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Decentralization as an incentive scheme when regional differences are large*

by

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Abstract

It has been suggested that large regional differences could be an obstacle to that part of the political accountability of office-holders which is based on yardstick competition among governments. The paper addresses that question and concludes that the obstacle is not too serious in general. The second part of the paper is devoted to the persistent economic underperformance of some regions in countries such as Germany, Italy and (with regard to regions overseas) France. How is it that the mechanism of yardstick competition induces a convergence of economic performance among European Union member countries, even those particularly poor initially, but fails to induce all the underperforming regions of these countries to catch up? A small model is used to explore that question. In the case of the persistently underperforming regions, it turns out that the degree of regional differentiation is not sufficient for yardstick competition to work and bring about an improvement in performance. The yardstick competition framework remains useful if it helps to understand more clearly why this is so.

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1. Introduction

The existence of large differences among regions occupies a large place in the current debate on decentralization and federalism in countries such as Belgium, Germany, Italy and Spain. In the case of France, a discussion in a sense similar is about regions overseas such as Guadeloupe, Martinique and Reunion. To discuss the implications of these differences, it is convenient, at the cost of some simplification, to distinguish between three economic perspectives on federalism and decentralization. Large spatial differences are essential to the first, may or may not be the source of a difficulty for the second, and threaten the relevance of the third. This paper is focussed on the third approach but a few words on the first two may bring the discussion in context. The first and earlier perspective may be referred to as “the traditional theory of fiscal federalism”. It concentrates on the assignment of competencies or tasks across levels of government, solutions to the problems that any assignment will raise (spillovers, equity, etc), and the ways subcentral governments are to be financed (Oates 1972). The assumption that many public policies - in particular, the provision of some categories of public goods - must be spatially differentiated is central to it. The larger the spatial differences among the preferences, needs or conditions of individuals, the stronger the case for decentralization and, when regions are concerned, federalism. When some differences are specific to particular regions, the traditional theory has no difficulty of principle to recommend a special status for these regions, a matter usually referred to as “asymmetric federalism”.

Two objections to the theory are that it is based on an idealized view of government and that it does not acknowledge the fact that central governments in unitary states often have the capacity (in particular thanks to their local agents) to introduce spatial heterogeneity in some policy areas while maintaining homogeneity in others, in both cases as needed. Many analyses worked out in the framework of the traditional theory remain valuable for the study and understanding of aspects of decentralized systems once these systems are in place. But for the justification of decentralization, and perhaps also to explain the forms it takes or the way it evolves, the introduction of political economy considerations is needed.

The second and third perspectives are based on such considerations, albeit ones which are different in the two cases. The second perspective may be called an

ademocratic political economy theory of federalism because the various analyses that it includes have in common a jaundiced view of government, unfettered faith in the working of markets, and no particular attention given to democratic processes. It portrays government as, at least potentially, predatory or the prey of interest groups (including its own bureaucracy). Thus, perhaps the main purpose of federalism is to discipline it (“taming the Leviathan”) by the way of jurisdictions competing among themselves for residents and investment (Brennan and Buchanan 1980). A more recent analysis stresses that the distribution of regulatory competencies among levels must be “market preserving” (Weingast 1995). And, more recently again (in particular with the case of China in mind), the recommendation is that the distribution of the benefits of economic growth be such that it induces subcentral governments to pursue it (Jin, Qian and Weingast 2005). To stress its distinctive characteristic again, in this general approach the question of whether governments on the different levels are democratic or not is largely irrelevant.

As to regional differences, they enter the reasoning only as the result of competition. Regions that succeed thanks to their policies are richer, more populated and have a higher rate of growth than those whose policy is less market- or growth-oriented. The rulers of the regions which succeed are rewarded by increased rents. Because all office-holders are assumed to understand this, all regions pursue the same objectives and the *ex ante* outcomes are more or less identical, even if, *ex post*, they may differ. The possibility that, from the start, some regions have a natural advantage or disadvantage of some kind and thus that competition among regions may be unbalanced – so much so that some regions may even decide not to participate in it – is a major objection to the approach (Cai and Treisman 2005). A second objection is that not only bad policies may be eroded by mobility-based competition, but also “good” ones (the “race to the bottom” possibility) or, at any rate, policies to which the population is strongly attached. As a consequence, in democracies the *ademocratic* characteristic of the second approach may well turn out to be unsustainable.

The democratic dimension is central to the third perspective. To be precise, because in all political regimes office-holders typically seek some consent from the population, the relevance of the approach is not limited to democracies in a narrow sense of the word (see Breton 1996). For convenience, however, we will refer to voters,

incumbents and elections. In democracies, the relationship between voters and politicians in office is multifaceted (Przeworski, Stokes and Manin 1999). We will consider here only the strand of political analysis that stresses the electoral accountability of office-holders. In it, the impact of decentralization or federalism is particularly direct. This is so because accountability is, in many policy areas, enhanced by “yardstick competition”.

In a nutshell, the idea is as follows. Office-holders want to be re-elected. If political competition is strong, this outcome is uncertain. Voters decide, to a degree at least, on the basis of their perception of how the government performs or has performed – the idea of “retrospective voting”, broadly understood. Their choice, however, is affected by information asymmetry. To assess public policies, voters do not have all the information that office-holders detain and they cannot rely completely on what they are told (not only by incumbents and other candidates, but also by interest groups, the media, etc.). In a world submitted to rapid historical change and various kinds of shocks, the obstacles voters encounter in many policy areas to assess the performance of government are substantial. Comparisons by voters between what obtains in the jurisdiction and what is the case in others – or, more generally, between what different governments, whether on the same or on different levels, do – may mitigate these difficulties. In turn, the fact that office-holders are aware of the existence or possibility of these comparisons affects their decisions. They want to be judged as performing comparatively well. This is the basis of what has been called “yardstick competition” among governments, which, under favourable circumstances, may strengthen in governments (not only politicians in office) the right kind of incentives.

For these comparisons to be at all possible, the co-existence of several governments is necessary. Federalism and political decentralization imply such co-existence and consequently offer a way to make office-holders more accountable. But comparisons raise various problems. One of the most serious is comparability. In Salmon (1987), the mechanism referred to today as yardstick competition was proposed as providing an argument for decentralization that is not based, contrary to the traditional theory of federalism, on spatial differentiation. This did not formally imply but could suggest that large differences among jurisdictions are an obstacle to effective comparisons. Actually, the affirmation that they are may be found here and there in the

literature. In the first part of the paper, thus, we discuss the degree to which large differences among regions may be an obstacle to yardstick competition. Governments may also compete for a good comparative evaluation with governments on other levels (central, regional, municipal). This is a form of vertical competition. As such, though important, we will not discuss it here (see Breton and Frascini 2003, Breton 2006), our analysis being limited to horizontal competition.

But there is another side to the matter. One may argue (Salmon 2003, 2006, *e.g.*) that yardstick competition at the level of the member countries of the European Union (EU) contributes to bring about a convergence of economic performance. If one country does a bit less well for a while (France, Italy), then forces related to yardstick competition tend to emerge that trigger reforms producing some catching up in subsequent periods. If one country is singled out for a time as doing much better (Britain), it is imitated and thus after a while loses its advantage or most of it. With regard to trends, some entrants (Greece, Ireland, Spain, Portugal) started from a level of economic development much lower than the EU average, others (Denmark, Sweden) from a level somewhat higher. In most cases these differences eroded in the course of time. We may expect many of the entrants of the last enlargements, all of them initially much poorer than the EU average, to catch up in a similar way.

It is interesting for our purpose to note that, along many dimensions, the member countries of the EU were and remain very different. Their political institutions and practice, their legal institutions and practice, their economic specialization, the way they organize their health, education and welfare systems, the structure of their budgets and many other structural characteristics vary widely. This does not prevent a convergence of economic performance as well as of several important components of social performance (Coelli, Lefèbvre and Pestieau 2008).

Along the same dimensions (political and legal systems, educational, health and welfare systems, etc.), the differences across the regions of a same country are typically much smaller than the differences across EU countries. This should be favourable to even greater or more rapid economic convergence. But this is not always the case. In four of the five countries mentioned at the outset, Belgium, France, Germany and Italy, the concern manifested with regard to large regional differences is principally a concern with a part of the country (the regions overseas in the case of France) not catching up

with the rest. How can we explain that, in some countries, yardstick competition fails to prevent the persistence of large regional differences in economic performance? This is the question explored in the second part of the paper.

2. Are large regional differences an obstacle to yardstick competition?

Large differences between jurisdictions seem an obvious obstacle to the feasibility of relevant comparisons and thus to yardstick competition. Whether they constitute a serious obstacle or not depends on the nature of the questions asked or the perspectives adopted. We should distinguish here between the empirical work, usually focused on the interaction between a limited and precise set of variables, and views about the systemic role that yardstick competition may play, under decentralization, in enhancing accountability. Two different perspectives on this systemic role should be distinguished. Large differences are a serious obstacle in the first, less so in the second.

2.1. Empirical studies in public finance: one dimension

In the domain of public finance, understood broadly, there is now a substantial number of empirical studies that refer to yardstick competition.¹ A typical approach is the following. Studies identify spatial interactions affecting one single variable (a particular tax for instance). These interactions may reflect various mechanisms or phenomena: some spillover effect of a non-political kind, an independently similar response to some common circumstances or change thereof, mimicking behaviour on the part of office-holders. Mimicking behaviour, in turn, may be related to one form or another of yardstick competition or to mobility-based competition. The way to disentangle these possible mechanisms (which may account for the same observed spatial interaction) and identify the presence of yardstick competition is to relate the spatial interaction with some political variable (term limits, size of the governing majority, date of the next election, popularity, probability of being re-elected, use of referendum). If such political variables prove significant, this will tend to comfort the interpretation of spatial

¹ An incomplete list includes Besley and Case (1995), Ashworth and Heyndels (1997), Heyndels and Vuchelen (1998), Jayet, Paty and Pentel (2002), Revelli (2002), Schaltegger and Küttel (2002), Bordignon, Ceniglia and Revelli (2003), Feld, Josselin and Rocaboy (2003), Solé-Ollé (2003), Allers and Elhorst (2005), Hendrick, Wu and Jacob (2005), Leprince, Paty and Reulier (2005), Revelli (2006), Vermeir and Heyndels (2006), Fiva and Rattsø (2007), Revelli and Tovmo (2007), Elhorst and Fréret (2008).

interaction or mimicking behaviour as a manifestation of yardstick competition. In some cases, the evidence only confirms the existence among politicians in office of a belief that voters engage in comparisons, not the fact that voters do that, but this possible limitation can be dealt with by the assumption that politicians are rational. In other cases, there is some empirical evidence that mimicking improves re-election prospects.

The empirical studies employ statistical techniques. Some differences across jurisdictions (term limits, or the role given to referendums, for instance) are welcome because they allow to discriminate between several explanations of the same mimicking behaviour and thus to confirm or disconfirm the role of yardstick competition. Other differences are not welcome but their effect is only to reduce the statistical significance of the overall relation or they can be dealt with in part by the way of control variables. Many studies are concerned with a relation not between the levels of variables such as taxes but between their variation (for instance, increases in taxation in each jurisdiction related to increases in taxation in other jurisdictions) and this relation may be assumed to be less affected by interjurisdictional differences.

In fact, existing large differences among jurisdictions do play a significant role in empirical work, albeit in a mostly implicit or invisible way. Typically, the jurisdictions studied are a subset of those that could be considered: regions in one country only, or local government in a particular part of a single country (Flanders, or the region around Milan, or that around Chicago, for instance). This may reflect either practical constraints or the opinion that comparisons extended to a larger space are unlikely to be made or are irrelevant because then the differences across jurisdictions would be too large.² The fact or assumption, in some studies, that the interactions are stronger between *contiguous* jurisdictions is ascribed to the likelihood that these jurisdictions are easier for voters to compare, and this in part because they are more similar, which is an explicit way to acknowledge that dissimilarity counts.

Altogether, from the perspective of empirical work, differences seem to be manageable, even when relatively large. But we must not forget that, in most of the empirical work, the underlying assumption is that yardstick competition takes place along a single dimension, or, implicitly along dimensions that are independent and can be studied separately. In one study, voters are assumed to compare the levels of the

² See Gérard, Jayet and Paty (2008) for a direct investigation, on Belgian data, of the impact of one difference, language.

property tax. In another, they are assumed to compare the levels of the business tax. In another still, voters compare the level of social expenditures. These studies are held to be compatible. This is standard practice in empirical work and it is perhaps also acceptable, as we will see shortly, under one of the two broader perspectives on the systemic role of yardstick competition referred to above. Under the other perspective, which we discuss first, large differences are more difficult to handle.

2.2 The quest for justified assessments of multidimensional performance

Under the systemic perspective discussed in this subsection, the accountability of office-holders is supposed to depend on the capacity of voters to make objective or justified assessments of performance. That requirement has two intellectual sources. First, it stems, naturally it seems, from the concerns of independent individual observers such as economists and statisticians or from neutrality constraints that international organizations such as the International Monetary Fund, the OECD and the World Bank must respect. Because of their deontological obligations, both these individuals and these organizations, when undertaking to evaluate or compare the performance of governments, are obliged to seek objectivity and to justify their results. When differences between jurisdictions are large and there are many policy dimensions, comparative evaluations satisfying these conditions are complex and contestable.

For convenience, let us assume that jurisdictions A and B are two countries rather than two regions. They have very different clusters of characteristics. Pensions, social security and unemployment benefits are more advantageous in country A but the average level of wages is higher and the rate of unemployment lower in country B; some time ago, the differences were smaller. Gauging the overall performance of the two governments or “national models” is tricky. Because of complementarity between the characteristics, considering only one of them would be questionable or unfair.³ But the weights put on the various dimensions to construct aggregate indexes depend on value judgements which can be questioned and must be explicit. It is quite natural to transpose to the level of individual citizens or voters the ideals that guide economists and international organizations. However, if it is difficult for trained economists and statisticians in the academia or in the staff of international organizations to make

³ For a criticism along that line of some of the literature on corporate governance, see Salmon (2006).

satisfactory comparative assessments when interjurisdictional differences are large, how implausible it is, it seems, that voters' assessments can be other than haphazard or arbitrary.

Although (as noted) we do not consider vertical competition here, let us observe in passing that the requirement of objectivity and transparency applies also to comparative evaluations of the performance of governments situated on different levels of the governmental systems. At a minimum, it is claimed, one should be able to say what government is responsible for what policy outcome. This suggests that competencies must be clearly defined and concurrency avoided. If this is not the case (and it will never be the case in practice, notably because of vertical competition), then a separate objective assessment of the different governments is difficult for experts to achieve and completely implausible when ascribed to voters.

The second intellectual influence leading to the requirement of objectivity and justification is the theory of agency as elaborated originally for the private sector. Mechanisms identified in the framework of that theory are assumed to underlie also the relationship between voters as principals and office-holders as agents. Yardstick competition itself (or, as in Salmon 1987, "contests and tournaments") is an instance of adaptation which will not be questioned here. But the transplant of other aspects of the theory of agency, in particularly those related to the notion of contract, are often too direct or literal, with implications that one is tempted to judge misleading. In the theory of contracts and incentives, in its original habitat, the necessity of some clarity in performance criteria follows from the fact that remuneration is related in an automatic or quasi-automatic way to the evaluation of performance. Good and bad performance are rewarded and sanctioned under conditions which must be contractually defined in advance – even if this is done only in broad terms (as stressed, actually, by the economic theory of contracts itself). As is well known, the automatic realization of contractually defined rewards and sanctions may generate perverse incentives, especially when the jobs assigned to agents include many tasks, unevenly definable or measurable, and it can prove catastrophic in unforeseen circumstances, as experienced recently in the financial markets. In particular, yardstick competition – that is, here,

remuneration based on automatic relative assessments of performance – may prove quite perverse in some contexts. But it is often the case that doing without it is worse.⁴

These are general remarks. When transposed to the question of the electoral accountability of office-holders, the contractual interpretation of the theory of agency has been used to give some rigour and precision to the pre-existing theory of retrospective voting. In the language of American political science (Key 1966, Fiorina 1981), the basic idea of retrospective voting is captured by Madison’s formula: “throw the rascals out”. But we may also cite Popper (1945), for whom democracy is merely a system in which “the ruled can get rid of bad rulers without bloodshed”. When formalized under the inspiration of a contractual version of the theory of agency (see Ferejohn 1986, *e.g.*), the theory typically involves three assumptions: first, there is a threshold of underperformance at which voters decide to replace office holders; second, the decision is collective and requires coordination or consensus among voters; third, 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 introduced in this context, any kind of ambiguity, heterogeneity among jurisdictions and individuals, or lack of transparency in vertical responsibilities is an obstacle to accountability. Ultimately, accountability objectives may be better served under centralization than under decentralization (Treisman 2006).

In the context of yardstick competition, the insistence on transparency and objectivity, even though inspired by concerns about democratic accountability, is often exaggerated. It underestimates the capacities of voters. But the idea of a contract between the electorate and the government and the ensuing requirement of coordination among voters are worse. They are misleading for most intellectual purposes. The idea of a threshold and that of asymmetry, properly reinterpreted, remain useful in some contexts, such as the mainly single dimensional one we will assume in the second part of this contribution. However, on a systemic level and when the multidimensional characteristics of the setting are essential, an image of accountability and yardstick competition different from the one underlying the perspective just discussed seems preferable, as explained now.

⁴ See Salmon (2005) for a balanced analysis along that line of the kind of benchmarking proposed by the World Bank in its *Doing Business* reports.

2.3. Trusting the individual voter's assessment of multidimensional performance

Under this second perspective, each individual voter assesses the performance of the incumbents as she sees fit. She may put any weights she wants on the different dimensions of the policy outcomes, without having any justification to provide or any obligation to remain fair or objective (or, for that matter, rational). The fact that there are many dimensions to the performance of incumbents raises no problem of aggregation at this individual level. To form an opinion, the individual voter can use any means that she finds appropriate. She may seek or follow advice from any source. She may use comparisons with what obtains in other jurisdictions if she has the occasion and feels inclined to do so. To make these comparisons, she chooses the jurisdictions and the outcomes compared which she thinks appropriate. In the end, on elections day, she decides to vote for or against the incumbents, again without any need to justify that decision, which may be inspired by a comparison of platforms, a subjective evaluation of performance, or, for that matter, the differential personal appeal of the candidates.

The incumbents do not know how each voter will vote. They know that some voters will never and some others always vote for them but they are uncertain about the votes of many. They are aware 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. But office-holders don't know exactly on what matter and with what jurisdictions these comparisons are made. Many voters will be mistaken. For instance, they will misjudge what obtains elsewhere. But if we believe in democracy we must assume that on average and as a rule the judgement of voters will not be widely incorrect. Voters will not on average compare what is not comparable. On average, they will manage somehow to deal correctly with large differences across jurisdictions.⁵ 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.

⁵ Breton and Frascini (2003) and Breton (2006), on the one side, and Geys (2006), on the other, discuss in a different way the implications of assuming that voters compare across jurisdictions some indicator of the tightness of the relationship between services delivered and taxes paid – *i.e.*, “Wicksellian connections” in the first case, “efficiency” in the second.

Whether this perception of office holders is important or not depends mostly on the intensity and nature of political competition and in particular electoral competition. The intensity may be deemed high if incumbents are very uncertain about their chances of being re-elected. But also the nature of competition must be such that the performance along the different dimensions plays some role in the outcome. If the two conditions are satisfied, each vote will count, as seen by incumbents, and decision-making by the incumbents will take into account the fact that there are voters comparing outcomes across jurisdictions even if it is known that few of them do so.

Provided the *ceteris paribus* clause just mentioned is kept in mind, that systemic view of yardstick competition justifies, even when there are many policy dimensions in reality, the piecemeal empirical approach in public finance discussed earlier. Both the systemic view and the empirical work imply that interjurisdictional differences are not insurmountable obstacles to the working of yardstick competition.

2.4 Shrinking dimensionality

Even though voters make up their minds on the basis of all sorts of considerations, and the comparisons among jurisdictions some of them engage in may be about all sort of items, it is often the case that circumstances make one dimension of policy-making acquire a major importance, and attract – or so one should expect as seen from the outside – most of the attention of voters. This is likely to be especially the case when the relative performance of government along that dimension is seriously inferior to that which should be expected.⁶ Persistent economic underperformance is particularly likely to gain such salience. Voter X is principally attentive to the facilities for sports and recreation available in his or her region compared to those offered in neighbouring ones, and he or she is also, albeit moderately, concerned with the relative growth rates in the regions. But as the negative gap between the growth rate in his or her own region and that in others increases, at one point this relative underperformance becomes predominant in X's mind and in the way X assesses the incumbents on the occasion of the election. If many voters change their priorities in this way, this allows us to revert, in part at least, to the theoretical interpretation of retrospective voting summarized (and criticized) earlier.

⁶ This is asymmetric accountability again. There is some empirical evidence supporting it. Electoral choices seem to be more influenced by dissatisfaction than by satisfaction. See James and John (2007).

3. Yardstick competition and the persistence of large regional differences in economic performance

3.1. A theoretical framework

Suppose that region A suffers from a relatively low economic performance. The performance gap is measured along a single dimension. It is established “objectively” (never mind the criticism of objectivity implicit in Section 2) by economists using comparisons with other regions in a sophisticated way.⁷ For instance, the apparent relative underperformance of a region is due (at least for a while) to a change in international prices about which the regional government can do nothing. Economists will correct for this. We will not suppose that voters notice what economists say, although their opinion may play a role in the political debate, but that direct comparisons with what obtains in other regions eventually enable at least some voters to become aware of the gap. We may assume that the greater the *objective gap*, the greater the awareness of it among voters – that is, the greater the *perceived gap*.

A perceived gap will generate some degree of dissatisfaction or discontent among some voters and, in a similar vein, we may assume that the greater the *perceived gap*, the more widespread and/or intense the *discontent* among voters. The two effects can be combined and we may assume that, altogether, the greater the *objective gap*, the more intense and widespread the *discontent* among voters. The relation, however, is not linear. In Figure 1, it takes the form of S-shaped curve V. A small gap is not perceived at all: up to a point, its effect on discontent is zero. Above some level of the gap, the marginal effect becomes strictly positive and is increasing. And above a still higher level, the marginal effect of the gap on discontent is still strictly positive but decreasing. At one point it may become zero. Curve V represents a case in which the reaction of voters to objective underperformance is strong. For reasons to be discussed shortly, the effect of objective underperformance on discontent may be weak. This is reflected in Figure 1 by curve W.

[Figure 1 about here]

⁷ For an early instance of such exercise at the international level, see Dowrick and Nguyen (1989)

How do office-holders react to discontent? This depends to a large extent on what we may call the political set-up. A given level of discontent will not have the same effect under a system in which office-holding is highly "contestable", and under one in which voters cannot but with great difficulty get rid of rulers whom they do not like. The effect of discontent on the likelihood of political or policy change may thus serve as an indicator of the nature of the political set-up. In Figure 1, the horizontal line passing through a point such as T_L or T_H on the vertical axis indicates the tolerance level of discontent associated with the political system – 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. Incumbents will do their best for that not to happen and thus to make sure that discontent does not reach the tolerance level. In Figure 1, only two political regimes are considered, and thus two political tolerance lines drawn. The line passing through T_L (tolerance low) corresponds to a “high contestability” political system and the line passing through T_H (tolerance high) corresponds to a system in which contestability is low. These lines intersect with curves V and W at points A , B , C and D . The performance gaps corresponding to these points are G_A , G_B , G_C and G_D respectively.

A brief commentary on the four points: yardstick competition works best in A and worst in D ; B corresponds to a situation in which 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 the tolerance of performance gaps

The logic of the framework suggests dividing the possible factors into three categories, depending on whether they affect perceived underperformance, discontent or political tolerance of discontent. With regard to the first, we need not dwell on obvious impediments to comparisons, like language or the lack of information. As noted, the identification and measurement of objective underperformance may be relatively complex. And complexity in establishing objective performance weakens the relation between objective performance and perceived performance. We may illustrate the point just made by taking the case not of a region but of a country, Britain. As compared to

other European countries, Britain had a high level of income per head after World War II. Then, over a relatively long period of time, it underperformed in terms of economic growth but still not in terms of income per head. Initially, this could be interpreted as reflecting a process of catching up by the other European countries. There was some growth in Britain and only economists argued, on the basis of comparisons, that there should be more. When income per head in Britain did fall below that of several other European countries – first Germany, then France, then Italy – it needed some time for public opinion to react but eventually the reaction took place. In terms of Figure 1, the relevant curve for post-War II Britain is clearly curve W rather than curve V.

This kind of difficulties should not be overstated, however. Post-war Britain was a particular case, as is perhaps the United States today. In general, there will be large differences among some countries or regions but sufficient similarity among others. Only seldom will one jurisdiction be completely apart and its inhabitants lacking relevant objects of comparison. If it argued that there are pitfalls, both for experts and for voters, in comparing economic performance between former East Germany and the rest of the country, between the Mezzogiorno and the rest of Italy, or between the former Communist countries of central and Eastern Europe and Western Europe, there are other comparisons available that the general public can easily understand. For instance, voters in Thuringia may engage in comparisons with Saxony and Brandenburg along some dimensions and with Bavaria and Hessen along others.

The willingness of voters to get – or perhaps more accurately, to register – information, even when at no or little cost, is related to their attention capacity, which is limited, and to the stakes involved. These determinants also explain in part the level of information provided by the media, which tends to reflect demand. In France the two levels attracting the most attention – notably because their decisions and influence on matters of concern to voters are important – are the central and the municipal ones. An intermediary tier like the regional one receives less attention. Thus, the bad economic performance of a region is less likely to become a major topic of the political debate and of conversation among the voters of the region than many issues concerning the national or municipal levels. This is of course quite different in decentralized federal countries such as Canada and Switzerland.

The effect of a perceived gap on the level of discontent is influenced in part by the same factors as those just discussed (some factors affect indistinctly the willingness to register information and the effect of information on discontent). But additional factors, of a more political nature, also play a role. Large sectors of the electorate may be aware of underperformance but fail to contribute to the overall discontent that ensues. The reason may be 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. An example of the salience of other issues is the concern with separatism in Quebec, which at times dominated the elections in that province. These various factors may or may not reduce political competition (for instance, in Quebec the outcome of elections could be quite uncertain, reflecting strong political competition), but they weaken the relationship between underperformance, even perfectly perceived, and discontent. Their main effect on the shape of curve W is, as depicted in Figure 1, to lower the higher inflexion point of curve W: to generate more overall discontent than the level corresponding to that point, underperformance encounters diminishing returns (in more precise language, the second derivative of the relation is negative).

In a given jurisdiction, the level of political tolerance to discontent depends on persistent characteristics of the political system and on more time dependent aspects of politics. In the first category, one finds matters such as whether the system is more presidential or parliamentary and the degree to which the electoral system by itself favours or hampers accountability. In some cases these characteristics interact with permanent (for instance ethnic or spatial) features of the electorate and with the organization of the political parties notably across levels. Recourse to a referendum may also be a way for voters to express their discontent with some policy and to impose some change. Consequently, the constitutional treatment of referendum may also be an important feature of the structural set-up.

Features of the political situation in the jurisdiction at a point in time – very important in empirical work, as we saw, to disentangle yardstick competition and other mechanisms producing the same observable results – are less relevant in the context of the present discussion. As already noted, politicians in office may be more impervious to discontent if the next election is far away, if they cannot be candidates in the next election because of term limits, or if the present majority supporting them is large.

As Figure 1 suggests, an improvement in the political set-up applicable to all regions – as happened in Italy in 1995 (see Padovano and Ricciuti 2009) – making that set-up more competitive and consequently policy-making more responsive to voters' discontent should have a particularly large effect on performance in the jurisdictions in which the relationship between underperformance and discontent is weak. Suppose that curves V and W correspond to two regions, and that actual underperformance is a function of – or, at the limit, equal to – the maximum tolerated level of underperformance. Then the introduction of more political competitiveness in the set-up (the horizontal tolerance line moving downwards) will improve performance mainly in the region whose performance was the worse. It might not change very much the situation in the region in which there was less underperformance. If changing the political set-ups in the regions falls in the competencies of the central government, and if political reforms are costly, this differential effect might inspire some differentiation between the set-ups themselves, which would create or strengthen some institutional asymmetry.

3.4. Some particular causes of persistent regional economic underperformance

The foregoing possibilities are not sufficient to explain the kind of long-lasting economic performance gaps 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 come to mind. They are plausible in particular cases but lack generality, which is a serious weakness given the similarity of the problem in the countries discussed here. Political competition is at least as strong in, say, Thuringia, than in Bavaria. One might argue that the lack of autonomy of the regions concerned (except perhaps in the Belgian case) and the fact that, often, the political parties in these regions are more or less the ones active at the national level tend to reduce the attention given by voters to the regional government and to the political debate in the region. Voters may feel that the regional incumbents cannot really be held accountable for the economic situation of the region. But, then, the voters of a region will make their discontent felt at the relevant level by voting in all elections (both national and regional) against the party in office at the national level (see Treisman 2006). This is perfectly compatible with strong political competition at the

regional level. The question thus does not seem to be the political response to discontent but the existence and nature of this discontent.

We must fall back, to serve as a starting point, on the widely made observation that the standard of living of the inhabitants of the regions concerned and their consuming habits are far from fully 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.⁸ Many public services (health, education, welfare, police, justice, defence, regulation, consumer protection, etc.) are provided in more or less homogeneous quantity and quality across regions. With respect to these services, there is no gap at all. If the cost of living is lower in the regions concerned while the remuneration of public servants is the same in all regions, the standard of living of public employees may be even higher than in the rest of the country. This is not, on average or as a rule, the case of the rest of the population, whose income per head is generally lower than the country average. But the difference is smaller than the one which could be expected from the economic gap.

This discrepancy between production or productivity, on the one side, and real income and consumption, on the other, has three consequences. The first concerns the perception of the economic underperformance. Everybody in the regions concerned has heard about it because, in the whole country, it is much discussed in the media and the cafés, but most people in these regions – except if they are unemployed or have unemployed relatives – have no personal experience of it. Thus even though, in the language of our model, the *perceived* gap is close to the *objective* gap, it generates relatively little discontent.⁹ Second, the comparisons made by inhabitants of a region not with other regions of the same country but with other countries in some respect similar to the region often tell these inhabitants that more economic performance abroad is associated with an inferior standard of living. People in Guadeloupe may envy the success of the tourism industry in the Dominican Republic but they are not ready to compromise, at least in the short and medium terms, their standard of living and way of life to get comparable results. If there is some discontent, it is targeted to the level of the

⁸ See Brosio (2007) for a discussion of the pros and cons of transparency and obfuscation in this context.

⁹ For a related argument, see Kotsogiannis and Schwager (2008). See also Donovan, Brown and Bellulo (2001).

transfers received by the region, deemed insufficient, and not to the underperformance itself, typically perceived as a second best, or to the complete integration of the region in the national system of public services and regulation. In general, not only independence but even the increased autonomy proposed by the national government tends to prove unwanted by the majority of the population.

Third, this deadlocked situation is propitious to – and made worse by – the development of the perverse exit-voice mechanism analysed many years ago by Hirschman (1970). If citizens in a jurisdiction are dissatisfied with public policies and emigration costs are low, while changing these policies appears to be uncertain, some citizens will emigrate. If dissatisfaction with the situation is not equally shared by individuals, it is likely that those who emigrate are more dissatisfied on average than those who decide to stay. Emigration makes the situation even more sustainable than it would be without it and thus is unlikely to induce any change of policies. If the process of exit goes on, disparities in performance across jurisdictions are thus particularly likely to last or even increase without check, even with a high level of information available to all.

This may happen to independent countries. But sub-national jurisdictions are more easily subject than whole countries to the process. Moving out of a region or city is less costly as a rule than moving out of a whole country, information about what obtains in other jurisdictions at the same level is easier to come by. A more crucial difference between the national and the regional settings is that national governments usually have the constitutional, fiscal and regulatory means to adapt policies so as to improve economic performance. And because of yardstick competition at the international level, national governments, especially in the setting of the EU, have an incentive to do so even if this is difficult (as argued in the Introduction). But 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 or stagnation of countries as a whole.

Yardstick competition is mainly a matter of information and, to work reasonably well, needs also political competition. But information and political competition in the underperforming regions cannot be assumed to be generally lacking. Thus, their

occasional or even frequent failures cannot be the factors mainly responsible for the kind of regional economic underperformance discussed here. The basic problem is that voters, even when well informed, have no real incentive to seek policy changes. Under these conditions, yardstick competition cannot work – or can work only potentially (it would influence policies only at levels of underperformance even greater than those observed).

4. Conclusion

It has been suggested that large regional differences are an obstacle to that component of the accountability of governments which is based on yardstick competition. The foregoing discussion concluded that the obstacle is not too serious in general. The second part of the paper was devoted to the persistent economic underperformance of some regions in countries such as Germany, Italy and (with regard to regions overseas) France. How is it that yardstick competition contributed to bring about a convergence of economic performance among European Union member countries, including those which were particularly poor at the outset, but fails to induce any process of catching up by the persistently underperforming regions of the countries above? A small model was used to explore that question. In the case of the persistently underperforming regions, it turns out that the degree of regional differentiation is not sufficient for yardstick competition to work and induce an improvement in performance. The incentives which are lacking are above all those of the voters in these regions, even though these voters may be well informed. The yardstick competition framework is useful if it helps understand more clearly why yardstick competition fails.

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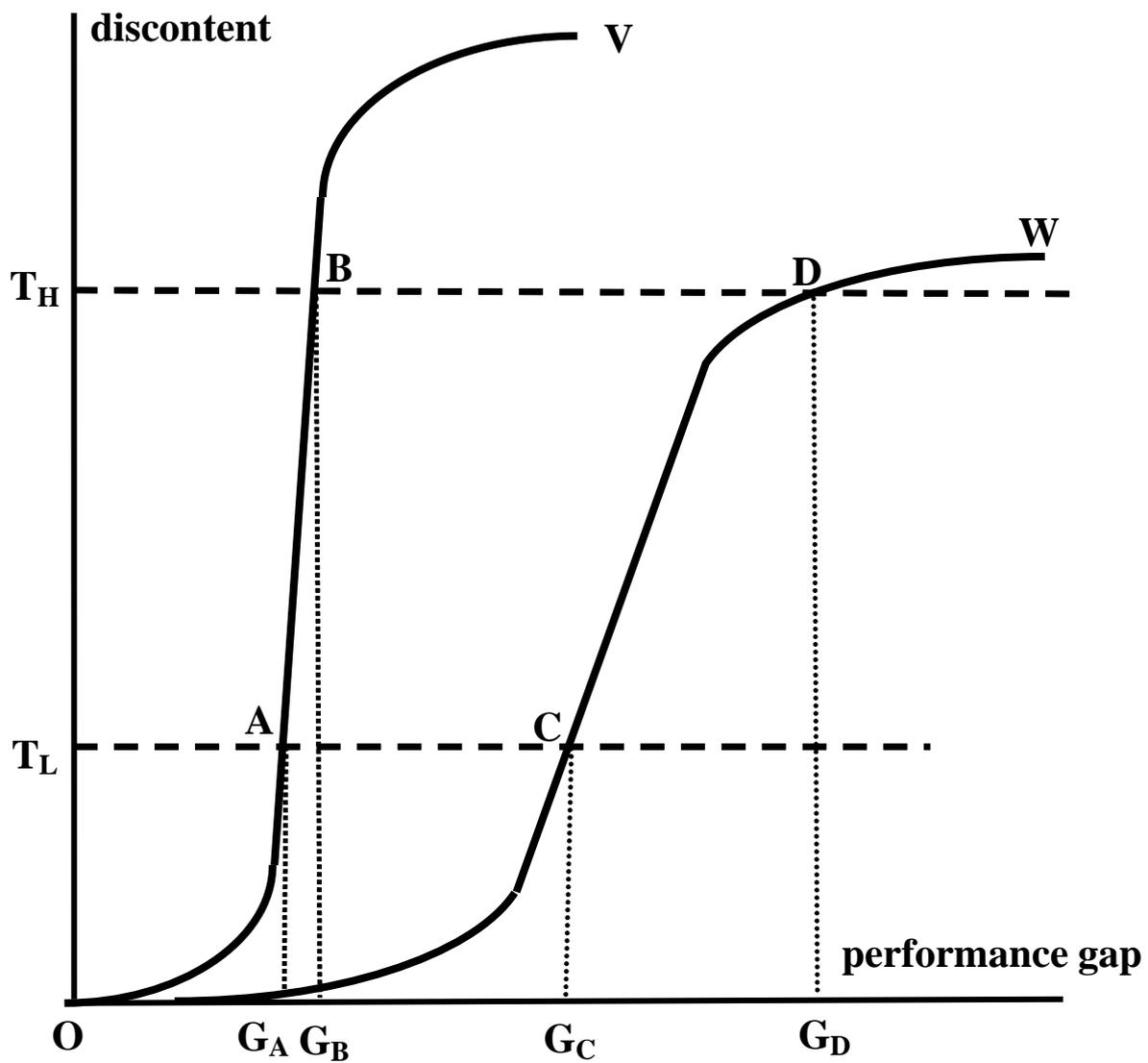


Figure 1: Political limits to negative performance