Soft budget constraint in health care: evidence from Italy

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In this paper we show that fiscal federalism in health care may produce perverse effects because both richer (and more efficient) Local Authorities and poorer (and less efficient) ones may have an interest in playing strategically. The former want to control expenditure, the latter have no incentive to raise resources locally and to become more efficient. We furtherly develop the model presented in Levaggi and Menoncin (2011) to show that a soft budget constraint policy is the likely outcome of a process of fiscal federalism when applied to health care provision.

We test the theoretical model using a balanced panel of data for the period 2002-2006. Our results prove the existence of a bargaining process between richer, oversized Regions and poorer ones which agree to increase expenditure and loosen their constraints using this policy.

In the short run this may be the best way to react to tighter controls, but the effects of a soft budget constraint are perverse: total welfare is lower, and Central Government is not able to control both total expenditure and the distribution of welfare between the two Regions.

Since 2007 Italian Central Government has tighten its control over deficits and we offer some evidence on the likely effects of this policy

Our model uses Italy as a benchmark, but the results can be extended to any federal context where resources are unevenly distributed.