Ratio Working Paper No. 82

Inter-Regional Redistribution in Sweden: A Survey of the Literature and a Call for Further Enquiry

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Inter-regional redistribution in Sweden:
A survey of the literature and a call for further enquiry

by

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December 26, 2005

Abstract

The Swedish system for inter-regional redistribution is examined from a political economy perspective and a growth perspective. A number of recent Swedish studies of this system are examined. Political economy concerns are found to be adequately represented in academic studies of this system, while lacking, at least explicitly, in all the major relevant government reports. Growth implications of extensive inter-regional redistribution are found to be relatively neglected in both academic studies and government reports. In particular, the short-circuiting of labour mobility (and hence the impairment of long-term structural adjustment) is examined at both micro- and macroeconomic levels. It is concluded that extensive inter-regional redistribution is likely to have considerable effects on labour mobility. The author argues that this almost entirely overlooked effect is an important consideration in evaluating the costs and benefits of inter-regional redistribution, and calls for further enquiry into the matter.

JEL classification**:** D72, D78, E60, H11, H31, H71, H77, O18, R23, R58
Keywords: Inter-regional redistribution, fiscal federalism, political economy, growth, labour force mobility

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[*]The author wishes to thank the Torsten and Ragnar Söderberg Foundations and the Ratio Institute for financial support, and Magnus Henrekson for moral support. The author has benefited from useful comments and suggestions from Anna Dreber, Kristin Magnusson, Björn Wallace, and Daniel Waldenström, as well as participants at the Ratio Institute research seminar.

Introduction

The normative principle of subsidiarity, according to which power originates at the local level and is delegated 'upwards' to a central authority, has been of key importance for European integration.[1] In Sweden, where a large share of the public sector is organized at county and municipal levels, the principle of local self-government, including the power to tax, was explicitly recognized in the municipal reform of 1862, and incorporated in the constitution in 1975. The systems for fiscal decentralization in Sweden and the other Nordic countries (not counting Iceland) are unique regarding the scale and scope of the public sector at the local level, amounting to almost 70 percent of public spending. This is in part a consequence of counties and municipalities having been assigned a number of responsibilities that in most countries are managed at the national level. These responsibilities, mainly within the areas of healthcare, schools and community services, constitute the majority of fiscal expenditures at the county and municipal levels.

For Swedish municipalities, self-government includes the power to tax and the right to influence, within limits, the allocation of the resulting tax revenue.[2] A large public sector at the local level is associated with difficulties caused by the mobility of the tax base. There are large differences between the per capita tax bases of different municipalities in Sweden. There are also large differences in costs faced by municipalities for the provision of goods and services, due to structural differences generated by demographic or geographic factors. To be able to maintain a public sector standard in line with the rest of the country, some municipalities, if relying entirely on their own tax base, would be forced to set tax rates at prohibitively high levels. This, in turn, would encourage the relocation of the mobile tax base, aggravating the situation further. This competition problem constitutes a considerable obstacle to maintaining an extensive public sector at the municipal level.

Partly in response to this competition problem, Sweden employs a far-reaching system for inter-regional redistribution. The stated aim is to enable all municipalities to provide a standard of public sector services in line with other municipalities, regardless of the size of the own (per capita) tax base. This system might be considered ambitious, but like many ambitious systems it also generates new problems. The extensive transfers necessary for the system to function could potentially be exploited for tactical, political purposes. Moreover, the far-reaching equalization of tax bases might affect the geographical mobility of the labour force. This could potentially have negative effects on long term economic growth at the national level. In addition, the restricted possibilities for retaining marginal increases in tax revenue entail severely diminished incentives for institutional competition between municipalities. Less institutional competition implies less policy experimentation and innovation and hence a less differentiated public sector. To the extent that policy preferences are heterogenous, this entails a loss for consumers (i.e. the public) which is distinct from the effect of reducing incentives to mobility.

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[1] The definition of subsidiarity is discussed extensively in Söderström (2002)

[2] Restrictions on the power to tax and limits on discretion in the allocation of tax revenue imply that the extent of municipal self-government is debatable. Here, the focus of our attention is the restrictions on the power to tax; specifically, on the retention of tax revenue.

It is the purpose of this article to shed some light on these potential problems, paying particular attention to issues pertaining to political economy and economic growth. The following questions are addressed: to what extent does the design of the system allow for politically motivated, tactical redistribution? How might far-reaching inter-regional redistribution be expected to effect labour force mobility? What consequences might such effects on mobility have on economic performance and long-term growth? The hypothesis put forward is that the dangers of tactical redistribution are relatively small, yet have been given considerable attention, while the danger of short-circuiting a natural 'signal' for geographical mobility, with negative consequences for long-term economic performance and growth, have been largely overlooked.

It is beyond the scope of this article to provide an exhaustive analysis of the system for inter-regional redistribution. The article focuses on municipalities, paying less attention to counties. The critical analysis of related official reports is selective, emphasizing more recent reports. Quantitative analysis is left to future research. The political economy discussion is kept simple, eschewing economic modeling in favour of a descriptive analysis of the extent of discretionary grants. The discussion draws heavily on the research of the Swedish Agency for Public Management. While some shortcomings of their analysis are highlighted, no attempt is made in this article to complement the picture they present with additional primary research. The discussion of potential implications for long term economic growth focuses on the link between inter-regional redistribution, labour force mobility, and economic growth, although particular attention is also paid to the effects on institutional competition between municipalities.

Background

A decentralized public sector might be desirable even when there are substantial difficulties in quantifying the economic benefits. According to Stigler (1957), decentralization is the most suitable way to bring the political sphere close to the citizens, thereby enriching democratic governance and enabling the public sector to respond to preferences at the local level. Stigler did warn, however, of the potential problems posed by competition for the tax base between regions. To avoid this, the operations of redistribution – collection, allocation - ought to remain at the centralized level: "…the proper amount of redistribution… could not depend on the accidents of income composition of a particular community. Hence, in pure principle, the Federal government should collect the progressive levies and redistribute them to local units with each receiving an amount governed by the number of its poor and the degree of their poverty."[3] In such a way, argued Stigler, all municipalities would be guaranteed a minimum level of public sector spending.

One might question whether Stigler ever envisaged a system for inter-regional redistribution of such scope and far-reaching ambition as the one currently at work in Sweden. Söderström (2002) points out that Stigler's main point seems to be that diversity is desirable *in and of itself*, regardless of economic considerations. A more

[3] Stigler (1957), p. 143

stringently economic argument in favour of fiscal decentralization is presented in Tiebout (1956). The Tiebout hypothesis predicts that decentralization enables a greater degree of heterogeneity in the design of the public sector. Provided mobility between regions is free, the population is then able to 'vote with their feet' and locate in the region most in line with their own preferences. If all individuals locate in this manner, aggregate welfare can be expected to increase.

The foundations of the Swedish system of local self-government were laid down as early as 1862. The public sector has expanded considerably in the 20th century, at the local levels and at the national level. Söderström (2002) refers to a 'Nordic model' of fiscal federalism, since the scale and scope of the local level public sectors in the Nordic countries (except Iceland) is unparalleled in the rest of the world.[4] The main source of financing for the extensive local level public sector is through local income taxes.[5] Local taxation is hence considerably higher than in most other countries. Söderström's 'Nordic model' of fiscal federalism is thus characterized by an extensive public sector at local levels, and by the high level of local taxation.

Swedish municipalities have differing abilities to finance public sector services through relying only on their own tax bases. In 2001, the per capita tax base of the municipality of Danderyd was 174 percent of the national average, the highest in the country, compared to 79 percent for the municipality of Årjäng, the lowest in the country. Without tax base equalization, Årjäng would need a municipal tax rate of 26 percent, and Danderyd a municipal tax rate of 12 percent, to attain the national average (per capita) municipal tax revenue.[6] In addition, there are structural cost differences, e.g. demographic or geographic factors that result in different costs across municipalities for providing service of an equivalent standard to other municipalities. Without inter-regional redistribution, these large discrepancies in income and cost structures would generate substantial differences in either tax rates or provision of public sector services, or both.

The prototype for the current system of redistribution between municipalities was introduced in 1966. Originally, the system consisted of tax base equalization between municipalities and discretionary, purpose-specific grants from the central government. In 1993 the majority of the purpose-specific grants were replaced by a general grant that is not tied to any specific purposes. The 1993 reform also separated the equalization transfers between municipalities into three categories: compensation for differences in tax revenue, compensation for structural cost differences, and compensation for municipalities with negative population growth.

The general framework of the current system was introduced in 1996. It consists of two similarly designed parts, one for municipalities and one for counties. Since its inception, this system has been continuously updated, most notably through the 2005 reform discussed below, but many of the essential features have remained intact. The current system for inter-regional redistribution consists of tax revenue

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[4] According to Söderström (2002), municipalities and counties account for approx. 70 percent of total public spending. Healthcare, schools, and community services make up approximately three quarters of this spending.

[5] In Sweden, income tax is raised at all three levels of government: municipalities, counties, and the national level, although the latter is in effect a marginal income tax, only paid by the highest tax brackets.

[6] Figures taken from Berggren and Tingvall (2005).

equalization, compensation for structural cost differences, a general, non-discretionary grant from the central government and the so called *införanderegler*, "introduction rules".[7] There is in addition to these transfers also a number of discretionary, purpose-specific grants from the central government which to a varying degree can be considered transfers from the central to local government.

As of 1996, all municipalities are affected by the system of inter-regional redistribution, although following the 2005 reforms fewer municipalities with higher-than-average levels of taxable income are required to contribute. The core principle is that all municipalities and counties be able to provide public sector services of an equivalent standard, regardless of the size of the local tax base or structural cost differences. The system is exceptionally far-reaching in its ambition to equalize revenue, even compared to the other Nordic countries. The system is intended to compensate municipalities and counties for differences in tax bases and structural cost differences only. *In principle*, the system should *not* compensate for differences in efficiency or ambition regarding the public sector at the local levels.[8]

As a result of the 1996 reforms, the system for tax revenue equalization became fiscally neutral at the national level. The equalizing transfers were hence financed entirely by the municipalities and counties themselves, so that the total sum of transfers paid out equal the total sum of transfers received by the system. The essential feature of the system put in place in 1996 has been to ensure that no municipality or county differs greatly from the national average in (post-transfer) per capita tax revenue.[9]

The system for inter-regional redistribution introduced in 1996 received much criticism for being overly obtuse. The system underwent continuous assessment and improvement, and following a government decision in 2001 a parliamentary committee was formed and given the task of evaluating the system in its current form.[10] In September 2003, the conclusions of the committee were presented in the report *Gemensamt finansierad utjämning i kommunsektorn* (SOU 2003:88). At the same time, a study of the financial flows in the system for inter-regional redistribution was carried out by the Swedish Agency for Public Management, resulting in the report *Statsbidragen till kommuner och landsting: en kartläggning och analys* (Statskontoret 2003:5), also published in 2003.

In May 2004 the Ministry of Finance presented its proposal 2003/04:155, based on the recommendations made in SOU 2003:88. Several of these were adopted

[7] The introduction rules, essentially a form of temporary rebate on transfers, were aimed at smoothing sudden increases in liabilities following the introduction of the new legislation. The main beneficiaries were the municipalities with high levels of per capita tax revenue that had not previously been required to contribute to the system.

[8] It is open to debate whether this principle is in fact applied. See for example the discussion in Söderström (2002).

[9] Municipalities and counties with higher than average per capita tax revenues become net contributors to the system, while those falling below the national average are net beneficiaries. The transfer providing the equalization of per capita tax revenue is calculated by comparing the average per capita taxable income in each municipality and county with the national average. The differential is multiplied by the county-wide tax rate, *länsvisa skattesatsen*. The result constitutes the tax revenue equalization transfer. In 2003, these horizontal transfers between municipalities amounted to SEK 14 billion, mainly from urban areas to rural regions.

[10] *Utjämningskommittén*

in January 2005. The complete eradication of differences in per capita tax revenue achieved previously has been relaxed somewhat, allowing for slightly larger differences between municipalities. Starting in 2005, all municipalities are assigned a theoretical revenue of 115 percent of the average per capita tax revenue for all municipalities. The theoretical revenue is calculated using the average national tax rate for all municipalities, and includes the general grant from the central government. Municipalities falling short of the 115 percent target receive a government grant making up for 95 percent of the shortfall. By using the national average tax rate for calculating the theoretical revenue, municipalities are prevented from exploiting the harmonizing grant to offset low taxes.[11] Municipalities with theoretical revenues in excess of the 115 percent target are expected to transfer 85 percent of the theoretical revenue surplus to the central government.

The compensation for structural costs differences was separated into two components: a cost difference compensation grant, similar in definition to what preceded it, and a structural grant, comprising those parts of the previous compensation transfers that could most readily be characterized as regional policy. The general, non-discretionary grant was given a different label (*regleringsbidrag* instead of *generellt statsbidrag*) but remained essentially unchanged, with one important caveat. Whereas the general grant had already previously been well suited to regulate the total financial flows form the central to local governments, this purpose has now become explicit. The *regleringsbidrag* is flexible by nature, and adjust in relation to the budget constraint, once the other disbursements have been made. This change can be seen as a direct response to the tax revenue equalization grant no longer being fiscally neutral at the central government level. The (per capita) amounts received are roughly the same for all municipalities and counties. The official report SOU 2003:88 recommended that a large number of the remaining discretionary grants be incorporated in the general grant, and to some extent this has been the case, through the 2005 reform. As a consequence, the total general government government to municipalities has increased from SEK 41.4 billion in 2004 to SEK 55.2 billion in 2005.[12]

The compensation for structural cost differences is fiscally neutral at the national level. It is calculated using the so called method of standard costs[13], with subsections based on a large number of quantifiable factors relating to each cost-incurring activity. The method has been criticized for its complexity. The compensating transfer is only intended to cover differences in costs beyond the control of the municipalities and counties themselves, e.g. demographic or geographic

[11] For municipalities chosing to set the tax rate below the county wide average, negative marginal effects can occur. In these cases, an increase in the per capita tax base would result in lower net revenues for the municipality. To avoid such outcomes, referred to as 'Pomperipossa effects' in reference to a Swedish childrens' story, an adjustment was introduced in 2001 guaranteeing every municipality 95 percent of the average per capita tax base increase for all municipalities, and 5 percent reflecting growth in the own tax base.
[12] Figures reported in Berggren and Tingvall (2005), p. 27
[13] *standardkostnadmetoden*

factors.[14] Measures were taken to facilitate the transition to the new system, through temporary adjustment allowances to municipalities facing large changes in revenues.[15]

To sum up, the 2005 reform implied two important changes: firstly, the equalization of per capita tax revenue is no longer fiscally neutral at the central government level, and secondly, "only" 85 percent of excess tax revenue is transferred from affluent municipalities to the central government, compared to 95 percent prior to 2005. This allows for a slightly larger (though still small) differentiation in *de facto* tax bases between municipalities.[16]

The political economy of inter-regional distribution

The effect of economic variables on electoral outcomes has long been an object of study. Stigler (1973) argued that such an analysis ought to focus on the redistribution between groups, rather than economic conditions in general. In Stigler (1973), the state of the economy had no significant effect on American voters during the period studied. This, Stigler argued, reflects the electorate's perception that both parties to an equal degree desire good economic conditions. Redistribution, on the other hand, entails winners and losers and could hence be expected to have a significant effect on the electoral outcome: "one cannot support both a rise and a fall in the share of income going to farmers, or the share of progressive taxes in the revenue system, or the share of income transferred to the poor."[17]

A number of (Swedish) contributions to the discussion about tactical redistribution make explicit reference to the current Swedish system for inter-regional redistribution and central government grants to local governments. The scale and scope of the transfers and grants imply a significant risk that the system be abused, for example through tactical redistribution with the intention of buying voter support. This section focuses on the contributions of Johansson (1999, 2001), Dahlberg and Johansson (2000, 2002), Jordahl (2002), and Hanes (2003).

The majority of these studies refer to a number of seminal American studies of tactical redistribution in the US during the New Deal era. These studies, notably Arrington (1969), Wright (1974), Wallis (1996), and Anderson and Tollison (1991) reach different conclusions regarding the hypothesis that regional grants during the

[14] In 2000, approximately SEK 5.2 billion was redistributed between municipalities to compensate for structural cost differences. In general, municipalities in and around larger cities were net beneficiaries, as were the more remote, rural municipalities. All other regions were net contributors.

[15] The 1996 reform of the system for inter-regional redistribution brought about large changes in revenue for certain municipalities, most notably for those with high levels of taxable income. To ameliorate the short term impact of the changes, temporary adjustments grants were disbursed, facilitating the transition. Similarly, following the 2005 reform, an adjustment grant is to be disbursed over a maximum of six years, ensuring that no municipality faces reductions in income due to changes in the system for inter-regional redistribution amounting to more than 0.08 percent of the local tax base.

[16] Net transfers, the poorest municipalities are guaranteed 113 percent of the average per capita tax base for all municipalities, while the most affluent municipalities can attain at most 124 percent. Figures taken from Berggren and Tingvall (2005). Actual differences are greater than this, but as a result of preferences regarding tax rates and levels of public sector service provision. See Berggren *et al*. (2003), pp. 10-11.

[17] Stigler (1973), p. 167

New Deal era were tactically motivated.[18] Arrington (1969) notes that the allocation of grants appeared to benefit states where income levels were already high. Wright (1974) uses political variables in a regression analysis of the allocation of grants, and concludes that certain political variables had greater explanatory power for these allocations than did strictly economic variables. Wright assumes that vote maximizing tactical redistribution ought to focus on states with a higher proportion of swing voters. He finds some evidence for a correlation between grants and swing voters, and concludes that differences between states in the allocation of grants in part could be attributed to the vote maximizing behaviour of politicians. Anderson and Tollison (1991) develop the arguments put forward by Wright, by adding a number of political variables found to be partially significant. Their conclusions have been questioned in Wallis (1996), whose study includes the New Deal period but also later years. His conclusion is that the economic variables played a central role for the allocation of grants, whereas political variables did not.

Johansson (1999, 2001) examines potentially tactical redistribution between Swedish regions, focusing in particular on central government grants to municipalities. Johansson (2001) notes that the American studies of tactical redistribution generally lack robust theoretical foundations on which to base conclusions about potential attempts to buy voter support. The main theoretical model used in Johansson (1999, 2001) as well as Dahlberg and Johansson (2000, 2002) is based on the model presented in Dixit and Londregan (1996, 1998), which is a development of a model presented in Lindbeck and Weibull (1987). In the Lindbeck-Weibull/Dixit-Londregan model two rival parties use grants to gain votes. The voters are influenced by a combination of purely political preferences and the level of consumption offered by either party. The relative strength of political preferences compared to consumption levels offered determines how easily votes can be bought; sufficiently large grants can bring a voter to vote against his political preferences. When dividing the voters into groups, such as municipalities, the model predicts that the magnitude of grants received by the group increases in the number of swing voters in that group. Groups with large numbers of swing voters should thus become major beneficiaries of discretionary grants.

A model similar in form, but arriving at different conclusions, is presented in Cox and McCubbin (1986). In this model, voters are divided into three categories: supporters, opponents and swing voters. The Cox-McCubbin model predicts that vote maximizing, risk averse politicians will chose the least risky investment, to the benefit of the supporter group, and at the expense of both other groups. This model hence suggests a direct correlation between grants and political preferences. The two models share the assumption that voters react positively to regional grants.

Johansson (2001) conducts an extensive survey of the total allocation of central government grants to municipalities, in order to investigate whether more grants are allocated to regions with a relatively large share of swing voters. The results are unclear. Johansson concludes that her investigation lends support to the hypothesis that central government grants are used to buy voter support, yet this conclusion is not evident from the analysis that precedes it. Of the two political variables that are tested,

[18] Recent applied work also includes Levitt and Snyder (1995, 1997).

one is found to be insignificant.[19] Johansson recommends prudence in drawing conclusions from the result, due to the small number of observations.[20] Johansson (2001) only covers central government grants during the period 1981-95, and hence does not take into consideration the significant changes to the system that have taken place since 1995, although she notes that there is less scope for discretionary grants following the 1993 reform. Johansson estimates that prior to the 1993 reforms, discretionary, special-purpose grants constituted approximately 25 percent of municipalities' incomes, while the general purpose, non-discretionary grants amounted to approximately 5 percent. Following the reform, the former constituted approximately 7-8 percent of municipalities' incomes, while the latter amounted to approximately 15 percent. Johansson does not show how she has arrived at these figures. While the figures illustrate the broad changes of the system, the estimate of the extent of discretionary grants is considerably higher than the estimate contained in, for example, the Swedish Agency for Public Management report 2003:5 (as discussed below).

The notion of swing voters is central to the political economy analysis in Johansson (2001). The exact definition of a swing voter is, however, problematic, and constitutes the weak link in Johansson's quantitative analysis. Johansson refers to studies by Case (2001) and Strömberg (2001) defining swing voters by use of a closeness proxy. By this method, the number of swing voters in a region is defined by how close the outcome of the previous election was. Using this definition, Johansson fails to find evidence of tactical redistribution in order to buy voter support. Instead, Johansson relies on factor analysis based on electoral surveys. The implicit assumption is that the variable denoting ideological preferences can be expressed as a linear combination of the variables in the electoral surveys.[21] Bearing in mind the limitations on data, the assumptions underlying the definition of swing voters, and the unclear results of the quantitative analysis, it is hard to join Johansson in her conclusion that the results support the hypothesis that central government grants are used to buy votes.[22]

Dahlberg and Johansson (2000) contains a detailed discussion of the actual mechanism for discretionary allocation of central government grants to Swedish municipalities. The discussion is facilitated by focusing solely on grants to municipalities in support of local investment programs for ecologically sustainable development. In 1998, these grants amounted to SEK 2.3 billion. According to Dahlberg and Johansson, these grants were characterized by the complete lack of transparent regulation of allocations, and by a very large direct influence of the government on the allocation of grants. After preparatory work by the Ministry of the Environment it was the government's prerogative to decide which applications to approve and the amounts disbursed. The authors contrast this against the 'traditional' central government grants, allocated according to clear, predetermined codes and

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[19] Johansson (2001), p. 29

[20] "…though some caution certainly is needed having in mind the relatively few observations available." Johansson (2001), p. 29

[21] Johansson (2001) p. 26

[22] "The results support the hypothesis that intergovernmental grants are used in order to win votes." Johansson (2001), abstract, p. 1

regulations. Dahlberg and Johansson find evidence that the allocation of 'ecological' central government grants has been used as a means of tactical redistribution, as predicted by the Lindbeck-Weibull/Dixit-Londregan model. They do not, however, find evidence that the grants have been allocated to the own supporter groups, as predicted by the Cox-McCubbin model. The conclusions in Dahlberg and Johansson (2000) are more stringent that those in Johansson (2001). Although their analysis is solely concerned with one type of grant, during one single year, their analysis does yield some support for the hypothesis that discretionary grants are abused for purposes of buying voter support.

The conclusions arrived at in Dahlberg and Johansson (2000) is given further support by Hanes (2003), who examines the allocation of temporary, central government grants during the period 1982-1988. Hanes's results are mixed but lend some support to the hypothesis that these grants were used for tactical redistribution. Hanes emphasizes that the temporary grants, unlike the regular grants, are vaguely formulated and have entailed considerable discretionary power for the government. The temporary grants under study in Hanes (2003) seized to exist in 1992. His conclusions do not have direct bearing on the current system of inter-regional redistribution, but they do lend further support to the hypothesis that discretionary central government grants are abused for tactical/political purposes.

Jordahl (2002) examines the connections between central government grants to municipalities and electoral outcomes in the parliamentary elections of 1991 and 1994. Jordahl finds no evidence of a significant correlation for total grants or general grants, but does find a statistically significant correlation between specific grants and electoral outcomes. He finds some weak evidence in support of the hypothesis that allocation is affected by the proportion of swing voters, but suggests that the difficulties in defining swing voters in a satisfactory way calls for prudence in interpreting the results.

A shortcoming of almost all the Swedish studies discussed above is the lack of detailed discussion of the actual design of the Swedish system for inter-regional redistribution and allocation of central government grants to counties and municipalities. Johansson (1999, 2001) and Jordahl (2002) in particular conduct elaborate quantitative analysis without really tackling the question of how much scope there is *in practice* for tactical redistribution (see discussion below). The current Swedish system might only have limited similarities with, for example, the US under Roosevelt's New Deal. This potential flaw lends an insinuating tone to the repeated parallels drawn between the American literature on tactical redistribution and the current system for inter-regional redistribution.

Special purpose grants

To what extent does the current system allow for discretionary grants? According to the Swedish constitution, parliament has executive power over fiscal affairs, but for reasons of efficiency a considerable amount of the decision-making is done by the government. The budget, which is presented by the government and ratified by the parliament, describes the allocation of funds in the form of appropriations. The appropriations specify purposes and amounts, and belong to one of three subcategories, with different restrictions.[23]

Appropriations are grouped into twenty-seven spending categories, each with a predetermined spending limit. In practice, parliamentary decisions regarding these appropriations are taken at an aggregate level, leaving the details of the disbursements up to the government. The government, in turn, gives directions regarding the appropriations, *regleringsbrev*, to the authorities concerned, specifying what funds have been allocated and for what purposes.

The appropriations allow the government considerable influence on the allocation of funds. Appropriations can be broken down into separate parts for allocation across different recipients/purposes. Appropriations, or parts thereof, can also be made conditional upon, for example, total amounts to be received by a certain recipient or used for a specific purpose. As a consequence of this method of allocating funds, it is not always clearly apparent when an appropriation has municipalities (or counties) as its recipients. For their report, the researchers at the Swedish Agency for Public Management conducted close to one hundred interviews with employees at more than fifty government works, in order to estimate the number of appropriations designated for municipalities and/or counties. The report estimates that 127 appropriations have been partially or entirely allocated to municipalities and/or counties.

The common distinction between general grants and special-purpose grants is not entirely adequate. Instead, the report by Swedish Agency for Public Management (2003:5) uses the categories 1-3 to describe to what extent an appropriation is intended for municipalities and counties. Category 1 contains grants that are entirely designated to municipalities and counties. Category 2 consists of grants that are only in part intended for municipalities and counties. Category 3 comprises those grants that are not explicitly intended for municipalities or counties, but where the Swedish Agency for Public Management found municipalities and counties to be the direct recipients. The subcategories “all”, “some” and “mixed” are used to indicate whether the appropriations was received by all, or only only some, municipalities and/or counties. “Mixed” implies that an appropriation was received in part by all, and in part only by some.

In its report, the Swedish Agency for Public Management examined government grants to both municipalities and counties. No attempt is made to arrive at separate estimates for municipalities only. There is however no indication in SOU 2003:5 or the report by the Swedish Agency for Public Management that there exist systematic differences between grants to municipalities and grants to counties. The bulk of grants of disbursed are received by municipalities. This holds true for all the categories (1-3) and hence the compilation in the report by the Swedish Agency for

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[23] Specifically: *obetecknade anslag*, with hard budget constraints and where funds may not be carried over into the following fiscal year, *reservationsanslag*, also with hard budget constraints but allowing for funds not spent to be carried over into the following fiscal year, and *ramanslag*, with softer budget constraints (a credit of max. 10 percent of the *ramanslag* may be used, but must be compensated for in the following fiscal year) and permitting carrying over of funds not spent to the following fiscal year. The *ramanslag* constitute the majority of the approximately 500 appropriation in the government budget.

Public Management may be considered a good indication of the distribution of grants to municipalities.

There are measurement difficulties involved when compiling data on central government grants to local governments. The definition of what grants to include in category 3 is particularly arbitrary, and in many cases the categorization is based on interviews with people involved in the workings of the system. Likewise, the pecuniary extent of these grants is based on arbitrary judgments. In those cases where a grant has been deemed to be partially disbursed to municipalities and/or counties, the researchers at the Swedish Agency for Public Management have made their own assessment of to what extent the appropriations should be listed under category 3. This differs from categories 1 and 2 which do not contain the same arbitrary judgments.

While grants are allocated to the three categories, the distribution across municipalities and counties is not revealed. Variation in amounts disbursed is not discussed for those grants received by all municipalities/counties. No distinction is made between grants received by "some" municipalities/counties whether the number of receivers is two or two hundred. From a political economy perspective, these differences are important, and this lack of detail means that the report by the Swedish Agency for Public Management presents only a perfunctory picture of the allocation of grants. Table 1 shows the result from the report.

Table 1 : Distribution of grants to municipalities and counties for the fiscal year 2001 (number of grants)[24]

Recipient\Category	Category 1	Category 2	Category 3	Total:
All	9	9	-	18
Some	8	17	-	25
Mixed	2	10	-	12
Total	19	36	72	127\55

The grants in category 3 constitute the majority of the total number of grants (72 of 127 grants in total). In the report from the Swedish Agency for Public Management, these grants are not grouped into the subcategories "all", "some", and "mixed". For the grants in categories 1 and 2, "some" constitutes the most prominent subcategory (25 of 55 grants in total). Merely 9 of the 55 grants in categories 1 and 2 are in their entirety directed toward all municipalities and/or counties.

Table 1 does not shed light on whether discretionary grants are used for tactical, political purposes. It does however give an indication of the degree of transparency in the allocation of grants. The grants deemed the least transparent from the perspective of inter-regional redistribution, i.e. those in category 3, are the most numerous. Moreover, the largest subcategory ("some") consists of grants allocated to a selection of municipalities and/or counties. It seems reasonable to assume that the grants in category 3, as well as all those in the subcategory "some", allow the greatest amount of discretion in their allocation. The large number of such grants should hence be considered problematic from a political economy perspective.

The appropriations in category 3 are the most numerous, but constitute a relatively small share of total spending. In terms of volume, it is category 1 that dominates, constituting 89 percent of total grant spending. To clarify this discrepancy,

[24] Data contained in the report by the Swedish Agency for Public Management (Statskontoret 2003:5).

tables 2 and 3 contain the same appropriations as table 1 but expressed in pecuniary terms and as shares of total government grants to municipalities and counties.[25]

Category 1 is dominated by the general purpose grant and the municipal tax revenue equalization grant. The general purpose grant is more or less the same (per capita) for all municipalities. The size of the tax revenue equalization grant, on the other hand, varies greatly between municipalities. Both grant forms are clearly rule-based and non-discretionary.

table 2.4.2: distribution of anslag to municipalities and counties, for the fiscal year 2001 (SEK million)[26]

Recipient\Category	Category 1	Category 2	Category 3	Total:
All	96619.8	2843.4	-	
Some	24588.5	1128.4	-	
Mixed	2372.7	6589.8	-	
Total	123581.0	9661.6	5349.0	138591.6

Table 2.4.3: distribution of anslag to municipalities and counties, for the fiscal year 2001 (%l of total)

Recipient\Category	Category 1	Category 2	Category 3	Total:
All	69.72%	2.05%	-	
Some	17.74%	0.81%	-	
Mixed	1.71%	4.75%	-	
Total	89.17%	6.97%	3.86%	100%

The large number of appropriations in category 3 implies that the individual grants are small: 72 appropriations share SEK 5.349 billion, less than four percent of total disbursements, compared to category 1 where a mere 19 appropriations amount to SEK 123.6 billion. For selective, directed grants to have a significant political effect would require the small, special purpose grants to be exceptionally effective in affecting electoral outcomes. This observation does not contradict the claim that the selective, directed grants constitute a genuine political economy concern. The allocation of those grants comprising category 3 is characterized by a lack of transparency, thus increasing the scope for buying voter support or accruing disproportionate benefits to special interest groups. The 2005 reform incorporated a number of smaller grants into the general grant, as did the previous 1996 reform. From a political economy perspective, this is clearly a positive development.

As mentioned earlier, the summary of financial flows presented in the report by the Swedish Agency for Public Management is not entirely satisfactory from a political economy perspective. The categorization matrix, defined by the headings 1-3 and sub-headings “all”, “some”, and “mixed”, does not offer much information on variation in disbursements between recipients, and does not distinguish between grants disbursed to many (but not all) municipalities or counties, and grants received by only the very few. There is clearly a need for more research into the distribution of these selectively allocated grants.

[25] These tables are my own and are not contained in the report by the Swedish Agency for Public Management. The tables are in effect summaries of calculations in that report.

[26] Calculations based on figures for individual spending areas, as reported by the Swedish Agency for Public Management report 2003:5.

The Swedish studies of tactical redistribution discussed above are highly aware of political economy problems, but also, generally, lack strong relevance for an analysis of the current system for inter-regional redistribution. Moreover, the Swedish Government Official Report SOU 2003:88 and the Swedish Agency for Public Management Report 2003:5 present a detailed descriptive analysis of this system, but consistently avoid any reference to a political economy perspective. Strikingly, the recommendation put forward in SOU 2003:88, that the number and volume of discretionary grants be reduced further (as was the case in the January 2005 reform), makes no explicit reference to political economy considerations.[27] As for the Swedish Agency for Public Management report, the surprising lack of detail regarding the distribution (across recipients) of selectively allocated grants suggests a similar reluctance to express (perhaps even to perceive) the problem at hand in political economy terms.

Inter-regional redistribution from a growth perspective

As mentioned above, a large public sector at the municipality level might require an extensive system for tax revenue equalization, to avoid excessive tax competition between municipalities. Direct redistribution at the local level entails the risk of losing high income residents to municipalities with low tax rates, and attract new residents with low incomes. Moreover, in order to provide services of an equivalent standard to that of other municipalities, those with low levels of taxable incomes would be required to set tax rates at prohibitively high levels. This could be expected to contribute further to migratory flows to municipalities with low tax rates, causing the fiscal situation to deteriorate further, and pushing local tax rates even higher. It is less evident, however, that tax revenue equalization between municipalities needs to be as far-reaching as is currently the case in Sweden. The modifications to the system introduced in January 2005 allow for slightly larger discrepancies in municipal tax bases, but the change is small: the maximum difference in tax bases, net equalizing transfers, increased from (approximately) five to ten percent, hardly an order of magnitude.[28] The other Nordic countries also maintain large public sectors at the municipal level, but not to the same extent as Sweden.

There are a number of potentially harmful effects of extensive inter-regional redistribution. The equalization of tax revenue is fiscally neutral at the national level,

[27] Rather, the emphasis on their recommendation is on efficiency gains, along the lines of the Tiebout hypothesis. If the welfare enhancing efficiency gains from decentralization is a function of heterogeneity at the municipality level, special purpose grants and other forms of designated funds entail the risk of reduced welfare. In addition, designating the use of allocated funds for specific purposes also conflicts with the principle of local self-government.

[28] As described earlier, the current system brings all municipalities to within the range of 113-124 percent of the average per capita tax base, including the regulating grant (*regleringsbidrag*) from the central government. (Figures taken from Berggren and Tingvall 2005.) Under the previous system, all municipalities were brought within the range of 99-104 percent of the average per capita tax base, not including the general government grant (figures taken from SOU 2003:88). Since the regulating grant as well as the general grant that preceded it was disbursed with approximately the same per capita amount to all municipalities, these figures can be meaningfully compared as an indication of the discrepancies in the tax base accommodated by the system.

i.e. disbursements equal receipts to the system. The current design implies considerably reduced incentives to municipalities to strengthen their own tax bases. Indeed, a number of municipalities have faced a so called "Pomperipossa effect", whereby an increase in taxable per capita incomes in the municipalities entails a net loss in revenue for the municipality. The reduction of the levy on excess tax bases from 95 to 85 percent, as described earlier, will hopefully go some way in avoiding such effects. Nonetheless, this does little to alter the conclusion that the incentives to increase the own municipality tax base are severely reduced by a system of far-reaching tax base equalization. Weak incentives to strengthen the local tax base can be expected to have negative effects on economic growth, as a result of reduced competition between municipalities and, consequently, a lower pace of rationalization as well as experimentation and innovation. A less differentiated public sector implies limited possibilities to cater to individuals' heterogenous policy preferences, as envisaged by Stigler or Tiebout (as discussed previously). There is also the view put forward by Brennan and Buchanan (1980), who argue that tax competition need in fact not be a problem. Rather, they see large public sectors at the municipality level *without* inter-regional redistribution as a means to foster competition within the public sector, improving performance and limiting expansionary tendencies. Their point of view is perhaps not easily reconciled with the ambitions of the Swedish welfare state, but it lends support to the argument that the presence of extensive inter-regional redistribution most likely generates a considerable reduction of competitive pressure between municipalities, resulting in inferior performance and negative effects on economic growth.[29]

One example of the consequences of reduced institutional competition between municipalities is the reduced incentives for construction of new housing at the municipal level. Söderström (2002) stresses that this could have particularly harmful effects on the Stockholm region, known for its housing shortage. This shortage of housing in and around Stockholm is regrettable from a growth perspective. The region is central to economic development in Sweden, and economic efficiency requires labour to be allocated to economically dynamic sectors and regions. This points to a related problem: there are reasons to expect that extensive inter-regional redistribution reduces labour force mobility, with negative effects on economic growth as a direct result.

From a static viewpoint, efficient allocation of resources requires factors of production to be allocated so as to achieve the highest productivity. Simply put, if a factor of production is allocated suboptimally, an improvement can always be made by reallocating to where productivity is higher. Optimal allocation has an equalizing effect whereby the marginal product converges for a factor of production, regardless of its allocation. Suboptimal allocation results in different marginal products for the same factor of production, depending on its allocation. This inefficient allocation constitutes a dead weight loss, since the factor of production is evidently not used where it achieves the highest productivity.

From a dynamic, long term viewpoint, a market economy in which economic growth reflects increased productivity requires continuous adaptation and structural

[29] The link between competition, increased productivity and economic growth is taken for granted and not elaborated on in this article.

adjustment, a process famously described as 'creative destruction' in Schumpeter (1942). Rapid technological change and increasing trade flows and international competition increase the need for the economy to adapt easily to changing conditions. To avoid dead weight losses, factors of production must be continuously reallocated to those sectors and regions where they achieve the highest productivity. The geographical mobility of the labour force is an important, natural component of this adaptive process. Gunderson (1994) summarizes this development: "In essence, a strong internal market is necessary to compete in external markets."[30] This adaptation, he points out, takes place both at the 'upside' location, through firm creation, vacancies and labour shortages, and the 'downside' location, through plant closures, redundancies and increased unemployment. A smoothly functioning adaptive mechanism can bring about a reduction in unemployment as well as a reduction in the bottle necks that hamper the growth of new sectors and economic development of regions that fare well in the competition. Economic growth is then facilitated by transferring labour from sectors and regions with low productivity to sectors and regions with higher productivity, in the process improving the competitive strength of the country as a whole. The importance of such an adaptation is further stressed by the increased global economic integration, since labour in the more developed countries, with significantly higher labour costs, must rely on highly productive labour to remain competitive. Labour force mobility can be expected to contribute to macroeconomic stability, by facilitating structural adjustment, thus contributing further to economic growth.[31] The neoclassical prediction of an equilibrium in which factor prices converge can be hard to reconcile with the dynamic, endogenous process taking place in the real world, where differences appear to be a fixture, albeit constantly evolving.[32] Moreover, there are social costs to structural adjustment that must be taken into consideration. This does not, however, reduce the validity of the conclusion that an inefficient allocation of resources, entailing considerable differences in factor productivity across regions, constitutes a continuous welfare loss and contributes to a reduction of economic growth and development.

Labour force mobility does entail risks of reduced growth at the *local* level, in particular if the most mobile groups are young with relatively high levels of human capital, as is often the case. As Myrdal pointed out, regional decline can be self-reinforcing, leading to an even more rapid deterioration of economic conditions in the region.[33] Economically, the counter-argument is that if those leaving the region are young and well educated, this should result in higher levels of compensation for the young and well educated labour remaining. Moreover, new neoclassical growth theory describes considerable positive externalities as a result of labour force mobility: efficiency gains spur economic growth which in turn generates new, endogenous increases in economic growth. This does not contradict Myrdal's concern regarding regional polarization, as opposed to regional convergence, as a direct consequence of labour force mobility. It should be noted, however, that if the economic gains from

[30] Gunderson (1994), p. 5
[31] A lengthy discussion of the link between macroeconomic stability and growth can be found in Fischer (1993).
[32] See discussion on factor price convergence in Krugman och Obstfeldt (1998).
[33] See Gunderson (1994), p. 8-9.

increased growth are sufficiently large, it should be possible for the losing parties to be compensated for this in a manner that does not hamper necessary structural adjustment.

Causes of mobility – and immobility

From an aggregate viewpoint it might appear self-evident that the marginal product for the same factor of production would converge over time. Relatively high returns to labour in one area should attract labour from other areas until marginal rates of return are the same. It is not, however, obvious how this occurs in practice, for example when individuals decide to relocate across regions. The model of migration presented in Harris and Todaro (1970) uses the observation that higher rates of workforce participation are not necessarily what induces individuals to move. This is given empirical support by the large inflows of labour to metropolitan areas in developing countries, despite higher unemployment rates in the cities. Standard neoclassical theory does not account for this behaviour: "This lack of an adequate analytical model to account for the unemployment phenomenon often leads to rather amorphous explanations such as the "bright lights" of the city acting as a magnet…"[34]. Harris and Todaro (1970) suggest expanding the neoclassical model of migration to take into account individuals *expected* incomes, rather than comparing employment rates. The utility maximizing individual moves if his expected income at the new location is higher than his current location. Their analysis is aimed at developing countries in general, and tropical Africa in particular. In their model expected income is simply a function of wage and employment levels, which is too simplistic a framework to be readily transposed to developed countries. Nonetheless, their key observation, that the decision to migrate depends on expected income – to be precise, expect utility – rather than employment levels, is highly relevant for the analysis at hand.

Another important contribution to the theoretical discussion of migration are those theories of human capital formation that treat the decision to migrate as an investment in human capital. This allows for clearer distinctions between individuals' differing propensities to move. The propensity to move can differ for several reasons. Individuals with a longer investment horizon have greater chances of making up for the transaction costs of relocating and reaping returns on the decision to migrate, and hence have a greater propensity to move. Individuals who attain more utility from consumption today, and hence discount the future more heavily, are less likely to move due to the higher value attached to the fixed costs of relocating. On the other hand, the value attached to future utility can induce an individual to relocate even when the initial utility levels at the new location are lower, provided the expected future utility – the returns from migrating – is large enough to compensate for this. If the costs of migrating are greater than the expected return from the investment in human capital (relocation), the individual stays put.

Theories of human capital formation have contributed to the understanding of what affects individuals' decision to migrate, but still leaves a large number of omitted variables that are likely to affect individual migration in practice. Fischer *et al*. (1997)

[34] Harris och Todaro (1970), p. 126

present a comprehensive model of individual migration. Their model incorporates the key conclusions of Harris and Todaro (1970) as well as those of human capital theory, but also includes a large number of variables and parameters that could plausibly determine individual decisions to migrate.

Traditional economic explanations for mobility fail to explain why individuals, in practice, often chose not to move despite considerable differences in income levels. Fischer *et al*. (1997) seeks to shed light on this empirical observation, and their work turns out to have substantial relevance for a growth-focused analysis of the system for inter-regional distribution. In line with most theories of labour mobility, Fischer *et al*. take as their starting point that the decision to migrate is determined by differences at the macro level between countries, regions or specific locations. In the view of Fischer *et al*., these macro difference go beyond the standard economic variables to incorporate social, cultural, political, and ecological aspects. It is the combination of all the factors that constitute the macro environment of the model. The individual decision to migrate is formed on the basis of a comparison of the macro environments at home and at all potential destinations for a relocation. The main point brought home by Fischer *et al*. (1997) as that a full understanding of individual decision regarding migration requires a comprehensive analysis of what differences attain the largest weights at the macro level, *as well as* a detailed understanding, at the micro level, of how the individual decisions are made.

At the micro level, Fischer *et al*. distinguish between (a) economic needs, (b) security and safety, (c) social needs, in particular a sense of belonging and acceptance, and (d) the desire for self-realization. This categorization is influenced by Maslow's 'hierarchy of needs' and reflects and interdisciplinary attempt to understand the motivations for human actions in general. Other non-economic variables taken into account at the micro level includes peace, freedom, health, and happiness. A number of common assumptions in conventional models of migration are discussed and rejected: moving, Fischer *et al*. point out, is *not* without transaction costs. Moving is *not* without risk. The potential migrants are *not* homogenous agents. The potential migrants do *not* have access to perfect and free information. Incomplete information implies that subjective factors and the degree of risk aversion play a more important role.[35] The potential migrants are *not* unboundedly rational agents, and they are *not* independent of a social context. Their sense of well-being can be greatly influenced by reference groups in the immediate surroundings, rather than comparisons at higher (national or international) levels of aggregation. The decision to migrate is seldom purely individual, and frequently takes other family members into account.

Fischer *et al*. (1997) offers a more complex representation of the micro level decision to migrate. They also include a large number of non-pecuniary variables in their analysis. Only by taking all these factors into consideration can empirically observed patterns of mobility be explained as the actions of utility maximizing individuals. The agents in their model operate from the confines of bounded rationality[36], i.e. the decision to stay or go is made in a rational manner, but

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[35] See the discussion in Fischer *et al*. (1997), pp. 64-65

[36] "The problems with tackling complex sets of alternatives, a description which is certainly appropriate for many 'stay' or 'go' decisions, led to the concept of bounded rationality. Simon (1957, 1983) describes the actions of human beings as bounded by the situation they face, the experiences they have

conditional on the available information, and incorporating a large number of non-pecuniary variables. For these reasons, it is possible that relevant macro level variables are overlooked when the individual decides to migrate.

The interdisciplinary model in Fischer *et al*. (1997) is perhaps impractical for economic analysis. Nonetheless, it is an important contribution to a comprehensive, growth-focused analysis of the system for inter-regional redistribution. A key conclusion of Fischer *et al*. (1997) is that immobility in and of itself can generate positive utility. In traditional theories it is mobility which is the positive force, as a means to increased economic efficiency, while immobility is presented as a rigidity or obstruction. Fischer *et al*. argue that this view on immobility is contradicted by the 'paradox of immobility', whereby most individuals chose not to migrate, despite the prevalence of considerable wage differentials.

According to Fischer *et al*., the paradox of immobility is in part explained by agents' *location specific assets*: insider advantages at the workplace and in one's leisure time, as a function of having spent a long time at a location, constitutes a considerable sunk cost forgone when relocating. Workplace specific insider advantages can give individuals a stronger position in the local labour markets. Leisure specific insider advantages include social capital and good knowledge of local possibilities for consumption, which can enable individuals to attain a higher utility level given a certain budget restriction. These insider advantages are lost when relocating, and instead the individual faces transaction costs for generating new insider advantages in a new environment: "To regain space and society-specific leisure-oriented insider advantages in a different macro-level unit is costly and time-consuming: to stay immobile has it's own value."[37]

The model presented in Fischer *et al*. (1997) offers a detailed understanding of the migratory decision at the micro level. Macroeconomic variables are given a swifter treatment. The point they wish to make is that assorted micro level variables affect the manner in which individuals perceive differences between locations at the macro level. Fischer *et al*. (1997) is first and foremost concerned with the interaction of micro environment and macro environment that forms the basis for the decision to migrate. A more extensive discussion of the macro environment is, however, lacking – in particular, a discussion about what role might be played by an extensive, largely decentralized public sector and a concomitant system for inter-regional redistribution.[38]

Shaw (1986) examines the relationship between the public sector, regional policies, and migration, focusing on macroeconomic variables. Shaw tests the hypothesis that 'traditional' variables have declined in influence on individual decisions to migrate, while other fiscal factors have come to play an increasingly important role. Shaw relates this development to a crowding-out process whereby expanding social security systems and increased transfer reduce the effects of, for example, unemployment and wage differentials. This is described as a 'short-

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acquired before, their emotional patterns and their limited computational abilities." Fischer *et al*. (1997), p. 69.

[37] Fischer *et al*. (1997), p. 77

[38] The authors note that an extensive social security system can reduce incentives to migrate, but do not develop the argumentation further. See Fischer *et al*. (1997), pp. 82-83

circuiting' of the market mechanisms that normally induce labour to migrate from regions with low income levels to regions with higher income levels (contributing, in the process, to the convergence of income levels). The 'short-circuiting' metaphor can be traced to the seminal studies by Courchene (1970, 1981), who argued that inter-regional redistribution and equalization entails costs in the form of reduced efficiency, by creating incentives for labour to remain in relatively poor regions despite lower productivity and wages. Shaw also covers some of the studies arguing against Courchene, including Broadway and Flatters (1982). Broadway and Flatters claimed that extensive inter-regional redistribution was indeed motivated by efficiency considerations, in particular due to the competition problem, as discussed above. Shaw contends that the conclusion drawn in Broadway and Flatters (1982) is exaggerated and lacking empirical validation.

Shaw employs Canadian migration data during the periods 1956-61, 1966-71, 1971-76 and 1976-81. The core hypothesis, that fiscal variables have crowded out traditional (market-based) variables in determining labour force migration, is separated into two sub-hypotheses: (i) that the traditional labour market variables, in particular wage and unemployment levels, have declined in influence on migration flows; and (ii) that fiscal variables, in particular extensive systems of social security as well as inter-regional redistribution and related transfers, have increased in influence, following the system reforms in 1971 that brought about large increases in these variables. In his quantitative analysis, Shaw is unable to reject either hypothesis. Inter-regional differences in wage and unemployment levels have had a decreasing effect on migration flows in Canada since 1971, and the fiscal variables have had an increasing effect. Shaw stresses the importance of distinguishing between the main hypothesis and the two partial hypothesis. The econometric analysis reveals the changes in effect of the variables over time, but does not explain causal relationships between the variables. The observation that the traditional variables have decreased in importance could potentially be attributed to other factors affecting individual preferences: "Income, for example, might matter less now because of diminishing marginal utility of money or because public goods are preferred over private goods. Furthermore, if recent times were characterized by slowed economic growth and slack labor markets… then smaller impacts of wage and job variables today might be no more than a transitional phenomenon caused by adverse cyclical conditions."[39] Nonetheless, Shaw draws the conclusion that the fiscal variables certainly *appear* to have crowded out the traditional, market-based mechanisms in their influence on migratory flows between regions in Canada. The results arrived at in Shaw (1986) are hence very much in line with the picture presented in Courchene (1970, 1981), where economic policies, notably extensive systems of social security and inter-regional redistribution, 'short-circuit' those market mechanisms inducing labour migration from regions of low productivity to regions of high productivity.

Shaw concludes that the public sector does have an impact on migration, in particular through systems of social security and through inter-regional redistribution, but does not develop this line of reasoning further. Charney (1993) offers a more detailed analysis of the connections between the public sector and migratory flows. Charney incorporates a large number of variables into this analysis, including the

[39] Shaw (1986), p. 654

relationships between public sector, firm localization, and employment growth. The departure point for the analysis is the hypothesis that inter-regional redistribution, through effectively subsidizing the cost of providing public sector services to certain regions, has significant effects on the tax-price of these services, creating large price differentials between (and within) regions. Referring to a number of related studies, including Day (1992), Herzog and Schlottman (1986), and Knapp and White (1993), Charney concludes that it is the *combination* of taxes and services from the public sector that ought to be the focus of attention.[40]

In Charney's view, the role of the public sector in determining firm localization is well established.[41] Assuming a one-way relationship between employment growth and migratory flows[42], she concludes that a positive impact of the public sector on firm localization (and hence employment rates) will also attract migratory flows. As is explained in detail below, this relationship does not hold in the case of Sweden, where employment levels have little explanatory power for migration patterns. This actually confirms the conclusions of Charney (1993). Her analysis indicates a number of channels through which an extensive public sector and a far-reaching system of inter-regional redistribution and equalization can affect geographic mobility. Inter-regional redistribution and equalization transfers allow for a far greater public sector at decentralized levels than would be possible if merely relying on the collection of local taxes. To the extent that firm localizations are affected by the level of public sector services, a larger proportion of firms will locate to subsidized areas that would otherwise have been the case. Firms are able to capture the benefits of localizing in regions of low productivity (lower labour costs, lower rents etc.) without having to confront some of the main disadvantages. A subsidized, and hence more extensive, municipal sector in and of itself creates more employment opportunities at the local level. These factors can be expected to have a joint effect on mobility, notably through reduced migration. If the local public sector is particularly extensive, as is the case in Sweden, is it reasonable to expect the effects to be stronger. An extensive public sector and far-reaching inter-regional redistribution can hence be expected to have an inhibiting effect on the geographical mobility of labour. This conclusion, drawn by Charney (1993), is entirely in line with the arguments put forward in Courchene (1970) and Shaw (1986), and reinforces the image of a 'short-circuiting' of the traditional market mechanisms determining the localization of the labour force across regions.

The general theories of migration discussed previously all appear to underestimate the effects of the public sector on geographical mobility. Charney (1993) constitutes an important contribution to the understanding of the interactions between the public sector, inter-regional redistribution, and labour force mobility. A weakness of Charney (1993) is the reluctance of its author to clarify in what manner the macro variables might interact with other variables at the micro level. It should be

[40] "The implication of studies that find significant public sector influences on migration is that areas with desirable fiscal packages can attract migrants." Charney (1993), p. 318

[41] Charney (1993) refers to Bartik (1991) for a survey of the literature dealing with the relationship between the public sector and firm localization. See Charney, p. 320

[42] "Because the link between jobs growth and human migration is well documented, the entire body of literature relating to the role of the public sector in industrial location and job growth becomes unavoidably tied to the analyis of human migration." Charney (1993), p. 314

noted, however, that her article is primarily intended as a survey of existing literature, and that this flaw might therefore be attributed to the literature on the topic in general. Charney points out that the relationship between the public sector and labour force migration is relatively unexplored. The strength of her analysis lies in the pertinent distinction between direct and indirect effects of the public sector on mobility, a distinction that shed some light on the difficulties involved in quantifying these effects.

Swedish mobility – and immobility

Geographical mobility in Sweden displays a declining trend since the 1960s. The number of moves has decreased and it is reasonable to also expect the motives for moving to have changed somewhat. At the beginning of the 1960s, active labour market policies sought to facilitate the migration out of the *Norrlandslänen* (the counties of Norrbotten, Västerbotten, Västernorrland, Jämtland, and Gävleborg) to the more economically expansive industrial regions in southern and central Sweden. Policies focusing on promoting mobility as a means to bolster national employment reflected the Rehn-Meidner model with its emphasis on efficiency and increased productivity as key to improved standards of living. The selective, effiency-promoting labour market policies were succeeded, in the early 1970s, by policies promoting an almost polar opposite line. Criticism of the so called *flyttlasspolitiken* (policies promoting migration) and a greater emphasis on employment security and directed subsidies to sectors and regions coincided with a break in the migration patterns: during the 1970s the *skogslänen* (the counties of Dalarna, Värmland, and Norrland) in the north became net receivers of migrants while large declines in migrant inflows were reported in a number of counties in central Sweden with considerable industrial activity.[43]

Nilsson (1995) compares the northern *skogslänen* counties with metropolitan counties during the period 1965-93 and reaches the conclusion that the 1970s saw increased differences between these two categories of counties in terms of active labour market policy efforts, and reduced differences in unemployment rates. As long as the labour market policies reflected the intentions of the Rehn-Meidner model, geographical mobility had a harmonizing effect on the regional imbalances of the national labour market. Nilsson describes this as a policy of structural adaptation where market forces played a pivotal role. By contrast, the policies introduced during the 1970s reduced geographical mobility and aggrevated regional differences in employment. This development was not primarily reflected in the unemployment figures of the period, but in the extensive programs for subsidies to regions and sectors of industry. Nilsson (1995) notes that while the new migratory patterns, counter-productive from the point of view of factor allocation, did not actually increase differences in the official unemployment rates, this is most likely explained by the extensive labour market policies and industrial policies conducted during that decade. These policies did little, however, to alter the over-arching trends of structural change. During the period 1965-93 the unemployment rate of the *skogslänen* counties was at

[43] For a more detailed description of migratory patterns during the 1970s, see Nilsson (1995), pp. 18-19.

an average 1.5 percentage points higher than in the metropolitan counties, and during the 1980s migratory patterns reverted to forms more in line with what preceded the 1970s.[44]

A similar picture is presented in Heiborn (1998), who also attempts a quantitative analysis of labour force mobility in Sweden. She finds some support for the hypothesis that unemployment and number of vacancies affects mobility between regions. She also finds evidence that labour market programs create locking-in effects. Heiborn's main conclusion, however, is that her model is misspecified, and advocates caution in interpreting the results. This underscores the difficulties of analyzing migration data and points to a need for further research in this field.

Importantly, the developments of the 1970s reveal the emergence of two different and not entirely compatible definitions of regional balance. The first definition, according to which regional balance is taken to mean a harmonization of employment opportunities, might be considered dominant during the 1960s. The second definition considers regional balance to occur when the proportions of the population resident in the different regions of the country remain unchanged. This second definition, hinging on some subjective notion of regional population equilibrium suggest a potential conflict of interest between labour market policies and regional policies.

In August 2002, the Ministry of Industry, Employment, and Communications[45] was commissioned by the government to investigate the possibilities for stimulating incentives to geographical mobility within the ramifications of existing labour market policies. In April 2003, the ministry presented its conclusions in the report *Ökad rörlighet för sysselsättning och tillväxt* (SOU 2003:37). The report suggests that the potential conflict between labour market policies and regional policies continues to be problematic. Moreover, they show that this conflict originates, in part, in differing definitions of what in fact constitutes regional balance. In line with the arguments put forward in Nilsson (1995), the authors of SOU 2003:37 observe that geographical mobility has been decreasing since the 1960s. During the mid-1990s, four percent of the population moved across county borders, compared to 5 percent at the end of the 1960s. Most move only a short distance: in 1994, 85 percent of migrants moved less than 50 kilometers. The authors of 2003:37 also stress that the motives for migration have changed to an ever greater extent: labour market conditions have decreased in importance, while social and environmental conditions have become more important.[46] They also emphasize the role played by developments in commuting (increases in numbers of commuters and distances commuted) as a precondition for the emergence of integrated labour markets during the recent decades. These integrated labour markets entail significant improvements for employment prospects, since a more differentiated business sector with has better chances of coping with structural adjustment than small, local labour markets dominated by a small number of firms of sectors. This is entirely in line with the argument put forward in Nilsson (1995).

[44] Nilsson (1995)
[45] *Näringsdepartementet*, henceforth referred to as the Ministry of Industry
[46] See SOU 2003:37, p. 11

Notably, it is a consideration that is entirely lacking in the aforementioned reports on the system for inter-regional redistribution.[47]

The authors of SOU 2003:37 stress that the main purpose of labour market policies is to contribute to the smooth functioning of labour markets, promoting full employment and economic growth *at the national level*. They refer to proposition 2002/03:1 in which the government states that the main aim of labour market policies is to match unemployed workers and vacancies. This is achieved primarily through state-run employment centres, job training programs, and by stimulating labour mobility. Labour mobility can be stimulated through grants subsidizing the costs of commuting or relocating.

Geographical mobility does not, however, appear to be of great priority within labour market policies. Job seekers have a legal right, during the first 100 days of receiving unemployment benefits, to contain their job search to areas in their immediate proximity. The guidelines given by the National Labour Market Board (AMS) to the country labour boards emphasize the importance of mobility but contain no directions or aims relating to stimulating geographical mobility. SOU 2003:37 refers to studies showing how local job agencies give little advice encouraging geographical mobility.[48] The report also notes that labour market policies have increasingly been assigned regional policy roles. Regional policy considerations, in particular the stated aim of promoting "well functioning and sustainable local labour markets"[49] is, in the view of the authors of SOU 2003:37, not necessarily compatible with the greater aim of promoting full employment and economic growth. This apparent conflict between labour market policy and regional policy is entirely in line with the argumentation put forward in Nilsson (1995), as discussed above.[50]

This conflict is also reflected in the policy suggestions presented in SOU 2003:37. Despite having noted a potential conflict between regional policy and the greater aims of labour market policies, the authors nonetheless make policy recommendations that appear to be heavily influenced by regional policy considerations. They propose an increase in subsidies to long distance commuters and labour market policies designed to encourage 'key workers' to move to supported regions. They also suggest abolishing a number of relocation subsidies. The motivation given for the latter suggestion is that these subsidies are frequently received by individuals that would have moved anyway. The former suggestions, which are not given explicit motivation, display a profound focus on dysfunctional local labour markets, and a lack of consideration of the aggregate, national labour market. In particular, a discussion of long term dynamic effects of labour market policies is entirely lacking. The report notes the labour shortage experienced by a number of regions and business sectors. The report also mentions the 2002 business survey[51] where labour shortages were listed as the single most important impediment to growth faced by small firms. Yet despite these insights the policy suggestions

[47] An interesting perspective on Swedish inter-regional migration is provided by the literature dealing with Swedish settlement policies regarding immigrants. See for example Edin *et al* (2004).
[48] SOU 2003:37 fails to specify what reports are being referred to. See SOU 2003:37, p. 13
[49] SOU 2003:37, p. 13
[50] For an informative dicussion of the shortcomings of Swedish regional policy in promoting employment and growth, see Andersson (2005).
[51] *Företagsbarometern* 2002, annual business survey referenced in SOU 2003:37, p. 29

contained in the report serve only to stimulate migration *to* economically stagnant regions. The report 2003:37 must hence be considered a prime example of how economic policies discussed without attempts at a comprehensive, evolutionary analysis run the risk of becoming seriously misguided.[52]

The Ministry of Industry report SOU 2003:37 notes that it is difficult to stimulate mobility outside of the natural migratory patterns.[53] From a policy perspective, it is puzzling, given this observation, that no reference is made to the possibility of reducing those factors inhibiting such 'natural migratory patterns'. On a couple of occasions, the report mentions how the decline in mobility during the 1970s and 1980s coincided with a rapid expansion of the public sector, providing opportunities for individuals to remain in and around regional centres. This development, whereby an extensive public sector contributes to an inefficient geographical allocation of labour, is not discussed further at any point in the report. That exceptionally extensive inter-regional redistribution might reinforce such a tendency is not mentioned.

The authors of SOU 2003:37 recognize that imbalances in the Swedish housing markets is an obstacle to migratory inflows in certain regions. Currently (2005), more than half the population is living in municipalities with housing shortages. In the report, no reference is made to the lack of incentives for municipalities to increase their tax base through the construction of new housing or other active policies to encourage migratory inflows. In practice, as noted above, some municipalities have even faced negative incentives, whereby per capita tax revenue decreases if per capita taxable incomes increase.

A further shortcoming of the Ministry of Industry report is the lack of any discussion concerning the long term effect of the composition of production and consumption. The authors note that positive developments in employment levels has a hampering effect on migration out of a region, but fail to distinguish between positive developments in employment levels as a result of a dynamic private sector and superficially similar developments resulting from an expanding public sector that, in combination with interventionist labour market programs, seeks to compensate for a stagnating private sector. From a growth perspective the difference is considerable, but apparently this not the main perspective of the report.

While the report recognizes that small regional wage differentials and a compressed wage structure in themselves constitute weakened incentives to geographical mobility[54], there is no mention of the manner in which extensive redistribution between individuals, and between regions, imply that a large proportion of individual consumption stems from the public sector. The consequence of a far-reaching system for inter-regional redistribution is that a key component of individuals' consumption is no longer affected by individuals' choice of domicile. These factors and their expected contributions to reduced mobility in general and reduced migration out of less economically dynamic regions in particular are not addressed whatsoever in the report by the Department of Industry.

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52 An interesting complementary perspective on this is offered by Edling (2005).
53 SOU 2003:37, p. 15
54 See for example SOU 2003:37, p. 44

A detailed, comprehensive understanding of the effects of an extensive public sector and a far-reaching system for inter-regional redistribution is generally lacking in the report. Not even the effects of reduced mobility on economic growth are discussed in a satisfactory manner. Hence the SOU 2003:37 report recognizes a potential conflict between regional policy and labour market policy but fails to contribute to our understanding of how to solve this conflict. The policy recommendations are evidently not primarily intended promote economic growth. Nor do they appear to be founded on long-term economic analysis. Rather, the policy recommendations of the report come across as bland manifestations of the less-than-instructive slogan "the whole of Sweden shall live".[55] Arguably, such economic policies, through supporting an inefficient allocation of labour and impeding the emergence of larger, integrated labour markets, might enable 'the whole of Sweden to live', but at lower levels of income in the future. Notably, there is nothing in the SOU 2003:37 report that contradicts the hypothesis discussed above, that extensive inter-regional redistribution entails a risk of 'short-circuiting' a natural migration process whereby labour is reallocated to regions with higher productivity.

Conclusion

> "We need decentralization because only thus can we ensure that the knowledge of the particular circumstances of time and place will be promptly used. But the "man on the spot" cannot decide solely on the basis of his limited but intimate knowledge of the facts of his immediate surroundings. There still remains the problem of communicating to him such further information as he needs to fit his decisions into the whole pattern of changes of the larger economic system." (Hayek, 1945, p. 524-525)

The quote from Hayek (1945) serves as a reminder that decentralization requires communication. This insight remains surprisingly overlooked. Hayek (1945) argues that it is the price system that is best suited to serve as the system of communication in the economy. While the tax-price of public services offered by municipalities may be difficult to quantify with precision, they are nonetheless part of a price system affecting individuals' choice of domicile. Moreover, if there is such a thing as 'natural' geographical mobility, here taken to mean mobility induced by the search for higher productivity and wages, then it seems reasonable to assume that a system for inter-regional redistribution that affects the relative tax-price of public services should be expected to hamper such mobility. When public goods and services constitute a relatively large share of consumption, we should expect this tendency to be aggrevated.

To the extent that structural adjustment entails a geographical reallocation of labour, such a causality should be expected to have negative effects on economic stability and long-term growth. Political economy problems relating to inter-regional redistribution between Swedish municipalities have been given a fair amount of attention in recent years. This article argues that political economy considerations do

[55] This was the slogan of *Folkrörelserådet Hela Sverige*, an interest group for rural regions, formed in 1989.

not pose a major problem given the actual design of the system, which gives little discretionary power to the government in allocating transfers between regions. The growth perspective on inter-regional redistribution is comparatively neglected. This article has sought to show that the long term effects of inter-regional redistribution have been largely overlooked. A general conclusion is that the existing studies point to an unresolved conflict between labour market policies and regional policies, whereby regional policy considerations undermine efforts to promote employment and economic growth. Clearly, in order to evaluate the current system for inter-regional redistribution we need a better understanding of its effects on labour mobility, by implication, on economic growth. In addition, a better understanding is needed of how the current system reduces incentives for institutional competition between municipalities, which could be expected to result in a lower pace of rationalization as well as experimentation and innovation. This in turn results in a less differentiated public sector with less ability to cater to individuals' heterogenous policy preferences.

This article is primarily intended as a call for further enquiry. The Swedish system for inter-regional redistribution is complex and extensive. Without doubt, it plays an important role for economic developments in the country. To clarify the effects on economic development more exhaustively, paying particular attention to dynamic, long-term effects – in the terminology of Pelikan (2004), *to attempt a comprehensive, evolutionary analysis of this area of economic policy* – is a hugely important task, and will require a great deal more research. Other aspects of the system need to be examined closely, and the assumptions and conclusions of official reports should be cross-examined further. Proper political economy analysis, making use of developments in economic modeling, could without doubt contribute valuably to the understanding of the system. Quantitative analysis of migration data – micro data, especially - could contribute significantly to our understanding of the links between inter-regional redistribution and geographical mobility. Applications of contemporary growth theory might shed more light on the potential effects of the aforementioned 'short-circuiting' of labour mobility, as well as the effects of reduced institutional competition, on economic growth and development. Clearly, such research is needed if we are to properly evaluate the costs and benefits of the current system of inter-regional redistribution. It is my hope that this article will at least inspire such further research.

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