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

Alessandro Dovis Rishabh Kirpalani

Discussion by ***Charles Brendon***

Madrid, May 18th 2017

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:

		Commit to enforce?	
		Y	N
Commit not to mutualise?	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:

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

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

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 ⇒ 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?*