

Dipartimento di Politiche Pubbliche e Scelte Collettive – POLIS
Department of Public Policy and Public Choice – POLIS

Working paper N. 42
Settembre 2004

**Intergovernmental equalization grants:
some fundamental principles**

Albert Breton, Angela Frascini

UNIVERSITA' DEL PIEMONTE ORIENTALE "Amedeo Avogadro"
ALESSANDRIA

INTERGOVERNMENTAL EQUALIZATION GRANTS: SOME FUNDAMENTAL PRINCIPLES

Albert Breton* and Angela Fraschini**

*Professor of Economics
Department of Economics
University of Toronto
150 St. George Street
Toronto – Ontario
Canada M5S3G7

and
Dipartimento di Economia
Università di Torino

albertbreton@sympatico.ca

** Professor of Local Government Finance
Dipartimento di Politiche Pubbliche e Scelte
Collettive,
Università del Piemonte Orientale "Amedeo
Avogadro"
Via Cavour, 84
15100 Alessandria - Italy

angela.fraschini@sp.unipmn.it

ABSTRACT

Propositions related to intergovernmental equalization grants are always implicitly or explicitly derived from one model of government or another. The paper assumes that governments are competitive organisms. In such a frame of reference, equalization payments serve to insure that all the units in a decentralized governmental system have a chance to share in the benefits of competition. In other words, equalization payments are stabilization instruments. As such they will generally have an effect on the interpersonal distribution of income, but they are not motivated by that effect. The paper also argues that economic globalization increases the need for equalization grants.

JEL classification number: H70

I. Introduction

What purpose do intergovernmental equalization grants serve? The literature on their efficiency is large, but far from consistent in the matter of what they are and what they (should?) do. In the pages that follow, we suggest an approach to these payments that has something to say on whether they improve or worsen the *overall* allocation of resources while departing from more standard or conventional approaches. In the last analysis, the view one adopts vis-à-vis equalization grants - vis-à-vis what they are (or should be?) designed to achieve - is very much determined by the model, explicit or implicit, of government one embraces and by one's priors concerning the nature of federalism.

In what follows, we begin by suggesting a particular model of government – one which, we believe, accounts for the historical and current observable patterns of production and supply of goods and services (including redistribution and regulation) by modern democratic governments. Later, we make clear what are our priors concerning the nature of decentralization and federalism.

The views of economists regarding the efficiency of governmental production and supply of goods and services range over the entire panorama of possibilities. This dispersion of views is, once more, a consequence of the priors held regarding the nature of democratic governments. We will suggest a hypothesis about efficiency that is consistent with the model of government we will be outlining. Following this, and before examining some consequences of what could be called a misspecification of terms regarding equalization payments, we consider by way of a comparative exercise the effects of economic globalization on the efficiency of governments and of intergovernmental transfers.

In the next section, therefore, we propose a model of government, followed in Section III by a discussion of efficiency in governments and in the economy at large. Then, in Section IV, we suggest a role for intergovernmental transfers. Section V is devoted to economic globalization and its effects on public sector efficiency. In Section VI, we look at how equalization can be "faultily" designed and at some of the consequences of these failures. Section VII concludes the paper.

II. Modelling Governments

There are many theories of government even if we restrict ourselves to the economic literature broadly defined. In *Competitive Governments* (1996), Breton attempted a classification and a brief summary followed by a critique of many of these theories. All of them are still in circulation. It

would serve no purpose to review those models and their use. Instead, we will briefly outline the approach to government Breton proposed and defended in his 1996 monograph.

The evidence, we suggest, is consistent with the hypothesis that modern democratic governments are compound structures made up of a large number of autonomous or semi-autonomous elected and non-elected centres of power. We can go beyond this observation to the view that the evidence is consistent with the proposition that even if the production of goods and services by public sector bodies requires and involves coordination among centres of power, these centres compete with each other. Before defending that view, we acknowledge that there are from time to time attempts at collusion between centres of power that are sometimes successful. Still, not anymore than in the marketplace, do successful collusions in particular instances point to the absence of competition generally.

It is best to conceive of competition among centres of power the way Joseph Schumpeter (1911; 1942) understood competition in the market economy: a process of creative destruction in which new processes, products, sources of supply, etc. replace old ones. We know from the work of Paul Samuelson (1943; 1982) that neo-classical economic price-quantity adjustments play a background role in Schumpeterian competition, even though the observed process and its manifestations as described by Schumpeter pay little attention to these underlying background forces. It is relatively easy to relate the fundamental mechanisms of Schumpeterian competition to those underlying the working of check and balances between centres of power in politics – a notion that has been around, both as normative injunction and as positive reference point for over 2000 years (see Panagopoulos, 1985). Indeed, the way Schumpeterian competition and checks and balances work are remarkably similar (see Breton, 1996, Chapter 3).

But there is more to competition in politics than intra-governmental competition – competition between centres of power in compound governments. There is growing acceptance of the idea that governments in a given society compete with each other. The mechanism that motivates that manifestation of competition, which years ago Breton (1987) labeled the Salmon mechanism,¹ is different from that underlying checks and balances, but is a competitive mechanism nonetheless. It is an application of the theory of labour tournaments introduced in economics by Edward Lazear and Sherwin Rosen (1981). Pierre Salmon (1987a; 1987b) was able to show that governing and

(^o) Acknowledgements: We wish to thank Jan Vermeir for useful comments to an earlier draft of the paper. The usual *caveat* applies.

opposition parties are led to compete with each other when citizens can compare the performance of their government with that of governments in other jurisdiction. That in itself will lead to intergovernmental competition. Moreover, the Salmon mechanism, initially crafted to explain horizontal competition - competition among governments inhabiting a given jurisdictional level - can be applied, with one important modification (see below), to vertical competition - competition among governments located at different tiers (see Breton and Fraschini, 2003).

The initial formulation of the Salmon mechanism assumed that citizens compared the performance of their own government to that of a benchmark government in terms of the "levels and qualities of services, of levels of taxes or of more general economic and social indicators" (Salmon, 1987b, 32). However, as argued by Breton (1996), competition in governmental systems compels all centers of power to forge wicksellian connections (defined in the next two paragraphs) so as to be granted the consent (vote) of citizens.² In the light of this result, we suggest that citizens evaluate the relative performance of governments in terms of the tightness of wicksellian connections – both for horizontal and vertical competition. In other words, if there are n centers of power indexed i and if we let w_i ($i = 1, \dots, n$) be a measure of the tightness of the wicksellian connection generated by center of power i , with w_i normalized so that $0 \leq w_i \leq 1$, citizens will rank the centers of power that make up compound governments in terms of w_i .

What are wicksellian connections and why is it an improvement to articulate the Salmon mechanism on them rather than on the vector of goods, services, taxes, and other indicators on which the mechanism has hitherto been expressed? A wicksellian connection is a link between the quantity of a particular good or service supplied by centers of power and the taxprice that citizens pay for that good or service. Knut Wicksell (1896) and Erik Lindahl (1919) showed that if decisions regarding public expenditures and their financing were taken simultaneously and under a rule of (quasi) unanimity, a perfectly tight nexus between the two variables would emerge. Breton (1996) argued that competition between centers of power, if it was perfect and not distorted by informational problems, would also generate completely tight wicksellian connections. In the real world, competition is, of course, never perfect and informational problems abound and, as a consequence, wicksellian connections are less than perfectly tight. Still, as long as some competition exists, there will be wicksellian connections.

¹ Salmon's first paper on the subject was published in 1987, but was delivered at a seminar on federalism in 1984.

The virtue of a Salmon mechanism expressed in terms of wicksellian connections is that a given citizen can carry out comparisons of performance in terms of a common standardized variable, whether the benchmark government inhabits the same or a different jurisdictional level from that in which the citizen dwells. A variable that serves that purpose well is the size of the utility losses inflicted on citizens whenever the volume of goods and services provided by centers of power differs from the volume desired at given taxprices. Put differently, citizens experience the same kind of utility losses from decisions made by governments whatever the jurisdictional tier the governments inhabit. The goods and services supplied can differ, but the efforts to achieve tightness in wicksellian connections will not.³ Indeed, the ability to compare performance horizontally is likely to reinforce the ability to execute vertical comparisons and *vice versa*.

There is still resistance to the idea of intragovernmental and intergovernmental competition. But this resistance sometimes turns to hostility when students of public sector adjustments are confronted with the notion that governments compete with families, churches, charitable organizations, cooperatives, and other bodies which supply goods and services that are close substitutes for some of the goods and services supplied by governments. Among these, the most obvious are day care, health and nursing, old age security, unemployment insurance, and a host of others. In addition, governments sometimes compete in markets in the provision of certain goods and services such as transportation, broadcasting, education, insurance, car production, oil exploration, and so on. The interdependence of the public and private sectors is all pervasive.

III. Efficiency

To simplify the presentation of what we wish to propose regarding efficiency, let us assume to begin that competition rules everywhere in the economy, including the public sector. Given the interdependence just noted, the resulting general equilibrium configuration of resource allocation is one which, if subjected to an exogenous shock, will register changes in both the private and public sectors, irrespective of the origin of the disturbance. For example, given the interconnectedness, an external disturbance in one or more markets may not require adjustments only in other markets, but in some parts of the public sector as well.

² For a defence of that assumption, see Breton (1996, 48-57). See also the literature on probabilistic voting in, for example, Calvert (1986).

The idea of some behavioral interaction between the public and private sectors has already been examined in, for example, the theory of "unbalanced growth" (Baumol, 1967) - a dynamic form of interaction. The interdependence we have in mind is more static in character: it is the interdependence we find in standard Walrasian general equilibrium theory. In that framework, efficiency in the (overall) allocation of resources is the product of competition which insures that resources are channeled toward the alternatives in which their yield is a maximum. When competition breaks down, either because of collusion or monopolization or when it is distorted by *ad hoc* interventions, efficiency in resource allocation is reduced. In the conventional approach to (static) efficiency, the prime *ad hoc* distortive interventions are taxes, subsidies, and other like policies. However, in a frame of reference in which governments are competitive, taxes and subsidies are in the nature of taxprices – positive or negative – paid per unit of good and/ or service provided. They are user fees, like the price paid for a newspaper.

In *Competitive Governments* (1996), Breton used Knut Wicksell's (1896) approach to the provision of goods and services by public bodies to argue that competition creates the conditions that lead to the satisfaction of the two conditions which he showed were necessary and sufficient to the formation of links between quantities demanded and their unit prices and thus to efficient supply. He labeled these links *wicksellian connections*. These, he noted, are not all or nothing relationships, but can be normalized to vary between zero and one. In other words, wicksellian connections can be loose or tight.

The point is not that in the real world there are no significant departures from competitive allocations as a result of distortions (collusions, monopolizations, corruption, and a host of other factors) in the private and/or public sectors. There are. However, we are suggesting that we can better understand the meaning of these barriers to competition in a framework in which it is recognized that there is intragovernmental, intergovernmental, and extragovernmental competition and in which the allocation of resources is seen to take place in a general equilibrium framework in which the private and public sectors are organically interdependent.

³ As in the tournament model suggested by Nalebuff and Stiglitz (1983), the comparison of performance will be more precise if the random disturbances affecting performance are common to all centres of power instead of being idiosyncratic to each.

IV. Understanding Intergovernmental Transfers

We now come to intergovernmental transfers. We begin by arguing that their purpose cannot be to cause a change in the interpersonal distribution of income - that is, to deal with an equity problem. That done, we offer a rationale for these grants that is consistent with the hypothesis suggested in the foregoing paragraphs regarding the nature of government and of efficiency in a general (private markets and public bodies) equilibrium framework.

There are many analytical traditions in the economic literature on intergovernmental grants. There is, for example, an interjurisdictional spillover tradition (Breton, 1965; Oates, 1972), an income redistribution tradition (Buchanan, 1952; Scott, 1952), a fiscal imbalance tradition (Musgrave, 1961), and an "inefficient" mobility of labour tradition (Flatters, Henderson and Mieszkowski, 1974; Boadway and Flatters, 1982). These are still not integrated and unified in any meaningful sense and, in all likelihood, cannot and never will be. The *theoretical* work in these various traditions has, however, one assumption in common: it treats provincial or state governments⁴ – the recipients of money from central governments – as conduits for transfers to individuals and/or firms for the purpose of achieving pre-stated objectives (the sources of the various traditions just noted): internalization of spillovers, redistribution of net fiscal benefits, etc.

Sometimes the provincial government-as-conduit assumption is camouflaged by a prior supposition that all citizens have identical preferences. But even in these cases, the province-as-conduit assumption delivers its pay-load. To understand the meaning of the assumption, it suffices to recognize that all the objectives that are assigned to transfer programmes can be more efficiently achieved by an interpersonal than by an intergovernmental transfer system. Indeed, one can probably make the case that, as a matter of historical fact, to the extent that governments have been preoccupied with the objectives which grant theorists impute to them and to the extent that they have used grants to achieve these objectives, they have resorted to interpersonal grants, namely to grants made to persons (families) and/or firms, but sometimes "mediated" by, or effected through, more junior governments⁵. In this connection, it is well to recall that in most societies income redistribution policy is embodied in a variety of 'welfare' programmes based on the age, the employment situation, the family status, the health conditions and on other characteristics of the

⁴ Henceforth we use the words province and provincial for cantonal, regional, state, and other like governments.

⁵ For example, to make effective the right of all youth to benefit from primary and secondary education, the Italian central government transfers funds to the regions that, in turn, hands the funds over to the municipalities. These then proceed to award grants to families in support of scholastic expenditures.

individuals, families and groups that are recipients. Proposals to 'streamline' these programmes have often been made by academics, royal commissioners, and others on the basis of little-known research which shows, one presumes, that existing programmes are inefficient. George Akerlof (1978) has shown, however, that a strong case can be made that the patchwork of programmes that form the income redistribution policy of societies is more efficient than some proposed 'streamlined' systems would be, because for any given volume of redistribution the excess-burden of the revenues needed to pay for it is smaller in the patchwork than in the streamlined system. What Akerlof calls "tagging", namely the use of certain characteristics to identify the individuals and groups in need, is simply a device that insures that resources are not transferred to those who are not in need.

On the basis of the foregoing, one would have to conclude that from an income redistribution point of view, intergovernmental transfers are inefficient because the governments of some jurisdictions in which rich and poor citizens reside receive funds, whereas the governments of other jurisdictions in which rich and poor citizens also reside do not receive any funds as a result of the fact that average per capita income (say) is lower in the first than in the second jurisdiction. Intergovernmental transfers, in other words, are inconsistent with "tagging" and, therefore, with efficient redistribution.

If interpersonal are more efficient than intergovernmental grants, why do central governments sometimes use the second type of grants⁶? Is it that central governments are not pursuing, through these grants, the objectives that analysts think they ought to be pursuing? Is it possible, in other words, that the objectives which central governments are pursuing require intergovernmental grants programmes in addition to the interpersonal grants programmes they are implementing? Our answer to this query is in the affirmative. Intergovernmental grants are needed to *stabilize* the outcomes of competition among provincial governments and, by achieving that objective, make competition more effective and more efficient. This does not mean that these transfers do not have effects on income distribution, on mobility, on the expenditure patterns of recipient governments, and on other variables, but it means that grants programmes should be analyzed and evaluated in terms of their contribution to the stability of horizontal intergovernmental competitive outcomes, not on some other basis.

How do intergovernmental grants contribute to competitive stability? Simply by equalizing the capacity of provincial governments to compete with each other, that is, by insuring that some (poor) provincial governments are not permanent losers in the competitive struggle that characterizes their relationship with other provincial governments. If the grants were interpersonal instead of intergovernmental, the relative positions of provincial governments would be unchanged by grants, even if that of their constituents was, unless of course the provincial tax rates were such as to fully recapture, province by province, the sums granted by central governments. If it is recalled that the jurisdictions in which governments are recipients of grants are made up, like those from which the funds are derived, of rich and poor persons, a tax recapture scheme would, of necessity, be quite complicated and not obviously constitutional in democratic states.

To have a more equal capacity to compete is not the same thing as providing the citizens of every province with the same bundle of governmentally supplied goods and services: the same schooling facilities and programmes, the same health services, the same number and quality of public libraries, the same number of hectares of public parks, and so on. That would amount to a denial of the very nature of decentralization and federalism. For a government to possess a more equal capacity to compete means that it is in a position to provide a volume and quality of goods and services that yield to its citizens a level of utility reasonably comparable to those provided in other jurisdictions without having to resort to unduly burdensome levels of taxation again relative to the levels collected elsewhere.

We note at this point that citizens have a demand for tighter wicksellian connections because the tighter the connection, the smaller the volume of utility loss they have to bear. However, as we have seen, tightness of wicksellian connection is a (positive) function of the effectiveness of intergovernmental competition. If that effectiveness is increased by intergovernmental equalization transfers, we must assume that citizens have a derived demand for efficient competition-inducing equalization payments. These transfers, like intergovernmental grants, are arguments in their utility functions. Taxprices collected to pay for them create utility losses only to the extent that the taxprices exceed or fall short of the marginal value citizens place on these transfers.

That view of equalization payments can be profitably contrasted to that of the school of thought that can be called the Queen's University (Kingston, Ontario) conception of federalism (see

⁶ In principle, central governments can implement a transfer programme by payments made out of a general revenue account or they could levy revenues from wealthier provinces and make payments to poorer ones as if out of an

Flatters, Henderson, and Mieszkowski, 1974; Boadway and Flatters, 1982). In that view, if the province of Alberta (say) benefits from large oil royalties following a rise in the price of crude, it is the duty of Ottawa to tax these provincial revenues to prevent "inefficient" in-migration of labour into Alberta. If that argument is granted, it would seem reasonable to argue that Ottawa should grant resources to the provincial government of Quebec (or to any other province) to prevent "inefficient" out-migration from the province if some Quebeckers adopt a destructive separatist agenda. We are led to ask: is it the central government's function in a true federation to incessantly undo what is done at the periphery? It is hardly surprising that those who have adhered to the Queen's model have come to think of federalism as second (or worse) best compared to a strictly unitary and fully centralized state.

In *Competitive Governments* (1996), Breton examined a variety of empirical economic, sociological, and political science literatures which tell stories that he interpreted as manifestations or indications of the workings of intergovernmental competition. One of these stories describes the rate of diffusion of policies over provinces after an initial introduction by one provincial government. To visualize how an intergovernmental grants programme can help stabilize competition, consider how it would affect the operation of that diffusion process. Assume, therefore, that a province innovates by introducing a new policy that receives support not only in the province in which it is implemented, and henceforth serves as a Salmon benchmark. The expected response within the competitive paradigm is for other provinces to follow. But what if one or more other provinces cannot follow because they lack the necessary resources to do so? Presumably, labour, capital and/or technology will leave these jurisdictions, worsening their position relative to the pre-innovation one, while improving that of the host provinces. That describes instability and it is apparent that an intergovernmental grants programme can prevent this from happening.

In concluding this section, we insist that these grants must be unconditional. To see this it suffices to note that if they were conditional and if the conditions were set by central governments, as they would have to be, the grants programmes would simply suppress competition. Central governments may want to do this in certain circumstances or in respect of specific policy areas, but if they did this on a broad front, it would simply extinguish the decentralized and/or federal

earmarked account. As we will see, the distinction though empirically interesting, is theoretically not meaningful.

character of the governmental system itself. Conditional grants can be seen as equivalent to a centralization of constitutional powers.

V. Globalization

We now engage in a simple comparative static exercise. For that purpose, we focus on economic globalization⁷ and assume that this phenomenon is a consequence of the operation of the following three factors: 1) the virtual elimination of all restrictions on the free movement of capital made possible by the removal of quantitative and non-quantitative barriers to trade; 2) the increasing harmonization and standardization of the rules that govern trade, investment, employment, property rights, environmental policies, and so on; and 3) as a consequence of (2), that is, as a consequence of the adoption of common standardized rules regarding investments – rules that necessarily tend to reflect the practices prevailing in the dominant economies of the world where at present more or less all assets are traded or tradable – the elimination of impediments to the private ownership of all assets.

Globalization is still only incipient. It is, however, sufficiently present to produce observable results. In respect of governments and governmental systems, globalization's main consequence is to undermine wicksellian connections. It does this in the following way. The capital of large corporations being increasingly mobile as trade in goods and services becomes freer, corporations can threaten to leave a jurisdiction unless the government of that jurisdiction provides the public services they demand. Corporate enterprises make similar threats to put downward pressure on the tax rates that apply to the income they earn. That by itself undermines wicksellian connections. But that is only the first step. The necessity to provide goods and services to corporations at taxprices that are not high enough to cover the jurisdiction's unit costs of production and delivery implies that goods and services will be provided to the citizenry in general at taxprices that are higher than unit costs. That finishes the job of undermining wicksellian connections.

The foregoing can be given a more analytical twist. An increase in the degree of economic globalization increases the market power of business corporations because globalization increases the mobility of capital. As a result, a government that chooses to attract capital or decides to hold

⁷ The word globalization should not be used without an epithet. Economic globalization, cultural globalization, technological globalization, human rights globalization, etc., though sometimes closely related are different from each other. Indeed, as recent history has documented, some countries support (indeed promote) economic globalization

onto capital already in its jurisdiction will accept to provide goods and services demanded by corporate interests at lower taxprices and/or in greater quantity or quality than it would if capital was less mobile. The greater mobility of capital, in other words, will have made corporations into more effective oligopsonists in their purchases of governmentally supplied goods and services and, as a consequence, will benefit from larger oligopsonistic rents – rents that will inflict a deadweight cost on society. The "transfer" to oligopsonists means that citizens would have to pay more for the goods and services provided them, assuming, as we must, no change in the government's budget constraint. The quantity of publicly supplied goods and services demanded by citizens will therefore decline. Citizens will search for alternative suppliers⁸. The proposition that globalization undermines wicksellian connections therefore means that in the new equilibrium, corporate interests benefit from larger oligopsonistic rents while the citizenry at large demands fewer governmentally provided goods and services. The increment in globalization will then have been accompanied by a transfer of supply from public to private institutions.⁹ In the process, globalization changes the distribution of political power in society in favour of corporate capital against the institutions that have responsibility for the general welfare of the citizenry. The special treatment of some groups in society – in this case corporate interests – that has been ascribed to capture or to rent-seeking, we impute to globalization.

To repeat. The forces that generate economic globalization are forces that lead to increased competition in private markets. The burden of the foregoing discussion is that the same forces decrease intergovernmental competition and, thus, reduce the tightness of wicksellian connections. A manifestation of this are the appearance of new or increased oligopsonistic rents to corporate enterprises.

However, globalization does not undermine wicksellian connections equally across all jurisdictions of governmental systems. It is reasonable to suppose that junior governments, whose inability to compete in a non-globalized (or in a less globalized) world was already a fact, would be

while seeking, at the same time, to curtail human rights globalization. We are concerned with economic globalization only.

⁸ In the short-term alternative suppliers may not even exist. However, it must be assumed that in the longer-run, supply will respond to demand. In any case, if the services supplied cannot be "privatized" – street lighting or street cleaning may be examples – we then expect the quality or the quantity supplied will be reduced.

⁹ Some countries are less affected by globalization. This will be the case if, for example, a large fraction of corporate interests are family owned and controlled. That ownership pattern will act as an impediment to the in- and out-flows of capital.

particularly hard hit by economic globalization. If that is the case, the need for intergovernmental transfers would be greater following an increase in globalization.

The external disturbance that takes the form of an increase in economic globalization allows us to be more precise about the costs and benefits involved. The increment in intergovernmental grants that will make it possible for a "weak" government to compete with the other governments of a given polity will do so by, let us say, attracting capital, whether physical or human, that would otherwise have gone elsewhere. The intergovernmental grant, in other words, re-allocates capital from a higher to a lower yield opportunity. The difference between the two yields multiplied by the volume of displaced capital is a measure of the total cost of the intergovernmental transfer and a measure of the loss in economic efficiency in that economy. It is a trivial exercise, from there, to calculate the cost of any increment in economic globalization.

It is very important, however, not to bring the analysis to a close at this particular point. The intergovernmental grant also increases the capacity of the "weak" recipient government to compete and as such allows a closer link between taxprices and the goods and services supplied by that government to its citizens. It makes for tighter wicksellian connections. As we have argued, the tighter the wicksellian connections the smaller the utility losses suffered by citizens. In other words, intergovernmental transfers, by allowing for tighter wicksellian connections, improve the allocation of resources on the consumption side of the ledger and thus increase efficiency from that point of view.

The reduction in utility losses – the gain in consumer welfare – consequent on the transfers must be matched against the cost in terms of distortions in the capital market defined to include human as well as non-human capital. The optimal size of intergovernmental grants is one that equates the two margins.

VI. Deviations

It is possible (easy?) to design intergovernmental equalization programmes in such a way that the marginal gains in utility from tighter wicksellian connections fall short of the marginal costs of distortions in the capital market. That is especially likely to be the case if equalization payments are rationalized as redistributive grants by those who design them. The tendency in that case is to configure the transfer system in such a way that the outcome is one that "harmonizes" the relationship between the governments of a polity by making them all essentially alike. That sort of

harmonization reduces and ultimately suppresses intergovernmental competition and, in this way, makes utility gains from grants equal to zero, while leaving the cost side unaffected.

The evidence seems to indicate that both Australia and Germany have designed intergovernmental grants systems that equalize to such a degree the position of all governments in the federations that interstate and interländer competition has been, in fact, greatly reduced, possibly extinguished.¹⁰ The situation in these two federations raises a problem on which the foregoing has been silent. We have indeed been concerned only with the size of intergovernmental transfers without paying any attention to the arrangements from which they flow.

This problem is important because the arrangement – the formulae that select what counts and what does not count in setting the size of the grants – is crucial in determining their effectiveness as stabilizing agents. If we accept the view that intergovernmental grants, though they have redistributive consequences like any other economic activity, should not be designed as redistributive, but as stabilizing, then the "needs" side – what citizens in a jurisdiction 'need' by way of public services – should *not* enter the calculus that determines their size. Fiscal capacity and fiscal effort relative to some benchmark – relative to the average of x "representative" provinces (say) – are the only relevant variables.¹¹ To put it differently, the transfers should be such that the government of each province is in a position to provide (is capable of providing) its citizens with a reasonably comparable level of basic services (as the benchmark) without having to resort to unduly burdensome levels of taxation. We suggest that as long as the definition of "basic services" is not too restrictive – it allows, for example, for the provision of training programmes that lead to high-quality jobs or to the possibility of concert halls if that is the way the government wants to compete with other neighbourhood governments – a formula based on these principles would introduce minimal distortions in factor and product markets and permit tighter wicksellian connections.

¹⁰ In a recent communication, Paul Bernd Spahn of Goethe Universität was unsure as to whether interländer competition in Germany had been only reduced or completely extinguished.

¹¹ In this connection, we note that the recent change to the Article 119 of the Italian Constitution (Constitutional Law n. 3/2001 that modifies Title V, Second Part, of the Constitution), mandating that equalization be based on per capita fiscal capacity alone and no longer on "needs", is a significant improvement.

VII. Conclusion

We have argued that intergovernmental transfers, in a framework in which governments are assumed to be competitive, should be conceived as stabilizing and competition-inducing payments, not as redistributive grants. Their function is to insure that all units in a federation – indeed, in any decentralized governmental system – are able to hold their own in the competitive struggle among units of government. Competition is not, however, pursued as an end in itself – a sort of panacea. Indeed, the virtue of competition is that it forges links between the taxprices paid by citizens and the units of goods and services they demand. The stronger the degree of competition, the tighter the links and the smaller the losses in utility suffered by citizens from the public provision of goods and services.

We have also argued that economic globalization operates to reduce the tightness of wicksellian connections in “weaker” provinces and, as such, increases the need for intergovernmental equalization payments if the effectiveness of competition is to be maintained.

References

- Akerlof, George A. (1978). The Economics of 'Tagging' as Applied to the Optimal Income Tax, Welfare Programs, and Manpower Planning, *American Economic Review*. 68(1): 8-19.
- Baumol, William J. (1967). Macroeconomics of Unbalanced Growth: The Anatomy of Urban Crisis, *American Economic Review*. 57(3): 415-426.
- Boadway, Robin and Frank R. Flatters (1982). Efficiency and Equalization Payments in a Federal System of Government: A Synthesis and Extension of Recent Results, *Canadian Journal of Economics*. 15(4): 613-633.
- Breton, Albert (1965). A Theory of Government Grants, *Canadian Journal of Economics and Political Science*. 31(2): 175-187.
- Breton, Albert (1987). Toward a Theory of Competitive Federalism, *European Journal of Political Economy*. 3(1-2): 263-329.
- Breton, Albert (1996). *Competitive Governments. An Economic Theory of Politics and Public Finance*. New York: Cambridge University Press.
- Breton, Albert and Angela Frascini (2003). Vertical Competition in Unitary States: The Case of Italy, *Public Choice*. 114(1-2): 57-77.
- Buchanan, James M. (1952). Federal Grants and Resource Allocation, *Journal of Political Economy*. 60(June): 208-217.
- Calvert, Randall (1986). *Models of Imperfect Information in Politics*. Chur, Switzerland: Harwood Academic Publishers.
- Flatters, Frank R., J. Vernon Henderson, and Peter Mieszkowski (1974). Public Goods, Efficiency, and Regional Fiscal Equalization, *Journal of Public Economics*. 3(2): 99-112.
- Lazear, Edward P., and Sherwin Rosen (1981). Rank-Order Tournaments as Optimum Labor Contracts, *Journal of Political Economy*. 89(5): 841-864.
- Lindahl, Erik (1919/1964). Just Taxation – A Positive Solution, in: Richard A. Musgrave and Alan T. Peacock (eds.), *Classics in the Theory of Public Finance*. London: Macmillan: 168-176.
- Musgrave, Richard A. (1961). Approaches to a Fiscal Theory of Political Federalism, in: NBER, *Public Finances: Needs, Sources, and Utilization*. Princeton: Princeton University Press: 97-122.
- Nalebuff, Barry J. and Joseph E. Stiglitz (1983). Information, Competition, and Markets, *American Economic Review*. 73(2): 278-283.

- Oates, Wallace E. (1972). *Fiscal Federalism*. New York: Harcourt Brace Jovanovitch.
- Panagopoulos, Epaminondas P. (1985). *Essays on the History and Meaning of Checks and Balances*. Lanham: University Press of America.
- Salmon, Pierre (1987a). The Logic of Pressure Groups and the Structure of the Public Sector, in: Albert Breton, Gianluigi Galeotti, Pierre Salmon, and Ronald Wintrobe (eds.), *Villa Colombella Papers on Federalism. European Journal of Political Economy*. 3(1-2): 55-86.
- Salmon, Pierre, (1987b). Decentralization as an Incentive Scheme, *Oxford Review of Economic Policy*. 3(2): 24-43.
- Samuelson, Paul A. (1943). Dynamics, Statics, and the Stationary State, *Review of Economics and Statistics*. 25(1): 58-68. Reprinted in Joseph E. Stiglitz(ed.) (1966), *The Collected Scientific Papers of Paul A. Samuelson*. Cambridge (Mass.): MIT Press: Vol.I: 201-211.
- Samuelson, Paul A. (1982). Schumpeter as an Economic Theorist, in: Helmut Frisch (ed.), *Schumpeterian Economics*. London: Praeger. Reprinted in Kate Crowley (ed.) (1986), *The Collected Scientific Papers of Paul A. Samuelson*. Cambridge (Mass.) and London: MIT Press: Vol. V: 301-327.
- Schumpeter, Joseph A. (1911). *The Theory of Economic Development*. Translated by Redvers Opie (1934). New York: Oxford University Press.
- Schumpeter, Joseph A. (1942). *Capitalism, Socialism and Democracy*. New York: Harper Brothers.
- Scott, Anthony D. (1952). Federal Grants and Resource Allocation, *Journal of Political Economy*. 60(December): 534-536.
- Wicksell, Knut (1896/1964). A New Principle of Just Taxation, in: Richard Musgrave and Alan T. Peacock (eds.), *Classics in the Theory of Public Finance*. London: Macmillan: 72-118.

Working Papers

The full text of the working papers is downloadable at <http://polis.unipmn.it/>

- | *Economics Series | **Political Theory Series | ^e ALEX Series |
|-------------------------|---------------------------|--|
| 2004 n.42 * | | Albert Breton e Angela Frascini, <i>Intergovernmental equalization grants: some fundamental principles</i> |
| 2004 n.41* | | Andrea Sisto, Roberto Zanola, <i>Rational Addiction to Cinema? A Dynamic Panel Analysis of European Countries</i> |
| 2004 n.40** | | Francesco Ingravalle, <i>Stato, große Politik ed Europa nel pensiero politico di F. W. Nietzsche</i> |
| 2003 n.39 ^e | | Marie Edith Bissey, Claudia Canegallo, Guido Ortona and Francesco Scacciati, <i>Competition vs. cooperation. An experimental inquiry</i> |
| 2003 n.38 ^e | | Marie-Edith Bissey, Mauro Carini, Guido Ortona, <i>ALEX3: a simulation program to compare electoral systems</i> |
| 2003 n.37* | | Cinzia Di Novi, <i>Regolazione dei prezzi o razionamento: l'efficacia dei due sistemi di allocazione nella fornitura di risorse scarse a coloro che ne hanno maggiore necessita'</i> |
| 2003 n. 36* | | Marilena Locatelli, Roberto Zanola, <i>The Market for Picasso Prints: An Hybrid Model Approach</i> |
| 2003 n. 35* | | Marcello Montefiori, <i>Hotelling competition on quality in the health care market.</i> |
| 2003 n. 34* | | Michela Gobbi, <i>A Viable Alternative: the Scandinavian Model of "Social Democracy"</i> |
| 2002 n. 33* | | Mario Ferrero, <i>Radicalization as a reaction to failure: an economic model of islamic extremism</i> |
| 2002 n. 32 ^e | | Guido Ortona, <i>Choosing the electoral system – why not simply the best one?</i> |
| 2002 n. 31** | | Silvano Belligni, Francesco Ingravalle, Guido Ortona, Pasquale Pasquino, Michel Senellart, <i>Trasformazioni della politica. Contributi al seminario di Teoria politica</i> |
| 2002 n. 30* | | Franco Amisano, <i>La corruzione amministrativa in una burocrazia di tipo concorrenziale: modelli di analisi economica.</i> |
| 2002 n. 29* | | Marcello Montefiori, <i>Libertà di scelta e contratti prospettici: l'asimmetria informativa nel mercato delle cure sanitarie ospedaliere</i> |
| 2002 n. 28* | | Daniele Bondonio, <i>Evaluating the Employment Impact of Business Incentive</i> |

Programs in EU Disadvantaged Areas. A case from Northern Italy

- 2002 n. 27** Corrado Malandrino, *Oltre il compromesso del Lussemburgo verso l'Europa federale. Walter Hallstein e la crisi della "sedia vuota" (1965-66)*
- 2002 n. 26** Guido Franzinetti, *Le Elezioni Galiziane al Reichsrat di Vienna, 1907-1911*
- 2002 n. 25^e Marie-Edith Bissey and Guido Ortona, *A simulative frame to study the integration of defectors in a cooperative setting*
- 2001 n. 24* Ferruccio Ponzano, *Efficiency wages and endogenous supervision technology*
- 2001 n. 23* Alberto Cassone and Carla Marchese, *Should the death tax die? And should it leave an inheritance?*
- 2001 n. 22* Carla Marchese and Fabio Privileggi, *Who participates in tax amnesties? Self-selection of risk-averse taxpayers*
- 2001 n. 21* Claudia Canegallo, *Una valutazione delle carriere dei giovani lavoratori atipici: la fedeltà aziendale premia?*
- 2001 n. 20* Stefania Ottone, *L'altruismo: atteggiamento irrazionale, strategia vincente o amore per il prossimo?*
- 2001 n. 19* Stefania Ravazzi, *La lettura contemporanea del cosiddetto dibattito fra Hobbes e Hume*
- 2001 n. 18* Alberto Cassone e Carla Marchese, *Einaudi e i servizi pubblici, ovvero come contrastare i monopolisti preconi e la burocrazia corrotta*
- 2001 n. 17* Daniele Bondonio, *Evaluating Decentralized Policies: How to Compare the Performance of Economic Development Programs across Different Regions or States.*
- 2000 n. 16* Guido Ortona, *On the Xenophobia of non-discriminated Ethnic Minorities*
- 2000 n. 15* Marilena Locatelli-Biey and Roberto Zanola, *The Market for Sculptures: An Adjacent Year Regression Index*
- 2000 n. 14* Daniele Bondonio, *Metodi per la valutazione degli aiuti alle imprese con specifico target territoriale*
- 2000 n. 13* Roberto Zanola, *Public goods versus publicly provided private goods in a two-class economy*
- 2000 n. 12** Gabriella Silvestrini, *Il concetto di «governo della legge» nella tradizione repubblicana.*
- 2000 n. 11** Silvano Belligni, *Magistrati e politici nella crisi italiana. Democrazia dei guardiani e neopopulismo*
- 2000 n. 10* Rosella Levaggi and Roberto Zanola, *The Flypaper Effect: Evidence from the*

Italian National Health System

- 1999 n. 9* Mario Ferrero, *A model of the political enterprise*
- 1999 n. 8* Claudia Canegallo, *Funzionamento del mercato del lavoro in presenza di informazione asimmetrica*
- 1999 n. 7** Silvano Belligni, *Corruzione, malcostume amministrativo e strategie etiche. Il ruolo dei codici.*

- 1999 n. 6* Carla Marchese and Fabio Privileggi, *Taxpayers Attitudes Toward Risk and Amnesty Participation: Economic Analysis and Evidence for the Italian Case.*
- 1999 n. 5* Luigi Montrucchio and Fabio Privileggi, *On Fragility of Bubbles in Equilibrium Asset Pricing Models of Lucas-Type*
- 1999 n. 4** Guido Ortona, *A weighted-voting electoral system that performs quite well.*
- 1999 n. 3* Mario Poma, *Benefici economici e ambientali dei diritti di inquinamento: il caso della riduzione dell'acido cromico dai reflui industriali.*
- 1999 n. 2* Guido Ortona, *Una politica di emergenza contro la disoccupazione semplice, efficace equasi efficiente.*
- 1998 n. 1* Fabio Privileggi, Carla Marchese and Alberto Cassone, *Risk Attitudes and the Shift of Liability from the Principal to the Agent*

Department of Public Policy and Public Choice “*Polis*”

The Department develops and encourages research in fields such as:

- theory of individual and collective choice;
- economic approaches to political systems;
- theory of public policy;
- public policy analysis (with reference to environment, health care, work, family, culture, etc.);
- experiments in economics and the social sciences;
- quantitative methods applied to economics and the social sciences;
- game theory;
- studies on social attitudes and preferences;
- political philosophy and political theory;
- history of political thought.

The Department has regular members and off-site collaborators from other private or public organizations.

Instructions to Authors

Please ensure that the final version of your manuscript conforms to the requirements listed below:

The manuscript should be typewritten single-faced and double-spaced with wide margins.

Include an abstract of no more than 100 words.

Classify your article according to the *Journal of Economic Literature* classification system.

Keep footnotes to a minimum and number them consecutively throughout the manuscript with superscript Arabic numerals. Acknowledgements and information on grants received can be given in a first footnote (indicated by an asterisk, not included in the consecutive numbering).

Ensure that references to publications appearing in the text are given as follows:
COASE (1992a; 1992b, ch. 4) has also criticized this bias....
and
“...the market has an even more shadowy role than the firm” (COASE 1988, 7).

List the complete references alphabetically as follows:

Periodicals:

KLEIN, B. (1980), “Transaction Cost Determinants of ‘Unfair’ Contractual Arrangements,” *American Economic Review*, 70(2), 356-362.

KLEIN, B., R. G. CRAWFORD and A. A. ALCHIAN (1978), “Vertical Integration, Appropriable Rents, and the Competitive Contracting Process,” *Journal of Law and Economics*, 21(2), 297-326.

Monographs:

NELSON, R. R. and S. G. WINTER (1982), *An Evolutionary Theory of Economic Change*, 2nd ed., Harvard University Press: Cambridge, MA.

Contributions to collective works:

STIGLITZ, J. E. (1989), “Imperfect Information in the Product Market,” pp. 769-847, in R. SCHMALENSEE and R. D. WILLIG (eds.), *Handbook of Industrial Organization*, Vol. I, North Holland: Amsterdam-London-New York-Tokyo.

Working papers:

WILLIAMSON, O. E. (1993), “Redistribution and Efficiency: The Remediableness Standard,” Working paper, Center for the Study of Law and Society, University of California, Berkeley.