

Decentralization as an incentive scheme when regional differences are large

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1. Introduction

- Large differences among regions plays a large role in the current discussions on decentralization and/or federalism in countries such as
 - - Belgium, Germany, Italy and Spain.
 - In the case of France, the main issue is about regions overseas such as Guadeloupe, Martinique and Reunion (about 1/2 million inhabitants each)
- Three economic perspectives on federalism and decentralization:
 - “traditional”, mainly normative, theory of fiscal federalism (Oates 1972): in it, regional differences are the main reason for decentralization and/or federalism
 - “*ademocratic*” political economy of federalism (Brennan & Buchanan 1980, Weingast 1995) : in it, regional differences are mainly the result of differential performance related in general to mobility-based competition
 - “democratic” political economy of federalism: in it, regional differences seem to be an obstacle to comparisons and thus to “yardstick competition”, deemed itself central to the electoral accountability of governments (we are concerned here with the third perspective, especially yardstick competition)

Yardstick competition among governments

Office-holders want to be re-elected. If political competition is strong, this outcome is uncertain.

Electoral outcomes are based, to a degree, on voters' evaluation of government performance.

Evaluation of performance by voters is affected by information asymmetry: voters lack in part the necessary information

Comparisons by voters between what obtains in the jurisdiction and what is the case in others may mitigate the problem.

In turn, office-holders being aware of the existence or possibility of these comparisons affects their decisions: governments compete among themselves for a good comparative evaluation

When this mechanism works well (not always the case), it provides "good" incentives to governments (not only politicians)

Vertical yardstick competition: governments may also compete for a good comparative evaluation with governments on other levels (central, regional, municipal) -- but that will not be discussed here (see Breton 2006, Breton and Fraschini 2003).

- **Comparability**

- In Salmon (1987), the mechanism referred to today as yardstick competition was proposed as providing an argument for decentralization not based, contrary to the traditional theory of federalism, on spatial differentiation.
- This did not imply, but could suggest that large differences among jurisdictions are an obstacle to effective comparisons. Actually, the affirmation that they are may be found in the literature.
- First part of the presentation: **to what degree can large differences among regions be an obstacle to yardstick competition?**

- **But there is another side to the matter.**
- **One may argue that yardstick competition at the level of the member countries of the European Union leads to a convergence of economic performance (Salmon 2003), and social performance (Coelli, Lefèbvre and Pestieau, 2008).**
- **If a country does a bit less well for a while, then forces related to yardstick competition emerge and lead to reforms allowing some catching up in subsequent periods.**
- **This occurs in spite of very large differences along many dimensions (institutional, legal, industrial, etc.).**
- **Differences across the regions of a same country are, along the same dimensions, much smaller.**
- **Yet, in Belgium, France, Germany and Italy, some regions (and the regions overseas in the case of France) do not catch up with the rest.**
- **Hence, the question explored in the second part of the presentation: How can we explain that, in some countries, large regional differences in economic performance prove so persistent?**

2. To what extent are large regional differences an obstacle to yardstick competition?

• 2.1. Empirical studies: one dimension

- The empirical work on spatial interactions involving yardstick competition is quite substantial now. To mention a few:
 - *Besley & Case (1995), Heyndels & Vuchelen (1998), Revelli (2002), Schaltegger & Küttel (2002), Bordignon, Ceniglia & Revelli (2003), Feld, Josselin & Rocaboy (2003), Solé-Ollier (2003), Allers & Ellhorst (2005), Feld & Reulier (2005), Reulier & Rocaboy (2005), Hendrick, Wu & Jacob (2005), Fiva & Rattso (2006), Charlot & Paty (2007), Ellhorst & Fréret (2007), Leprince, Madiès & Paty (2007), Gérard, Jayet & Paty (2008).*
- Most of these studies focus on one dimension (one tax e.g.) and many assume that variations rather than levels might be compared
- Thus large differences between jurisdictions do not raise serious problems: they reduce the statistical significance of the overall relation, and they can be dealt with in part by the way of control variables.
- Actually, political differences across jurisdictions may even be valuable inasmuch as they serve to disentangle statistically yardstick competition from other processes that may be at work, mobility-based competition in particular.

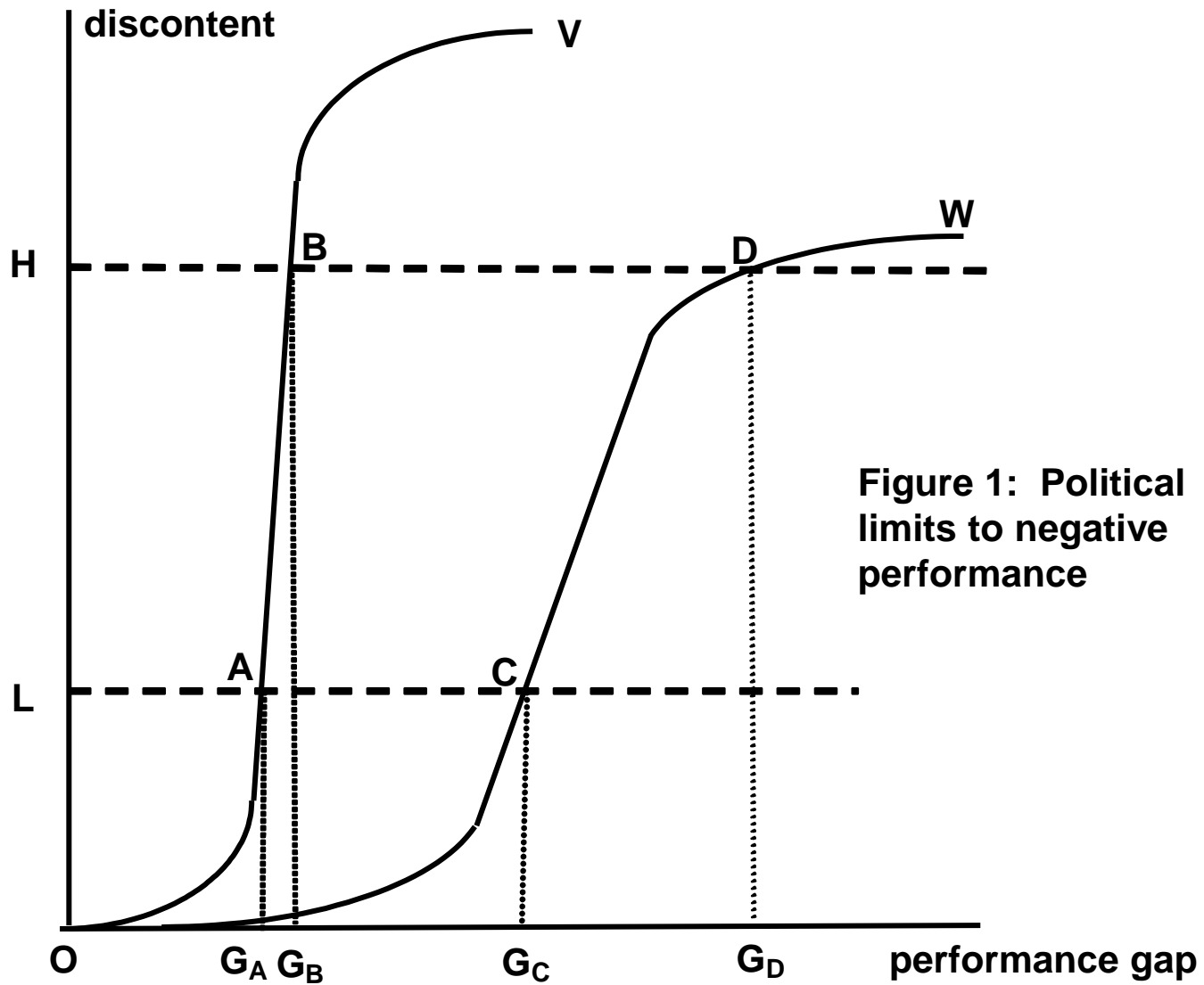
- **2.2 Multidimensional performance: the quest for justified assessments**
- **There are many dimensions of performance and they are subject to many complementarities and relations of substitution. Example:**
 - **Pensions and social security are more advantageous in jurisdiction A but the average level of wages is higher in jurisdiction B. Some time ago, the differences were smaller.**
- **Objective and transparent weighting of the different aspects is typically required by international organizations (and economists). Inspiration: the theory of agency and of contracts in which comparative performance has a quasi-automatic effect on remuneration and sanctions**
- **Application to the modelling of retrospective voting**
 - **The idea of retrospective voting was: “throw the rascals out” (Key 1966, Fiorina 1981) or “get rid of bad rulers without bloodshed” (Popper 1945)**
 - **The models (Ferejohn 1986) make three assumptions:**
 - **1) there is a threshold of underperformance beyond which voters decide to replace office holders;**
 - **2) the decision is collective and requires coordination or consensus among voters;**
 - **3) the assessment is asymmetric, in the sense that it does not matter whether performance is a little or very much above the limit.**
 - **If yardstick competition is considered in this context, any kind of ambiguity, heterogeneity among jurisdictions or lack of transparency in vertical responsibilities is an obstacle to accountability. Centralization may be better (Treisman 2006)**

- **2.3. Multidimensional performance: trusting the individual voter**
- **Each individual voter assesses the performance of the incumbents as she sees fit. If she uses comparisons she chooses the jurisdictions and the outcomes compared also as she thinks best. On election day, she decides alone to vote for or against the incumbents without any need to justify her choice. Many voters will be mistaken but, if we believe in democracy, we must suppose that on average the judgement of voters will be correct, in particular in handling large differences across jurisdictions.**
- **Incumbents know that some votes might be in part inspired by an assessment of performance and that such assessment may involve comparisons with what obtains in other jurisdictions. If political competition is intense and performance plays a role in it, each vote will count as seen by incumbents, and decision-making by the incumbents will take into account the fact that some voters compare outcomes across jurisdictions.**
- **In that context, incumbents see any improvement of their relative performance in any dimension as increasing, *ceteris paribus*, the aggregate probability of being re-elected, and, conversely, any deterioration as increasing the probability of being defeated.**

- **2.4 Shrinking dimensionality**

- **Circumstances may give one dimension of policy-making a major importance, and attract -- or so one should expect as seen from the outside – all the attention of voters.**
- **Enduring economic underperformance is particularly likely to gain such salience. As the negative gap between the rate of economic growth in a region and that in others persists, it seems reasonable to suppose that at one point this relative underperformance becomes predominant in the way voters evaluate the incumbents.**
- **But is it so?**

- **3. Yardstick competition and the persistence of large regional differences in economic performance**
 - **3.1. A theoretical framework**
- **From objective underperformance to discontent**
 - Region A suffers from a relatively low economic performance as is established “objectively” by economists
 - Direct comparisons with what obtains in other regions enable some voters to become aware of the gap; the greater the *objective gap*, the greater the awareness of it among voters – that is, the greater the *perceived gap*.
 - The perceived gap generates some degree of *discontent* among some voters; the greater the perceived gap, the more widespread and/or intense the *discontent* among voters.
 - Adding the two effects, the greater the *objective gap*, the more intense and widespread the *discontent* among voters.
 - The relation takes the form of S-shaped curves V and W



From discontent to policy change

- The reaction of office-holders to discontent depends on the political system.
- The horizontal lines passing through H and L on the vertical axis indicate the tolerance levels of discontent associated with the political systems -- that is, the level of discontent that would create a political crisis serious enough for compelling a change in the political personnel in power or, at least, a drastic policy change with the same office-holders.
- The line passing through L (tolerance low) corresponds to a “high contestability” political system and the line passing through H (tolerance high) correspond to a system in which contestability is low.
- These lines intersect with the curves at points A, B, C and D.
- Yardstick competition works best in A and worst in D; in B comparisons work well and their effect on discontent is strong, but the political tolerance of discontent is large; in C, the political tolerance of discontent is low but comparisons meet some obstacles and/or their effect on discontent is weak.

- **3.3. Factors that may in general increase political tolerance of performance gaps**
- **Factors that affect the political tolerance to discontent**
 - *persistent characteristics of the political system (whether the system is more presidential or parliamentary, degree to which the electoral system favours or hampers accountability, organization of the political parties notably across levels, status of referendum)*
 - more time dependent aspects of politics (term limits, date of next election, size of present majority)
- **Factors that may affect perceived underperformance**
 - obvious impediments to comparisons, (language, lack of information, etc.), complexity in establishing objective performance, weak salience of the regional level
- **Factors that may affect discontent**
 - clientele ties with the incumbents, loyalty to political parties, domination of ideological cleavages, expression of national concerns in the regional vote, salience of other specific issues.

- **Effects of changes in these factors**
- **An improvement in the political set-up applicable to all regions, as happened in Italy in 1995 making that set-up more competitive (Padovano & Ricciuti 2009), and consequently policy-making more responsive to voters' discontent, should have a particularly large effect on the performance of government in jurisdictions in which the relationship between underperformance and discontent is weak (see Figure)**
- **Is this relevant for the problem of persistent economic underperformance in some regions mentioned at the outset?**

- 3.4. Some particular causes of persistent economic underperformance in some regions

- The foregoing factors are not sufficient to explain the kind of enduring economic performance gap which is a matter of concern in the countries listed at the outset (Belgium, France, Germany and Italy).
- Explanations based on some characteristics of the political system or on a lack of political competition lack generality (political competition is at least as strong in Thuringia than in Bavaria, say)
- The starting point must be the widely made observation that the standard of living of the inhabitants of the regions concerned and their consuming habits are far from reflecting the negative economic performance gap.
- The reason, of course, is that the said regions typically benefit from a substantial transfer of resources from the other regions, some of the transfer relatively transparent but the bulk of it hidden (uniform public services)

- **The discrepancy between economic performance and income has three consequences:**
- **1) Economic underperformance is perceived but not experienced personally; thus it generates relatively little discontent**
- **2) comparisons made by inhabitants of a region with other countries similar in some sense with the region often tell these inhabitants that more economic performance abroad is associated with an inferior standard of living.**
 - **People in Guadeloupe or Sicily may envy the success of the tourism industry in the Dominican Republic or Greece, respectively, but they are not ready to compromise, at least in the short and medium terms, their standard of living and/or way of life to get comparable results.**
- **3) the deadlock is propitious to -- and made worse by -- the development of the Hirschman (1970)'s perverse exit-voice mechanism: the most dissatisfied citizens emigrate, which makes the situation even more sustainable**

- **Regions vs countries**

- **Disparities in performance across jurisdictions may thus remain or even increase without check over long periods of time, even under the assumption of a high level of information.**
- **This may happen to independent countries but national governments usually have the capacity or freedom and (as argued above) are given the incentive to improve economic performance.**
- **Both the freedom and the incentive may be lacking in the context in which regions are often placed.**
- **Thus, we can expect regional decline or stagnation to be a much more widespread and significant phenomenon and to extend over longer periods of time than the decline of countries as a whole.**

- **4. Concluding remarks**

- **Regional differences are not generally a serious obstacle to yardstick competition**
- **Yardstick competition is mainly a matter of information and, to work well, needs also political competition.**
- **But information and political competition (in the underperforming regions) are not the main problems in the cases of regional economic underperformance discussed here.**
- **In these cases, paradoxically, regional differentiation is not sufficient for yardstick competition to work and induce an improvement in performance**
- **The yardstick competition framework is useful if it helps understand better why this is so.**