Achieving Fiscal Discipline in Federations: Germany and the European Union

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“The creation of Debt should always be accompanied with the means of extinguishment.”

Alexander Hamilton
Report on Public Credit, 1790
Overview

• The bailout game
• Intergovernmental grants, taxation, and commitment
• Credit ratings and bailout expectations
• The bailout game in action: Germany
• Is Germany an outlier?
• Policy implications
Figure 1: The bailout game
Intergovernmental grants, taxation, and commitment
Figure 2: Debt burdens and credit ratings in four federations

Graphs by country name
Figure 3: Debt burdens and credit ratings in the German Länder
The bailout game in action: The Federal Republic of Germany
Real Accumulated Debt of Bund, Laender, and Gemeinden (1995 DM)
Figure 4: Equalization and Deficits among the German Länder

Figure 5: Log real expenditures and revenues per capita, 1974-1995

Graphs by payertothree and land
### Table 2: Expenditure responses of Länder to deviations from revenue trend

<table>
<thead>
<tr>
<th>Dependent variable:</th>
<th>Paying and neutral Länder</th>
<th>Recipient Länder</th>
</tr>
</thead>
<tbody>
<tr>
<td>Change real expenditures per capita (log)</td>
<td>Coef.</td>
<td>PCSE</td>
</tr>
<tr>
<td>Positive revenue gap(_t)</td>
<td>-2.82</td>
<td>0.92 ***</td>
</tr>
<tr>
<td>Positive revenue gap(_{t-1})</td>
<td>2.54</td>
<td>0.86 ***</td>
</tr>
<tr>
<td>Positive revenue gap(_{t-2})</td>
<td>-0.64</td>
<td>0.81</td>
</tr>
<tr>
<td>Negative revenue gap(_t)</td>
<td>-1.83</td>
<td>0.78 **</td>
</tr>
<tr>
<td>Negative revenue gap(_{t-1})</td>
<td>-1.07</td>
<td>0.78</td>
</tr>
<tr>
<td>Negative revenue gap(_{t-2})</td>
<td>1.63</td>
<td>0.77 **</td>
</tr>
<tr>
<td>Lag change real expenditure per capita (log)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Constant</td>
<td>0.00</td>
<td>0.01</td>
</tr>
</tbody>
</table>

- Observations: 100, 98
- # of Länder: 5, 5
- R\(^2\): 0.30, 0.46

Fixed effects model assuming first-order autocorrelation

* p<.1
** p<.05
*** p<.01
Is Germany an outlier?
Figure 6: Transfer-dependence and subnational borrowing autonomy in Europe (1990s)
Figure 7: Transfer-dependence, subnational borrowing autonomy, and subnational deficits in Europe (1990s)
Conclusions

• “Pure” market discipline not likely among most European local governments
  – Especially difficult in the presence of equalization
• Decentralization does not (usually) provide a justification for central withdrawal from regulating local access to credit markets
• The bailout logic is not a good justification for deficit restrictions in the EMU