

## The U.S. experience shows that union-wide fiscal policies, targeted transfers and lower tax rates may help to stimulate growth at the state and national level.

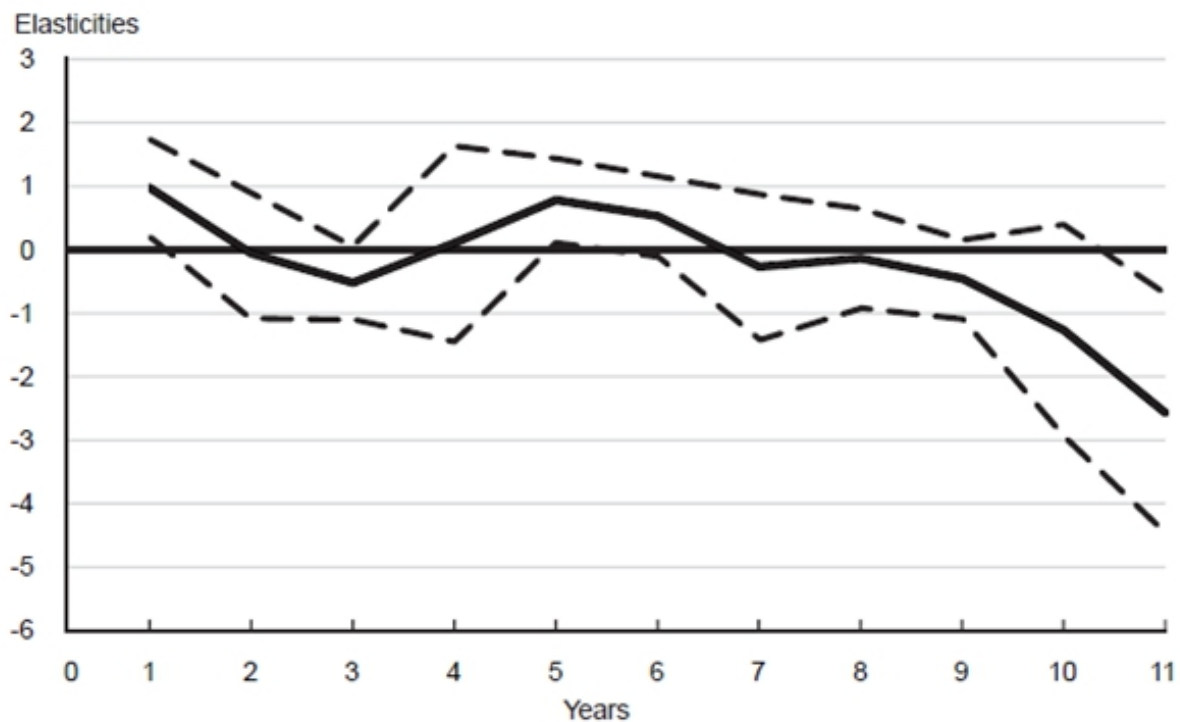
*The 2008 Great Recession and slow recovery have created a new interest in a broader fiscal union for the EU. Drawing on the U.S. experience from 1973-2009, [Robert P. Inman](#) identifies three key lessons for creating efficient macroeconomic policy in a fiscal union: that state level fiscal policies have spillover effects; central government must pick the most cost effective stimulus policies; and that economic efficiency does not always equate with political feasibility. His findings are particularly relevant to the challenge of creating effective stimulus plans and broader growth.*



The 2008 Great Recession raised anew, in both the United States and the European Union, the importance of fiscal policy as a tool for restoring declining economies to positive growth and full employment. An important institutional fact in both economies is the central role that lower-tier governments play in the implementation of any fiscal decision. In the established fiscal union of the US, state governments are responsible for over 40 percent of all non-defense government spending, 50 percent of all taxation, and 20 percent of all income transfers. In that nascent fiscal union of the EU, member countries account for over 95 percent of all fiscal activities. One cannot make fiscal policy in an economic union without recognizing the importance of lower-tier governments, both as a provider of public services but also as central players in the decisions that set those policies. States and provinces, and for the EU, the member countries, are both “agents” and “principals” in making fiscal policies in economic unions. My recent research suggests some important lessons for the efficient management of macroeconomic fiscal policies in such public economies.

Lesson No. 1: *While union members’ own fiscal policies can impact jobs and economic growth in their own economies, spillovers across members’ economies call for policy cooperation.* Gerald Carlino of the Federal Reserve Bank of Philadelphia and I [use data](#) for the 48 mainland U.S. states for the years 1973-2009 to show that states’ own fiscal policies can influence job growth in the state. We estimate that a one year increase in a state’s own deficit of \$400/person—roughly 10 percent of an average state’s tax revenues—can increase the rate of job growth in the typical state by 1.2 percent in the year after the deficit, as shown in Figure 1, below. For a typical state with 2.8 million jobs, this is an increase of 33,600 jobs. But deficits today mean higher taxes in the future, with job growth declining eight years after the initial increase in debt as taxes rise to cover scheduled debt repayments. The present value of these future taxes implies a cost per job created of about \$74,000/job.

**Figure 1 – Response of State Job Growth to an Increase in State Own Deficits**



**Note: Impulse responses are computed by local projection method for a 1 percent increase in state own deficits introduced in period 0. Responses are reported as a percentage increase in a state's own jobs. The dashed lines represent the 95 percent confidence bands for each projection.**

The \$74,000 price tag for job creation seems a bit steep, especially when compared to the fact that any new jobs may be temporary and, for the US economy, likely to generate a wage equal to the workers' contribution to higher GDP of little more than \$60,000/job. From an economic perspective alone, temporary deficits do not look like a good investment for the state. But the state's own jobs are not the full benefit of the state's deficit. Carlino and I find there are significant job and growth spillovers enjoyed by the neighboring states in the state's economic region. For example, job spillovers from the largest state within each region can add upward to 20,000 more jobs in its neighboring states. When we include these "spillover jobs" as part of the deficit's benefits, the price tag per job in future taxes falls to \$46,400/job. Now from the perspective of the wider economic region, the likely output per job exceeds the cost per job from the state's deficit policy.

Unfortunately, from any one state's point of view, its own cost per job exceed its own benefits per job. What may be a socially efficient strategy for each economic region is a privately inefficient policy from the point of view of any one state within the region. The states have a collective action problem. The solution is for the states within the region to cooperate and design a common deficit policy.

Lesson No. 2: *Central government policies can internalize cross-economy spillovers, but it is important to pick the efficient, cost-effective policies for doing so.* In the US, the federal government's fiscal policies are the states' answers to their collective action problems. In our most [recent research](#), Gerald Carlino and I explore which central government fiscal policies are most effective as a macroeconomic stimulus during economic downturns. Our period of analysis between 1960 and 2010. We use two prominent empirical strategies to study this question –Structural Vector Autoregression and the Narrative Approach – and their estimated effects of federal fiscal policies on the aggregate economy are (reassuringly) very similar. We want to discover the impact on aggregate GDP one or more years after a one-time, \$1 increase in federal government spending or tax cuts, all financed by a \$1 increase in the federal government deficit. The resulting impact on GDP is known as the policy's fiscal multiplier.

We found, first, that federal tax cuts are the most effective, having fiscal policy multipliers near 3 one year after the tax cut (\$1 of tax cuts generates \$3 of new GDP) and continue to stimulate the aggregate economy for another

two years thereafter. Second, direct federal government purchases of goods and services are only mildly successful as a fiscal stimulus, with \$1 of new federal spending stimulating at most \$.80 of new GDP growth. Further, the effect is short-lived and not statistically different from zero. These two effects are for the federal government working on its own.

In federal public economies such as that of the US, however, lower-tier governments also provide important government services, raise significant tax revenues, and administer and fund income transfers to unemployed and lower income families. As part of a stimulus strategy, the federal government might try to affect these decisions too. If the lower-tier governments are politically independent, then the appropriate policies are transfers from the central government to the states to stimulate state spending, state tax relief, and perhaps additional transfers to lower income households. President Obama's American Recovery and Reinvestment Act (ARRA) did just that. Of the \$797 billion in ARRA funding, \$318 billion went to US states and cities.

ARRA helped to stimulate the national economy, but not as much as it might have. If the US central government wishes to influence the fiscal decisions of states and cities, it must recognize that the elected officials of those governments have their own agendas. We find that giving states unconstrained grants, or grants that simply replace already planned state funding, leads to only \$0.50 of the transfer actually being spent on additional government activities. There is no tax relief either. The remaining \$0.50 is saved or used to repay state debts. The macroeconomic impact of such transfers is therefore modest. We estimate the fiscal multiplier for unconstrained aid is never larger than \$0.80 for each dollar of federal assistance, and never statistically different from zero. What does work as a macroeconomic stimulus, however, are grants that directly reward increased state spending, called matching grants. Particularly effective as a stimulus policy are grants that target increased payments to lower income households. For these grants, the estimated fiscal multiplier is never smaller than 1.5, and always statistically different from zero.

We conclude that if you want to stimulate the private economy, and do so using transfers to lower-tier governments, then give these governments an incentive to spend the money and target the incentive towards increased economic assistance for lower income households. We estimate that had the ARRA stimulus been directed only at federal tax relief and matching aid to states for spending for lower income households, ARRA's impact on the private economy would have been 30 percent greater.

Lesson No. 3: *What is economically efficient may not always be politically feasible.* To understand why ARRA used relatively less efficient policies for its stimulus package, [one simply needs to look at what was needed to fashion a winning coalition in US Congress for ARRA's passage](#). To be effective as an economic stimulus, quick approval was needed; there was no time to fashion new programs. Expansion of existing tax and spending policies was the only feasible political strategy. To win support from the urban states, the decision was made to expand welfare spending, primarily state relief for Medicaid expenses. This was done by expanding the matching grant for state spending for lower income health care. To win support from the more rural states, the decision was made to expand highway spending. To please all states, a sizeable expansion of unconstrained federal aid for public education, called Stability Aid, was included. And perhaps as grease for the wheels, the many smaller, newer programs included in ARRA were disproportionately allocated to those states whose Senators were members of the important budgetary committees. The final ARRA policy transferred \$318 billion to state and local governments, roughly 40 percent of all stimulus money. Of the \$318 billion, 2/3's of the funds were allocated to less effective, but politically necessary, unconstrained transfers while 1/3 was directed towards the relatively more effective matching grants for assistance to lower income households.

Recovering from the Great Recession has been a long, and for many, a painful process. While the US is now on its way to sustained growth, European economies are only now beginning to show improvement and the recovery is uneven. In response, there is a new interest in a wider fiscal union for the EU. Our three lessons from the US experience have value in these discussions too. EU countries running their own fiscal stimulus will create economic benefits for their trading neighbors. Thus, union wide fiscal policies should be encouraged. From the US experience, the most effective of such policies are direct transfers to households, either through lower EU-wide tax rates (if ever implemented) or through targeted transfers to member countries that give assistance only if the recipient country lowers its tax rates or increases its transfers, ideally to lower income households. Finally, the institutions that decide EU wide fiscal policies should seek to insulate themselves from the inevitable political

pressures to give every country something, with as few strings attached as possible.

*This article is based on the research papers ‘[Local deficits and local jobs: Can US states stabilize their own economies?](#)’ in the July 2013 issue of the *Journal of Monetary Economics*; ‘*Macro fiscal policy in economic unions: states as agents*,’ *NBER Working Paper 19559*; ‘*States in fiscal distress*,’ *Federal Reserve Bank of St. Louis, Regional Economic Development*. Vol. 6, No. 1, 2010.*

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