Fiscal delegation in a monetary union: Instrument assignment and stabilization properties

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Abstract

Motivated by the failure of fiscal rules to eliminate deficit bias in Europe, this paper analyzes an alternative policy regime in which each member state government delegates at least one fiscal instrument to an independent authority with a mandate to avoid excessive debt. Other fiscal decisions remain in the hands of member governments, including the allocation of spending across different public goods, and the composition of taxation. We study the short- and long-run properties of dynamic games representing different institutional configurations in a monetary union. Delegation of budget balance responsibilities to a national or union-wide fiscal authority implies large long-run welfare gains due to much lower steady-state debt. The presence of the fiscal authority also reduces the welfare cost of fluctuations in the demand for public spending, in spite of the fact that the authority imposes considerable "austerity" when it responds to fiscal shocks.

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