On public spending and unions

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February 2020
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February 15, 2020

Abstract

We analyze the conduct of fiscal policy in a financially integrated union in the presence of financial frictions. Frictions create a wedge between the return to investment and the union interest rate. This leads to an over-spending externality. While the social cost of spending is the return to investment, governments care mostly about the (depressed) interest rate they face. In other words, the crowding out effects of public spending are partly “exported” to the rest of the union. We argue that it may be hard for the union to deal with this externality through the design of fiscal rules, which are bound to be shaped by the preferences of the median country and not by efficiency considerations. We also analyze how this overspending externality – and the union’s ability to deal with it effectively – changes when the union is financially integrated with the rest of the world. Finally, we extend our model by introducing a zero lower bound on interest rates and show that, if financial frictions are severe enough, the union is pushed into a liquidity trap and the direction of the spending externality is reversed. At such times, fiscal rules that are appropriate during normal times might backfire.

JEL: E62, F32, F34, F36, F41, F42, F45

Keywords: public spending, crowding out, financial frictions, fiscal union, spending externalities, fiscal coordination

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1 Introduction

During the last three decades there has been a large and growing spread between estimates of the return to capital and the interest rates at which many governments borrow. This increase was driven mostly by a reduction in interest rates, while estimates of the return to capital have remained stable. This has been true, in particular, among European countries, as illustrated by Figure 1. The figure shows that since 1990, while real interest rates in European countries have fallen from 5% to -2%, the return to capital in these countries has remained around 7%-8%.

[INSERT FIGURE 1]

What are the implications of these trends for fiscal policy? A popular view is that the downward trend in interest rates implies that governments should increase public spending. The argument is very simple: If the rates at which governments borrow reflect the social cost of funds, and the marginal value of public spending has not declined dramatically, governments should react to a reduction in their cost of borrowing by spending more.

Despite how natural this view seems, it relies on the assumption that interest rates do in fact reflect the social cost of funds. But this is not at all clear, especially given the large and growing spread between interest rates and estimates of the return to capital. And how one interprets this spread turns out to make a big difference for the effects of fiscal policy.

A first interpretation is that the spread illustrated in Figure 1 only reflects mismeasurement of the return to capital, possibly due to the rise of intangibles. A second interpretation is that the spread is real, but does not reflect any market friction. Instead, it reflects growing risk premia from higher investment risk or lower tolerance for such risk. In other words, the risk-adjusted return to capital has instead fallen alongside interest rates. According to both of these interpretations, interest rates do reflect the social cost of funds.

In this paper we explore a third interpretation: There are market frictions, such as financial constraints and market power, that depress investment demand, creating a spread between the

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1 Similar trends have been documented for the US. See, for instance, Caballero et al. (2017) and Farhi and Gourio (2019).
2 See for example Blanchard (2019). Note that one does not need to appeal to Keynesian arguments to argue this.
3 For evidence consistent with this view, see Farhi and Gourio (2019).
4 For evidence in support of this view, see Caballero et al. (2017), Farhi and Gourio (2019), and Marx et al. (2019).
(risk-adjusted) return to capital and interest rates. But to the extent that public spending crowds out private investment, its social cost is the return to capital, and interest rates provide a misleading measure of these costs. This would not be a problem in financial autarky since governments would internalize this discrepancy. But we show that in a financially integrated union it leads to excessive public spending.

To establish these results, we focus throughout on the case in which investment demand is constrained by financial frictions. We construct a simple multi-country model of an economic union. Each country is composed of a government, which decides how much public spending to undertake, and a private sector, which decides how much to invest. Public spending is useful because it provides a valuable public good to a country’s residents, but this taste for the public good varies across countries. The private sector, in turn, is composed of workers and savers. Workers organize themselves in firms to invest in capital, which is combined with their labor to produce the private good. Savers have resources to invest, but they lack the ability to do so. This creates gains from trade between firms and savers in the credit market.

We make two crucial assumptions regarding the credit market. First, it is integrated across borders, i.e., savers located in any country within the union can lend to firms located in any other of the union’s countries. In fact, this is the defining feature of a union for us. Second, its functioning is hampered by a financial friction. Namely, we assume that firms can only pledge a fraction of their capital income to savers. This financial friction gives rise to a constraint that limits borrowing and investment by firms. In equilibrium, this generates a wedge between the return to capital and the interest rate.

Our main result is that, under these two assumptions, public spending in a decentralized equilibrium is inefficiently high. There is an overspending externality because each individual country does not internalize the crowding-out effect of its spending decisions on the capital stock of the entire union.

To see this, assume that countries are small relative to the union and that they take the interest rate as given. Financial integration implies that, from the perspective of any individual government, the cost of its public spending is equal to the union interest rate. The reason is that, regardless of whether it is financed by issuing debt or by taxing savers, a country’s public spending is effectively funded through an increase in capital inflows from the rest of the union and does not crowd-out domestic investment. This is not true of the union as a whole, however: since total resources are limited, higher public spending in any one country

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5For evidence consistent with the relevance of such market frictions see Eggertsson et al. (2018), Farhi and Gourio (2019), and Faltermeyer (2019). The former two show that market power plays a significant role in accounting for the spread, while the latter shows that financial frictions must also play a role.
must crowd out investment somewhere else. Thus, from the perspective of the union the cost of public spending equals the return to capital. Since the interest rate is lower than the return to capital due to the financial friction, public spending is inefficiently high.

Our second result is that it is generically difficult for the union to correct the overspending externality through a centralized system of taxes or limits on spending. To show this, we endow the union with the power to set some aspects of fiscal policy. In particular, we endow the union with enough policy tools to attain efficiency, and analyze how it actually uses these tools. We make two assumptions about the union’s policy-making process. The first one is that decisions are made democratically, i.e. by majority vote. The second assumption is that compliance with union decisions is compulsory, i.e. there are no opt-out clauses.

We proceed in two steps. First, we endow the union with the power to set idiosyncratic spending or borrowing limits on its members. Unfortunately, this institutional arrangement produces undesirable outcomes, as the union uses its fiscal power to impose extreme fiscal austerity and policy uniformity. The reason is that the union’s marginal voter, which effectively sets the policy of the group, does not internalize the local benefits of public spending but only its costs to the rest of the union in terms of crowding out. Second, we endow the union with the power to tax public spending and distribute the proceeds among its members lump-sum. This institutional arrangement works much better, and might help to mitigate the overspending externality. But it can also worsen it, or even convert it into an underspending problem. The reason is that the policy adopted by the union will be guided by the preferences of the median voter and not by efficiency considerations.

These results are derived under the assumption that public spending crowds out investment in the union one-to-one. But this is not the case if part of the union’s public spending can be financed with foreign resources, i.e., by issuing debt outside of the union. To allow for this (realistic!) possibility, we consider the effects of financial integration between the union and the rest of the world. In particular, we assume that some countries are “credible” and their governments can issue debt outside of the union. By doing so, they effectively export the crowding out effect of their public spending. Financial integration thus mitigates the overspending externality and raises the efficiency of the decentralized equilibrium. Somewhat paradoxically, we show that it may also reduce the ability of a fiscal union to deal effectively with the overspending externality that remains. The reason is that financial integration might give rise to an extreme austerity bias within the union because credible countries, which have access to funding from the rest of the world, have an incentive to impose excessive costs on the public spending of the countries that lack such market access.
Finally, we reconcile the view developed here, in which financial frictions lead to excessive public spending, with the widespread notion that public spending in the euro area has been insufficient in the wake of the financial crisis. To do so, we extend the model and introduce a lower bound on the real interest rate. When financial frictions are not too severe, the interest rate remains above this lower bound and our main results remain valid. But if financial frictions become severe enough, private demand becomes so low that the interest rate reaches its lower bound. At this point, the economy enters a liquidity trap, output becomes demand-determined and there is economic slack. From the perspective of the union, the cost of public spending falls discontinuously from the marginal return to private investment, which is higher than the interest rate, to the marginal cost of production, which is below the interest rate. Consequently, the overspending externality is replaced by an underspending externality. We use this extension of the model to provide a narrative of the European crisis and to illustrate how austerity measures adopted during “normal” times can backfire when the economy is in a liquidity trap.

Our paper is related to the large literature on the coordination of fiscal policy in open economies. Part of this literature, which sought specifically to understand the need for fiscal policy coordination in a monetary union, was motivated by Europe’s adoption of the Maastricht Treaty as it advanced towards monetary integration.\footnote{See Beetsma and Giuliodori (2010) for a survey of this literature.} Within this literature, we are closest to models that analyze the transmission of fiscal policy through the interest rate.\footnote{See Chang (1990), Chari and Kehoe (1990) and Canzoneri and Diba (1991). Also, Faini (2006) documents that in the euro area fiscal expansions do raise the euro-wide interest rate. Other papers analyze the fiscal policy spillovers that arise from induced fiscal transfers or inflationary bias (e.g. Gourinchas, Martin, and Messer, 2018).} A general result that emerges from this line of work is that uncoordinated fiscal policy is suboptimal if (i) countries have power in world markets, or (ii) there are distortions that create a wedge between interest rates and the social cost of public spending. We focus on (ii), as we assume that countries are small. But while the previous literature emphasized distortionary taxation, we focus on frictions that create a positive wedge between the return to capital and the interest rate.

The paper is structured as follows. Section 2 develops the baseline model and derives the over-spending externality. Section 3 analyzes the effects of endowing the union with fiscal powers. Section 4 introduces financial integration between the union and the rest of the world. Finally, Section 5 modifies the baseline model to allow for liquidity traps. Section 5 concludes.

\footnote{Fiscal policy also affects countries’ terms of trade. Epifani and Gancia (2009) show that, to the extent that public spending is biased towards domestic goods, there is an overspending externality.}


2 A fiscal policy problem

We study an economic union with countries that have heterogeneous preferences over public spending. Factor markets are local, but there is a single financial market for all union members. As a result, public spending choices in one country are transmitted to the rest of the union through the common interest rate.

Public spending crowds out investment. Its social cost, thus, is the marginal product of the capital it displaces. Its private cost, however, is the interest rate paid on the debt used to finance it. If financial markets work well, the interest rate equals the marginal product of capital and decentralized governments choose the efficient level of public spending and debt. If financial markets do not work well, a wedge arises between the interest rate and the marginal product of capital. In particular, the interest rate drops below the marginal product of capital if credit constraints depress the demand for credit. As a result, decentralized governments do not pay the full social cost of borrowing and choose levels of public spending and debt that are too high.

This section describes this overspending externality and the factors that determine its importance. It also provides a recipe to fight it consisting of: (i) a set of fiscal policies that move the union from the decentralized equilibrium to a Pareto optimum, and (ii) a set of country transfers that ensure that the efficiency gains from this move are equally shared by all union members.

2.1 The setup

There are two dates, Today and Tomorrow. The union contains a unit mass population uniformly distributed across countries. There is a single consumption good that can be shipped across countries at zero trade costs. There are two factors of production, capital and labor, which can produce together only if located in the same country. The union has removed all barriers to trade.

Countries differ on their taste for public goods, as measured by a parameter \( \gamma \in [\gamma_L, \gamma_H] \). Let \( F(\gamma) \) be its distribution function, i.e., \( F(x) \) is the measure or share of member countries such that \( \gamma \leq x \). Since all countries have the same population, \( F(x) \) is also the measure or share of the union’s population such that \( \gamma \leq x \). Since (i) there is no other source of heterogeneity across countries and (ii) we always focus on symmetric equilibria, we can index country variables by \( \gamma \). For instance, we refer to the country with parameter \( \gamma \) as “country \( \gamma \)”, and write its utility function as \( U(\gamma) \).
Country $\gamma$ maximizes the utility function

$$U(\gamma) = c(\gamma) + \gamma \cdot \ln g(\gamma),$$

where $c(\gamma)$ and $g(\gamma)$ are the consumption of private and public goods Tomorrow. Equation (1) implies that (i) there is no consumption of private or public goods Today; and (ii) utility is linear in the consumption of private goods Tomorrow. This choice of preferences simplifies the analysis substantially. For instance, it makes the savings decision trivial as countries save any income they have Today.

All countries start Today with an endowment of private goods equal to $\omega$. Tomorrow, their income will consist of the wage $w(\gamma)$, plus the return to savings $R \cdot \omega$, minus taxes $t(\gamma)$. Thus, we can write the budget constraint of country $\gamma$ Tomorrow as follows:

$$c(\gamma) = w(\gamma) + R \cdot \omega - t(\gamma).$$

Note that the wage can vary across countries, since labor markets are local. But the interest rate is common to all countries since there is a global financial market.

To produce private goods, firms use capital and labor using a standard constant-returns technology:

$$y(\gamma) = f(k(\gamma)),$$

where $y(\gamma)$ and $k(\gamma)$ are output and capital per worker, respectively. The function $f(\cdot)$ is continuous, twice differentiable, with $f'(\cdot) > 0$, $f''(\cdot) < 0$ and $\lim_{k \to 0} f'(k) = \infty$. To produce one unit of capital for Tomorrow, one unit of private goods must be invested Today.

To produce public goods, governments use public capital only. We normalize units so that one unit of public capital produces one unit of public goods. To produce one unit of public capital for Tomorrow, one unit of private goods must be spent Today. Thus, $g(\gamma)$ stands for both public goods and public capital, and we refer to it as public spending.

Let us now describe how factor markets work. Firms are nothing but contracts between workers and savers that provide labor and funds to invest in capital, respectively. Under the optimal contract, workers receive the marginal product of labor while savers receive the marginal product of capital. Ex-post, however, both factors would like to appropriate all output. We now introduce a standard limited-pledgeability constraint. In particular, firms are controlled by workers and they can only pledge a fraction $\lambda \in (0,1)$ of the marginal product of capital to savers. Thus, ex-ante contracts must reflect this constraint and output
is distributed as follows:

\[ w(\gamma) = f(k(\gamma)) - \lambda \cdot f'(k(\gamma)) \cdot k(\gamma), \quad (4) \]

\[ R = \lambda \cdot f'(k(\gamma)). \quad (5) \]

This limited-pledgeability constraint plays a central role in what follows. It reduces the demand for savings and it creates a wedge between the interest rate and the marginal product of capital. Thus, savers only receive a fraction \( \lambda \) of the marginal product of the capital they finance (See Equation (5)). And workers receive not only the full marginal product of their labor, but also a fraction \( 1 - \lambda \) of the marginal product of capital (see Equation (4)).

Since all countries have the same technology and the friction \( \lambda \) is common to all countries, it follows that all countries must have the same stock of capital and wage. Indeed, for a given interest rate \( R \), Equations (4) and (5) define these common values \( w(\gamma) = w \) and \( k(\gamma) = k \). Thus, factor prices are equalized across countries and, despite the limited-pledgeability constraint, the union’s capital stock is efficiently distributed across countries. We shall see shortly, however, that this constraint distorts the size of the union’s capital stock.

Let us consider next the financial market. On the supply side, savers supply funds. On the demand side, firms and governments demand funds to invest. Since there is no production or default risk, there is a unique interest rate \( R \) for all borrowers that clears the financial market

\[ \omega = \int_{\gamma_L}^{\gamma_H} [k + g(\gamma)] \cdot dF(\gamma). \quad (6) \]

Equation (6) simply says that the interest rate must be such that the supply of funds by savers must equal the demand for funds by firms and governments.

We can now collect the results obtained so far to find that

\[ U(\gamma) = f(\omega - g) + \lambda \cdot f'(\omega - g) \cdot g - t(\gamma) + \gamma \cdot \ln g(\gamma), \quad (7) \]

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9 Could a single individual overcome the limited-pledgeability constraint by setting up an infinitesimal firm with only her saving and labor? We do not allow this. To justify this, assume that only a finite number of individuals (the “entrepreneurs”) in country \( \gamma \) can write contracts with savers and workers. Thus, country \( \gamma \) has a finite number of firms. Each of these firms consists of separate contracts between an entrepreneur and a continuum of workers on one side; and the same entrepreneur and a continuum of savers on the other side. Workers can only pledge to the entrepreneur a fraction \( \lambda \) of the marginal product of capital for each unit of capital invested. Thus, the entrepreneur can only pledge to savers a fraction \( \lambda \) of the marginal product of capital for each unit of capital invested. Competition among entrepreneurs ensures that they make zero profits and all output is distributed between workers and savers.
where $g$ is total union public spending or public capital (as a rule, we denote union totals by omitting the index $\gamma$)

$$g = \int_{\gamma L}^{\gamma H} g(\gamma) \cdot dF(\gamma).$$  \hspace{1cm} (8)

Equations (7)-(8) show how utility depends on the fiscal policies of all countries. Naturally, low taxes and high public spending at home raise welfare. But fiscal policy in the rest of the union also affects welfare at home. In particular, high public spending around the union reduces the capital stock and this lowers utility. This crowding-out effect will play a central role in the discussion that follows.

To complete the model, we need to explain how fiscal policy is determined. That is, we need a theory for the functions $\{g(\gamma), t(\gamma)\}$. Before developing such a theory, we note that the equilibrium functions $\{g(\gamma), t(\gamma)\}$ must be such that

$$\int_{\gamma L}^{\gamma H} \left[ \lambda \cdot f'(\omega - g) \cdot g(\gamma) - t(\gamma) \right] \cdot dF(\gamma) = 0. \hspace{1cm} (9)$$

Equation (9) says that debt payments must be financed by taxes. This is an aggregate or union resource constraint for governments. But it does not preclude transfers between country governments. If $\lambda \cdot f'(\omega - g) \cdot g(\gamma) > t(\gamma)$ for some $\gamma$, for instance, part of the debt payments of country $\gamma$ are financed by a transfer from governments of other countries.

Finally, to simplify the analysis we assume throughout that $\omega$ is large enough to ensure that the non-negativity constraint on private consumption is never binding. This constraint is given by

$$t(\gamma) \leq f(\omega - g) + \lambda \cdot f'(\omega - g) \cdot g. \hspace{1cm} (10)$$

If $\omega$ were small there might be corner solutions in which the consumption of private goods is zero in some countries. We ignore this possibility in what follows.

### 2.2 The decentralized equilibrium

Let us start by describing the decentralized or Nash equilibrium of this world. In such an equilibrium, (i) there are no transfers across governments, i.e., $t(\gamma) = R \cdot g(\gamma)$, and (ii) each government chooses $g(\gamma)$ so as to maximize $U(\gamma)$.

Without transfers, we can write the utility function in Equation (7) as follows:

$$U(\gamma) = f(\omega - g) + \lambda \cdot f'(\omega - g) \cdot [g - g(\gamma)] + \gamma \cdot \ln g(\gamma). \hspace{1cm} (11)$$
Then, government maximization implies

$$\frac{\gamma}{g^D(\gamma)} = \lambda \cdot f' (\omega - g^D),$$  \hspace{1cm} (12)$$

where $g^D(\gamma)$ is public spending in the decentralized equilibrium, and $g^D = \int_{\gamma_L}^{\gamma_U} g^D(\gamma) \cdot dF(\gamma)$. Equation (12) says that governments choose spending so that the marginal utility of public goods equals the interest rate.

The simplicity of Equation (12) is in part due to some strategic assumptions. One should read this equation essentially as stating the optimal rule to allocate public and private capital from the perspective of the country. This rule says that the marginal product of public capital (which here is one!) times the marginal utility of public goods must equal the interest rate times the marginal utility of private goods (which here is one!).

Equation (12) defines $g^D(\gamma)$ as a function of $g^D$. We can use it to obtain (implicitly) the entire distribution of public spending:

$$g^D \cdot f' (\omega - g^D) = \frac{\gamma_A}{\lambda},$$ \hspace{1cm} (13)$$

$$g^D(\gamma) = \frac{\gamma}{\gamma_A} \cdot g^D,$$ \hspace{1cm} (14)$$

where $\gamma_A$ is the union average $\gamma$, i.e. $\gamma_A = \int_{\gamma_L}^{\gamma_U} \gamma \cdot dF(\gamma)$. Equation (13) implicitly defines the union’s average public spending. For $g^D \in [0, \omega]$, the LHS defines a continuous and increasing function that takes values in $[0, \infty)$, while the RHS is a constant. Thus, we know that Equation (13) defines a unique solution $g^D$. Moreover, it is easy to check that this solution is increasing on $\omega$ and decreasing on $\lambda$. The reason is that an increase in $\omega$ lowers the interest rate, while an increase in $\lambda$ raises it. Equation (14) shows how the union’s public spending is distributed across countries. Not surprisingly, country level public spending is increasing on $\gamma$. Also, we note that changes in $\omega$ and $\lambda$ affect public spending in all countries proportionally.

### 2.3 The overspending externality

From a country perspective, the cost of government debt is the interest rate. From a union perspective, however, the cost of government debt is the marginal product of capital. To see this, we construct the set of Pareto optima. In particular, we choose the functions $\{g(\gamma), t(\gamma)\}$ so as to maximize the utility in Equation (7) for some country $\gamma$, keeping the utility of all other countries constant at some pre-specified levels. By changing these levels, we find the set of all Pareto optima. Note that this is a notion of constrained Pareto efficiency since it takes
the allocation of capital and labor as given by the market.

We restrict our attention to the subset of Pareto optima such that the non-negativity constraints in Equation (10) are not binding. There are many Pareto optima in this subset, each of them with a different function \( t(\gamma) \). But all of them have the same function \( g^P(\gamma) \), which is defined as

\[
\frac{\gamma}{g^P(\gamma)} = f'(\omega - g^P),
\]

where \( g^P(\gamma) \) the Pareto efficient provision of public goods, and \( g^P = \int_{\gamma_L}^{\gamma} g^P(\gamma) \cdot dF(\gamma) \).

Equation (15) says that Pareto efficiency requires that public spending be chosen so that the marginal utility of public goods equals the marginal product of capital.

Equation (15) defines \( g^P(\gamma) \) as a function of \( g^P \). We can use it to obtain (implicitly) the entire distribution of public spending:

\[
g^P \cdot f'(\omega - g^P) = \gamma_A
\]

\[
g^P(\gamma) = \frac{\gamma}{\gamma_A} \cdot g^P
\]

Equation (16) defines a unique solution \( g^P \) which is increasing on \( \omega \). Comparing Equations (13) and (16), we find that union spending in the decentralized equilibrium is too high relative to the Pareto optima, i.e. \( g^D > g^P \). Equation (17) shows that public spending is indeed too high in all countries, i.e. \( g^D(\gamma) > g^P(\gamma) \) for all \( \gamma \).

The pledgeability constraint depresses the interest rate and this creates an overspending externality. From a union perspective, an additional unit of public spending by country \( \gamma \) reduces the union’s capital stock by one unit, which in turn reduces union’s output by \( f'(\omega - g) \) units. The unit reduction in the union’s capital stock is split across countries uniformly, so that all countries experiment an infinitesimal reduction in their capital stock and output. A fraction \( \lambda \) of the output loss is suffered by savers all over the union. But this loss is compensated by country \( \gamma \), who needs to borrow to pay for the additional unit of public spending and offers savers government debt that is a perfect substitute for capital. A fraction \( 1 - \lambda \) of the output loss is suffered by workers all over the union. But workers receive no compensation for their loss. Since country \( \gamma \) is infinitesimal, only an infinitesimal fraction of this loss affects its own workers. Thus, country \( \gamma \) does not take this output cost into account when choosing its public spending.

It is instructive to see how to produce a Pareto improvement. Consider the gain that country \( \gamma \) would experience after a move from the decentralized equilibrium to a Pareto optimum with
a tax function $t^P(\gamma)$

$$U^P(\gamma) - U^D(\gamma) = f (\omega - g^P) - f (\omega - g^D) + \gamma_A \cdot (\ln g^P - \ln g^D) +$$

$$+ (\gamma - \gamma_A) \cdot (1 - \lambda + \ln g^P - \ln g^D) +$$

$$+ \lambda \cdot \gamma - t^P(\gamma).$$

Equation (18) provides a useful decomposition of this gain. The first line shows the average utility effect of the move, which is always positive. The second line contains the differential utility effect of the move in the absence of transfers, i.e. if we impose $t^P(\gamma) = R \cdot g^P(\gamma)$. On the one hand, countries with $\gamma > \gamma_A$ experiment a larger reduction in their borrowing and debt payments and therefore a larger increase of private consumption. On the other hand, these countries also experience a larger utility loss as their consumption of public goods shrinks. Finally, the third line shows the transfer that country $\gamma$ receives which can be positive or negative.

This discussion sets the stage for the analysis that follows. There are gains from cooperation and the question is how to structure interactions among countries to reap these gains. In particular, a move from $g^D(\gamma)$ to $g^P(\gamma)$ can be coupled with an appropriate set of country transfers to raise the welfare of all countries in the world. How could the union produce such a move?

### 2.4 Overspending or overborrowing?

Before addressing this central question, we tie a loose end. Some readers might be asking why do we use the label “overspending” instead of “overborrowing” when we refer to the externality. But country governments are financing their public spending exclusively with debt. Is it really spending or is it debt that matters?

To find out, we assume now that countries can finance their spending with a combination of taxes Today, i.e. $t_0(\gamma)$; and taxes Tomorrow, i.e. $t_1(\gamma)$. Then, the budget constraint of country $\gamma$ becomes:

$$c(\gamma) = w(\gamma) + R \cdot [\omega - t_0(\gamma)] - t_1(\gamma)$$

In the decentralized equilibrium, there are no transfers among countries and the budget constraint of the government of country $\gamma$ is now given by:

$$t_1(\gamma) = R \cdot [g(\gamma) - t_0(\gamma)]$$
For a given spending, taxes Today reduce government debt and the need for taxes Tomorrow. A quick look at Equations (19) and (20) reveals that this extension makes no difference. Equation (11) still holds and all our results flow from it. Thus, a shift from debt to taxes has no effects on consumption and welfare.

This is an important observation. We analyze next various policies such as limits and taxes on spending. As we do so, we should keep in mind that these policies cannot simply be replaced for limits and taxes on debt. The latter would only produce a shift from debt to taxes without affecting consumption and welfare.

3 A union with fiscal powers

A pure economic analysis of the fiscal policy problem would end with the solution described by Equations (16) and (17). These equations provide the recipe for a fiscal policy that eliminates the overspending externality. What else could one wish for? Unfortunately, it is unlikely that such a fiscal policy be the outcome of the union’s policy-making process. Economic unions are not mythical social planners, but real-life institutions that produce imperfect outcomes. It is to these outcomes that we turn next.

We now endow the union with the power to set some aspects of fiscal policy. We always give the union enough power to achieve a Pareto optimum, as described in Equations (16) and (17). The question is how the union uses this power. We make two assumptions about the union’s policy-making process. The first one is that decisions are made democratically, i.e. by majority vote. The second assumption is that compliance with union decisions is compulsory, i.e. there are no opt-out clauses.

We proceed in two steps. First, and consistent with observed practice in the European Union, we endow the union with the power to set spending or borrowing limits. Unfortunately, this institutional arrangement produces undesirable outcomes, as the union uses its fiscal power to impose extreme fiscal austerity and policy uniformity. Second, and unlike observed practice in the European Union, we endow the union with the power to tax public spending and distribute the proceedings among its members lump-sum. This institutional arrangement works much better. It might help mitigate the overspending externality. But it can also worsen it, or even convert it into an underspending problem.

\footnote{To see this use Equation (19) instead of Equation (3) to find that:

\[ U(\gamma) = f(\omega - g) + \lambda \cdot f'(\omega - g) \cdot g - R \cdot t_0(\gamma) - t_1(\gamma) + \gamma \cdot \ln g(\gamma) \]

Then, use Equation (20) to recover Equation (11).}
3.1 Setting spending limits

Let the union have the power to set spending limits. Recognizing that countries have different tastes for public goods, we allow these limits to be country-specific. That is, the union chooses a function $\bar{g}(\gamma) \geq \varepsilon$ and then countries choose $g(\gamma)$ subject to $g(\gamma) \leq \bar{g}(\gamma)$. The lower bound on spending limits $\varepsilon > 0$ is assumed to be arbitrarily small but not zero. This is just a technical requirement to ensure that utilities are always well defined.

The equilibrium with spending limits satisfies: (i) there are no transfers across governments, i.e., $t(\gamma) = R \cdot g(\gamma)$; (ii) spending limits are chosen case-by-case by majority voting; and (iii) each government chooses $g(\gamma)$ so as to maximize $U(\gamma)$ subject to $g(\gamma) \leq \bar{g}(\gamma)$.

Without transfers, Equation (11) still applies. Thus, for given spending limits $\bar{g}(\gamma)$, country $\gamma$ chooses its spending as follows:

$$g^U(\gamma) = \min \left\{ \frac{\gamma}{\lambda \cdot f'(\omega - g^U)} \cdot \bar{g}(\gamma) \right\},$$

where $g^U(\gamma)$ is the equilibrium fiscal policy under the union, and $g^U = \int_{\gamma_L}^{\gamma_U} g^U(\gamma) \cdot dF(\gamma)$.

Equation (21) says that, if the spending limit is not binding, country $\gamma$ chooses public spending so that the marginal utility of public goods equals the interest rate. If the spending limit is binding, though, the country sets its public spending equal to the limit. Adding up across countries, we find that the union’s average spending is implicitly determined as follows:

$$g^U = \int_{\gamma_L}^{\gamma_U} \min \left\{ \frac{\gamma}{\lambda \cdot f'(\omega - g^U)} \cdot \bar{g}(\gamma) \right\} \cdot dF(\gamma).$$

Equation (22) shows that relaxing a binding limit $\bar{g}(\gamma)$ for country $\gamma$ raises the union’s average spending $g^U$, i.e. $\partial g^U / \partial \bar{g}(\gamma) > 0$. There is a direct effect, which is the increase in public spending in country $\gamma$ itself. But there is also an indirect effect since the interest rate increases and this lowers public spending in countries where the spending limit is not binding. This indirect effect cannot fully offset the direct one, though.

Equations (21)-(22) determine the equilibrium fiscal policy for given spending limits $\bar{g}(\gamma)$. The union would implement a Pareto optimum if it could somehow deliver the policy outcome: $\bar{g}(\gamma) = g^P(\gamma)$ for all $\gamma$. Unfortunately, this is not going to happen as it will become clear soon.

The first step is to determine preferences over policy. An almost trivial observation is that relaxing its own spending limit cannot lower the welfare of country $\gamma$, i.e. $\partial U(\gamma) / \partial \bar{g}(\gamma) \geq 0$. A less trivial observation is that relaxing the spending limit for other countries, i.e. $\gamma' \neq \gamma$,
has the following effect on the welfare of country $\gamma$:

$$\frac{\partial U (\gamma)}{\partial g (\gamma')} = -\frac{\partial g^U}{\partial g (\gamma')} \cdot \{(1 - \lambda) \cdot f' (\omega - g^U) + \lambda \cdot f'' (\omega - g^U) \cdot [g^U - g^U (\gamma)]\}. \quad (23)$$

Relaxing spending limits in other countries increases the union’s average public spending, and this raises the interest rate and crowds out capital. This has two effects for country $\gamma$, which correspond to the two terms inside the brackets. The first term is always positive and it captures the wage loss in country $\gamma$ that results from a reduction in its capital stock. This is nothing but the cost of the overspending externality. The second term is a terms-of-trade effect that results from an increase in the interest rate. This terms-of-trade effect is a cost for debtor countries (i.e., $g^U (\gamma) > g^U$), but a benefit for creditor ones (i.e., $g^U (\gamma) < g^U$). Since the only asymmetry across countries is the taste for public goods, public spending is the key determinant of the net foreign asset position. Countries choosing high public spending are debtors, while countries choosing low public spending are creditors.

Preferences over other countries’ spending limits are determined by the balance of these effects. If country $\gamma$ is either a debtor or a small creditor, the balance of these effects is negative and its welfare grows monotonically as the spending limit of any other single country becomes tighter. If country $\gamma$ is instead a large enough creditor, the terms-of-trade benefit exceeds the cost of the overspending externality and its welfare declines monotonically as the spending of any other single country becomes tighter. Thus, for a given set of spending limits for all other countries, country $\gamma$’s preferences over the spending limit of country $\gamma'$ are single-peaked. There is a threshold $\gamma$ such that for all countries below the threshold the maximum corresponds to the tightest spending limit, and for all countries above the threshold the maximum corresponds to any non-binding spending limit.

The union chooses spending limits case-by-case, which means that a specific spending limit is voted for each country separately. Since preferences are single-peaked and the policy-space is unidimensional, the median voter theorem applies to each of these votes. Thus, the spending limits for all countries coincide with the bliss point of the median country $\gamma_M$, i.e. $F (\gamma_M) = 0.5^{11}$. Interestingly, this procedure might generate multiple equilibria. The reason is that the outcome of the vote for the spending limit of a given country depends on the outcomes of the votes for the spending limits of other countries.

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11To be precise, the median country keeps changing in all votes. But the assumption that $F (\cdot)$ is continuous and differentiable ensures that it is always arbitrarily close to $\gamma_M$. 

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There is always an equilibrium in which all spending limits are as tight as possible:

$$\bar{g}(\gamma) = \varepsilon.$$  \hspace{1cm} (24)

To prove this, we simply note that, if $\bar{g}(\gamma) = \varepsilon$ for all $\gamma$, the median country is neither a debtor nor a creditor and it prefers to set $\bar{g}(\gamma) = \varepsilon$ for all $\gamma \neq \gamma_M$. Thus, the flexible union ends up imposing a single limit to all countries. Moreover, this limit is the tightest possible one. Since $\varepsilon$ is arbitrarily small, endowing the union with the power to set spending limits produces an arbitrarily large utility loss.

Why does the union exhibit such extreme austerity bias? An increase in public spending in any one country would generate a local benefit but also a negative externality in all other countries in the union. In the decentralized equilibrium, countries maximize the local benefit and disregard the externality. Since the externality is negative, the decentralized equilibrium produces overspending. In the union equilibrium, the union minimizes the externality and disregards the local benefit. Since the local benefits are positive, the union equilibrium produces underspending.

Is this undesirable equilibrium unique? The answer is affirmative if the median country’s taste for public goods is not too low relative to that of the average country. Otherwise, there is also an equilibrium in which the spending limits are irrelevant, i.e.

$$\bar{g}(\gamma) \geq g^D(\gamma).$$  \hspace{1cm} (25)

To prove this, simply note that, if $g(\gamma) = g^D(\gamma)$ for all $\gamma$, the median country prefers to set a non-binding limit if and only if

$$\frac{\gamma_M}{\gamma_A} < 1 - \frac{1 - \lambda}{\lambda} \cdot \frac{f'(\omega - g^D)}{-f''(\omega - g^D) \cdot g^D}.$$  \hspace{1cm} (26)

That is, the median country has to have a sufficiently large creditor position in the decentralized equilibrium. If this is the case, there is an equilibrium in which the union sets non-binding limits and these have no effects on public spending.

We conclude therefore that endowing the union with the power to set spending limits is a bad idea. At best, it is ineffective. At worst, it generates harmful uniformity and austerity biases. The union sets policy country-by-country and, when each country is considered, all the

\[^{12}\text{Ventura (2019) shows that this result applies to democratic fiscal unions even under more complex voting schemes.}\]
other countries (which naturally form a majority) care only about externalities and disregard local benefits. Thus, they all vote for the tightest possible spending limit. This converts an overspending problem into an underspending one. Moreover, this also introduces a new policy-uniformity problem.

Somewhat paradoxically, one way to soften the austerity bias is to reduce the power of the union and force it to impose a single uniform spending limit for all countries. Such a restriction links local benefits and externalities in the union’s decision-making process. When each country votes for this single limit, it knows that it will affect its own spending in addition to the spending of other countries. Thus, if a single spending limit \( \bar{g} \) were voted, we conjecture that it would soften or remove the austerity bias. This cannot be the right solution, though, since it imposes an undesirable degree of policy uniformity. This seems too high a cost to pay. Furthermore, there are better institutional arrangements that produce outcomes that respect preference heterogeneity.

An alternative, more classic, approach to fight the overspending externality consists of taxing public spending. If we give the union the power to set a tax schedule country-by-country, the same problems resurface. Essentially, the union’s strong uniformity and austerity bias lead it to choose a set of country-specific taxes that produce a uniform and arbitrarily low level of public spending. If we instead restrict the union to choose a single tax for all countries, local benefits and externalities become linked in the union’s decision-making process. Moreover, this is achieved without much of a cost. Having a uniform tax is much less costly (in fact, it is the right thing to do!) than having a single spending limit (which is clearly the wrong thing to do!). We explore this idea next.

### 3.2 Taxing public spending

Let us now endow the union with the power to choose a single tax schedule for all countries. In particular, let the union choose \( t \geq 0 \) such that

\[
t (\gamma) = -z + t \cdot R \cdot g (\gamma),
\]

where \( z \) is a lump-sum transfer that balances the union’s budget:

\[
z = (t - 1) \cdot \int_{\gamma_L}^{\gamma_H} R \cdot g (\gamma) \cdot dF (\gamma).
\]
If \( t = 1 \), each country pays for its own public spending and there are no transfers, \( z = 0 \). If \( t > 1 \) the union imposes a tax on public spending and transfers are positive, \( z < 0 \). If instead \( t < 1 \), the union gives a subsidy on public spending and transfers are negative, \( z < 0 \). As before, we assume for technical reasons that \( t < \tau \), where \( \tau \) is assumed to be arbitrarily large.

The equilibrium with taxes/subsidies on public spending is such that (i) the tax schedule is given by Equations (27)-(28); (ii) the union chooses \( t \); and (iii) each government chooses \( g(\gamma) \) so as to maximize \( U(\gamma) \).

We can now write the utility of country \( \gamma \) as follows:

\[
U(\gamma) = f(\omega - g) + t \cdot \lambda \cdot f'(\omega - g) \cdot [g - g(\gamma)] + \gamma \cdot \ln g(\gamma) .
\]  

(29)

Thus, for a given tax/subsidy \( t \), we now have that:

\[
\frac{\gamma}{g^U(\gamma)} = t \cdot \lambda \cdot f'(\omega - g^U) ,
\]  

(30)

where \( g^U(\gamma) \) is again the equilibrium fiscal policy under the union, and \( g^U = \int_{\gamma_L}^{\gamma_H} g^U(\gamma) \cdot dF(\gamma) \). Equation (30) says that country \( \gamma \) chooses public spending so that the marginal utility of public goods equals the after-tax interest rate. Equation (30) implies the following distribution of spending:

\[
g^U \cdot f'(\omega - g^U) = \frac{\gamma_A}{t \cdot \lambda} ,
\]  

(31)

\[
g^U(\gamma) = \frac{\gamma}{\gamma_A} \cdot g^U .
\]  

(32)

The comparative statics are essentially the same as those of the decentralized equilibrium, except that now we have an additional variable which is the tax/subsidy \( t \). An increase in \( t \) raises the cost of borrowing and reduces public spending in all countries proportionally. Thus, there is a one-to-one mapping between \( g^U \) and \( t \) and, as a result, also between \( g^U(\gamma) \) and \( t \).

Equations (31)-(32) determine the equilibrium fiscal policy for a given tax/subsidy \( t \). If the union somehow chose \( t = \lambda^{-1} \), it would implement a Pareto optimum. Whether this happens is unclear, though.

Let us start again by describing the policy preferences of country \( \gamma \). That is, we want to know how \( U(\gamma) \) changes with \( t \), under the restriction that the distribution of public spending is given by Equations (31)-(32). A little bit of straightforward algebra, shows that country \( \gamma \) has

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13 To see this, compare Equations (31)-(32) to Equations (13)-(14).
14 To see this, simply note that, as \( t \to \lambda^{-1} \), Equations (31)-(32) converge to Equations (16)-(17).
preferences over $t$ that exhibit an inverted-U shape with a maximum given when $t = \frac{\gamma_A}{\gamma} \cdot \lambda^{-1}$. This implies that the optimal tax/subsidy for country $\gamma$ is such that $g^U(\gamma) = g^U$.

The union chooses the tax/subsidy by majority vote. Since preferences are single-peaked and the policy-space is unidimensional, the median voter theorem applies. Thus, the equilibrium tax rate is the bliss point of the median country

$$t = \frac{\gamma_A}{\gamma_M} \cdot \lambda^{-1}. \quad (33)$$

The equilibrium tax achieves a Pareto optimum if and only if $\gamma_M = \gamma_A$. Generically, there is no reason to expect this to happen. If the median country has a strong taste for public goods, then the equilibrium tax is too low and it can even be a subsidy. If the median country has a weak taste for public goods, then the tax is too high.

The key takeaway is that endowing the union with the power to tax public spending is likely to work only if the taste for public spending of the median country is not too far from that of the average one. Is this result robust though? It seems to rely heavily on the observation that, in our environment, a single or common tax to public spending is the right solution to the overspending problem. And this, in turn, seems to be a direct consequence of assuming that one unit of spending by any government reduces private investment by exactly the same amount. But this need not be the case if some governments have access to financial markets outside of the union. We show this next.

4 Domestic and foreign debt

Let us consider the effects of financial integration between the union and the rest of the world. In particular, we analyze the effects of allowing governments to issue some debt outside of the union. To simplify the analysis, we adopt the classic small-economy assumption and take the world interest rate as given. This approach allows us to analyze the effects of alternative institutional arrangements for union welfare, but not for the rest of the world. In this regard,

\[ \text{To see this, use Equations (31)-432} \] to rewrite the utility function in Equation (29) as follows:

$$U(\gamma) = f'(\omega - g^U) + \gamma_A - \gamma + \gamma \cdot \ln \left( \frac{\gamma}{\gamma_A} \cdot g^U \right).$$

Thus, $U(\gamma)$ is increasing in $g^U$ when $g^U$ is low, but decreasing when $g^U$ is large. The maximum or peak is given by:

$$f' \left( \omega - g^U \right) = \frac{\gamma}{g^U}.$$

Equation (31) shows that the tax rate that delivers this outcome is $t = \frac{\gamma_A}{\gamma} \cdot \lambda^{-1}$. \]
our welfare analysis should be considered only as partial.

Financial integration has one key benefit for the union: namely, it allows it to “export” some of the crowding out effects of public spending. When the union is in a regime of financial autarky, as in the previous sections, all the resources needed to finance public spending are “domestic”, i.e., they must come from within the union. This is true regardless of whether spending is financed through taxes or through debt. Under financial integration, however, some of the resources to finance public spending can be imported from the rest of the world. This happens insofar as union governments can issue and sell public debt to the rest of the world, i.e., insofar as they can issue “foreign” debt.

By enabling the union to (at least partially) finance its public spending through foreign debt, financial integration mitigates the crowding-out effect of public spending and the associated externality. This clearly enhances welfare in the decentralized equilibrium. But the ability to issue foreign debt may be unevenly distributed across countries in the union. Some countries may have substantial access to the rest of the world’s financial markets, whereas others may have none at all. This difference among countries may exacerbate their heterogeneity in preferences, in turn, which may severely distort their collective decision making under a fiscal union. Ultimately, there are potentially two reasons why financial integration reduces the benefits of providing the union with fiscal tools: it mitigates the overspending externality and it distorts the union’s decision-making process.

4.1 Financial integration

The effects of financial integration depend on the assumptions we make about international financial frictions. We have assumed so far that these frictions are so severe that the union cannot trade with the rest of the world. If we went to the other extreme and made these frictions negligible, the overspending externality would disappear at once. To see this, note that we would simply have to replace Equation (6) with

\[ R = R^*, \]

where \( R^* \) is the interest rate in the rest of the world. It is straightforward to check that, in this case, the capital stock of the union is independent of public spending. All the crowding-out effects are exported to the rest of the world. There is no fiscal policy problem (at least from the union’s perspective), and there is therefore no need to endow the union with any fiscal
power\textsuperscript{16}

But this extreme case is not realistic either. In earlier research, we have argued that contract enforcement tends to discriminate against foreigners (see Broner et al. 2014). For instance, courts might discriminate against foreigners when enforcing debt contracts. In this case, workers could only pledge a fraction $\lambda^*$ of the marginal product of capital to foreigners, with $\lambda^* < \lambda$. As a result, there would be a range of inaction in which firms do not borrow from foreign savers, while union savers do not lend to the rest of the world. In particular, this range would be given by

$$\lambda^* \cdot f'(k) < R^* < \lambda \cdot f'(k),$$

where $k$ is the equilibrium capital in the union. We will assume throughout that the equilibria we study are located in this range\textsuperscript{17}.

Does this mean that financial integration has no effects? Not necessarily, since financial integration offers governments around the union the opportunity to borrow from the rest of the world at an interest rate that is below that of the union. All governments would want to take advantage of this opportunity. The question is, of course, whether they can. After all, courts also discriminate against foreigners when enforcing public debt contracts. We assume that there is a fraction $1 - \nu$ of governments that have built a reputation and can credibly commit to repay their debts without resorting to courts. These “credible” countries can borrow from the rest of the world at the low interest rate $R^*$, and they naturally choose to do so. The remaining fraction $\nu$ of union governments are not credible and cannot borrow from the rest of the world. To denote country types, we use the indicator variable $\delta \in \{0, 1\}$, and set $\delta = 1$ to indicate a country with a credible government and $\delta = 0$ otherwise. Thus, countries are now defined by the pair $(\gamma, \delta)$\textsuperscript{18}.

\textsuperscript{16}If the union were large relative to the world, all the effects we discussed in previous sections would still apply. Spending would crowd out union capital, although by less than one-to-one. Part of the crowding-out effect would be exported outside of the union. Also, the union would import crowding-out effects from the rest of the world. To determine the welfare effects of these “exports” and “imports” we would need to take a stand on how strong financial frictions are outside the union, and how policymaking is conducted there. These dimensions of the problem are certainly interesting and worth studying in future research.

\textsuperscript{17}Sufficient conditions for Equation (35) to hold are that (i) $R^* < \lambda \cdot f'(\omega)$; and (ii) $\lambda^*$ be low enough.

\textsuperscript{18}This section follows Broner et al. (2019) and models governments’ access to the rest of the world through the fraction of spending that they finance with foreign debt. Alternatively, we could assume that the probability of repayment to rest-of-the-world creditors is lower than that for union creditors as in Broner et al. (2014). In this case, access to the rest of the world would depend on the difference between these probabilities and would potentially be reflected in the interest rate spread on public debt. We do not follow this route here to keep the analysis as simple as possible.
4.2 Decentralized equilibrium

In a decentralized equilibrium, each government chooses \( g(\gamma, \delta) \) so as to maximize

\[
U(\gamma, \delta) = f(\omega - g_0) + \lambda \cdot f'(\omega - g_0) \cdot g_0 - [(1 - \delta) \cdot \lambda \cdot f'(\omega - g_0) + \delta \cdot R^*] \cdot g(\gamma, \delta) + \gamma \cdot \ln g(\gamma, \delta),
\]

where \( g_0 \) denotes spending by “non-credible” countries, i.e., \( g_0 = \int_{\gamma L}^{\gamma H} g(\gamma, 0) \cdot dF(\gamma, 0) \), where \( F(\gamma, 0) \) is the joint cdf over \( \gamma \) and \( \delta \). The share of countries that are not credible is given by \( \nu = \int_{\gamma L}^{\gamma H} dF(\gamma, 0) \).

Letting \( g^D(\gamma, \delta) \) denote public spending in the decentralized equilibrium, it follows from maximization of Equation (36) that,

\[
\frac{\gamma}{g^D(\gamma, \delta)} = \begin{cases} \lambda \cdot f'(\omega - g^D_0) & \text{if } \delta = 0, \\ R^* & \text{if } \delta = 1, \end{cases}
\]

where \( g^D_0 = \int_{\gamma L}^{\gamma H} g^D(\gamma, 0) \cdot dF(\gamma, 0) \). Equation (37) says that, in the decentralized equilibrium, governments equalize the marginal utility of public goods to the interest rate paid on public debt. In this regard, financial integration changes nothing. But now the relevant interest rate differs across countries: for credible countries that borrow from the rest of the world (i.e., \( \delta = 1 \)), the relevant interest rate is \( R^* \); for non-credible countries that issue debt inside the union (i.e., \( \delta = 0 \)), the relevant interest rate is \( \lambda \cdot f'(\omega - g^D_0) \).

Equation (37) defines \( g^D(\gamma, 0) \) as a function of \( g^D_0 \). To find the latter, note that

\[
g^D_0 = \int_{\gamma L}^{\gamma H} g^D(\gamma, 0) \cdot dF(\gamma, 0),
\]

where \( g^D_0 \) is the average \( \gamma \) among non-credible countries, i.e. \( \gamma_{A,0} = \nu^{-1} \cdot \int_{\gamma L}^{\gamma H} \gamma \cdot dF(\gamma, 0) \). Once \( g^D_0 \) has been found, it follows from Equations (37)-(38) that

\[
g^D(\gamma, \delta) = \begin{cases} \frac{\gamma}{\gamma_{A,0}} \cdot \frac{g^D_0}{\nu} & \text{if } \delta = 0, \\ \frac{\gamma}{R^*} & \text{if } \delta = 1. \end{cases}
\]

In both credible and non-credible countries, public spending is increasing in \( \gamma \). In non-credible countries, it makes no difference whether non-credible countries finance their spending through taxes or through domestic debt. Countries themselves are indifferent between both means of financing, as both have the same costs, and both means of financing have the same crowding-out effect, as we saw in Section (2.4). To simplify the exposition, we assume throughout that they resort fully to domestic debt.
countries, moreover, spending depends on the union interest rate and thus on the equilibrium within the union. In particular, public spending in these countries is increasing in \( \omega \), which expands the supply of savings and reduces the union interest rate; it is also decreasing in \( \gamma_{A,0} \) and \( \nu \), since both raise total public spending by non-credible countries thereby increasing the union interest rate. For credible countries, instead, the union interest rate is irrelevant and spending depends only on the international interest rate \( R^* \).

4.3 Foreign versus domestic debt and overspending

From the perspective of each individual country, the cost of public spending is the interest rate on public debt. From the perspective of the union, this cost is accurate for credible countries that finance their public spending with foreign or rest-of-the-world debt. But it is not accurate for non-credible countries that issue domestic or union debt: due to the crowding-out effect, their social cost of public spending equals the marginal product of capital.

To see this, consider once again the subset of Pareto optima with positive consumption of private goods for all countries. In all of them, it is straightforward to show that the following condition holds:

\[
\frac{\gamma}{g_{P}^{P} (\gamma, \delta)} = \begin{cases} 
    f' (\omega - g_{0}^{P}) & \text{if } \delta = 0, \\
    \frac{R^*}{\nu} & \text{if } \delta = 1,
\end{cases}
\]

where \( g_{P}^{P} (\gamma, \delta) \) the Pareto efficient provision of public goods for \( \delta \in \{0, 1\} \), and \( g_{0}^{P} = \int_{\gamma_{L}}^{\gamma_{U}} g_{P}^{P} (\gamma, 0) \cdot dF (\gamma, 0) \). Equation \( (40) \) says that, in a Pareto efficient allocation, the marginal utility of public goods must be equal the international interest rate in credible countries, and to the marginal product of capital in non-credible countries.

Again, Equation \( (40) \) defines \( g_{P}^{P} (\gamma, 0) \) as a function of \( g_{0}^{P} \). The latter is given by

\[
g_{0}^{P} \cdot f' (\omega - g_{0}^{P}) = \nu \cdot \gamma_{A,0}. \tag{41}
\]

Comparing Equations \( (38) \) and \( (41) \) we can verify that, relative to the Pareto efficient allocation, spending in the decentralized equilibrium is efficient in credible countries but it is too high in non-credible countries, i.e. \( g_{0}^{D} > g_{0}^{P} \). Moreover, since

\[
g_{P}^{P} (\gamma, 0) = \frac{\gamma}{\gamma_{A,0}} \cdot \frac{g_{0}^{P}}{\nu}, \tag{42}
\]

it follows that public spending is indeed too high in all non-credible countries, i.e. \( g_{D}^{P} (\gamma, 0) > g_{P}^{P} (\gamma, 0) \) for all \( \gamma \).
The intuition for this result is by now familiar. The financial friction depresses the equilibrium interest rate of the union. This creates an overspending externality, but only for non-credible countries that finance their spending with domestic debt. From the perspective of these countries, the cost of an additional unit of spending equals the union interest rate $\lambda \cdot f'(\omega - g_0)$. From a union perspective, however, an additional unit of public spending by these countries reduces the union’s capital stock by one unit, which in turn reduces union’s output by $f'(\omega - g_0)$ units. For credible countries, on the other hand, there is no overspending externality because they finance their spending with foreign debt: from the perspective of both, these countries and the union, the cost of a unit of public spending is the interest rate paid to the rest of the world, $R^*$.

4.4 Implications for a fiscal union

It is straightforward to show that, relative to autarky, financial integration raises aggregate welfare in both the decentralized equilibrium and Pareto efficient allocations. It also has natural implications for the design of a fiscal union. Namely, the need to control public spending varies across union members depending on whether they finance their public spending with domestic or foreign debt. In principle, the union should tax the share of public spending that is financed through domestic debt. In practice, this amounts to taxing public spending by non-credible countries, since credible countries are able (and willing!) to finance their spending fully through foreign debt.

In light of this, let us consider a differentiated tax/subsidy system that depends both on public spending and on $\delta$,

$$t(\gamma, \delta) = \begin{cases} 
-z + t \cdot R \cdot g(\gamma, \delta) & \text{if } \delta = 0, \\
-z & \text{if } \delta = 1, 
\end{cases} \quad (43)$$

where $z$ is a lump-sum transfer that balances the union’s budget,

$$z = (t - 1) \cdot R \cdot g_0. \quad (44)$$

It is clear that this differentiated spending tax is enough for the union to implement a Pareto efficient allocation. By setting $t = \lambda^{-1}$, the union can induce non-credible countries to fully internalize the externality that their spending generates to the rest of the union, and it does so without distorting spending by non-credible countries.

But would the union choose such a tax in equilibrium? The equilibrium with taxes/subsidies

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on public spending is such that (i) the tax is given by Equations (43)-(44); (ii) the union chooses $t$ by majority voting; and (iii) each government chooses $g(\gamma, \delta)$ so as to maximize $U(\gamma, \delta)$.

The preferences of country $(\gamma, \delta)$ can be written as:

$$U(\gamma, \delta) = \left\{ \begin{array}{ll} f(\omega - g_0) + t \cdot \lambda \cdot f'(\omega - g_0) \cdot [g_0 - g(\gamma, \delta)] + \gamma \cdot \ln g(\gamma, \delta) & \text{if } \delta = 0, \\
\int (\omega - g_0) + t \cdot \lambda \cdot f'(\omega - g_0) \cdot g(\gamma, \delta) + \gamma \cdot \ln g(\gamma, \delta) & \text{if } \delta = 1. \end{array} \right. \quad (45)$$

Thus, for a given tax/subsidy $t$, we now have that

$$\frac{\gamma}{g^{U}(\gamma, \delta)} = \left\{ \begin{array}{ll} \frac{t \cdot \lambda \cdot f'(\omega - g_0)'}{R*} & \text{if } \delta = 0, \\
R* & \text{if } \delta = 1, \end{array} \right. \quad (46)$$

where $g^{U}(\gamma, \delta)$ is once again the equilibrium fiscal policy under the union, and $g^{U}_0 = \int_{\gamma \in L} g^{U}(\gamma, 0) \cdot dF(\gamma, 0)$. As before, all countries set public spending so that the marginal utility of public goods equals its marginal cost.

To determine the equilibrium policy of the union, we begin once more by describing the policy preferences of country $(\gamma, \delta)$. That is, we want to know how $U(\gamma, \delta)$ changes with $t$, under the restriction that the distribution of public spending satisfies Equation (46). A little bit of algebra delivers two results.

First, credible countries maximize their welfare by setting arbitrarily high value of $t$, i.e., $t = \tau$. By doing so, they minimize public spending by non-credible union members and thus the crowding-out effect that this spending entails, but they do not have to pay taxes themselves. In other words, they capture the benefits of taxation while fully avoiding its costs.$^{20}$

What about non-credible countries? Maximization of Equation (45) yields a preferred tax rate of

$$t = \frac{\nu \cdot \gamma A,0}{\gamma} \cdot \lambda^{-1}, \quad (47)$$

$^{20}$To see this, use Equations (46) to rewrite the utility function in Equation (45) as follows:

$$U(\gamma, 1) = f(\omega - g_0) + \nu \cdot \gamma A,0 - R^* g(\gamma, 1) + \gamma \cdot \ln g(\gamma, 1).$$

Thus, $U(\gamma, 1)$ is maximized by setting $t$ as high as possible to minimize the crowding out effect of $g_0$. Some readers may wonder why there are no terms-of-trade effects. In particular, credible countries are net creditors in the union and they are hurt when taxes on public spending reduce the union interest rate. This terms-of-trade effect, however, is offset by a positive redistribution effect, which arises because part of the union’s tax revenues is appropriated by credible countries.
This result mirrors the tax rate of Section 3.2, with one key difference. The average preference for public spending among non-credible countries, $\gamma_{A,0}$, is “normalized” by the measure of these countries $\nu$. The reason is that country $(\gamma, 0)$ takes into account that a fraction of tax revenues is being transferred to credible union members. When $\nu \to 1$, this leakage is insignificant and we are back in the world of Section 3.2. When instead $\nu \to 0$, this leakage is extreme and non-credible countries prefer to set taxes as low as possible.

Whose preferences will be reflected in equilibrium? The union chooses the tax/subsidy by majority vote and the medium voter theorem applies. If the median country is credible, the tax rate will never be Pareto optimal: it follows from our previous discussion that the union will display an extreme austerity bias and the tax rate will be arbitrarily high. This is great from the perspective of credible countries, who minimize the crowding-out effect of public spending and transfer resources to themselves in the process. But it is a potential disaster from the perspective of the union: taxation is in this case decided by a subset of countries that capture its benefits without internalizing any of its costs.

If the median country is instead non-credible, the union will set a tax rate

$$
t = \frac{\nu \cdot \gamma_{A,0}}{\hat{\gamma}_M} \cdot \lambda^{-1},
$$

where $\hat{\gamma}_M$ is implicitly defined by

$$
F(\hat{\gamma}_M, 0) = \nu - 0.5.
$$

Equation (48) says that, when the medium country is non-credible, there are two effects that distort the union’s tax rate relative to the one that would be set in autarky (see Equation (33)). On the one hand, non-credible countries want low taxes to limit the transfers to credible union members: this is captured by the presence of $\nu$ in the numerator of Equation (48). On the other hand, credible countries want taxes to be as high as possible and – even if the median country is not credible – these preferences affect the voting outcome: this is captured by $\hat{\gamma}_M < \gamma_M$ in the denominator of Equation (48). These two effects distort the equilibrium tax rate in opposite directions, so that the latter achieves a Pareto optimum if and only if

$$
\hat{\gamma}_M = \nu \cdot \gamma_{A,0}.
$$

---

To see this, use Equations (46) to rewrite the utility function in Equation (45) as follows:

$$
U(\gamma, 0) = f(\omega - g_0) + \nu \cdot \gamma_{A,0} - \gamma + \gamma \cdot \ln \left( \frac{\gamma}{\nu \cdot \gamma_A} \cdot g_0 \right),
$$

Thus, $U(\gamma, 0)$ is maximized by setting $t$ to satisfy Equation (47).

---
The key takeaway of this discussion is that financial integration can further distort the union’s equilibrium tax rate. All else equal, the presence of credible countries introduces an austerity bias and leads to inefficiently high tax rates. Since these countries can issue foreign debt, they do not pay the tax themselves but they still benefit from setting it as high as possible. This force is present regardless of whether the median country is credible or not. If the median country is non-credible, moreover, there is an additional force that operates in the opposite direction because these countries take into account that their taxes are partially transferred to the rest of the union. Ultimately, financial integration raises welfare in the decentralized equilibrium and reduces the need for a fiscal union in the first place. But it may also hinder a fiscal union’s ability to set policy efficiently.

4.5 A union stability mechanism

If some countries in the union are credible and others are not, is there any way in which the former can “transfer” some of this credibility to the latter? Credible countries could, for instance, act as intermediaries, borrowing from the rest of the world and then lending part of these resources to the union’s less credible members. We can think of this intermediation as being carried out through a Union Stability Mechanism (USM) that is run by credible members of the union: this institution borrows from the rest of the world and then lends to some of the union’s less credible members at the international interest rate $R^*$. Effectively, the USM reduces the share of non-credible countries.

As described, the benefits of such a USM are transparent. By raising the share of public spending that can be financed with foreign debt, it reduces the crowding-out effects of public spending and thus the strength of the overspending externality. In this sense, the establishment of the USM is analogous to greater financial integration. Although such an institution may seem like a theoretical contraption, moreover, it resonates with the recent experience of the euro area.

Prior to the financial crisis, all euro area countries had ample access to the rest of the world and private financial markets worked well. Through the lens of our model, $\nu = 0$, which resulted in high public spending but also in high investment because crowding out was low. Between 2009 and 2012, however, countries in the euro area periphery lost access to the rest of the world. Through the lens of our model, $\nu$ increased, which led to a rise in crowding out throughout the union and generated two types of policy responses. First, there

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22 Thus, we focus throughout on the case in which the USM makes zero profits. Nothing substantial would change if the USM made profits by lending to non-credible governments at an interest rate $R > R^*$. 

26
was a strong pressure for periphery countries to engage in fiscal consolidation. Second, various mechanisms were put in place that de facto resulted in intermediation of funds by countries with higher credibility. This started with bilateral agreements and IMF programs, followed by loans from the European Financial Stability Facility and the European Stability Mechanism. The same could be said, albeit less directly, of various measures taken by the European Central Bank, such as the Securities Markets Program, the modification of collateral rules, the Long-Term Repurchase Operations, and even the possibility of purchasing unlimited amounts of sovereign securities through Outright Monetary Transactions. All these actions reduced the cost of borrowing for periphery governments, which allowed them to soften their fiscal consolidations.

Without denying these benefits, our model also suggests that a word of caution is in order: namely, insofar as these intermediation schemes change the political equilibrium of the union, they may also entail costs. To see this, suppose that by lending to a subset of non-credible countries, the USM changes the identity of the union’s median voter. After all, membership in the USM *de facto* turns a non-credible country into a credible one. In this case, we speculate that the USM’s net effect on efficiency is ambiguous. On the one hand, it eliminates the overspending externality in non-credible countries that are granted membership to the scheme. On the other hand, it translates into extreme austerity for the remainder of non-credible countries. If this last effect dominates, the establishment of a USM may actually reduce welfare in the union.

5 Liquidity traps

We have so far emphasized the role of financial frictions in generating public spending externalities in unions. In particular, we have shown that financial frictions depress market interest rates relative to the marginal return to private investment. Since the cost of public spending from the point of view of an individual country is the interest rate, financial frictions lead to overspending by governments.

An alternative view, however, is that financial frictions are associated with underspending by governments. This view has been quite popular in the wake of the recent financial crisis in the euro area, which according to many led to a large reduction in aggregate demand and an increase in “economic slack.” According to this view, this slack distorts governments’ incentives: in particular, each individual government fails to internalize the beneficial value of its own spending in reducing slack across the union. In other words, this view emphasizes
underspending.

Is there then an overspending or an underspending externality? Are these two views compatible? In this section, we show that they can indeed be reconciled as long as there exists a lower bound on the real interest rate. When financial frictions are not too severe, the interest rate remains above this lower bound and the analysis of the previous sections remains valid. But if financial frictions become severe enough, private demand becomes so low that the interest rate reaches its lower bound. Once this happens, the cost of public spending falls discontinuously from the perspective of the union, from the marginal return to private investment, which is above the interest rate, to the marginal cost of goods, which is below the interest rate. At this point, the overspending externality is replaced by an underspending externality.

To formalize this discussion, we extend the model by incorporating a lower bound on interest rates. We analyze formally how the nature of spending externalities varies with the severity of financial frictions. We describe both the optimal policy response and the policy that is likely to arise in the union equilibrium. Finally, we use these results to provide some insights on the euro area financial crisis.

5.1 Zero lower bound on real interest rates

Let us return to the baseline model with financial autarky. We introduce two key modifications. First, at $t = 0$, instead of receiving an exogenous endowment $\omega$, savers in each country have the ability to produce up to $\bar{\omega}$ units of output by exerting a positive but very small per-unit effort. In other words, the endowment is now endogenous and given by $\omega \in [0, \bar{\omega}]$. Second, following many recent papers in the New Keynesian tradition, we assume that there is a zero lower bound on the real interest rate, i.e. $R \geq 1$.\(^{23}\)^{24}

To obtain the decentralized equilibrium, note that nothing changes regarding the choice of public spending and capital accumulation. Namely, it is still true that in equilibrium both the return to public spending and the pledgeable return to investment are equal to the union

\(^{23}\)The lower bound on the real interest rate is typically justified as an implication of two assumptions. (i) There is an upper bound on inflation that arises either from nominal rigidities or from the central bank’s commitment to price stability. As a result, there is an upper bound on the difference between nominal and real interest rates. (ii) The central bank is the only producer of money, and it sets the nominal interest rate by trading money for nominal bonds. As a result, the nominal interest rate cannot be negative, since otherwise the demand for money would be infinite and the central bank would go bankrupt. (See Krugman 1998, Eggertsson and Woodford 2003, 2004).

\(^{24}\)The zero lower bound usually applies to the nominal interest rate. To save on notation, we assume that inflation is zero so the zero lower bound applies to the real interest rate as well. Nothing would change if the lower bound were different from zero.
interest rate,
\[ g^D(\gamma) = \frac{\gamma}{R} \quad \text{and} \quad \lambda \cdot f'(k(\gamma)) = R. \] (49)

As for the market clearing condition, it is still true that total public spending plus investment must equal union-wide resources \( \omega \),
\[ k + g^D = \omega, \] (50)
where \( k \) denotes the stock of capital in every country. The key difference is that now \( \omega \) is endogenous and may be below its potential level.

In particular, the decentralized equilibrium can be in one of two regimes. There is an unconstrained regime in which \( R \geq 1 \), \( k + g^D = \omega = \bar{\omega} \) and the equilibrium is as in Section 2. This happens when the total demand for goods by governments and firms is so high that the interest rate that clears the market with \( \omega = \bar{\omega} \) lies weakly above the zero lower bound. But there is also a constrained regime, or liquidity trap, in which \( R = 1 \) and \( k + g^D = \omega < \bar{\omega} \). This happens when the total demand for goods by governments and firms are so low that the interest rate that would clear the market with \( \omega = \bar{\omega} \) lies below the zero lower bound. Since the interest rate cannot fall below zero, however, market clearing is instead attained through a reduction in output below potential, i.e., \( \omega < \bar{\omega} \). \[ ^{25} \]

Formally, the equilibrium satisfies,
\[ R \geq 1, \quad \omega \leq \bar{\omega} \quad \text{and} \quad (R-1) \cdot (\omega - \bar{\omega}) = 0. \] (51)

Equations (49)-(51) characterize the decentralized equilibrium.

From the perspective of each country, the cost of public spending is equal to the interest rate. From the perspective of the union, however, the cost of public spending depends on whether the zero lower bound is binding or not. To see this, we construct the set of Pareto optima as before. A Pareto optimal allocation satisfies,
\[ g^P = \max \left\{ \frac{\gamma}{f'(\omega - g^P)}, \hat{g}(\lambda) \right\}, \] (52)
where
\[ \hat{g}(\lambda) = \bar{\omega} - f'^{-1}(\lambda^{-1}), \] (53)
and
\[ g^P(\gamma) = \frac{\gamma}{\gamma_A} \cdot g^P. \] (54)

\[ ^{25} \text{During liquidity traps there is rationing since, at prevailing prices, all savers would like to produce and sell all their potential output } \bar{\omega}. \text{ We focus throughout on symmetric equilibria in which all savers in the union produce and sell the same fraction of potential output } \omega/\bar{\omega}. \]
Equation (52) says that the Pareto optimal allocation can be in one of two regimes. In the unconstrained regime everything is as in the baseline model, and Pareto optimality requires equalizing the marginal benefit of spending in all countries to the marginal product of capital in the union. But there is also a liquidity-trap regime, in which the zero lower bound on the interest rate is binding and output is below potential. Instead of equalizing the return to spending to the marginal product of capital, Pareto optimality in this case requires raising public spending up to the level \( \hat{g} \) to eliminate slack. The reason is that, as long as \( g < \hat{g} \), there is no crowding out of investment and the marginal cost of public spending is effectively zero from the perspective of the union.

By comparing the decentralized equilibrium with the constrained optimal allocation, it is immediate that the former can entail too much or too little public spending depending on the regime. If the decentralized equilibrium is in the unconstrained regime, there is overspending and the analysis of Section 2 applies. If instead the decentralized equilibrium is in a liquidity trap, there is underspending.

### 5.2 Implications for a fiscal union

Whether the economy lies in the unconstrained regime or in a liquidity trap clearly depends on parameter values. A key parameter in the model is the level of pledgeability \( \lambda \), which determines the severity of financial frictions. A reduction in \( \lambda \) decreases investment demand and thus makes liquidity traps more likely. There are two critical values, \( \hat{\lambda}^D \) and \( \hat{\lambda}^P \), that respectively determine whether the decentralized equilibrium and the Pareto optimal allocation lie in a liquidity trap. These critical values are defined implicitly by

\[
\gamma_A = \hat{g} \left( \hat{\lambda}^D \right) \quad \text{and} \quad \hat{\lambda}^P \cdot \gamma_A = \hat{g} \left( \hat{\lambda}^P \right),
\]

where \( \hat{g}(\cdot) \) is as in Equation (53). \(^{26}\)

If \( \lambda \geq \hat{\lambda}^P \), the decentralized equilibrium entails overspending and the analysis of Section 2 applies. The optimal tax on public spending is \( t = \lambda^{-1} \). If \( \lambda \in \left( \hat{\lambda}^D, \hat{\lambda}^P \right) \), the decentralized equilibrium entails overspending but now the optimal tax is smaller, \( t \in (1, \lambda^{-1}) \). The reason is that, if the union tried to equalize the marginal benefit of public spending to the marginal product of capital by setting a spending tax equal to \( \lambda^{-1} \), it would push the economy into a

\(^{26}\) These critical values are obtained by combining the decentralized equilibrium condition \( \gamma_A / \hat{g} = \lambda \cdot f' (\bar{w} - \hat{g}) \) and the optimality condition \( \gamma_A / \hat{g} = f' (\bar{w} - \hat{g}) \) with the zero lower bound condition \( \lambda \cdot f' (\bar{w} - \hat{g}) = R = 1 \). Since \( \hat{g}(\lambda) \) is decreasing in \( \lambda \), \( \hat{g}(0) = \bar{w} \), and \( \hat{g}(1) = \bar{w} - f'^{-1}(1) \), there is exactly one solution to both equations if \( \bar{w} \in [\gamma_A, \gamma_A + f'^{-1}(1)] \).
liquidity trap. For \( \lambda \leq \lambda^D \), in the decentralized equilibrium entails underspending and the tax turns into a subsidy, \( t < 1 \). Formally, the optimal tax is given by

\[
t^P = \min \left\{ \frac{\gamma_A}{\hat{g}（\lambda）}, \lambda^{-1} \right\}.
\]

Whether a fiscal union will in fact set the tax on public spending at the optimal level is of course unclear. One thing that is certain is that the fiscal union will never find itself strictly inside the liquidity trap. All countries, regardless of \( \gamma \), prefer a low enough tax (or a high enough subsidy) to ensure that public spending does not fall below \( \hat{g} \). The reason is that, even though all countries must pay the subsidy to raise spending to \( \hat{g} \), they also benefit from the ensuing reduction in inefficient slack.\(^{27}\) Outside of the liquidity trap, however, spending may be too high or too low due to the biases described in Section 3.2 i.e., insofar as the preferences of the median country may differ from the average. Formally, the tax adopted by the union is given by

\[
t^U = \min \left\{ \frac{\gamma_A}{\hat{g}（\lambda）}, \frac{\gamma_A}{\gamma_M} \cdot \lambda^{-1} \right\}.
\] (55)

Relative to the Pareto optimum, the union may thus set taxes that are too high or too low depending on whether \( \gamma_M \) is lower than or greater than \( \gamma_A \). But it will never set taxes so high so as to push the economy inside the liquidity trap.\(^{28}\)

### 5.3 Austerity during liquidity traps

We can use this simple extension of our baseline model to sketch a narrative of the last two decades in the euro area. Before the crisis, financial markets worked relatively well and

\(^{27}\)To show this, note that when the economy is in a liquidity trap, welfare can be expressed as

\[
U(\gamma) = f(f^{-1}(1)) + \gamma_A - \gamma + \gamma \cdot \ln \left( \frac{\gamma}{\gamma_A} \cdot g \right),
\]

which is monotonically increasing in \( g \). So all countries, regardless of \( \gamma \), benefit from an increase in \( g \) in liquidity traps. So no country would favor a tax that is so high (or a subsidy that is so low) that \( g < \hat{g} \).

\(^{28}\)To derive Equation (55), simply note that the analysis is exactly as in section 3.2 when the economy is outside the liquidity trap. Hence, the equilibrium tax is as in Equation (33). When the economy is inside the liquidity trap, the capital stock is fixed at \( f^{-1}(\lambda^{-1}) \). Thus, the welfare of an individual country can be expressed as

\[
U(\gamma) = f(f^{-1}(\lambda^{-1})) + \gamma_A - \gamma + \gamma \cdot \ln \left( \frac{\gamma}{\gamma_A} \cdot g \right).
\]

The welfare of all countries, including the median, is thus monotonically increasing in \( g \) when the economy is in a liquidity trap. The median country will thus never choose a tax rate higher than \( \frac{\gamma_A}{\hat{g}(\lambda)} \), as this would imply that \( g < \hat{g} \).
Thus, there was a tendency by governments to overspend, as they did not properly internalize the effects of their spending on investment in the union. To address this externality, the euro area adopted a set of rules to constrain the fiscal policy of its members. These rules had the same underlying goal as the taxation scheme analyzed in Section 3.2, namely, to coerce its members into adopting a more austere fiscal stance.

The crisis was associated with a loss of trust in the enforcement of financial contracts, which can be interpreted as a fall in $\lambda$. As a consequence, investment demand fell, leading to a fall in the interest rate. In fact, the crisis was so severe that the euro area was pushed into a liquidity trap. Aggregate demand was insufficient and output fell below potential. Individual governments had insufficient incentives to increase public spending because they did not internalize its effect on union demand. At this point it would have been beneficial to remove fiscal constrains and possibly incentivize public spending. Instead, most constraining rules remained in place, at least during the first years of the crisis. According to this narrative, the resulting austerity contributed to deepening the crisis.

One clear implication of this discussion is that, ideally, fiscal rules should be flexible and contingent on economic conditions. Rules designed to contain the overspending externality are beneficial during “normal” times, but they may backfire when the economy is in a liquidity trap.

6 Concluding remarks

During the last three decades there has been a large and sustained decline in the rates at which many governments borrow. Yet the return to capital has remained fairly constant. If this spread is the result of market frictions the social cost of public spending—which reflects crowding out of private investment—is higher than the interest rate. This would not be a problem in financial autarky since governments could internalize this discrepancy. In a financially integrated union, instead, it leads to excessive public spending.

We have shown, moreover, that it may not be easy for the union to correct this distortion through a centralized system of spending limits or taxes. The reason is that, insofar as decisions in the union are made democratically, they are bound to be guided by the preferences of the median country and not by efficiency considerations. In particular, the union is likely to impose excessive austerity on its members.

Our results have been derived under a set of stylized assumptions to keep the analysis simple and transparent. A crucial assumption is that compliance with union decisions is compulsory,
i.e. there are no opt-out clauses for member countries. This assumption is clearly not realistic, as has been recently demonstrated by Brexit. Relaxing it would lead to a theory of endogenous unions, in which gains from trade and similarity in preferences are likely to play an important role. Understanding the endogenous formation of unions is an exciting research avenue going forward.

7 References


Figure 1: Return to Capital and Real Interest Rate in Europe

**Note on computation:** The EA12 countries are Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, and Greece.

Real short-term interest rates are as reported by the OECD as the indicator ‘Short-term interest rates’ (which reports the three-month money market rate where possible), adjusted by realized inflation, also as reported by the OECD as ‘Inflation (CPI)’. The EA12 average of real short-term interest rates is computed with each country weighted by its GDP in the respective year.

The return to capital for the EA12 countries is calculated with data taken from the AMECO database. Here, we use the aggregated measures for the EA12 countries that AMECO provides. The data series can be found in the database by selecting as ‘country’ one of the values ‘Euro area (12 countries)’ or ‘EA12 (including D_W West-Germany)’. We divide the indicator ‘Net operating surplus: total economy’ by the indicator ‘Net-Capital Stock at 2015 prices: total economy’, where the latter is multiplied by the indicator ‘Price deflator gross fixed capital formation: total economy’.