

Does Equity or Efficiency Matter in Intergovernmental Transfers?

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Abstract

Intergovernmental transfers are used to close vertical fiscal gaps and remove horizontal fiscal inequities. Despite the necessity of such rebalancing, intergovernmental transfers may have negative effects such as fiscal indiscipline and moral hazard. This study focuses on a redistribution mechanism that tries to capture the properties of an ideal transfer mechanism (equity and efficiency) and investigate the effects of this rule-based mechanism under a decentralized fiscal system. The aim of this search is to answer how this redistribution mechanism affects fiscal policy and which part of the mechanism is more effective in government policy, equity or efficiency. Under dynamic endogenous growth model, the effects of a redistribution mechanism in a decentralized fiscal set-up are examined. Model introduces tax competition between local governments with capital mobility and spillovers of public goods are allowed.

Keywords: Intergovernmental Transfers, Equity, Efficiency

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