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Volume Title: NBER International Seminar on Macroeconomics 2005

Volume Author/Editor: Jeffrey Frankel and Christopher Pissarides, editors

Volume Publisher: MIT Press

Volume ISBN: 0-262-06265-8, 978-0-262-06265-7

Volume URL: http://www.nber.org/books/fran07-1

Conference Date: June 17-18, 2005

Publication Date: May 2007

Chapter Title: Comment on "Fiscal Externalities and Optimal Taxation in an Economic Community"

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Chapter URL: http://www.nber.org/chapters/c0348

Chapter pages in book: (258 - 259)

Comment

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The accepted wisdom in Brussels is that coordination of fiscal policies among the countries that belong to the European economic and monetary union (Emu) is desirable. For instance, the "Sapir Report," a highly influential document commissioned by the President of the EU to a group of independent experts, recommends that *"There should be greater coordination among national budgeting processes."* The paper by Baxter and King is important in the European debate since it shows what might be the consequences of such coordination. Coordination of fiscal policies could reduce the political cost of an increase in government spending in one country by shifting part of this cost upon the residents of other countries.

To study the nature of the fiscal externalities within an economic community Baxter and King analyze the effects of an (unanticipated) shock to government consumption in one country: a temporary, but persistent increase in the amount of the consumption good used up by the government. Consider first the optimal response in a closed economy. Since insurance is impossible—because a closed economy does not trade with the rest of the world—the real interest rate rises inducing households to work more and consume less. Consumers must bear the full burden of the increase in government spending. On the contrary, in a small open economy, consumers are fully protected: there are no effects on either work or consumption since the country can borrow from the rest of the world at the given world interest rate.

Consider now an intermediate size country integrated in an economic community. The community is closed to the rest of the world, but country-specific shocks can be redistributed among the residents of all countries. The optimal response to a government spending shock consists in allowing the consumers in the country hit by the shock to insure borrowing from the rest of the community. Thus, following a government spending shock in one country, everybody in the community ends up working more and consuming less, but the effects in the country hit by the shock are dampened compared with the closed economy case. In a Nash equilibrium, on the contrary, the optimal response of the country hit by the shock would take into account its possibility to affect the community interest rate. This results in a lower degree of risk sharing: consumers in the country hit by the shock bear a greater burden, but consumers in the rest of the community are less affected by the spending shock in one country. This is a result of the Nash equilibrium. The large country has an incentive to shift upon its partners some of the burden of adjustment—this is why it tries to affect the community-wide interest rate. In equilibrium, however, it transmits less than it would in a coordinated solution and is thus worse off.

As Baxter and King point out, there are two types of externalities. The country where government spending increases exerts a pecuniary externality on the community: in order to consume more it must induce residents in other countries to consume less (and work more). This externality is largest under coordination. But there is also what Baxter and King define as a policy externality, which arises when countries fail to coordinate and thus to optimally insure. Lack of coordination means that the community does not take full advantage of the possibilities offered by region-wide risk sharing.

The point about the cost of coordinating fiscal policy could not be made in a sharper way. Coordination is undesirable because fiscal shocks exert a pecuniary externality. Under Nash the pecuniary externality is smaller than under coordination, which means that residents in the country where the increase in government spending occurs bear a larger burden. Baxter and King do not realize that there is a political economy corollary to their results. If the frequency and the size of shocks to government spending depend on the burden they impose upon a country's residents, coordination is the way to make such shocks larger and relatively frequent. In this context what matters is the pecuniary externality: correcting the policy externalities is a mistake. This is an important argument and one that is typically overlooked in Brussels.