

Incentive Problem in Intergovernmental Transfers: Differences between Two Infinitely Iterated Leadership Models*

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May 2, 2007

The "Decentralized Leadership (DL)" and "Central Leadership (CL)" models are used to explain soft budget constraint (SBC) problem between a central and local government. Many existing literatures about SBC make an explanation of inefficiency in subsidization policy to local governments, and state that inefficiency occurs if the central government can observe the action of the local government before choosing by the central government.

However, this assertion is problematic since futures' consumption is not fully considered by these literatures. Authors analyze the above problem by "infinitely iterated models". The conclusion in this paper is as follows.

The outcomes of the Markov perfect equilibria (MPE) in both models are inefficient. The root cause is the same, namely, both local governments scramble to consume the net present value of lifetime income. By interpreting the net present value of lifetime income as a common resource, this model has the same structure as some kind of social dilemma and overconsumption occurs in these models. In the infinitely iterated DL model, intra- and inter-temporal resource allocation are both distorted which authors call *price effect distortion* and *basic SBC distortion* respectively. On the other hand, only intertemporal resource allocation is distorted, i.e. *direct over-competitive distortion*, in the infinitely iterated CL model. However, the total distortion in the infinitely iterated CL model is more aggravated than that in the infinitely iterated DL model if β is large enough. The reason is that, by competitive restriction, direct over-competitive distortion is more aggravated than price effect distortion with respect to each transition from a period to the next, and that this difference is amplified if agents attach importance to futures' consumption.

*This work was supported by Grant-in-Aid for Scientific Research (C) (18530226).

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