6^{th} ECB's "Fiscal policy and EMU governance"

Ramon Marimon's discussion of

"Fiscal Federalism and Monetary Unions"

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Two (non-orthogonal) dimensions of Fiscal Federalism...

- The *Subsidiarity principle* (SP)
- The *Federal internal externalities fact* (IEF)

The *SP* & the 'Who should start my battery?'problem

- The obvious economists' answer: who ever is more efficient in starting it! (and if there is a tie, the smallest wins; i.e. SP)
  - Better battery technology... 'Then and Now...'

Then...

Now?

The *SP* & Who should implement fiscal policies?

- The obvious economists' answer: who ever is more efficient
  - Better information... 'The Locals know better...'(Oates (1999) *dixit*)

The *SP* & Who should implement fiscal policies?

- The obvious economists' answer: who ever is more efficient in starting it! (and if there is a tie, the smallest wins; i.e. SP)
  - Better information... 'The Locals know better...'(Oates (1999)*dixit*)
  - Better commitment... 'The Center has full commitment, the Locals don't' (Chari, Dovis and P. Kehoe (2020) *dixit*)

The *Internal Externalities Fact*

If the Center's better technology is a joint (public) good then the Locals may **free ride**...

Two *Folk Theorems* for Fiscal Federalism...

- The *(Generalized) Decentralization Theorem* (SP $\Longrightarrow$ GD)

'Generalized' because Oates' Center can only implement *uniform* fiscal policies, while BGKP's Center can implement – possibly, not very well-target – local-specific policies.

Two *Folk Theorems* for Fiscal Federalism...

- The *(Generalized) Decentralization Theorem* (SP $\Longrightarrow$ GD)

  Theorem 1. *If the Locals are better informed (of citizens needs and aspirations) fiscal policies should be run by Local governments and the welfare gains are larger the more relatively informed Local governments are.*

  Key proof element: 'informativeness' of the Center.

Two *Folk Theorems* for Fiscal Federalism...

- The *(Generalized) Decentralization Theorem (SP $\Longrightarrow$ GD)*
- The *Free Rider's Law of Large Numbers Theorem* (IEF $\Longrightarrow$ FR-LLN)

  Theorem 2. *As the number of Locals increases the 'free rider problem' aggravates.*

  Key proof element: 'the elasticity ' of the Local action w.r.t. the Centre's public good (decreases as the number of Locals increases).

The Two *Folk Theorems' Corollary*

Corollary 1. *If SP and IEF coexist and none of them dominates, independently of the number of Locals, then there must be a* **Cutoff** *number of localities, below which fiscal policies should be run by Local governments and above which they should be run by the Centre.*

From the ‘real’ to the ‘monetary’ economy

BGKP lay out a Fiscal federalism static model of a ‘real’ economy in which

- without a fiscal externality $\to$ Theorem 1,
- with a fiscal externality $\to$ Theorem 2 and Corollary 1 with two cutoffs (just one with $\log$ & correlated preferences)
- A peculiar externality:

$$u(c_i) + \theta_i h(G_i(\bar{g})), \text{ where } G_i(\bar{g}) = g_i + \gamma \sum_{j \neq i} g_j$$

From the 'real' to the 'monetary' economy

Then (properly, to come here) they move to a *Fiscal and Monetary federalism* two-period model without a fiscal externality where rep. consumer i:

$$\max_{c_{i,1},c_{i,2}} \{u(c_{i,1}) + \theta_i h(g_i) + \beta u(c_{i,2} - v(l_i))\}$$

$$\text{s.t. } c_{i,1} = y_1 - k_i - d_i$$

$$c_{i,2} = (1 - \tau_i)A(\frac{M}{\pi})l_i + (1 + r)k_i + (1 + r)\pi\frac{d_i}{\pi},$$

with M given, k_i storage and d_i government bonds. While the government:

$$g_i = \frac{B_i}{(1 + r)\pi} \ \& \ T_i = \frac{B_i}{\pi} \implies g_i = \frac{T_i}{(1 + r)}$$

Timing, Commitment, & Externalities

Timing: If $\pi \geq 1$ is decided first, as well as $\{g_i, B_i, \tau_i\}$ and NOT changed, i.e.

Full commitment, then, obviously, $\pi = 1$, both in a *Centralized* or *Decentralized* Federalism & **Theorem 1** applies.

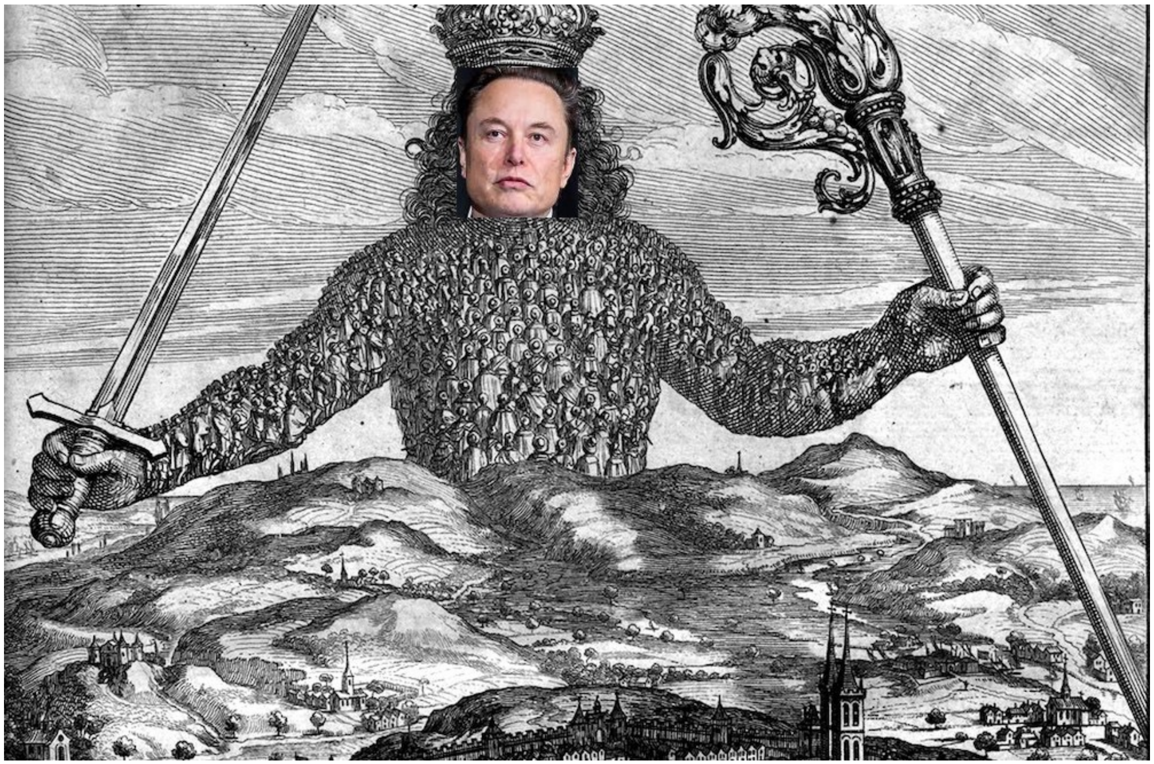
Timing: but if the timing is reversed, and π is decided after Period 1 decisions are taken,

Limited commitment creates **IEF**: i.e. $\pi = \pi(\bar{B})$, where $\bar{B} = (\bar{B}_1, ..., \bar{B}_I)$, elasticities differ:

$$\eta_i^D(B, I) \equiv \frac{B_i}{\pi(\bar{B})} \frac{\partial \pi(\bar{B})}{\partial B_i} = \frac{1}{I} \eta^C(B), \implies \eta_i^D(B, I) \to 0 \text{ as } I \to \infty$$

In sum: Theorem 2 & **Corollary 1** (with two cutoffs) apply; furthermore, under reasonable assumptions, welfare is worst in D than in C if I is large...

Who is the Center?



Democracy and the *stragegic delegation* problem

Let's change

$$u(c_{i,1}) + \beta u(c_{i,2} - v(l_i)) \ \text{ to}$$
$$u(c_{i,1} - v(l_i)) + \beta \mathbb{E}\left[u(c_{i,2}) + \theta_i(s) h(g_i)\right],$$
$$\text{with } \theta_i(s_i) = \hat{\theta} > 0 \ \ \& \ \theta_i(s_j) = 0 \text{ if } j \neq i$$

Then we can have **Theorem 2** & **Corollary 1** in a similar fiscal & monetary union:

- "Strategic Delegation in Monetary Unions", Chari, Jones & Marimon (*MS* 2004)
  A 'obscure' and 'representative' paper based on:
- "The Economics of Split-Ticket Voting in Representative Democracies", Chari, Jones & Marimon (*AER* 1997) Less 'obscure' or 'representative'.

The *stragegic delegation problem* and its ‘solutions’

- U.S. Fiscal Union’s “bring home the bacon”: Split-Ticket Voting and Endogenous Local Budget constraints & No-Bailout (after Hamilton II)
- U.S. Monetary Union, Euro Area, *et al.*: *Central Bank Independence* with *Price Stability Mandate*...
- EU ‘Fiscal Union’ SGP (Then and Now...), Fiscal Compact, ... (Back to Oates’ uniform policies?)
- ...

Is the number of EU Locals getting larger?


With the
“Granada declaration”
EU27 to EU35!

Is the number of EU Locals getting larger?

- Membership expansion of I is one way, but there are others:
- Populist (former eurosceptics) appointed to local governments that claim "bring home the bacon"!
- Nationalists who claim the same! A 60 oficial languages EP is not a problem with AI's help (only 3600 pairwise simultaneous translations), but it is if they are 'strategically delegated' MEPs!
- Furthermore, the list of EU public goods is becoming very large and locals may not know better...

Can the Center EU do better?

Is not a two-period EU, nor is the ECB a two-period Central Bank. A *European Stability Fund* with long-term state-contingent country risk-specific fiscal contracts is feasible (not just a New SGP, and can have a 'head-start' with the current EU/EA Fiscal and Monetary framework)

- without undesired permanent fiscal transfers across countries
- providing efficient risk-sharing and, therefore, proper counter-cyclical fiscal policies,
- with a *minimal intervention* in the private debt market, but possibly with some help...
- "Making Sovereign Debt Safe with a Financial Stability Fund" Liu, Marimon & Wicht (*JIE* 2024)
- "On a Lender of Last Resort with a Central Bank and a Stability Fund" Callegari, Marimon, Wicht & Zavalloni (*RED* 2023)


Sure, let's have a independent *ESF*!
With the "Granada declaration" EU27 to EU35!


But remember
the Center can have
its problems
(I am not getting it
back until 2024!)