing at the past lack of reforms and fiscal adjustments in Southern Europe, while Southern Europeans argue that they cannot bear a larger burden than they already do.

A final manifestation of the common pool problem is the bailout of large financial institutions Europe witnessed in the financial crisis of $2008-2009$. Governments loved shmoozing with bankers, because they project an image of economic relevance. As the bankers went under, they quickly invented the concept of systemic relevance for their institutions to prove the inevitability of being rescued by tax payers' money, and the politicians willingly gave in. All of these manifestations have played a role in the emergence of the public debt crisis in Europe.

The canonical common pool model considers a government consisting of a group of decisionmakers all drawing money from the same general tax fund to finance projects benefitting their own constituencies. Current spending can be paid for with current or future tax revenues, i.e., the government can borrow at a given interest rate. Spending on each project has positive and declining marginal benefit, while taxation has positive and increasing marginal cost. Each decisionmaker takes into account only the share of the marginal cost that falls on his constituency. The decisionmakers play a non-cooperative game in which each submits a bid specifying an amount of spending taking all other bids as given. The (symmetric) equilibrium of this game is characterized by inefficiently high levels of spending on each project and too large deficits relative to a solution that would maximize social welfare (von Hagen and Harden (1995)). Theory and ample empirical research shows that this spending and deficit bias increases with the number of decisionmakers and constituencies involved, the number and the depth of political, cultural, and ethnic cleavages in society, and the degree of opacity of the decisionmaking process. The difference between the collectively and the individually optimal solutions, which is at the heart of the externality problem, implies that, even if an agreement to adopt the former could be reached, each individual decisionmaker has a strong incentive to deviate from it and secretly increase spending in his area. Implementing such an agreement, therefore, needs strong enforcement.

The deficit bias can be eliminated by imposing a cost on each decisionmaker for contributing to a deficit by increasing spending in his domain. To reach the socially optimal spending and deficit levels, this cost must be sufficiently large, and the larger the number of decisionmakers involved, the larger must be the cost of contributing to the deficit to enforce the socially optimal policy.

Since the beginning of the public debt crisis in Europe, politicians, including many in Germany, have been calling for a European Fiscal Union to complement the European Monetary Union and ensure the sustainability of public finances of its member states. Implicitly, the claim is that collective decisions over public sector deficits and debts at the European level would be a better and safer way to implement what is socially optimal than decentralized decisions at the national level. What does the above argument about the common pool problem imply for the proposed European Fiscal Union?

Such a Union would create a European tax fund from which spending in individual member states would be financed. Furthermore, the Fiscal Union would be vested with the authority to borrow on behalf of the member states. Compared to the setting in each member state, a European Fiscal Union would imply a larger number of constituencies and their representatives drawing from the common tax fund, and more and deeper cleavages as different nationalities, cultures, religions, regional identities etc. would come into play. Experience with other European decisionmaking processes suggests that it would also lead to more opacity and less democratic control of the decisionmaking processes. Therefore, a European Fiscal Union can only aggravate the common pool problem. It follows that a European Fiscal Union has an even greater deficit bias than each national fiscal policy. It would make the European public debt problem worse.

One might argue that the decisions in a European Fiscal Union could be subject to rules enforcing small deficits and that decisionmakers contributing to larger deficits would be punished for their behavior. Our analysis, however, implies that the punishment would have to be stronger than the punishment in the case of national fiscal policies. It is not clear, why and how that should come about. Experience with the European fiscal framework so far has shown that enforcement of the common rules is weak. National administrations have ample room for creative accounting and hiding deficit financing.[2] If anything the political cost of causing large deficits would be smaller at the European than at the national level.

Alternatively, a European Fiscal Union could come with the restriction that tax revenues collected in a given member country can only be spent on projects

[2] On creative accounting in the euro area see von Hagen and Wolff (2006) For using private institutions to create public debt recall that the hidden inflation in Germany in the late 1930s was caused by the issuing of seemingly private trade bills (so-called Mefo Wechsel) by the German government.

benefitting constituencies in the same country. The Union's common fiscal policy would then be a collection of national fiscal policies with the same properties as under a decentralized arrangement. Obviously, this would simply replicate the national policies with the same deficit bias.

Proponents of the Fiscal Union argue that the Stability and Growth Pact and the new Fiscal Compact (see European Commission (2012)) in the European Monetary Union will yield an improvement over purely national fiscal policies nevertheless. The idea is that they create a process of monitoring national fiscal policies and exert pressures on national governments to reduce the spending and deficit bias. In practice, however, they do not serve this function. National governments merely submit their budget plans to the European Commission for approval. The Commission makes its assessment of them based on purely statistical criteria which have neither economic nor political content. And again, it lacks the means to enforce the European rules effectively. At the same time, however, the Stability and Growth Pact and the new Fiscal Compact create the illusion of a European framework assuring fiscal discipline. It dilutes accountability at the national level, as policymakers can point to the adherence to purely formal criteria to excuse excessive spending and borrowing at the national level. Furthermore, the complexity of the European procedures adds opacity to the decisionmaking processes. No improvement over national policies can be expected.

I summarize these arguments in the following *Decentralization Theorem*: With respect to excessive spending and deficits, neither a European Fiscal Union nor the Stability and Growth Pact *cum* Fiscal Compact can do better than national fiscal policies. Chances are, it will do much worse.

One might argue, of course, that there are other advantages of a common fiscal policy. Coordinating anti-cyclical policies is a traditional example (see von Hagen and Mundschenk (2003)). But it is unclear that the externalities caused by spill-overs of aggregate demand from one country to another are truly significant. De Grauwe (2011) argues that a common fiscal policy could implement transfer payments to countries hit by negative economic shocks and act as an insurance mechanism against asymmetric shocks. This is true, but empirical evidence from existing large federations suggests that the need for such insurance is not very large. In Germany, for example, the system of horizontal transfers of tax revenues among the states and vertical transfers between the federal government and the state governments has only spurious insurance capacity against asymmetric shocks. It is mainly a redistributive mechanism (see Hepp and von Hagen (2012a), Hepp and von Hagen (2012b)). Overcoming collective action problems in the face of a crisis is another argument. The claim here is that a common policy would be able to react faster to a crisis than coordinated national policies. Obviously such a claim is unsubstantiated unless the decision procedures at the national and the European level are clearly defined. After all, it is also popular to say that the ECB has been reacting too slowly to the crisis, and the ECB represents a truly common policy. Whatever the argument in favor of a common fiscal policy is, it has to be weighed against the perilious consequences of a substantially larger common pool problem.

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