

# General Grants vs Earmarked Grants: Does Practice Meet Theory?\*

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## Abstract

In the literature on fiscal federalism, both general grants and earmarked grants have their own roles for the efficiency and equity of the intergovernmental grants system. In practice, however, there is a clear tendency to favor general grants over earmarked grants in the design of intergovernmental grants. The European Charter for Local Self Government explicitly takes such a position and many countries try to transform earmarked grants into unconditional block grants. This paper discusses practical and theoretical factors that affect the form of intergovernmental grants based on international comparison studies and literature survey. In general, the principle of subsidiarity supports a simple and transparent formula-based general grants. However there is a trade-off between the principle of subsidiarity and equitable and efficient redistribution. In many countries, categorical block grants are used for the standardized provision of redistributive public services and efficient redistribution.

**JEL:** H2, H7

**Keywords:** general grants, earmarked grants, redistributive public services

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## 1 Introduction

The intergovernmental grants are important revenue sources for any country which has a decentralized government system. In many OECD member countries, the amount of intergovernmental grants is larger than 40 percent of local governments' revenue. Even for the countries which rely less on intergovernmental grants, their economic and political effects are significant. Therefore the optimal design of intergovernmental grants has been an important issue in the field of fiscal federalism. Especially, the choice between general grants and earmarked grants has been an important practical and theoretical issue for a long time.

In the economic literature, the theoretical view on this issue is not clear-cut but it can be said that both general grants and earmarked grants have their own roles for efficient and equitable resource allocation across local governments. Generally speaking, earmarked matching grants is desirable in the case when a local government's activity generates spillover benefits for other local governments. On the other hand, the principle of subsidiarity supports the use of general grants so that local governments have as much an independent decision-making power as possible. Also, in the case when central government has better capacity for raising tax revenue than local governments, general grants are required to fill the vertical fiscal gap. In short, the theoretical studies on the design of intergovernmental grants imply that general grants and earmarked grants are both necessary for efficient resource allocation and redistribution.

Despite these theoretical results, however, there is a general tendency that general-purpose grants are favored over earmarked grants in the actual implementation of the intergovernmental grants system. The European Charter of Local Self-Government is the well-known example in this respect since Article 9 of the Charter (henceforth, the European Charter) stipulates that earmarked grants should be avoided as much as possible.<sup>1</sup> Given the influence of the European Charter on the EU member countries, the outright advocacy of general grants over earmarked grants has a significant policy implication in the EU member countries. At the same time, it is quite curious why there is such a distinctive discrepancy between the position of the European Charter and the implication of the traditional economic theory.

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<sup>1</sup>"as far as possible, grants to local authorities shall not be earmarked for the financing of specific projects. The provision of grants shall not remove the basic freedom of local authorities to exercise policy discretion within their own jurisdiction."

Faced with this discrepancy, many countries appear to choose the position of the European Charter. Nordic countries launched fiscal reforms to transform many earmarked specific grants into block grants during the 1980s and 1990s. In the UK, the size of general grants had been predominantly larger than that of earmarked grants (ring-fenced grants) until 2007.<sup>2</sup> In Italy, the 2000 reform of intergovernmental fiscal relations clearly shows the country's preference for tax sharing and general grants over specific grants. The federal countries such as Germany, Austria, Australia, and Belgium have a system of tax sharing as a major source of subnational governments' revenue, which is a kind of formula-based general grants in the sense that it contains equalization component. In Korea and Japan, although both general grants and specific grants are important revenue sources for local governments, there has always been a tendency to try to transform specific grants into general grants or tax sharing.

This apparent trend, however, needs to be interpreted with caution. The size of earmarked grants in Sweden is almost as large as that of general grants despite the fiscal reforms in the 1990s. In Norway, the size of earmarked grants is about fifty percent of general grants, but still play an important role as central government's fiscal tool to control local tax rates (Borge, 2004). In Korea and Japan, the size and the number of specific grants are large despite the long efforts to reduce them. In the United States, a federal revenue sharing was abolished a long time ago, but specific grants are widely used. In the UK, the amount of ring-fenced grants is now larger than that of general grants, as a result of the introduction of education block grants.

To conclude, general grants are a preferred type of intergovernmental grants in many countries, but it is also true that earmarked grants, especially categorical block grants, play important roles as well. The question is then whether the theoretical and empirical research results are consistent with the actual practices that seem to show somewhat schizophrenic attitudes in the choice of intergovernmental grants: on the one hand, general-purpose grants are advocated as a better form of intergovernmental grants; on the other hand, categorical block grants are widely used.

In this paper, practical and theoretical factors that affect the form of intergovernmental grants are discussed based on international comparison studies and literature survey. In gen-

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<sup>2</sup>In 2007, a ring-fenced education grants, Dedicated Schools Grants, was introduced and the balance between general and earmarked grants significantly shifted toward the latter.

eral, the principle of subsidiarity supports a simple and transparent formula-based general grants. However there is a trade-off between the principle of subsidiarity and equitable and efficient redistribution. As a result, in many countries, categorical block grants are used for the standardized provision of redistributive public services and efficient redistribution. Also, since standard levels of redistributive public services are monitored or guaranteed by the central government even in the case when such services are finance by block grants, the dividing line between general-purpose grants and categorical block grants is not very sharp.

The paper is organized as follows. In the next section, the general grants and earmarked grants in selected countries are surveyed to get qualitative information on the historical and institutional factors that affect the design of intergovernmental grants. In section 3, after reviewing the key literature on the choice between general grants and earmarked grants, the theoretical implications on the balance between general grants and earmarked grants are discussed. Section 4 concludes.

## **2 General vs Earmarked Grants in Selected Countries**

### **2.1 Surveys of OECD and Council of Europe**

Despite the extensive literature on intergovernmental grants, there are not much empirical data on the balance between general and earmarked grants. Recently, however, both OECD and Council of Europe conducted survey studies to find out the trend and composition of intergovernmental grants. In the OECD study, Blöchliger and Rabesona (2009) conducted a survey study on the intergovernmental grants in the OECD member countries, and show that, on average, the shares of the two types of grants are roughly equal, indicating that the specific grants are as much important as the general grants as a source of local governments' revenue. Also, between 2000 and 2006, earmarked non-matching grants declined most noticeably in relative terms and the various types of matching grants increased.<sup>3</sup> With regard to the trend of the balance between the two types of grants, non-earmarked grants increased by more than 3 percent points, with an equivalent decline in earmarked grants during the said period, in-

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<sup>3</sup>Blöchliger and Rabesona (2009, p. 18).

dicating that the share of general grants, on average, slightly increased during the first half of this decade.

In the Council of Europe study, however, Lotz(2009) reports a different evidence on the balance between general and earmarked grants. In the report, the survey results of Council of Europe's pilot study cited therein indicate that the use of earmarked grants among the EU member countries has been increased. The main reason for this was that some EU member countries find it necessary to use earmarked grants to compensate local governments for their costs of complying with legislation on new competencies for local governments. The issue addressed in Lotz(2009) is whether the funding of new functions for local governments requires the use of earmarked grants since it is believed that well-designed general grants can also perform the same role. From a survey conducted on 21 EU member countries<sup>4</sup>, Lotz indeed finds that six EU member countries solely use general grants for the funding of new competencies of local governments.<sup>5</sup> However, six other countries use earmarked grants for compensation, and eight countries use mixture of general and earmarked grants for compensation.

An interesting question raised in this study is how some countries get to use general grants for compensation. When earmarked grants are used for the new competencies of local governments, conflict with decentralized decision-making can be an issue but measurement and compensation of the costs involved can be relatively straightforward. On the other hand, when general grants are used for compensation, it is in more conformity with the Article 9 of European Charter, but the link between financial assistance to local governments and their new spending responsibilities might not be clear. This in turn can invite the concern that local governments might not fully spend the intergovernmental grants for the new competencies. According to Lotz's report, the six countries that use general grants for compensation rely on well-defined indicators (criteria) for the distribution of the funding of new competencies. Also an open and transparent process in the determination of intergovernmental grants seems to be an important factor that makes it possible to use general grants for compensation. In this regard, it is notable that the countries that use general grants for compensation in the survey

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<sup>4</sup>The countries surveyed in the study are Belgium (Bruxelles-Capitale Region, Flemish Region, Walloon Region), Croatia, Denmark, Estonia, Finland, France, Greece, Hungary, Iceland, Latvia, Lithuania, Luxembourg, Malta, Netherlands, Poland, Portugal, Romania, Serbia, Spain, Sweden, UK (England).

<sup>5</sup>The six countries are Denmark, Finland, France, Luxembourg, Spain and UK (for England).

sample are the ones that have relatively mature system of decentralization.<sup>6</sup> So the choice between general grants and earmarked grants seems to be affected by the economic development and decentralization stage of a country. For a country with a short history of decentralization or weak democratic institutions, having a system of an open and transparent intergovernmental fiscal relations based on the dialogue among central and local governments is definitely a challenge.

## 2.2 Evolution of Intergovernmental Grants System

The studies by OECD and Council of Europe are very interesting cross-country comparisons with regard to the choice between general and earmarked grants. However, a shortcoming of the cross-country survey study is that it doesn't quite reveal a country's historical and institutional background surrounding the surveyed results. So now we briefly overview the intergovernmental grants system of the selected countries focusing on the historical and institutional characteristics that affect the balance between general and earmarked grants.

In Schwarz (2001) and Hermansson(2009), the local public finance reforms in Sweden that transformed many specific grants into a block grant are well explained. In Sweden, the size of specific grants was much larger than that of general grants until 1993, the year when a major reform took place to transform many specific grants into general grants. As a result, the share of specific grants in local governments' revenue fell from 19 percent in 1992 to 7 percent in 1993. By late 1990s, however, the number of specific grants grew again very rapidly. As a result the average share of specific grants in local governments' revenue was larger than that of general grants during the early part of this decade. Only very recently, the size of general grants has become larger than that of specific grants.

Another interesting feature of the intergovernmental grants in Sweden is that the general grant before 1990s was, according to Schwarz (2001), an open-ended matching grant. This is because the general grant in Sweden before 1990s was determined as the product of the local tax rate and the added tax base. This meant that an increase in the local tax rate accompanied by reduced tax base is subsidized by the central government which uses, for the purpose of the distribution of general grants, 'guaranteed tax base' that was above the average tax capacity.

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<sup>6</sup>The countries that use earmarked grants for compensation are Croatia, Latvia, Lithuania, Malta, Poland, Romania and Serbia.

Naturally, the rapid expansion of local public sector continued until major fiscal consolidation reforms took place in the 1990s. The historical observation of the Swedish intergovernmental grants system has the following implication. Firstly, contrary to the general expectation that the 1993 local finance reform in Sweden must have made the block grants to play a dominant role in Sweden, the role of specific grants has never been negligible in the country. Secondly, the reforms that transformed many specific grants into block grants were prompted by the need to consolidate the fiscal position of the central government, rather than to enhance the local governments' fiscal decision-making power. Thirdly, the fact that the general grant was a kind of open-ended matching grants does not quite fit the textbook definition of intergovernmental grants. But it reveals the fact that, in many country cases, general grants do not have the property of pure lump-sum grants that have only income effect and can have the price effect that stimulates local spending.

The example of the Sweden's general grant that had the characteristic of an opened-ended matching grant leads to a more fundamental question as to the exact nature of general-purpose grants. As Boadway (2001) notes, major public services in areas like health, education and welfare constitute a substantial component of public sector budgets, and in many countries are highly decentralized. In this case, even if the provision of such public services is financially assisted by general grants, it is unlikely that, given the redistributive nature of such public services, the central government do not monitor or control the amounts local governments spend for such public services. If minimum standards of certain types of public services are mandated, as would be very likely in the case of health care, education and welfare programs, the dividing line between general grants and earmarked grants becomes quite blurred.

In the case when redistributive public services are jointly provided by central and local governments, general-purpose grants that support the provision of such services often take the characteristics of categorical block grants. The case of education in the UK is a good example. In the UK, the general grant (Revenue Support Grant) included education component until 2007. But the question whether local governments actually spend the full amount of RSG that was distributed for local education has been controversial for a long time, and so-called "named and shamed" policy was used to make general grants to have the effect similar to that

of the categorical grants.<sup>7</sup> For the education, England has decided that the strategy of “named and shamed” is not enough to align the central government’s grants with local government’s expenditure, and an earmarked grant for education (Dedicated Schools Grant) was introduced in 2007.

The historical observation of the evolution of England’s education grants raises a fundamental question about the trade-off between local choice and central government’s desire to ensure a minimum level of some important public services. On this matter, Lyon (2007, p. 84) takes a critical view of the new system by mentioning that it reduced the scope of local authorities to prioritise and manage pressures between services. But this is exactly the intention of the central government which criticized local governments for not spending enough fiscal resources for education. Given that the central government tightly monitored the level of local education expenditures under the system of general grants, there might not be much difference between the old and new systems. But this episode indicates that the choice between general grants and earmarked grants ultimately depends on the value system of the society which changes with political environment.

In the case of Italy, it’s health care that creates tensions between decentralization and merit goods provision by local (regional) governments. In 2000, major fiscal reform took place in Italy that greatly replaced intergovernmental grants by local tax revenue (VAT tax sharing). This implied that provision of public services became much more decentralized than before. However the provision of health care, the biggest subnational expenditure item, was largely an exception since the constitution designates health care as an essential public service (Bro-sio and Piperno, 2008; Arachi and Zanardi, 2004). For essential public services, subnational governments are required to provide them up to specified levels in terms of quality and quantity. According to Arachi and Zanardi (2004, p. 345), the VAT sharing rate was adjusted in 2001, a year after the reform took place, to guarantee resources sufficient to finance the sum of all Regions’ standardized health needs. Thus in the case of Italy, even tax sharing takes the characteristics of categorical block grants for health care.

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<sup>7</sup>... recent trend has been for at least some Government Departments and their Ministers to make it absolutely clear that they expect the full amount of any increase in SSA for “their” service area to be passed on in full to that service. Councils which have failed to do this have been “named and shamed” by Government Departments in some cases. There is therefore a good deal of pressure to pass on SSA service increases in full to their respective service areas (North Yorkshire County Council, Corporate Policy Committee, 2000).

The case of United States is quite different from the countries discussed above. As is well known in the public finance literature, U.S. does not have the system of general grants or tax sharing, and specific grants are widely used to financially support subnational government.<sup>8</sup> Therefore U.S. takes a completely opposite position of European Charter with regard to the balance of general and earmarked grants. In principle there can be a good reason for this but, as Inman (1988) notes, only a part of U.S. system of federal grants to subnational governments can be explained by the standard efficiency and equity arguments provided by the fiscal federalism literature. There have been efforts in the US, however, to transform specific grants into categorical block grants. In the early 1980s, several block grants were created by combining similar types of specific grants.<sup>9</sup> An important recent case is the transformation of Aid to Families with Dependent Children (AFDC), an open-ended matching grant, into Temporary Assistance to Needy Family (TANF), which is a categorical block grant. As is discussed in Baker, Payne and Smart. (1999), a similar change took place in Canada where Canada Assistance Plan (CAP), originally an open-ended matching grant, changed to a closed-ended matching grant and then finally to a block grant. It should be noted that the purpose for these transformations of specific grants into block grants was not to increase subnational governments' decision-making power. As is criticized in Quigley and Rubinfeld (1997), the main reason for introducing TANF as block grant was to reduce the fiscal burden of the federal government.

The overview of the evolution of the intergovernmental grants systems of the countries in Europe and North America seem to have the following implications. First, in the area of redistributive public services, explicit or implicit categorical block grants are widely used as a way to financially support subnational governments that provide such services. Second, the textbook definition of intergovernmental grants often do not fit with the actual implementation of them. In the case of general grants and tax sharing, many implicit controls exist. In other words, general grants are not really general-purpose. As for the specific grants, matching grants are very often closed-ended rather than open-ended, as pointed out by Oates (1999). Therefore, in many cases, price effects are absent in the system of specific matching grants. Thirdly, because of the blurred dividing lines between different types of intergovernmental

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<sup>8</sup>According to Catalog of Federal Domestic Assistance (CFDA), the number of federal assistance was close to 2,000 in 2008.

<sup>9</sup>In US, block grants mean *categorical* block grants while in Nordic countries block grants mean *general-purpose* grants.

grants, the statistical data on intergovernmental grants used for international comparison have their limitations. In particular, there is limitation in understanding the exact nature of the balance between general and earmarked grants from the statistical data.

### **3 Literature Review and Implications for General vs Earmarked Grants**

#### **3.1 Efficiency argument for matching grants**

In the literature on fiscal federalism, the optimal design of intergovernmental grants has been studied for a long time, but it can be said that it is still an evolving subject, as are discussed in Oates (2005, 2008). The seminal works on the issue are Buchanan (1950, 1952), Oates (1972), Flatters et al. (1974), Boadway and Flatters (1982). These works have developed the concepts of fiscal equity and fiscal externality, and laid the theoretical foundation of intergovernmental grants.

In the papers by Boadway (2004, 2007), these concepts are well explained. The reason why intergovernmental grants can be efficiency enhancing is basically because migration of labor and capital across local governments creates fiscal externalities. In such a case, inter-regional transfers that internalize them are efficient. For example, in the model considered by Boadway and Flatters (1982) and Boadway (2004), fiscal externality arises as a result of the difference between a migrant's tax payment and the marginal cost of public goods provision. If there is no congestion effect in the provision of public goods, then the difference in fiscal externality depends on the difference in the migrant's tax payment, which in turn depends on, for example, the amount of resource rents a local government collects. In this case, intergovernmental grants that neutralize the differences in resource rent prevent inefficient fiscal migration. It should be noted that, in this case, the form of intergovernmental grants is the general grants since the objective is to equalize fiscal capacities of local governments rather than stimulate a particular type of public goods.

Another classic model that deals with intergovernmental grants that enhance efficiency is that of Wildasin (1991). In this model, redistribution is a local public good, which arises because the rich in a state are altruistic toward the poor living in the same state. Since it is

assumed that the poor are mobile across local governments, redistribution toward the poor in a state attracts welfare migration from outside creating fiscal externality or additional burden of redistribution to the rich. As a result, the level of welfare benefit chosen by the rich in each state is lower than the optimal level that would be chosen without the fiscal externality. In this situation, federal matching grants that support state's welfare program enhances efficiency by raising the level of welfare benefit in each state to that of the optimal level.

The form of the intergovernmental grants in Wildasin's model is open-ended matching grants that provide a subsidy to raise the level of benefits per mobile household but also increase in proportion to the number of beneficiaries (Wildasin, 1991, footnote 14). The welfare program AFDC in the US, cited in Wildasin (1991), did have this property, so at that time state welfare policy in the US was in conformity with economic theory. However AFDC was changed to TANF, a categorical block grant, during the 1990s. From economic theoretical point of view, this change is undesirable since it will lead to a race to the bottom or more accurately a downward bias in welfare benefit. So although the Wildasin model has attracted much attention in the theoretical literature<sup>10</sup>, it doesn't seem to have as much impact on the design of intergovernmental grants in the real world.

The key mechanism that makes a block grant undesirable in the Wildasin model is welfare migration. So Brueckner (2000) addressed this issue and did find empirical evidences that state's *perception* about welfare migration creates a downward bias in benefits, making him conclude that the demise of matching grants may be undesirable from a policy perspective. Brueckner notes several qualifications, however, that suggest that the switch from open-ended matching grants to a block grant might not be too problematic. First, a block grant can induce more flexibility and innovation from states. Second, the magnitude of fiscal externality and the matching rates of the matching grants can be negligible. More fundamentally, they are too hard to estimate to be implemented in a policy. Third, due to the flypaper effect, block grants can have stimulative effect. Fourth, institutional constraints such as eligibility have much larger effects than the form of intergovernmental grants. Bruecker also notes an important disadvantage of a block grant for welfare program, which is that it is insensitive to the recession-induced rise in unemployment.

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<sup>10</sup>See Dreze et al. (2007).

### 3.2 Local Redistribution: general grants or earmarked grants?

The efficiency of intergovernmental grants is a theoretically important issue and also its impact on the economy is hard to ignore. However, as Oates (1999, p. 1128) notes, interregional transfers are primarily justified on equity grounds. The justification of intergovernmental grants on equity ground is explained in Boadway (2004, 2007). Since vertical equity can be more effectively addressed by central government, the notion of equity that has relevance for intergovernmental grants is horizontal equity, which is defined as the equal treatment of equals by the public sector throughout the nation. A difficult issue, however, arises when horizontal equity is applied on a nationwide basis. According to Boadway (2004, p. 235), horizontal equity implies that “all regions must not only have the resources to apply national standards of redistribution, but they must actually apply them.” So, to explain the need for fiscal equalization, Boadway suggests the notion of fiscal equity under which “the role of equalization transfers is to provide regions with the resources that would enable them to meet national standards of redistributive equity if they so chose, but does not compel them to do so.”

Since the main reason intergovernmental grants exist in the real world is mostly for redistribution, the concept of “fiscal equity” suggested by Boadway is a helpful guideline that has an important implication on the form of intergovernmental grants. The intergovernmental grants that fiscally support but not compel local governments to meet national standards of redistributive equity is clearly general-purpose grants. But as Boadway (2004, 2001) recognizes, there is a fundamental conflict between the notion of horizontal equity that emphasizes the nationwide standard of redistribution and that of fiscal equity under which the ultimate decision-making on redistribution is left to local governments.

In a sense, the evolution of intergovernmental grants systems in many countries discussed in the previous section reflects the fundamental conflict between horizontal equity and fiscal equity. In deciding the way to finance important redistributive public services such as education, health care and welfare programs, the pendulum has swung back and forth between these two concepts in most of the countries. In the UK, the recent introduction of Dedicated Schools Grant, a ring-fenced education grants, was the result of a long conflict between fiscal equity and horizontal equity. A similar tension between the two concepts is also affecting the way health care is financed in Italy. In Korea, there was an effort in 2005 to decentralize

the provision of welfare programs by transforming specific grants for welfare programs into a general grant. But this has been met with strong criticism that such a change considerably weakened local welfare programs.

In evaluating the roles of general grants and earmarked grants in the provision of public services, another issue that needs to be noted is that, in some countries like Italy and Denmark, regional governments are mainly responsible for health care. In this case the lines dividing tax sharing, general-purpose block grants, and earmarked grants are quite thin since there is not much competition between different types of public services at the regional level. That is, even if the major financial resource for health care is VAT tax sharing in Italy or block grants in Denmark, they are not much different from earmarked grants to the states in the US and Canada which are responsible for providing many different types of public services. Given that money is fungible, there is even a possibility that categorical block grants to the states that provide many kinds of public services are more general-purpose than the tax sharing or general-purpose grants to regional governments whose major responsibility is providing a single type of public service such as health care. In this sense, in the case of providing the critically important public services like health care, it is rare to find a country in which subnational provision of such public service is financed by a pure form of general-purpose grants.

### **3.3 Political Economy**

In the previous discussion on general-purpose versus earmarked grants, the focus of the analysis was the subnational provision of redistributive public services such as health, education and welfare programs. As Boadway (2007, p. 57) argues, this approach is distinguished from classical view of fiscal federalism, in which the central government has the sole responsibility for redistribution and subnational governments are providing local public goods.<sup>11</sup> In the classical view, the main role of intergovernmental grants is to internalize the spillover effects of local public goods, and therefore matching grants is the chosen type of intergovernmental grants.

As Boadway explains, this classical view does not accurately depict the actual role of the

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<sup>11</sup>Following Bewley (1981), local public services refer to the publicly provided private goods and local public goods refer to the public goods that exhibit economies of scale.

subnational governments in the countries with mature decentralized system. The local governments in most OECD countries share with central government the responsibilities of providing redistributive public services. Since the expenditure on redistributive public services dominate that of public goods in this economy, the classical view of the role of local governments has a narrow range of application. As Boadway argues, the spillover managing role of grants is of limited relevance in mature decentralized system.

Even if this interpretation is generally correct, however, it does not fully answer the question why the European Charter decisively advocate general grants over specific grants. For redistributive public services, implementation of this position is not very clear-cut and not much fruitful either for the reasons discussed above. However, in the case when local public goods generate spill-over effects, the use of earmarked matching grants can still be desirable. It is often suggested that the size of spillover effects is so hard to estimate that the matching rates of earmarked grants do not correctly reflect the magnitude of spillover effects. But it doesn't seem that the difficulty of finding the right matching rates is the reason for the European Charter's decisive position on specific grants since it implicitly assumes some kind of undesirable effects of specific grants.

To this question, the recent literature on political economy of fiscal federalism seem to provide some answers. In Sato (2007), many political economy aspects that influence the system of intergovernmental grants are explained. An interesting theoretical issue is whether political competition generates efficient equilibrium, as addressed in Dixit et al (1997). However the issue more relevant for our discussion is how the political economy factors affect the balance between general and earmarked grants. There is not much political economy literature directly dealing with this issue. However, the pork barrel politics and rent seeking lobbying activities seem to have an important implication on the desirability of specific grants. The pork barrel politics refer to the efforts of politicians to use central government's grants to strengthen their own political positions. As a result of pork barrel politics, a disproportionately large amount of central government grants can be provided to swing districts or used to build cohesion within governing legislative coalitions (Milligan and Smart, 2005). In either case, grants distribution affected by the pork barrel politics is not efficient, nor fair. Local governments' lobbying activity to gain more grants from the central government has the same implication

since it reinforces pork barrel politics.

If pork barrel politics and rent seeking are important issues to be concerned about in designing the system of intergovernmental grants, it seems reasonable to make an effort to minimize specific project grants, which are usually discretionary and therefore more susceptible to pork barrel politics than formula-based general purpose grants. The recent empirical studies on this issue seem to provide some empirical evidence to support this view: Sole and Sorribas (2008) find an evidence of pork barrel politics in the distribution of specific project grants in Spain; Leigh (2008) finds the evidence of pork barrel politics in the distribution of discretionary programs in Australia; and Cadot et al. (2006) find that lobbying activities influence the regional distribution of infrastructure spending in France.

Although these evidences seem to support the European Charter's position to favor general grants over earmarked grants, it should be noted that there are views, especially in Nordic countries, that formula based block grants are also susceptible to distributive politics. In empirically investigating the influence of distributive politics on intergovernmental grants in Norway, Sorensen (2003) implicitly assumes that the distribution of the total amount of block grants and specific grants is influenced by distributive politics. Johansson (2003) is more explicit about this approach. In Sweden, the largest share of intergovernmental grants is distributed to the municipalities by civil servants according to detailed regulations. Therefore parties lack the opportunity to distribute grants according to tactical considerations. However, Johansson argues that parties can influence the rules of grants distribution themselves, and therefore formula based block grants are also susceptible to distributive politics.

### **3.4 Budget Control**

Despite the vast literature on factors influencing the balance between general and earmarked grants, a casual observation of the changes in the intergovernmental system throughout many countries indicates that a major reason for such changes was the central government's effort to reduce budgetary burden of intergovernmental grants. As was criticized by Quigley and Rubinfeld (1997), the main motivation of transforming AFDC, an open-ended matching grants, into TANF, a categorical block grant, was to reduce the budgetary burden of the federal government. Also, the fiscal reforms in Nordic countries that transformed specific grants into

general grants took place during 1990s when economic crisis hit the region.

As Oates (1999) observes, most of matching grants in practice are closed-ended rather than open-ended. Since the effect of closed-ended matching grants is similar to that of categorical block grants, this aspect is not easily explained by traditional economic theory. In Huber and Runkel (2006), this issue is investigated and it is argued that the use of categorical block grants is a second-best policy required by the self-selection constraint of contributing regions under the environment of asymmetric information. Intuitively, the closed-ended matching grants, which induces receiving regions to oversupply a certain type of public service, make the interregional redistribution reasonably unattractive to contributing regions so that it does not violate the self-selection constraint.

The analysis by Huber and Runkel seems to suggest an interesting implication on the balance between general-purpose block grants and categorical block grants. As a budgetary device to control the central government's fiscal burden, categorical block grants can be a better choice than general grants from the second-best point of view since the former makes the interregional redistribution not too much attractive. If fiscal decentralization in a country relies too much on general-purpose grants or tax sharing with strong equalization component, the use of categorical block grants can be efficiency enhancing as well as desirable on equity grounds.

#### **4 Conclusion**

In this paper, intergovernmental grants system has been evaluated focusing on the balance between general grants and earmarked grants, motivated by the position envisaged by the European Charter which unequivocally advocates using general purpose grants as much as possible. The international comparison of intergovernmental grants system shows that, although the general purpose grant is a favored type of intergovernmental grants, categorical block grants play an important role, if not the major role of financing subnational public goods and services.

In the countries with mature decentralized system, subnational governments share with central government the fiscal burden of financing the redistributive public services such as health

care, education and welfare programs. In terms of expenditure size, the subnational government's responsibility of providing such services dominate that of providing public goods that generate spillover effects. Because of this there is a fundamental conflict between political demand for standard level of redistributive public services and the principle of subsidiarity emphasized in the European Charter. There is no clear-cut answer to this question, but, in many countries, explicit and implicit types of categorical block grants are used to strike the balance between standardized redistribution and the principle of subsidiarity.

The literature on political economy of fiscal federalism, however, does provide some reasons for the preference for general purpose grants. The theoretical and empirical literature on the pork barrel politics and rent seeking activities show that they are both inefficient and inequitable. Since it is believed that discretionary specific grants are more susceptible than formula based general grants, advocacy of general purpose grants can be interpreted as an effort to minimize pork barrel politics and rent seeking. But it needs to be noted that, in some literature on the distributive politics in Nordic countries, general purpose grants are regarded as susceptible to distributive politics.

Among the many factors that affect the form of intergovernmental grants, central government's budgetary concern appears to be an important reason that has made open-ended matching grants transformed into general purpose grants or categorical block grants. Then there is a question whether general-purpose grants or, more broadly, tax sharing with equalization component is a better device for budget control than categorical block grants. Since the latter makes the interregional redistribution reasonably unattractive to contributing regions, categorical block grants can be both second-best efficient and equitable alternative. This view has important implications for the countries in which interregional redistribution is based on a large amount of general purpose grants.

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