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# *The Political Economy of Equalization Transfers*

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## **1. Introduction**

Normative theories of fiscal federalism postulate that intergovernmental transfers should be determined by equity and efficiency considerations, to support local governments in providing differentiated public goods to heterogeneous populations, while ensuring an even distribution of basic services across all regions (Musgrave, 1959, 1983; Oates, 1972; Gramlich, 1977). However, a recent surge of empirical evidence shows that variations in intergovernmental transfers to sub-national jurisdictions within countries cannot be explained by traditional concerns of equity and efficiency alone, and that political variables representing electoral incentives of public agents are additional and significant determinants (Inman, 1988; Grossman, 1994; Pereyra, 1996; Worthington and Dollery, 1998; Porto and Sanguinetti, 2001; Ansolabehere and Snyder, 2003; Johansson, 2003; Khemani, 2003).

Wright (1974) provided some of the first indications that political factors were significant in determining the allocation of federal funds across states in the United States. In particular, he found a strong positive correlation between New Deal spending

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\* The findings, interpretations, and conclusions expressed in this paper are entirely those of the author, and do not necessarily represent the views of the World Bank, its Executive Directors, or the countries they represent.

per capita and electoral votes per capita across states. Inman (1988) argues that the pattern of distribution of central grants to the states in the United States does not seem consistent with policies designed to correct inefficiencies of a decentralized tax system, but rather reflects decisions taken by bargaining within the central legislature. Grossman (1994) models grants to the U.S. states as being determined by the “political capital” of state politicians and interest groups, and finds that empirical measures of this are positively correlated with per capita grants. Johansson (2003) brings evidence from Sweden that grants to municipal governments are targeted to those with the most swing voters in elections. Extending this literature to federal arrangements in developing countries, Porto and Sanguinetti (2001) and Khemani (2003) provide evidence from Argentina and India respectively that provinces that are politically more important for the central government receive greater transfers.

Indeed, in this new political economy literature, “equalization” has come to mean something quite different than what we assume in this conference—equal votes produce equal distribution of resources, with provinces and counties having greater per capita representation in the central legislatures receiving greater per capita resources (Ansolabehere, Gerber, and Snyder, 2003; Porto and Sanguinetti, 2003). In addition to legislative representation, other political factors have systematically emerged in the literature as being significant in explaining the distribution of national resources across regions, either as general transfers to sub-national jurisdictions or through direct spending by national governments. A second is whether a larger proportion of voters in a region are “core” supporters of the party in power at the center in that they vote largely on ideological grounds, or whether they are “swing” voters, that is, the non-ideological whose vote can be influenced through spending policies (Schady, 2000; Case, 2001; Strömberg, 2001; Johansson, 2003). These empirical findings are grounded in theories of legislative bargaining (Weingast, Shepsle, and Johnsen, 1981) and electoral competition (Cox and McCubbins, 1986; Lindbeck and Weibull, 1987; Dixit and Londregan, 1995, 1996, 1998).

A third factor is the partisan affiliation of voters and governments, where the effect of party identity depends upon the nature of electoral competition (Grossman, 1994; Levitt and Snyder, 1995; Worthington and Dollery, 1998; Khemani, 2003). A fourth is the degree to which citizens are informed and participating in the electoral process, with regions with more households exposed to the news media receiving greater welfare transfers and public services (Besley and Burgess, 2002; Stromberg, 2004).

What can policymakers do in the face of such political constraints when they indeed do have the objective of equalizing fiscal capacity or ensuring access to minimum services across regions? This paper aims to explore answers to this question by examining existing institutional measures to combat political influence, and by deriving potential interventions from the underlying political economy problem itself.

## **2. Delegation of intergovernmental transfers to independent agencies**

Several federations around the world have attempted to create politically independent bodies that are responsible for determining federal transfers to sub-national jurisdictions.<sup>1</sup> However, until recently (Khemani, 2003), there was no evidence in the literature that explicitly tested whether these constitutional rules indeed make a difference. For instance, in Australia, intergovernmental transfers are determined by an independent Commonwealth Grants Commission, which is supposed to be “free from political and bureaucratic bias” (Matthews, 1994, p. 16). Worthington and Dollery (1998) find evidence that some transfers that are not subject to strict fiscal equalization formula that govern other fiscal assistance grants in Australia, are distributed across states in a manner that is consistent with a Grossman-style story of states with greater “political capital” receiving greater transfers. However, they do not provide any evidence to show whether formula-driven financial assistance grants, on the other hand, are indeed impervious to political control, as suggested by the different institutional framework within which they are determined.

The Indian federation provides a valuable laboratory for the purpose of examining the impact of such delegation because of the existence of two major channels of general purpose federal transfers to state governments: one that is determined by an explicitly political body made up of the executive heads of the central and state governments, while the other is determined by a quasi-judicial body with constitutional authority. Using disaggregated data on transfers and political variables for the major Indian states from 1972-1995, Khemani (2003) finds a pattern of evidence that shows that while the transfers that are determined by political agents are indeed distributed to serve political objectives, the distribution of transfers by an independent agency curbs political influence and is consistent with promoting equity. These transfers are by far the largest source of central assistance to the states, together constituting 30 percent on average of state revenues, and over 50 percent of state borrowing.

Transfers in India that are determined at the discretion of political agents are significantly greater to those states whose governments belong to the same political party as that of the national government. Furthermore, amongst partisan states, these discretionary transfers are greater to those states where the party controls a smaller proportion of seats allotted to the state in the national legislature, and therefore has more to gain. Politically affiliated states where the ruling party controls less than half to a quarter of the seats assigned to the state in the national legislature receive discretionary transfers that are greater by 10 to 30 percent of the sample average.

In contrast, transfers that are determined by the independent agency with constitutional authority serve to counter these partisan effects on resources available to

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<sup>1</sup> The Commonwealth Grants Commission in Australia is the best example from amongst the older federations of the world. However, it is in the newer federations in Asia and Africa that decision-making over intergovernmental transfers are increasingly being delegated to an independent agency, such as the National Finance Council in Malaysia, the Revenue Mobilization Allocation and Fiscal Commission in Nigeria, and the Finance Commission in India (which is studied here).

state governments. Constitutional transfers are also effected by the same political variables, but in exactly the opposite direction than those predicted by the model of electoral competition—politically affiliated states receive lower constitutional transfers than non-affiliated states. Such an outcome is predicted as a Nash equilibrium of a simultaneous-move game between the two central agencies—one having political objectives, and the other equity objectives—that determine resource transfers to state governments. Khemani (2003) argues that these results suggest that constitutional rules indeed act as a check on politically motivated distribution of resources by the national executive. The mandate of the independent agency is to provide equalizing transfers, with greater resources allocated to disadvantaged states. If non-affiliated states are politically disadvantaged, and likely to have fewer national resources directed towards them, whether through intergovernmental fiscal transfers or direct spending by the central government, then greater constitutional transfers would be directed to them not because of political motives but because they happen to be the resource-poor states.

If the two sets of transfers are pooled, then the partisan effect on discretionary transfers dominates, that is, total general-purpose transfers from the center are greater when a state government is politically affiliated with the center. Affiliated states whose ruling parties control less than half of the state's seats in the national legislature receive total transfers that are greater by 4 to 18 percent of the sample average. This suggests that even when delegation to an independent agency makes a difference, it is difficult to completely reverse the impact of political influence.

Furthermore, the contrast between the different types of Indian transfers suggests that the difference is due to the effect of constitutional rules on the general decision-making process rather than the difference between formula-driven versus non-formulaic, discretionary transfers. Although both statutory tax sharing and plan grants are formula-driven, we find a partisan effect on each of them albeit in meaningfully opposite directions. These findings highlight the significance of the political incentive environment within which policy decisions are made, and the limitations of technical formulae in neutralizing or blocking the impact of political imperatives.

### ***Impact of formula-driven transfers***

Political factors can mediate the impact of even formula-driven transfers on fiscal policies, and not always in undesired directions. I provide one example from India on how political bargaining actually blunts the disincentives inherent in a particular transfer design. Intergovernmental transfers in India have long been assumed to provide perverse incentives to state governments for fiscal profligacy because of the so-called “gap-filling” approach where some transfers are directed to cover the discrepancy between planned expenditures and expected revenues (Rao 1998, McCarten 2001). Khemani (2004) tests this hypothesis by simultaneously estimating the effect of the *level* of transfers (in per capita real terms) on Indian states' fiscal deficit and the determinants of transfer distribution across states, using three-stage least squares.

There is an inherent simultaneity problem in identifying the effect of transfers on deficits, because both are presumably determined in equilibrium under general economic conditions. Unfortunately, this endogeneity is not addressed in a satisfactory manner given lack of good instruments that only effect transfers and not state fiscal behavior directly. However, this is a first attempt to do so by using lagged values of transfers as instruments. To the best of my knowledge, this is the first time a rigorous test has been undertaken of the conventional wisdom that the design of intergovernmental transfers in India creates perverse incentives for state governments to run higher deficits.

Khemani (2004) distinguishes between the specifications for the distribution of the two types of transfers—those determined by the independent agency and those determined under political discretion. Lagged transfers are used in each specification for the determination of transfers, and omitted from the deficit equation, to identify the impact of transfers on deficits. Political effects on the distribution of transfers across states are identical to that reported in Khemani (2003)—while discretionary transfers are targeted to those affiliated states where the ruling party controls a smaller proportion of seats in the national legislature (to maximize the party's representation in the legislature), transfers determined by the independent agency is consistent with promoting equity across states by curbing political influence.

The level of transfers received by state governments has a negative effect on fiscal deficit—a one percent increase in either category of per capita transfers is associated with a fall in deficit of 0.4 percent, calculated at the sample average. Hence, although the effect is not elastic, it runs counter to the received wisdom that greater transfer dependence is associated with higher deficits. Greater transfer receipts in this case appears to be indicative of greater resources available to state governments, which lowers their need for deficit financing.

Khemani (2004) argues that this lack of effect of transfers on fiscal performance in India is because of the precedence of political relationships between the central and state governments in determining state fiscal outcomes. Formal rules regulating fiscal relations in federations will have limited impact if deficits are determined by the nature of electoral competition between political parties, and the rules of fiscal federalism do not change the nature of party competition in the federation.

Formula-driven transfers are usually promoted on the grounds of transparency and predictability. But there is evidence from Nigeria that political economy considerations lead to a situation in which even such transfers can generate considerable uncertainty and confusion and thereby undermine accountability of local governments.

Nigeria is one of the few countries in the developing world to have significantly decentralized both resources and responsibilities for the delivery of basic health and education services to locally elected governments. Local governments in Nigeria are constitutionally entitled to a share of about 20 percent of federal revenues, which in recent years of oil price booms has implied substantial resource flows to local governments, distributed in strict accordance to a formula that includes equity elements.

Khemani (2004) presents evidence that over-dependence of local governments on federal transfers has undermined local accountability and created perverse incentives at the local level to misallocate public resources.

A survey of local governments, public primary health facilities, and health care providers in the state of Kogi revealed that 42% of staff respondents report not receiving any salary for 6 months or more in the past year at the time of the survey. Variation in non-payment of salaries cannot be explained by variation in resources available to local governments, nor in actual spending on salaries reported by local governments, and is therefore evidence suggestive of a problem of general accountability of local governments in managing substantial resource transfers from taxpayers outside their jurisdiction. Non-payment of salaries of health staff by local governments is reminiscent of a similar problem of non-payment of teacher salaries in primary schools in the 1990s, when primary education was decentralized to local governments (Olowu and Erero, 1995). Following nation-wide agitations by teacher unions a policy of deducting primary school teacher salaries from the revenue share of local governments in the Federation Account was adopted (termed “deductions at source”), with the salaries being directly passed-on to the teachers.

This “solution” of essentially converting a portion of an untied federal transfer into a specific purpose grant for teacher salaries, although successful in ensuring that teachers get paid, has unintended pernicious effects of undermining overall accountability of local governments. Local governments claim that deductions at source in essence lead to “zero allocations”, thereby preventing them from carrying out any of their responsibilities for service delivery (The World Bank, 2003). Such uncertainty about resources actually available to local governments facilitates local evasion of responsibility under the guise of fiscal powerlessness. What local governments do receive as transfers is therefore sometimes treated as the personal fief of local politicians (The World Bank, 2002).

### ***Taking politics seriously—moving beyond technocratic solutions***

The evidence of an overall problem of political accountability of local governments suggests that the design of intergovernmental transfers is likely to be a blunt instrument to strengthen incentives for better allocation of public resources. Furthermore, in the face of political constraints I would hazard to contend that true fiscal equalization might be an unattainable goal. But there might be ways in which political incentives could be strengthened for the provision of minimum basic services to all regions

The conditions under which local governments, or any elected government for that matter, will have the right incentives to improve the delivery of basic services have been explored in a large political economy literature, and one of the “solutions” to these political constraints suggested by the literature is greater information dissemination about the roles and responsibilities of government, and the outcomes of public resource allocation (see Keefer and Khemani, 2005, for a review of the literature and suggested solutions). Based on this political economy view of public accountability this paper proposes a specific type of policy intervention to promote the availability of minimum

basic services in all regions, namely, providing citizens with greater information about the actual outcomes of basic services and which agents are responsible for these.

Social services have several characteristics that pose substantial informational challenges to citizens attempting to assess politician contributions, and to structure punishments and rewards based upon the quality of services available to them. Because of these information problems, politicians prefer to expend resources in constructing and staffing schools and clinics that remain empty and unused, as they get some credit for the easy to observe building activity and the provision of public employment, but little or no credit for the quality of services available. Mani and Mukand (2002) show formally that if elections serve the purpose of voters choosing amongst candidates to select the most competent one, then resource allocation will be biased against those public goods whose outcomes are more noisy and harder to use to assess politician ability, as politicians will have the incentive to provide other goods that are better signals of high ability.

First, the *quality* of services such as health and education, which actually impacts citizen welfare, depends critically on day-to-day provider behavior rather than easily observable actions of remotely located politicians. Although policy decisions taken by politicians, such as in teacher management or preventive health care initiatives, can have large impact on provider incentives and behavior, citizens need specific and substantial information to deduce which policies have contributed to better quality services. Second, measurable benefits (or costs) may simply not emerge until several years after the policy action has been taken, which makes it difficult for voters to reward (or punish) political agents within a particular electoral cycle. The effects of education reforms, for example, are typically difficult to verify until a cohort of students has been exposed to them for a sufficient period of time.

Third, the provision of service provider jobs to constituents is precisely the sort of activity for which politicians in low-information societies can easily take credit. Like roads and buildings, jobs are easily targeted and highly visible. Unfortunately, it is politically more rewarding to give jobs to unqualified job recipients, who have fewer outside opportunities and therefore owe a greater debt to politicians than do high quality recipients. Gazdar (2000) and the World Bank (1998, 2001) make it clear that non-professional qualifications are key factors in the placement of teachers in Pakistan. Similar reports from the Dominican Republic suggest that posting of teachers is highly discretionary and not clearly related to educational concerns (Keefer 2002a).

There are numerous examples of particular experiences from around the globe of how “information campaigns” regarding public services have succeeded. For example, an information-dissemination strategy, through newspapers and other media, was adopted in Uganda after survey evidence revealed that district governments were not transferring budgeted resources to schools. A follow-up survey in Uganda showed that this information dissemination had a substantial impact in preventing leakage of public funds away from purposes intended in public budgets (Reinikka and Svensson, 2004). However, we have no rigorous evidence for what kinds of information dissemination strategies significantly and systematically alter the nature of political competition. We can, however, speculate on some

features of the type of information and dissemination strategy that would make a difference in terms of improving political incentives.

Information about broad public sector performance aggregates, whether based on surveys, budget studies, or report-cards on sector-wide service provision, is likely to be politically relevant only if it provides individual voters with a sense of how their specific representatives in government hurt or help them. It is even more likely to promote reform when the information providers show evidence of being able to coordinate voter responses to poor service provision. This suggests that they are more effective to the extent that they transcend the role of simple information collectors or survey firms and take a more aggressive stance themselves with regard to political accountability. Finally, information campaigns are most helpful when they tell citizens not just how bad services are, and which are worse than others, information that citizens tend to have already, but also how bad the services are in their neighborhood relative to others, who or what processes are responsible for this, and whether services have improved as a result of specific policy reforms pursued by political representatives. The process of collecting such information might, in and of itself, trigger improvement if the organizations collecting it could credibly threaten to mobilize voters around public service issues. Politicians in all countries respect interests that can bring voters to the polls. To the extent that the process of information collection by organizations lowers their costs of mobilizing voters, service improvements are likely to follow.

Independent agencies with no direct political ambitions—civic society organizations, NGOs—might be the implementers of such information campaigns. They would present a latent political challenge to incumbents without in fact having any political ambitions, other than mobilizing voters and holding political agents accountable around particular policy issues. Their power would be derived from their credibility on public service issues, and their ability to disseminate information widely amongst voters on the performance of public services.

Development of mass media in specific ways could also be useful. The importance of journalist training is often touted. The arguments here suggest particular emphases in such training, including improving their ability to ask the right questions (how to report on whether government policy succeeds or fails, including how to identify the right benchmarks). A second step to improve media is to reduce barriers to entry that allow existing media to be easily captured by special interests or government. A third step is precisely to reduce media dependence on government and large private interests dependent on government largesse.

This discussion on the issue of information campaigns is to provide an example of a particular, tractable, instrument that might be used to address political constraints to the provision of minimum basic services across all regions. Information campaigns might also be particularly amenable to be combined with policy instruments of intergovernmental transfers, such as transfers conditional upon service delivery outcomes. Thus far the literature on intergovernmental transfers has focused on the informational needs of the agencies determining transfers, and some amount of information sharing, although largely with other units of government, and not directly with citizens. The political economy

analysis suggests a role for carefully designed information dissemination by these agencies that are traditionally only in the business of determining grants, to mobilize and concentrate citizen attention on issues of service delivery.

These are clearly preliminary ideas, as yet not based on proper theory nor on evidence, but represent a start in the direction of finding solutions that take the political economy of fiscal policies and service delivery seriously. Formal studies in this area are currently underway in several countries.

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