

'Fiscal Rules, bailouts, and Reputation in Federal Governments'

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Overview

- ▶ Very thought-provoking paper, highly recommended
- ▶ Motivating observations:
 1. 'Local' governments (**may**) have an incentive to over-borrow
 2. Centrally-imposed rules an intuitive way to prevent this
 3. But if rules are imperfectly enforced ... could they do more harm than good?
- ▶ **Yes, if enforcement decision exacerbates over-borrowing**

Overview/Recap

Basic environment allows two competing concerns for central govt:

1. **Cross-sectional** inequality

- ▶ *Utilitarian govt, S poorer than N*

$$u'(G_S) > u'(G_N)$$

2. **Dynamic** inefficiency

- ▶ *Mutualisation \Rightarrow fiscal externality \Rightarrow overborrowing*

$$u'(G_{i,0}) < \frac{\beta}{q} u'(G_{i,1})$$

Overview / Recap

Intermediate time period: live in one of three possible worlds:

1. *The government will **possibly** mutualise debt.*
2. (a) *The government will **never** mutualise debt.*
2. (b) *The government will **certainly** mutualise debt.*
 - ▶ **NC govt:** $1 \succ 2. (b) \Rightarrow$ **delay revelation**
 - ▶ **South:** $2. (b) \succ 1 \Rightarrow$ **force revelation ... ?**

Overview/Recap

Fiscal rules

- ▶ **Rules** stipulate resource cost ψY for $b > \bar{b}$
- ▶ Enforce \Rightarrow utilitarian central govt suffers
- ▶ Fail to enforce \Rightarrow reveal NC type \Rightarrow increase overborrowing

Overview / Recap

Fiscal rules

- ▶ Parameters exist where non-enforcement preferable
- ▶ Knowing this, *South over-borrows to force revelation*
- ▶ So fiscal rules \Rightarrow S can change NC govt prefs betwn 1 & 2. (b)

Comment 1

What can I infer from non-enforcement?

- ▶ Paper assumes division into two central govt types: C or NC
- ▶ Equivalently, **perfect correlation** betwn commitment to enforce & commitment not to mutualise:

		<i>Commit to enforce?</i>	
		Y	N
<i>Commit not to mutualise?</i>	Y	π	0
	N	0	$(1 - \pi)$

Comment 1

What can I infer from non-enforcement?

- ▶ In practice 'non-enforcement of rules' & 'mutualisation' are different things...
- ▶ Analytical results (I think) require:

$$P[\text{Mutualise}|\text{No enf.}] = 1$$

- ▶ Relaxing this would (I think) reduce value to S of 'testing' enforcement
- ▶ *Can results extend to case where $P[\text{Mutualise}|\text{No enf.}] < 1$?*

Comment 2

Making mutualisation less tempting

- ▶ **Utilitarianism + inequality** \Rightarrow *This is a central government that would like transfers in a first-best world!*
 - ▶ Ex-post incentive to mutualise depends on $(b_{S,t} - b_{N,t})$
 - ▶ Inequality $\Rightarrow b_{S,t} > b_{N,t}$ even with dynamic efficiency
- ▶ Mutualisation (transfers) inherently tempting \Rightarrow easier to support separating eqm
- ▶ C.f. European case...

Comment 2

Making mutualisation less tempting

- ▶ Could change objective \Rightarrow central govt wants no transfers at first best:

$$W_0 = \sum_{i=N,S} \theta_i \mathcal{U}_i$$

- ▶ *Could results survive this?*
 - ▶ *[Other sources of asymmetry...]*

Comment 3

How to design costs?

- ▶ Paper treats penalty ψY as pure loss
- ▶ If instead fiscal revenue, could be spent on **N**
- ▶ \Rightarrow Cost to **NC govt** much lower
- ▶ Starting from near equality ($\pi \simeq 0$), loss to **S** \simeq gain for **N**
- ▶ \Rightarrow **NC govt** less reluctant to impose, harder for **S** to induce revelation
- ▶ *Can the 'pure loss' assumption be relaxed?*