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Political economy of fiscal unions☆

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ABSTRACT

Fiscal unions often use fiscal transfers to counter asymmetric shocks, but such transfers may be politically controversial. I present a model of a two-region fiscal union with region-specific shocks where the threat of secession imposes a limit on fiscal redistribution between regions. I show that both correlation of shocks across regions and their persistence over time are important for political support for integration. The gains from inter-regional risk sharing are potentially large when shocks are negatively correlated and temporary. In contrast, unions with negatively correlated permanent shocks are likely to be fragile.

1. Introduction

One of the most intriguing questions of economics concerns the conditions under which deeper integration is possible and the circumstances that make integration fail. And fail it does remarkably often: more than 100 new countries emerged in the course of the 20th century alone. Clearly, political and cultural motives such as a sense of separate identity and nationalism are of paramount importance as factors behind secessionist tendencies. Nevertheless, economic considerations also play an important role. Among them, the fact that unions tend to use fiscal policy to redistribute income across regions is often controversial. Such fiscal unions can feature inter-regional transfers that have been agreed upon, negotiated, and formalized explicitly, or that occur because of centralized automatic stabilizers such as progressive income tax, unemployment benefits, and the like. Disagreements about inter-regional fiscal redistribution can become an important driver of disintegration; fiscal transfers, and their perceived unfairness, played an

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important role in the break-up of Czechoslovakia and have significantly contributed to inter-regional tensions in Belgium, Spain, and the United Kingdom.

Nevertheless, fiscal transfers also have an important benefit in that they facilitate risk sharing. This aspect of integration has been highlighted by, among others, Beetsma and Jensen (2005), Gal and Monacelli (2008), and Farhi and Werning (2013). These studies emphasize the benefits – higher welfare due to consumption smoothing – that accrue to the participating countries when they enter into a mutual-insurance arrangement. As Farhi and Werning (2013) point out, these benefits are particularly large when fiscal policy is the only tool at the government's disposal (for example, when a country gives up independent monetary policy in order to participate in a currency union and thus loses the ability to use monetary policy to counter asymmetric shocks) and when financial markets are incomplete (because regions and individuals cannot use financial products to insure against shocks). Furthermore, the bigger and the more persistent are the shocks, the more attractive it is to form a fiscal union (Farhi and Werning, 2013).

The aforementioned contributions, while insightful, focus on the economic and welfare implications of fiscal unions. In this paper, instead, I consider the political economy of such arrangements. In a nutshell, a mutual-insurance arrangement that is optimal *ex ante* may be rejected by one of the parties *ex post*, once the shocks are realized. I formulate a model that is a dynamic version of the static model of Bolton and Roland (1997). It features a union composed of two countries with a centrally provided public good. As long as integration continues, fiscal policy reflects the union median voter's preferences which, in turn, depend on the aggregate effect of regional shocks.[1] The two regions thus constitute an implicit fiscal union: fiscal redistribution occurs through centralized fiscal policy rather than by means of explicit inter-regional transfers. The regions, however, have the option to secede and implement their own preferred fiscal policy if the utility gain from doing so outweighs the cost of secession. Because of the shocks, a union that was previously stable can break-up following a particular regional shock, whether positive or negative. The opposite is also true; a region that preferred independence initially can come to prefer integration in the wake of a particular shock.

The analysis suggests that two aspects of shocks are important: the symmetry (or correlation) of shocks across regions and their persistence over time. With respect to the former, holding everything else constant, positively correlated (symmetric) shocks are good for the stability of integration. This is because the shocks change both regions' preferred fiscal policies in a similar manner: either both prefer more extensive redistribution or both prefer to scale it down. In this, my results echo the main finding of the optimum currency area theory (Mundell, 1961; McKinnon, 1963), which considers currency unions with common monetary rather than fiscal policy. The situation becomes more complicated when shocks are negatively correlated. In this case, fiscal-policy preferences diverge but the regions benefit from mutual insurance: under centralized fiscal policy, the region with a positive shock makes a net transfer to the region hit by a negative shock. This is where persistence of shocks proves crucial. With temporary shocks, the disutility from having suboptimal fiscal policy is short-lived and may be compensated by the benefits from risk sharing. When shocks are permanent, however, fiscal transfers become largely deterministic and unidirectional. The cost of having to put up with suboptimal fiscal policy, likewise, becomes long lasting. As a result, either region, or both, can prefer to secede in such a case so as to implement the region's preferred fiscal redistribution.

To illustrate the workings of the model, consider the disintegration of Czechoslovakia in 1993.[2] The model predicts that a previously stable union can unravel due to asymmetric and persistent shocks. In Czechoslovakia's case, the shock was precipitated by the economic reforms initiated in 1990–91. While the reform took place in both parts of Czechoslovakia, it affected Slovakia much more severely than the Czech Republic: per-capita GDP fell by 12 percent in the Czech Republic during 1991–92 and by 20 percent in Slovakia; Czech unemployment, similarly, remained low, 2.6 percent in 1992, while the Slovak figure was 11.8 percent (see Fidrmuc et al., 1999, and Fidrmuc, 2000). This asymmetric effect of the reform shock was largely due to the greater dependence of Slovakia on trade with the former Eastern Block: much of the Slovak industry was built during the communist period so that the economy was highly dependent on trade with other communist countries (see Fidrmuc et al., 1999, and the references therein). This trade essentially collapsed after the communist regime and central planning were abandoned. The reform thus constituted a negative and persistent shock, which affected Slovakia more severely and more persistently than the Czech Republic.[3] The greater cost of reform translated into greater support for redistribution in Slovakia than in the Czech Republic, which was reflected in the outcomes of the 1992 election (Fidrmuc, 2000).

The nature of the reform-induced shocks should have given an incentive to the Czech Republic to push for a break-up: it experienced a less-severe shock and it was also richer and therefore cross-subsidized Slovakia fiscally.[4] However, the Czech Republic was twice the size of Slovakia (10 million vs 5 million) so that it had much more sway over fiscal policy than Slovakia. It was, therefore, the poorer country that pushed for the break-up. As I argue below, the poor region may prefer secession if income inequality in the union is high enough and/or the negative shock is sufficiently severe: then, the poor region can choose to secede in order to impose higher taxes and redistribute more, even if this comes at a cost of losing the fiscal transfer from the rich region.

[1] The shocks need not be only output shocks (i.e. deviations from the trend growth rate): the analysis is general enough to allow also demographic shocks such as migration flows, or natural disasters.

[2] For an extensive discussion of the economic background of the break-up of Czechoslovakia, see Fidrmuc et al. (1999).

[3] Slovak unemployment continued to rise steadily also after the break-up until it peaked at 19.2 percent in 1999. Czech unemployment remained in single digits, peaking at 8.8 percent in 2000.

[4] See Fidrmuc et al. (1999, Section 3.2) for some evidence of fiscal transfers within Czechoslovakia.