

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.”

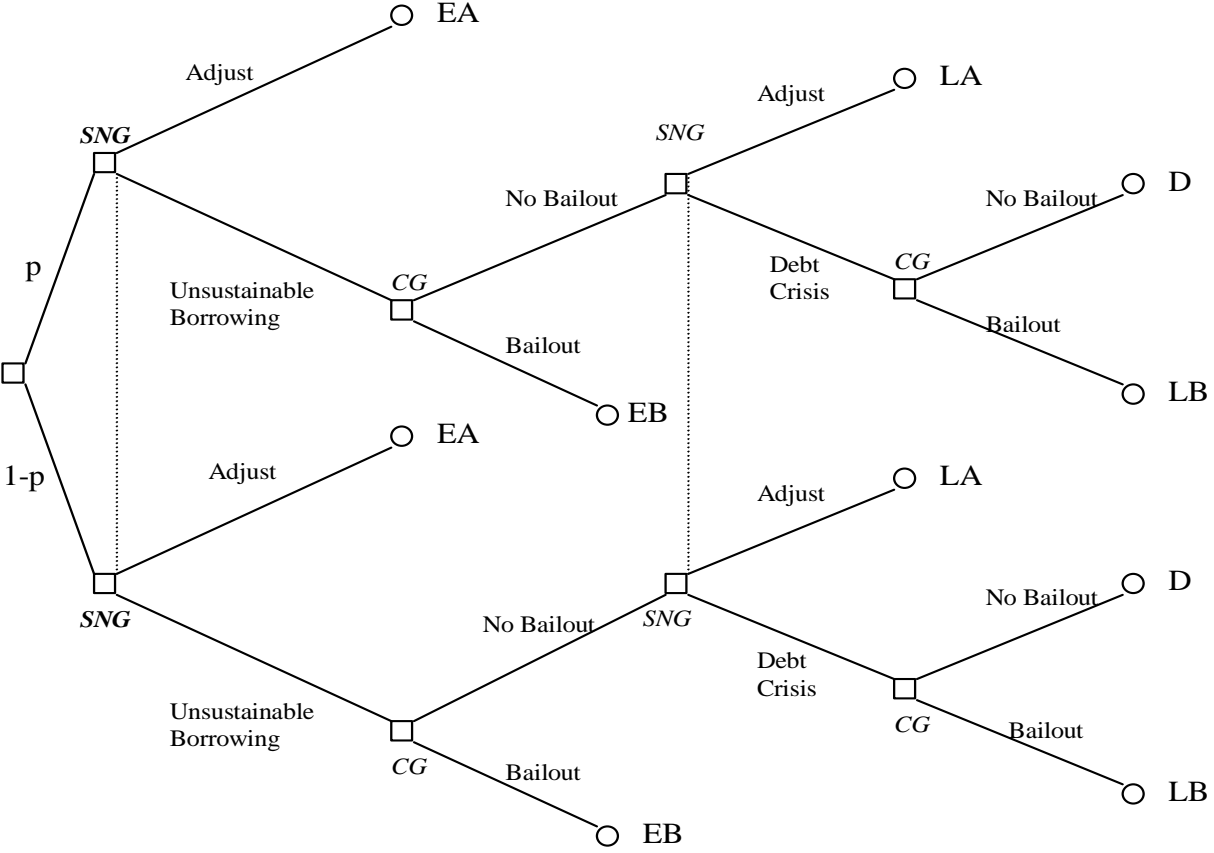
Alexander Hamilton

Report on Public Credit, 1790

Overview

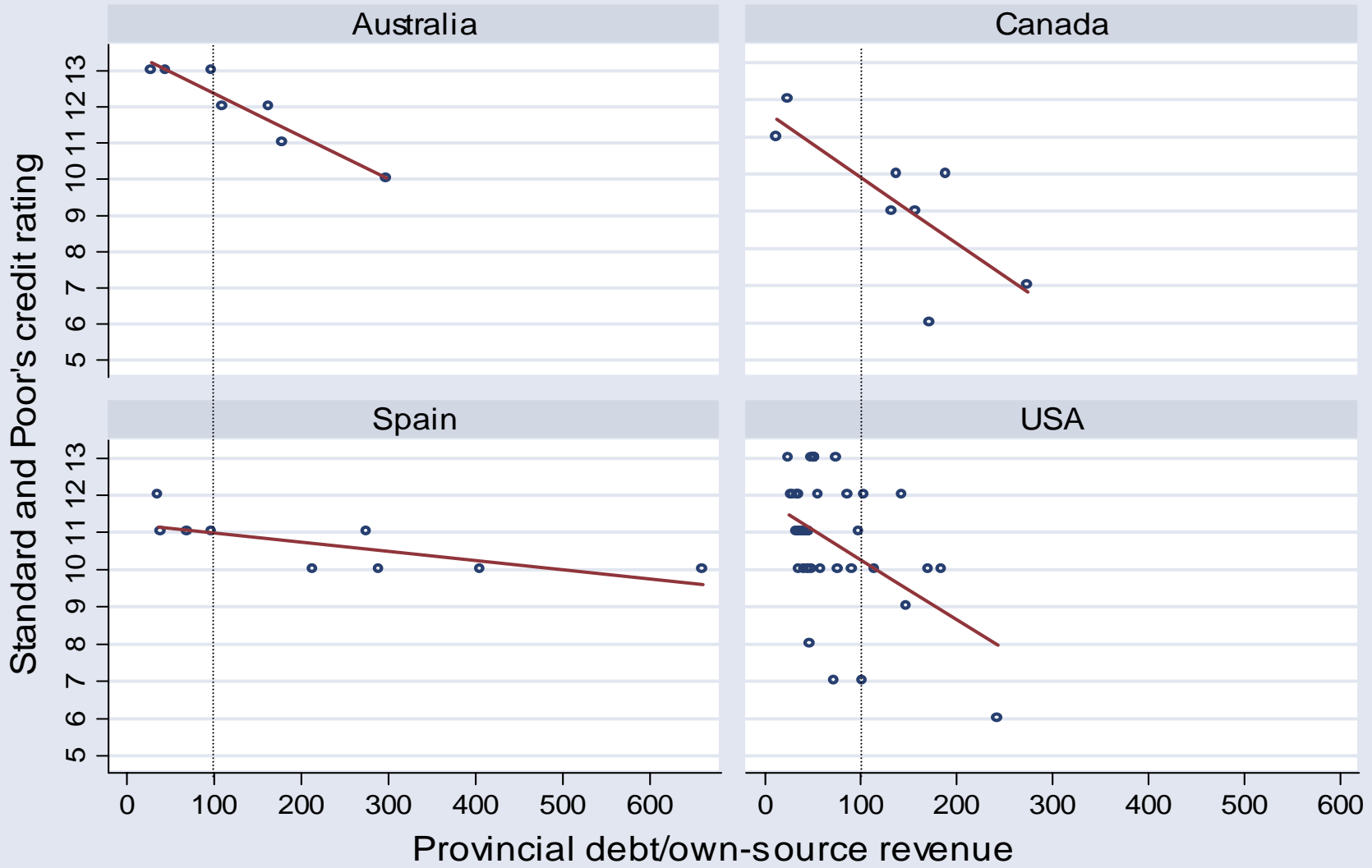
- The bailout game
- Intergovernmental grants, taxation, and commitment
- Credit ratings and bailout expectations
- The bailout game in action: Germany
- Is Germany an outlier?
- Policy implications

Figure 1: The bailout game



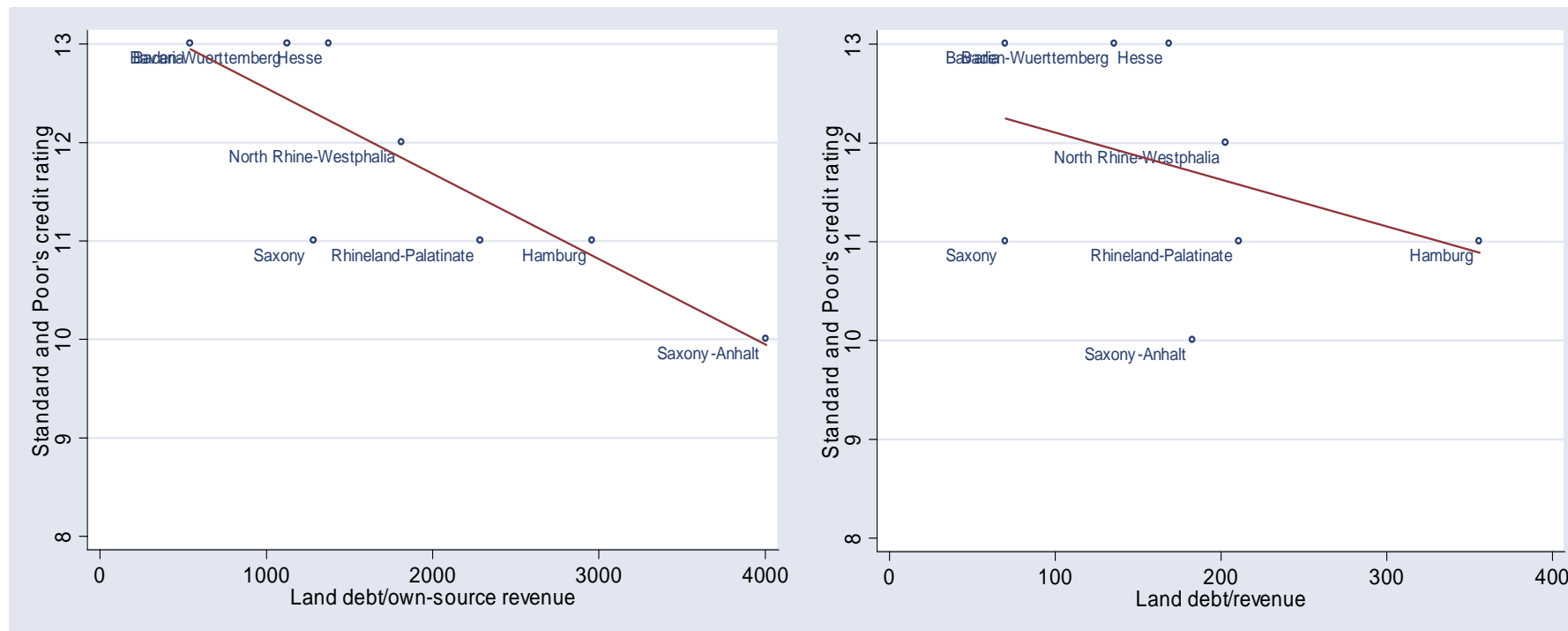
Intergovernmental grants,
taxation, and commitment

Figure 2: Debt burdens and credit ratings in four federations



Graphs by countryname

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)

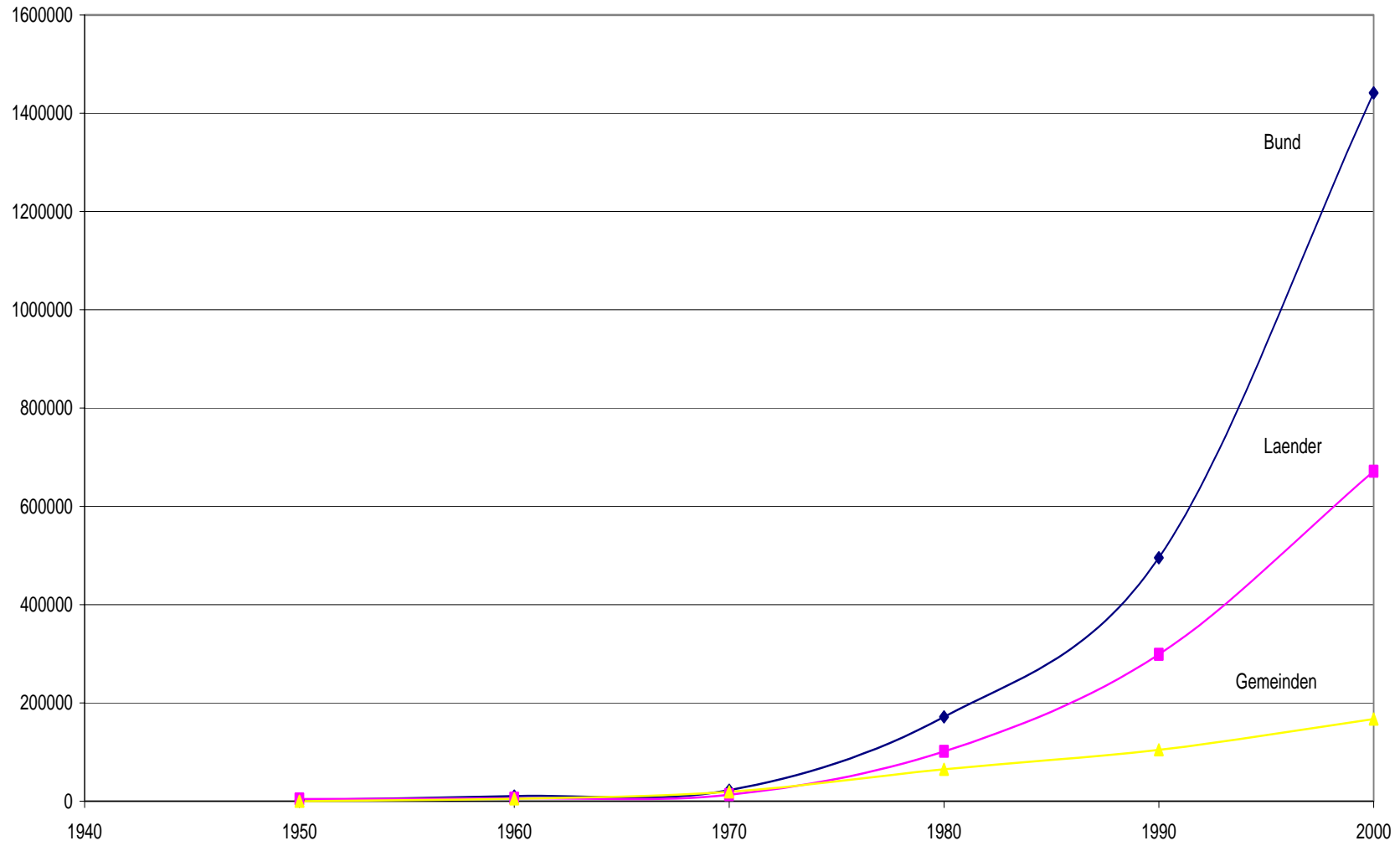


Figure 4: Equalization and Deficits among the German Länder

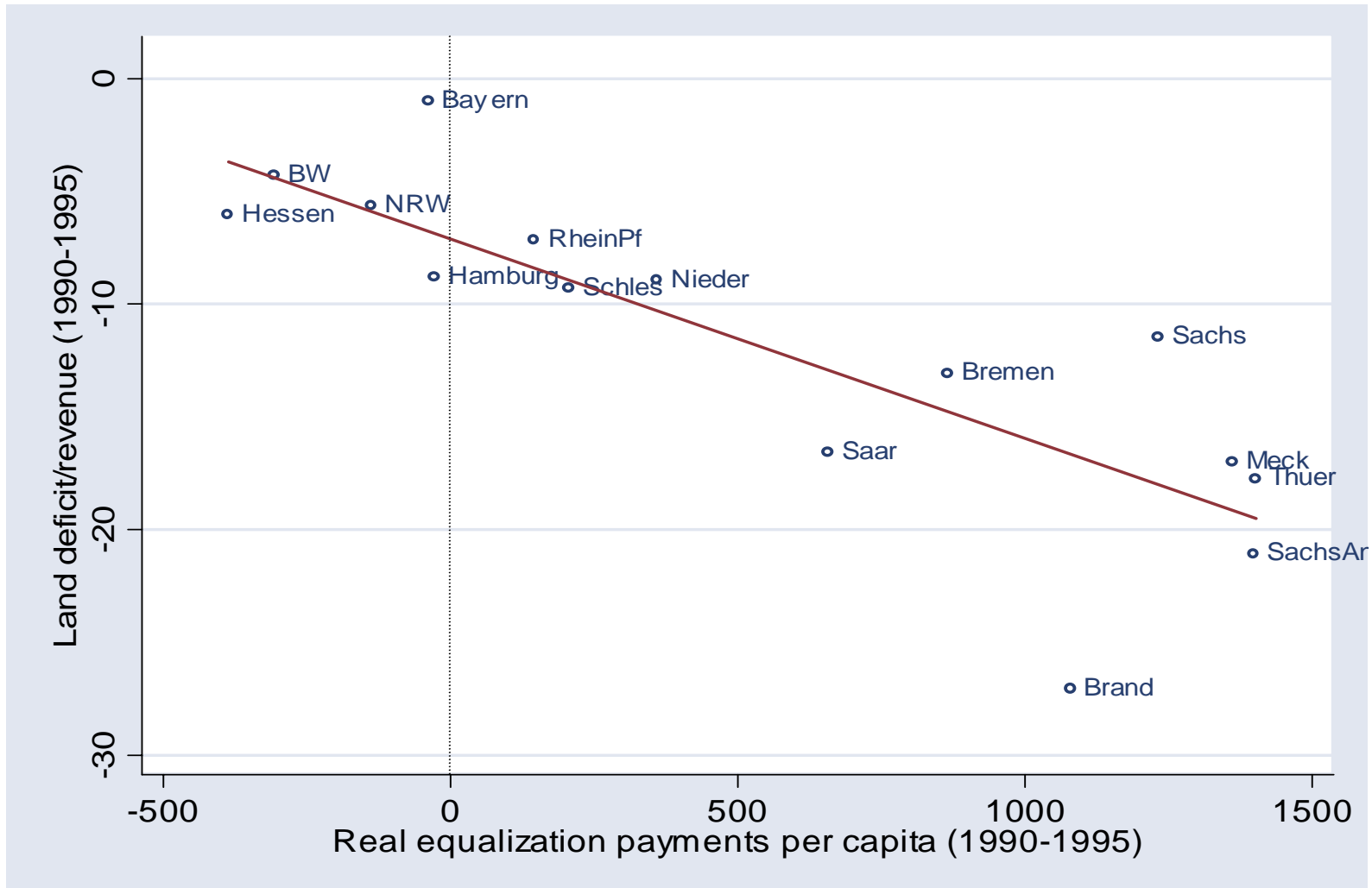
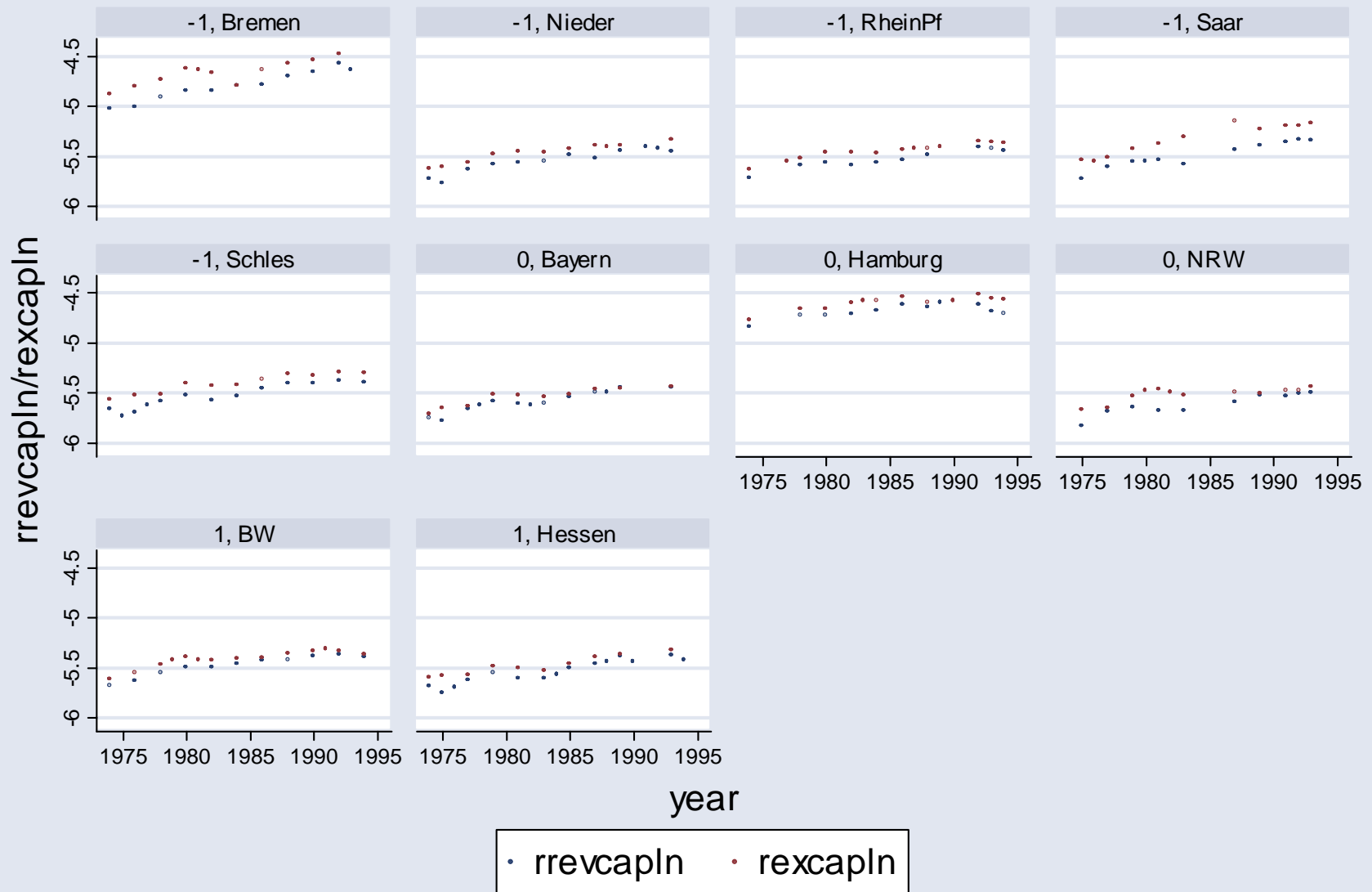


Figure 5: Log real expenditures and revenues per capita, 1974-1995



Graphs by pay erthree and land

Table 2: Expenditure responses of Länder to deviations from revenue trend

Dependent variable: Change real expenditures per capita (log)	Paying and neutral Länder		Recipient Länder	
	Coef.	PCSE	Coef.	PCSE
Positive revenue gap _t	-2.82	0.92 ***	2.60	1.54 *
Positive revenue gap _{t-1}	2.54	0.86 ***	-1.46	1.68
Positive revenue gap _{t-2}	-0.64	0.81	2.59	1.53 *
Negative revenue gap _t	-1.83	0.78 **	-4.31	1.54 ***
Negative revenue gap _{t-1}	-1.07	0.78	-2.48	1.58 *
Negative revenue gap _{t-2}	1.63	0.77 **	-0.17	1.56
Lag change real expenditure per capita (log)	-0.01	0.11	-0.59	0.11 ***
Constant	0.00	0.01	0.01	0.02
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)

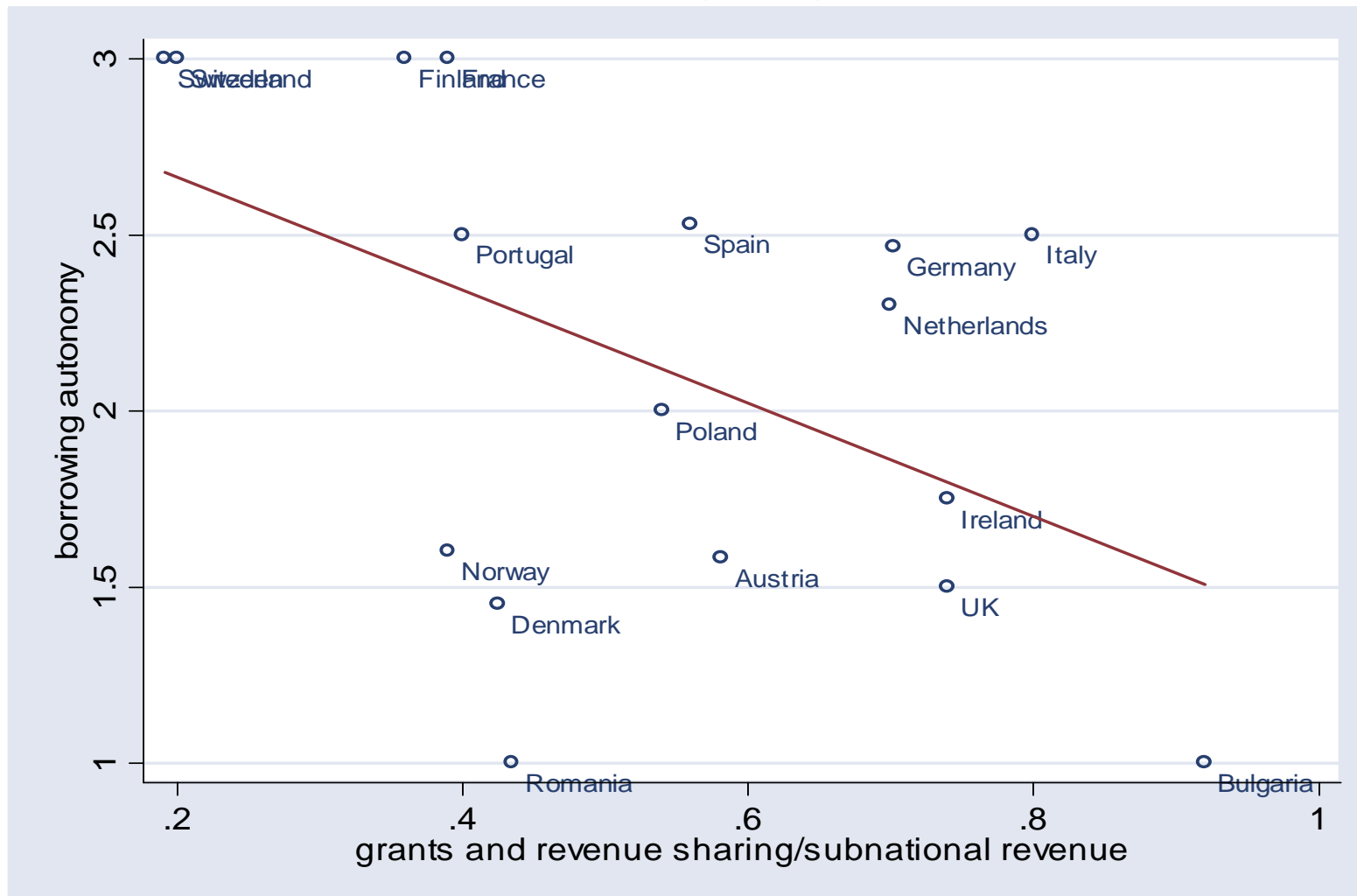
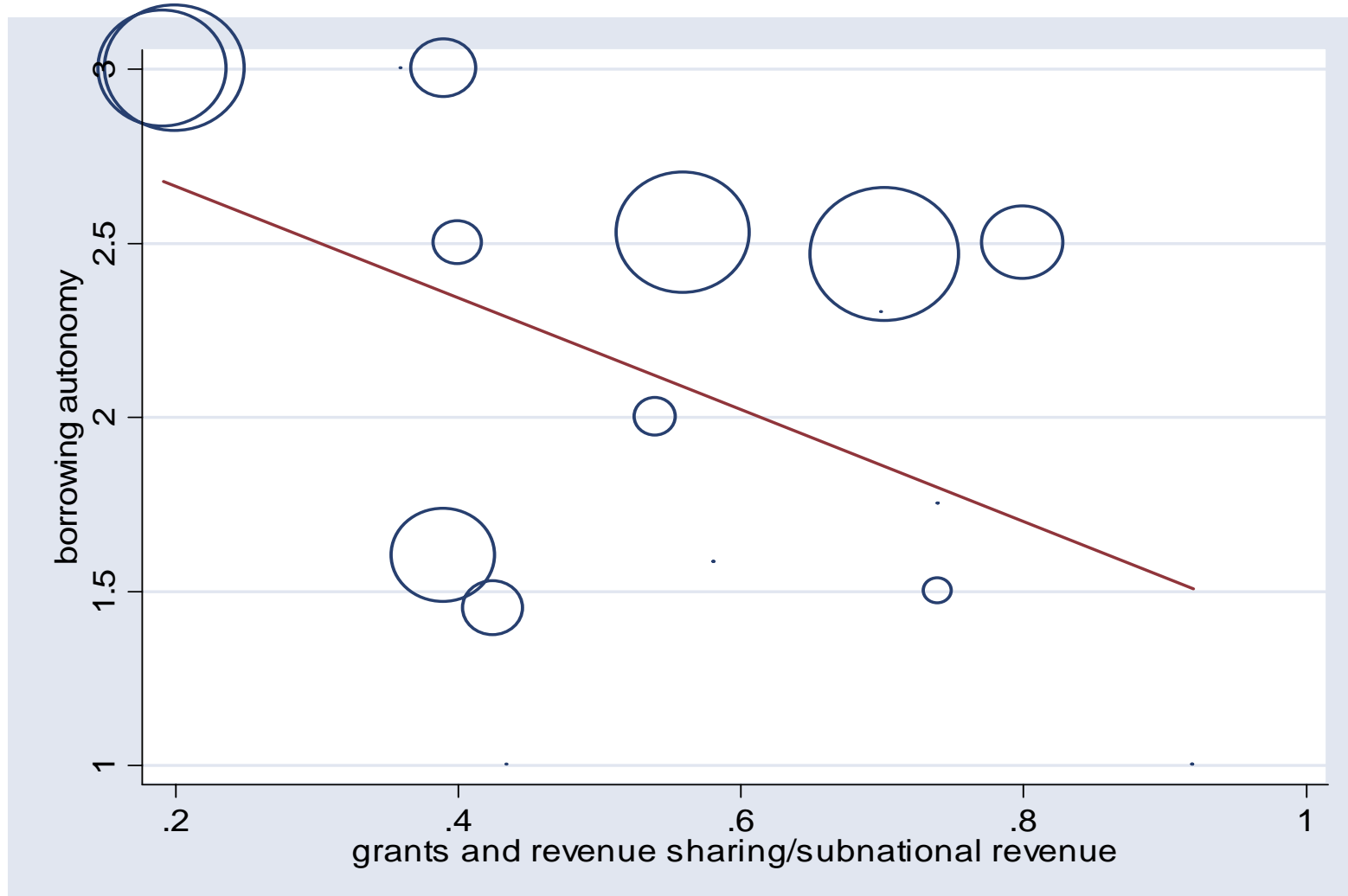


Figure 7: Transfer-dependence, subnational borrowing autonomy, and subnational deficits in Europe (1990s)



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