

Fiscal Federalism for the Euro Area?
Hamilton's Paradox in the political
economy of monetary solidarity

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Discussed by Johannes Fleck

– HOW MUCH OF A FISCAL UNION FOR THE EMU? –
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Research question

How to split policy functions between governments in a federation?

Which Policy functions?

1. Fiscal (borrowing, taxing and spending)
2. Financial (regulation, deposit insurance and resolution)
3. Monetary (liquidity, interest rate and exchange rate management)

What is a federation?

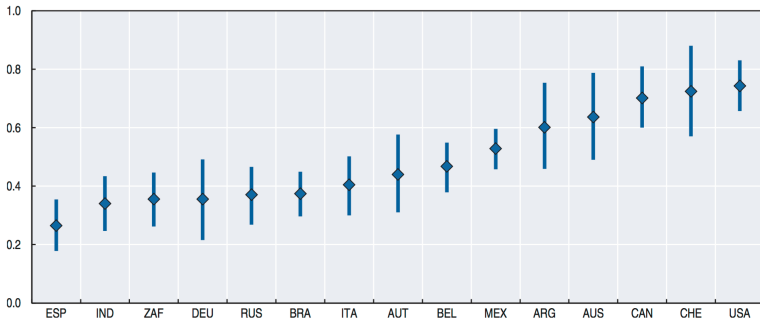
- ▶ Rodden 2006: "A complex nexus of interlocking contracts"
- ▶ Schelkle 2017 presupposes that contracts across different levels of government and across policy functions are incomplete
 - ▶ ex-ante: lack of commitment
 - ▶ ex-post: moral hazard

The assignment of fiscal policy across countries

- ▶ Heterogeneity in state level fiscal autonomy is large (OECD 2016)

Figure 2.3. **Fiscal autonomy of the state level**

Intermediate-level indicator representing building block 1



Note: The diamonds show indicator levels, while the vertical bars show indicator coherence. Longer bars depict less coherent constitutional arrangements.

'Fiscal autonomy': taxation, spending, budgeting, borrowing powers

- ▶ The same is true for
 - ▶ federal versus state tax bases
 - ▶ redistribution versus insurance

The 'original' Hamilton's Paradox (Rodden 2006)

- ▶ Rodden provides evidence that federations either
 - ▶ tend to over-accumulate debt at the state level (Germany and Brazil)
 - ▶ or have restrictions on state governments' deficits (US)
- ▶ He rationalizes this observation by arguing that
 - ▶ federal governments have an inclination to bail out state governments
 - ▶ need for bailouts is inevitable due to
 - ▶ 'intrinsic desire to overspend' of state governments
 - ▶ exogenous reasons
- ▶ My summary of Hamilton's Paradox:
 - ▶ The credibility of the federal government's no-bailout commitment sorts federations into two self-fulfilling equilibria
 1. State governments free-ride on federal tax revenue and over-borrow
 2. State governments are responsible for their debts and curb borrowing
 - ▶ The determinants of the federal credibility remain opaque (to me)

Contribution of Schelkle 2017

The paper convincingly argues

- ▶ considering fiscal policy assignment alone is insufficient to understand when and for what reasons federal bailouts occur
- ▶ need to consider fiscal, monetary and financial policy simultaneously to understand when the federal government can credibly commit

and provides guidelines for the design of EMU institutions

- ▶ 'fiscal discipline' is not always a choice of state governments
- ▶ commitments of members to share risks are not credible ex-post
 - ▶ fortunate tempted to renege their promises
 - ▶ unfortunate tempted to exacerbate their externalities

→ common fiscal authority pushed/tempted to bail out

→ there has to be *some* lender of last resort (Ireland vs. Iceland)

My first thoughts on Schelkle 2017

- ▶ Consider an assignment which compromises the federal commitment
 - ▶ state governments with balanced budget rules are also responsible for bank resolution
 - ▶ absorbing banking sector shocks requires federal support
 - ▶ the federal government is tempted to help to limit externalities

- ▶ *Which federal-state policy assignments work (and why)?*
 - ▶ loops across policy functions have been studied
(Monetary-fiscal: Sargent and Wallace 1981, Del Negro and Sims 2015)

- ▶ *What are specific policy implications for the EMU?*
 - ▶ Example: Does banking union allow removing
 - ▶ restrictions on national budgets?
 - ▶ federal tendency to bail out?

My second thoughts on Schelkle 2017

- ▶ Schelkle tests Rodden's theory against three episodes of US history
 - ▶ Banking Crisis of the 1840s
 - ▶ Bank panics during Free Banking regime
 - ▶ The Savings and Loan Crisis
- ▶ Conclusions:
 - ▶ Hamilton's Paradox fails to provide a complete explanation for why state bailouts occurred (or not)
 - ▶ Need to also account for monetary and financial policy assignment

How robust is the 'extended Hamilton's Paradox'?

- ▶ Is it point or set identified?
 - ▶ different narratives on US fiscal-financial-monetary history
 - ▶ other federations (Germany, Italy, Switzerland)
- ▶ Does it have observationally equivalent competing theories?
 - ▶ are other theories consistent with the presented historical narrative?

My final thoughts

I liked to read this paper

- ▶ Its topic is interesting
- ▶ It is thought provoking
- ▶ It complements existing research
- ▶ It makes a compelling argument
- ▶ There is a lot to learn from it