

FEDERALISM AND THE GLOBAL FINANCIAL CRISIS: IMPACTS AND RESPONSES

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Dossier

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***Fédéralisme
et crise financière globale***

Federalism and the Global Financial Crisis: Impacts and Responses

Introduction

John Kincaid, G. Alan Tarr, and Sonja Wälti

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Introduction

The global financial crisis has rocked the world's economies since late 2007, leaving no country untouched. To various degrees and in different contexts, many countries have experienced a protracted economic downturn unparalleled since the Great Depression of the 1930s. As a result, many governments are struggling to balance their budgets while also assuming a greater role in regulating markets, stimulating the economy, and ensuring the well-being of those hurt by the crisis. This special issue looks at seven federal and quasi-federal systems in an effort to understand better the impacts they experienced from the global financial crisis and recession, the measures they adopted in response, and the degrees of success they achieved in coping with the crisis.

The contributors to this special issue address clusters of questions relevant to the following three topical inquiries: (1) How have federal systems been affected by the global financial crisis? (2) What were their responses to the crisis; and how effective have their responses been thus far? (3) Have the crisis and its responses altered the structures or balance of powers in federal systems?¹ The contributions,

1. The full list of questions each contributor was asked to address under each of the three topics can be accessed at the conference website: <http://www.camden.rutgers.edu/federalism/> (last accessed January 12, 2011)

which touch on Australia, Germany, Italy, South Africa, Spain, Switzerland, and the United States, were presented at a joint conference entitled “Federalism and the Global Financial Crisis: Impacts and Responses” co-hosted on September 16-18, 2010, by the Center for State Constitutional Studies at Rutgers University-Camden, New Jersey, and the Center for the Study of Federalism at the Robert B. and Helen S. Meyner Center for the Study of State and Local Government at Lafayette College, Easton, Pennsylvania, for the International Association of Centers for Federal Studies and the Research Committee on Comparative Federalism and Federations of the International Political Science Association.

Examining federal systems is important for several reasons. First, about 40 percent of the world’s people live in federal and quasi-federal countries. Second, by most accounts, the economic crisis originated from a financial crisis in the United States (see Kincaid and Tarr in this issue), a federation that often serves as a reference point for federal systems around the world. Third, federal systems are sometimes thought to be less well equipped than unitary systems to tackle significant national economic crises because, with their structures of shared rule and self-rule, they cannot always respond to crises in the rapid, focused, complementary, and coordinated ways said to be more characteristic of unitary systems. Furthermore, in federal arrangements where constituent governments have substantial fiscal autonomy, the national government and constituent governments can move in opposite directions during an economic crisis. Dissonance can be compounded when one or more constituent governments are controlled by parties that oppose the party in power in the national arena or when the national government is itself a coalition of regional parties. Indeed, some federal systems may come under such strain that a major economic crisis can affect their very structure and operation. Lastly, federal and multilevel governance arrangements are on the rise because of worldwide trends toward regionalization and decentralization as well as the integration of national and regional markets (see Enderlein et al. 2010). The resilience of federal systems to economic shock, their capacity to regulate financial markets in a global environment, and their ability to deploy monetary and fiscal policy instruments to alleviate such crises should therefore be evaluated carefully.

Problems

To address the first cluster of questions, the authors were asked to detail the problems as they originated in or were triggered by the global financial crisis in their country by paying attention to the nature and the timing of the crisis and to its concrete impacts on various sectors of their country’s economy.

The global financial crisis originated in the United States, where it precipitated an economic recession that had started in December 2007 (and ended in

June 2009). The origins of the crisis are seen, basically, as a combination of a crash in the housing market, as a result of which many complex financial assets of banks evaporated, and lax regulatory oversight of the banking and securities industries (see Kincaid in this issue). Banks became unwilling and unable to lend while corporations increased their cash holdings, both of which sent the United States economy into a tailspin and spilled over into the global financial system and the world economy.

Spain was among the hardest hit countries in Europe. Its GDP dropped by -3.6% in late 2009 and triggered a recession that is also among the longest (see Viver Pi-Sunyer in this issue). Viver Pi-Sunyer points to a major decline in the consumer price index, a severe drop in revenues at all levels, an increase in public deficit far exceeding the limit set by the EU's Stability and Growth Pact, a rise in private debt levels, a rise in the unemployment rate beyond that of most other European countries, and a major spike in the poverty index. Besides pre-existing internal economic imbalances and low productivity, extraordinary levels of private debt and the country's its dependence on external financing made Spain particularly vulnerable to the crisis. The collapse of its real estate and building industries, chief sources of economic growth in Spain, in conjunction with the floundering of savings banks, shows many similarities with the US case.

Germany was directly affected by the financial crisis emanating from the United States because its banks had purchased subprime asset-backed securities from American banks, which they had to write off at substantial losses (see Renzsch in this issue). However, despite a dramatic drop in GDP, which shrunk – albeit later – more significantly than in some other countries such as France, Spain and the United Kingdom, its economy was rocked less in other respects. With no real estate bubble to cope with and little reliance on credit, consumers were less shortchanged and unemployment rose less than elsewhere. By contrast, Italy was less affected by the global financial crisis due to a relatively sound banking system that had not relied as much as other systems on complex credit-risk products (Anonymous 2009a). As elsewhere, however, decreased lending to households and businesses became a concern, and the world recession hit Italy's economy particularly hard, generating a steep decline in industrial production and exports (see Pola in this issue).

With an economy heavily dependent on the financial sector, Switzerland was especially hard hit by the global financial crisis. Its biggest banks, UBS and Credit Suisse Group, whose balance-sheet totals amount to 44 times (UBS) and 27 times (Credit Suisse Group) the annual tax revenues of the Swiss federal government and which grant 35 percent of all loans (see Hanni in this issue), suffered massive losses because they had invested heavily in the mortgage-backed securities and credit-risk products that crippled the US financial sector. Customers lost confi-

dence in the big national banks, and many moved their money to government-backed cantonal banks, whose soundness had a stabilizing effect on the Swiss financial market (see Hanni in this issue). The financial crisis affected the economy as a whole, with GDP growth – albeit still higher than its neighbors – reaching a historic low in December 2008.

Australia's financial system, although less exposed to "toxic assets" than the US and UK banking industries, was also affected significantly by the global financial crisis (see Anderson and Fenna in this issue). Most impacted were the States, whose credit ratings were threatened. By contrast, thanks to the continuing demand for Australia's commodity exports on the world market, the financial crisis did not spill over into the economy as much as elsewhere, with the Australian economy registering only slightly negative growth at the height of the recession. Nevertheless, Australia experienced a plunge in the stock market and Australia's federal government under Prime Minister Kevin Rudd (in office December 2007 to June 2010) grappled with inflation (see Anderson and Fenna in this issue).

The global financial crisis severely affected South Africa's financial sector, although less so than elsewhere due to the resilience of its banking sector, which was not directly exposed to troubled assets (see Powell and Steytler in this issue). With deficit financing heavily reliant on portfolio inflows (Powell and Steytler quoting OECD 2010: 22), the federal government was particularly hurt by the resulting economic recession. Consumer demand and private investment dropped sharply as commercial credit was hard to come by. Unlike Australia's commodities market, which benefits from a privileged position in the China-led minerals boom (see Anderson and Fenna in this issue), South Africa's mining industry contracted significantly due to decreased demand on the world minerals market. Its manufacturing industry, too, declined and South Africa experienced its first recession in seventeen years as export and import volumes plummeted, net financial inflows turned into net outflows, and unemployment skyrocketed, especially among youth (see Powell and Steytler in this issue).

Responses

In an effort to describe as well as assess each federation's governance capacity in the face of the financial crisis, the authors delved into their country's responses to the crisis by investigating, in particular, the roles played by different orders of government in addressing the crisis. To the extent possible, they assessed whether the responses were facilitated or rather obstructed by the prevailing federal arrangements and division of powers in their country.

The authors report about a wide variety of responses, which range from a primary attention to the financial crisis affecting the banking sector (Switzerland) to federally initiated and regulated economic recovery programs (United States).

With the 2008 federal elections handing the Democrats control of Congress and the presidency, both the executive and legislative branches of the US federal government turned in 2009 to Keynesian policies of expenditure programs to jumpstart the economy. Under Republican President George W. Bush, the federal government had already made unprecedented expenditures to bail out banks and other financial-services firms. Barack Obama's administration then bailed out and restructured the once giant automobile company, General Motors, on terms favorable to labor. Federal expenditures aimed at enhancing state and local government expenditures and reducing layoffs of state and local workers by increasing subsidies for public infrastructure, health care, and education grew dramatically (see Tarr and Kincaid in this issue). Although US states have seen their public finances in great turmoil as a result of the recession, forty-nine states have a state constitutional or statutory requirement to balance their annual operating budget, which they can do by relying on federal transfers, making spending cuts, increasing taxes, borrowing for capital projects, delaying payments to pension funds, and drawing down rainy-day funds (i.e., monies saved from prosperous years for lean years). Hence, an unprecedented Keynesian effort mounted by the federal government has been offset to some extent by contractions of state and local government expenditures.

Spain relied heavily on deficit spending in response to the crisis. Its "Spanish Plan to Simulate the Economy and Employment" approved in 2009 was earmarked 2.3% of the GDP, significantly more than other European countries, less only than Japan, the USA, Canada and Australia (Viver Pi-Sunyer in this volume). This plan of attack was then followed by an austerity program and subsequently by an effort to reform the structure of the Spanish economy. The central government focused on measures to stabilize the financial system by means of purchasing troubled financial assets, job creation by means of grants targeted to local governments, support to small and medium-sized enterprises and hard-hit industries such as manufacturing, building, and tourism, and tax cuts. The central government – more specifically its executive branch – played a preeminent role in coordinating efforts to address the crisis at every turn. The Spanish regions did not significantly help shape the policies to address the crisis, as they traditionally have little say in the central policymaking process (Viver Pi-Sunyer in this volume). Albeit to a much lesser degree, the regions followed the central government's lead, first by backing credit to small and medium-sized enterprises, and providing additional grants and tax cuts, and subsequently by in balancing their budgets to comply with stringent budgetary requirements. Both the central government and the subnational governments operated under narrow constraints imposed by the European Union.

Albeit in more modest proportions, Germany, too, relied on deficit spending to respond to both the economic crisis and the financial crisis. As in the United States, public expenditures helped stimulate the economy by investing in infrastructure, and significant subsidies went to support failing banks, but Germany also added incentives for the banking industry to hold on to its workforce (see Renzsch in this issue). Contrary to other countries, Germany also resorted to nationalization (in the case of Hypo Real Estate) and the establishment of a “bad bank” to acquire troubled financial assets (Anonymous 2009b). Germany’s system of cooperative federalism largely forced the *Länder* to comply with federal economic and fiscal policies, a trend that was corroborated by new debt restrictions imposed on the *Länder* in 2009 (see Feld and Baskaran 2010). The fact that the notoriously weaker eastern *Länder* seem to have weathered the crisis better than the economic strongholds also diminished the urgency for the German federal government to tend to growing fiscal imbalances between the *Länder*.

Switzerland’s response to the crisis focused on rescuing and restructuring the banking sector, which was already under attack for its secrecy and its provision of safe tax heavens for private and corporate income from around the world. In an unprecedented and highly contested bank bailout, the Swiss National Bank relieved UBS of toxic assets by transferring them into a government-run stabilization fund in return for liquidity. The financial crisis’ potential to destabilize the economy made urgent and, in the eyes of some experts, unconstitutional measures acceptable to the Swiss people (see Hanni in this issue). The traditionally strong role of the cantons and the voting public as well as the legislative process in national policy-making were largely suspended; thus, they were not obstacles to this controversial process. As in Germany, the economically strongest constituent units such as Zurich were the hardest hit by the ensuing economic crisis, further legitimizing an unprecedentedly centralized response by the Swiss federal government. Due to its independence from the European Union as well as the European Monetary Union, Switzerland faced few external constraints. Indeed, its banking sector weathered the storm well due to the Swiss Franc’s worldwide popularity to hedge against currency losses and a weak US Dollar. As a result, Switzerland grapples with inflation.

Italy faced a significant external constraint while responding to the combined financial and economic crisis due to the European Council’s request that Italy lower its excessive debt. The Italian government made a stern commitment to drive down its debt (Anonymous 2009a). While putting tax cuts on hold, Italy refrained from adopting a fiscal stimulus policy. The newly established and in part ongoing reform of Italy’s decentralized fiscal relations, which were put in place with the need for concurrent national and subnational fiscal policies in mind, was a driver in shaping Italy’s response to the crisis rather than being jeopardized by it

(see Pola in this issue). The regions, while far more powerful in terms of resources, had no choice but to follow suit.

Similar to the Italian case, Australia's responses were marked by its recent past of reforming federal-state fiscal relations to make them more resilient in the face of financial and economic crises (see Anderson and Fenna in this volume). The Rudd government adopted a combination of immediate stimulus and long-term infrastructure investment. The stimulus contained a legally contentious Tax Bonus for Working Australians, which was brought before the High Court by opponents of Australia's centralizing distribution of powers. Although little public discussion emerged over it and the High Court swiftly confirmed the Commonwealth's executive powers to combat a crisis of this magnitude, the ruling affirmed that central spending powers must comply with appropriations firmly anchored in law, thereby creating a, to this day largely theoretical, opening for States to reclaim powers (see Anderson and Fenna in this volume). As in Italy, the global financial crisis accelerated reforms in federal-state relations and, while embedded in a centralizing trend of fiscal federal relations, helped make them more cooperative. Both countries exhibit a high degree of centralization in revenue-raising as well as fiscal policies, which predestined and further legitimized the central government becoming active in response to this significant economic crisis. In Australia, state revenues are comparatively less coupled with the federal government's because some states enjoy significant revenue streams from commodities. However, many States were in need of federal assistance to prevent a drop in their credit ratings.

South Africa's responses were marked by its concern for surging unemployment, which exposed structural economic problems and, unlike Germany and Switzerland for example, exacerbated regional disparities. As elsewhere, the central government adopted stimulus programs focusing on infrastructure investment and took measures to strengthen the social safety net to prevent unrest. As in Germany, job-sustaining and poverty-reducing measures were adopted by an otherwise economically conservative government. By contrast to Australia, the South African government proceeded without the participation of provincial and local governments, in line with their largely insignificant taxing and spending powers and further propelling a centralizing trend in federal-state relations on fiscal and economic matters (see Powell and Steytler in this issue).

Impacts and Implications

The authors examined the impact of the financial crisis by focusing on its effects within their country's particular federalist setting. They were asked to investigate the financial crisis' impact on both intergovernmental (or vertical) and interjurisdictional (or horizontal) relations by examining how various orders of

government were affected by the crisis and whether some constituent units were affected more or differently than others. The authors also examined whether the financial crisis had a fundamental effect on the structure and operation of their federation, for example, by affecting intergovernmental transfers and interjurisdictional equalization.

In the United States, the economic crisis and recovery policies have not had a significant impact on the distribution of powers or resources between the federal government and the states. The federal budget witnessed tremendous expansion because the federal government can engage in deficit spending while most state budgets contracted to levels not seen since the Great Depression because they do not formally engage in deficit spending (see Kincaid and Tarr in this issue). The states' principal reliance on income and sales taxes makes them particularly vulnerable to a combined contraction in the labor market and in consumption. State revenues tend to shrink faster than does the economy (see Tarr in this issue). The federal government's overwhelming reliance on the personal income tax and payroll tax also makes it vulnerable, which is one reason why its deficit spending skyrocketed. However, while the states ultimately benefit from federal resources, states are largely uncoupled from the federal economic recovery policy process, which is dominated by national partisan debates and conflicts. Although the states grew more fiscally dependent on the federal government, the crisis has not yet altered "the balance of federal-state power, the constitutional or legal structure of federalism, or the long-term trajectory of federalism and intergovernmental relations" (see Kincaid in this issue). In fact, in major new legislation regulating financial services, the federal government restored and expanded some state regulatory authority over banks and financial services (see also Dinana and Gamkhar 2009).

By contrast, Switzerland, which has seen a similar dramatic exposure to the global financial crisis but with little to no lasting effect on its economy, was plunged into an unprecedented constitutional crisis pertaining to the powers of the federal government to bail out UBS relying – as in the Australian case – directly on spending powers conferred through the constitution rather than a federally and democratically sanctioned legislative process (see Hanni in this issue). However, the resulting public debate was quelled by historic memories of the national government using unprecedented executive powers during war time. The federal government further attenuated criticism by pointing to a successful outcome in that the Swiss financial sector is, in many respects, as strong as ever, and the economy is so far largely unscathed.

In Germany, the global fiscal crisis has not affected the fundamental balance of power between the orders of government. If anything, the crisis may contribute to rebalancing horizontal fiscal relations, with transfer payments from donor

Länder to receiving (mainly eastern) *Länder* diminishing for the first time in recent history (see Renzsch in this issue). Likewise, Italy has seen no detrimental effect of the global fiscal crisis on its ongoing fiscal federal reform. Pola (in this issue) argues that the crisis has come “too soon” to call into question Italy’s fiscal decentralization and equalization efforts. However, the crisis may have further legitimized a fiscal federal solution that sees Rome being in charge of economic and budgetary policies, with subnational units tightly coupled to central policies. By contrast, in Spain, the economic crisis has triggered a recentralisation of the system of political decentralization, most notably by boosting the central government’s spending power, in some cases in violation of constitutional principles, Viver Pi-Sunyer argues. The central government’s increased spending powers have strengthened its relations with the local level, thereby weakening the autonomous communities. The increased conditionality of transfers has further curtailed their fiscal autonomy. When austerity measures were adopted, tight spending limits forced the autonomous regions into step with central fiscal policies and significantly affected their administrative capacity (Viver Pi-Sunyer in this volume).

In Australia, too, the crisis has largely strengthened the reform path of federal-provincial relations (see Anderson and Fenna in this issue). In contrast to the other cases but in line with its own reform path, the Australian federal government developed its policies in consultation with the state governments. As in Italy, the economic crisis was seen as an opportunity to “get the federation right” while re-asserting Commonwealth authority over economic matters (Anderson and Fenna in this issue). Whatever contention arose from the Commonwealth’s wide use of executive powers in responding to the crisis was settled swiftly by the High Court in the immediate favor of the federal government, although with possible future implications less favorable to the federal government.

South Africa, while more dramatically affected by the financial crisis as well as the ensuing economic crisis, has not seen a significant impact from these crises on the thrust of its federal-state relations. Its provinces, which are already largely insignificant in the policy-making process, may see their legitimacy to acquire more powers eroded even further. While this finding differs from the Italian and Australian case, where reforms are also ongoing, it confirms nevertheless that the global financial crisis has tended to strengthen rather than undermine existing structures or ongoing reform efforts.

Among the federations and quasi-federations examined in this issue, the United States, Spain, and Switzerland appear to have been the worst affected by the financial crisis, with the United States and Spanish economies more gravely in turmoil at all levels than the Swiss. The crisis appears to have affected Australia the least adversely. However, the United States exited the recession after eighteen months in June 2009, although unemployment remained unusually high. Swit-

zerland recovered, too, as also did Germany, which went on to play an important fiscal role within the European Union of trying to prevent a financial contagion stemming from the severe budget problems of such unitary countries as Greece, Ireland, and Portugal. Among the federal countries in the EU, only quasi-federal Spain is on the verge of deep financial trouble. Significant economic and fiscal problems continue in Italy and South Africa, but these problems stem more from long-term structural maladies than from the global financial crisis.

Interestingly, among the federations studied in this issue, only Switzerland and to a lesser degree Spain and Australia encountered a constitutional crisis, although it was not a broad-based crisis that called into question the legitimacy of these countries' existing federal balance of power. Except for Spain, where the crisis may have a lasting impact on the quasi-federal balance of powers, the constitutional disputes centered more narrowly on a specific exercise of power by the federal government. Otherwise, the global financial crisis was absorbed into the ongoing practices and trends of all the federal systems examined in this issue. Consequently, the global crisis occasioned no constitutional reforms, structural alterations, or dramatic shifts in the balance of powers within these federal systems. Perhaps this stability was due significantly to the fact that, again with the possible exception of Switzerland, the national government possessed sufficient fiscal and monetary powers to address the crisis with or without consultation and cooperation with the constituent governments. Where intergovernmental cooperation was not the prevailing norm, the national government acted largely unilaterally. Where such cooperation was the norm, except for the Swiss case, the national government honored the norm during the crisis.

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