Balanced-Budget Rules and Composition of Public Goods in a Fiscal Union

Vladimir Dashkeev[§]

The latest version is available for download from Google Sites

Abstract

This paper addresses the following question: If the asymmetry of balanced-budget rules is detrimental for the interregional risk sharing in a fiscal union, how should the design of the rules be altered to increase efficiency? I investigate my research question in a two-region open economy DSGE model augmented with public sector features of a federal state. I show that the unique parameter that determines the specific type of the welfare-maximizing borrowing limits in the fiscal union is the productivity of public goods. Other aspects of the economy, such as the type of technology process, or the shock type (aggregate or idiosyncratic), do not matter for the policy choice. If public goods productivity is sufficiently high, risk sharing is improved by lifting restrictions on public borrowing. When the productivity is sufficiently low, imposing borrowing limits improves the risk sharing. I also explore the space for policy coordination and show that the objectives of regional governments and the federal government do not contradict each other.

Keywords: balanced-budget rule, fiscal federalism, fiscal union, occasionally binding constraints, productive public expenditures
JEL codes: E62, H60, H74, H77

[§]University of Washington, Department of Economics, Savery Hall 305, Box 353330, Seattle, WA, 98195. Email: vvd@uw.edu. Website: sites.google.com/site/dashkeev.