Centralization, Decentralization and Incentive Problems in Eurozone Financial Governance: A Contract Theory Analysis◆

Yutaka Suzuki

Hosei University

Abstract

We use a Contract Theory framework to analyze the mechanisms of Eurozone financial governance through the Stability and Growth Pact (SGP), with a focus on centralization vs. decentralization and incentive problems. By constructing a Stackelberg game model with n Ministries of Finance as the first movers, and European Central Bank as the second mover, we show that each government can create growth in its own country (self-benefit) by increasing government spending, but it will increase inflation and the euro value will fall. Since these effects are shared equally by euro countries (cost sharing), there exists an incentive to free-ride on other countries. We then analyze a solution to the free-rider problem through the penalty scheme in the SGP, and derive a second best solution where a commitment not to renegotiate penalties ex-post is impossible. Lastly, we derive the parameter conditions for optimizing the EU's current allocation of authority, "divided authority structure," which consists of Monetary Centralization and Fiscal Decentralization. We find that what is effective is "contingency dependent governance" based on "relative sovereignty," where there is a division of authority as the basic structure and the main body governs with leading sovereignty depending on the contingency.

Key Words Stability and Growth Pact, Monetary Centralization, Fiscal Decentralization, Free-Rider Problem, Penalty Schemes and Renegotiation, Authority Allocation Structure, Relative Sovereignty

JEL Classification Numbers E61, F59, H11, H63, H87

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