The role of commitment

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Like two workers gain from insuring each other against the risk of losing their income, two regions gain from insuring each other against shocks in their revenues or expenditures. The cost of transferring resources to the other region when times are good is offset by the benefit from receiving transfers from the other region when times are bad. If the future prospects for one region are generally better than for the other region, this could be incorporated in the insurance agreement, but the agreement can generally make both regions better off. Professor Drèze's exposition clearly underlines the value of future risk sharing and distinguishes this 'dynamic solidarity' from 'static solidarity'. The value for both regions from future risk sharing does not depend on the imbalance between the two regions today. This is an important observation. Unfortunately, the opposite argument is often heard.

Professor Drèze's proposal assumes strong commitment between Flanders and Wallonia to follow up on their initial agreement. I am convinced that Flanders and Wallonia are not in an uncommitted relationship and I hope that the commitments remain strong. However, it is important to understand the value of commitment and the impact policy proposals may have on this. If two regions cannot fully commit to an agreement made today, 'static solidarity' and 'dynamic solidarity' become interdependent. Even if an agreement of 'dynamical solidarity' is mutually beneficial, it can only survive depending on how much 'static solidarity' the agreement implies in the future. Let me elaborate on this point and analyze the role of subsidiarity in this particular context.

Assume two regions agree today to organize unemployment insurance at the federal level and thus pool all income risks deriving from unemployment. When in the next year unemployment in the one region is higher than in the other region, the interregional structure of the unemployment scheme implies that the second region is paying some of the benefits to the unemployed in the first region.[22] The ex-ante value of the insurance agreement for both regions -receiving help when experiencing relatively bad times- necessarily implies a cost for one of the two regions ex-post, namely helping out when experiencing relatively good times. The question arises what keeps the region with low unemployment from reneging on its earlier commitment to pay the other region's unemployed workers? The region could indeed decide not to pay. However, by doing so, the region will put the future solidarity at stake and hurt itself as well. Once one region has decided not to fulfil its promise, it is likely that the other region won't do so either in the future. Only if the promised transfer is smaller than the value of future risk sharing, a region will keep her promises. An agreement is thus *self-enforcing* if none of the contingent transfers specified in the agreement exceeds the value of future risk sharing. In Drèze's words, if the 'static solidarity' that the agreement potentially entails in the future is too large relative to the value of future risk sharing, the 'dynamic solidarity' will not survive in the long run, even though 'dynamic solidarity' is beneficial for both regions. The value of future risk sharing thus puts an upper bound on the static solidarity that the two regions can credibly expect from each other.

Anything that increases this upper bound increases the extent to which two regions can insure each other and is therefore valuable for both regions. A first factor is the regions' preferences for the future. The more a region discounts the future, the faster it will be tempted to renege on promised payments. For obvious reasons such as the danger of not being re-elected, politicians often have a stronger focus for the present and this will limit the scope for

[22] If the two regions expect different unemployment rates on average, the realized unemployment rates could be compared with the expected unemployment rates to determine the transfers, as Drèze suggests.

interregional insurance. A second factor is the commitment devices that help regions to keep their promises. Ex ante both regions like to tie their hands and benefit from delegating the power to enforce the agreement to some external (or super-regional) entity. Every institution that increases the cost of leaving the interregional insurance scheme, reduces the temptation to renege on the contract and increases the interregional insurance possibilities. Of course, a strong interregional identity and culture helps as well. Recognizing the role of commitment brings forward an argument against subsidiarity and the tiered implementation that Drèze suggests in his proposal. Setting up regional unemployment insurance arguably comes at a cost. When unemployment insurance is organized at the interregional level, this cost will be taken into account by the region that considers to renege on its commitment. When each region already organizes the unemployment insurance among its own members, this cost will be sunk and the temptation not to pay interregional transfers is stronger. Decentralization increases the temptation for regions to renege on interregional promises and makes further decentralization more likely. This mechanism thus predicts that subsidiarity may initiate a *cascade* of decentralizing initiatives.

Professor Drèze has analyzed many dimensions of the interaction between subsidiarity and interpersonal solidarity. In the end, empirical research should shed light on the relative importance of these dimensions. Related to the one issue that I have raised, empirical research could shed light on the extent to which (1) static imbalance reduces interregional insurance and (2) commitments between regions increase the scope for interregional insurance.