

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 the distribution of transfers across local jurisdictions, and what local governments do with these transfers is heavily influenced by political incentives facing both national and local policy-makers. Although the notion that intergovernmental transfers, like most other public policy issues, are influenced by and interact with political institutions and processes, is far from earth-shattering, until recently there had been little attempt to internalize the political implications when analyzing the role of transfers in equalizing access to basic services for all citizens. However, the new evidence shows that politics has such substantial impact on both the distribution and use of resources for local service delivery that it cannot be avoided nor side-stepped when developing intergovernmental fiscal policies for equalization.

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

This chapter reviews the evidence on the impact of politics on the distribution of national resources across regions, and on the performance of local jurisdictions in using these resources for service delivery. This evidence is largely “reduced-form” in that it measures political impact on distribution and service delivery for a given system of intergovernmental sharing of resources and responsibilities. The impact of political institutions is of course more fundamental, in that it helps shape the intergovernmental institutions themselves. But the chapter abstracts from this more fundamental interaction, and focuses on the implications of political analysis for technocratic solutions to the problem of equalization transfers, given currently operational intergovernmental institutions.

Section 1 shows that there is remarkably consistent and robust international evidence that politics impacts the distribution of transfers across local jurisdictions, with particular forms of political decision-making leading to particular forms of political distortions in the distribution of national resources across regions. The impact of political considerations on distribution may not necessarily be regressive, if for instance citizens in low-income regions are particularly active and informed participants in political processes, but it is more likely to lead to deviations from the benchmark outcomes assuming social welfare maximization or equalization of basic services across regions.

Fiscal institutions such as formula-based transfers or delegation of distribution decisions to independent agencies have limited success in curbing political influence—although they do change the terms of political bargaining, they do not cancel completely the impact of political considerations on the distribution of resources across regions. This is both because the formula itself is determined by a political process, or is not binding and leaves room for political discretion, and because even when it is binding national governments can turn to other fiscal instruments at their disposal, such as direct spending or financing deficits of sub-national governments, to place funds where there is political advantage. This analysis suggests that the objective of equalization of resources across local jurisdictions might be best served through equalization of political representation, that is through political institutions, in the absence of which even the most sophisticated fiscal arrangements are likely to fail.

Section 2 argues that the design and functioning of the system of intergovernmental sharing of resources and responsibilities has political implications, in that it influences relative accountability of different tiers of government to citizens. This is an important issue particularly in the context of newly decentralizing countries in the developing world, where national resources are often concentrated at the center, for historical and sometimes geographic reasons, and where nascent systems of intergovernmental transfers leaves room for uncertainty and confusion about the resources and responsibilities of local governments. This undermines local government accountability and creates perverse incentives for misallocation of public resources transferred from higher tiers of government.

More generally, the impact of transfers on actual delivery of basic services by local governments depends upon their political incentives. Thus, even if national political agents were to get resource distribution equalized, according to the needs and production possibilities of different jurisdictions, whether these transfers convert to equalization in

access to basic services depends upon how local politics works across jurisdictions. It is likely that the poorer regions of a country are also those where the poor find it harder to influence public policies and hold their representatives accountable for policy outcomes, because of entrenched inequalities and imperfections in political competition. This section explores the role of conditional grants and matching grants in addressing this problem of political accountability. The broad conclusion is that unless accompanied by reforms in political institutions, or informed by the nature of political market imperfections, such transfer design strategies are likely to be blunt instruments to solve the problem of political accountability. Just as national governments can circumvent formula-based design to target transfers to politically favored constituencies, local governments are also likely to circumvent conditionalities in transfers to continue to pursue their political objectives.

Section 3 provides a conclusion to this analysis by suggesting directions for future research on how political incentives can be explicitly internalized into the design of intergovernmental institutions to promote the objective of equalization.

2. How does politics impact the distribution of transfers ?

Central decisions about the regional distribution of resources actually take place within a political economy context where national legislators are elected from regional constituencies, and political bargaining within the legislature determines outcomes (Weingast, 1979; Shepsle, 1979; Weingast, Shepsle, and Johnsen, 1981; Baron and Ferejohn, 1989; Becker, 1983). For transfer instruments where the legislature has the greatest power in determining allocations to states or counties, political variables measuring legislative bargaining influences the distribution of intergovernmental transfers.

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. Indeed, in the new literature on the importance of legislatures, “equalization” has come to mean something quite different than what is assumed in this volume—equal votes in the legislature produce equal distribution of resources, with states 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).

The first evidence of the importance of political factors came from the examination of the distribution of federal welfare spending during the Great Depression in the US under President Roosevelt. Wright (1974) found a strong positive correlation between New Deal spending per capita and electoral votes per capita across states. However, careful scrutiny of these New Deal spending results by Wallis (1998) highlights the sensitivity of these results to empirical specification. More recently, definitive evidence on the importance of legislative representation is provided by Ansolabehere et al (2003), using a “natural experiment”—in the mid-1960s, the U.S. Supreme Court ordered the redistricting of U.S. state legislative districts to equalize

legislative seats per person across counties. They find that counties with relatively more representation per person prior to this court-ordered redistricting received relatively more transfers from the state per person. But after redistricting, counties that lost legislative seats received a smaller share of transfers, with approximately \$7 billion diverted annually from formerly overrepresented to formerly underrepresented counties. Porto and Sanguinetti (2003) provide evidence from a developing country, Argentina, that overrepresented provinces, both at the senate and at the lower chamber, have received more intergovernmental transfers than more populous and less represented provinces.

For transfer instruments that are amenable to direct control by the central executive, such as the President, Prime Minister, or central cabinet, political targeting can be more fine-tuned, with regional and even district-level voting patterns in previous elections influencing the distribution of transfers. At the regional level, the partisan identity and influence of regional governments has emerged as empirically significant in explaining the distribution of national resources. Grossman (1994) models grants to the U.S. states as being determined by the “political capital” of state politicians and interest groups in the national legislature, and finds that empirical measures of this are positively correlated with per capita grants. Levitt and Snyder (1995) find that the percent voting Democratic in a congressional district is a significant factor explaining the distribution of overall federal assistance spending across districts in the U.S, when Democrats control the US Congress and the Presidency. Khemani (2003) finds that state governments in India that belong to the same political party as the national government receive greater transfers, and interprets this within a model where the political objectives of state and national policymakers are linked through the party system.

Three separate features of voting at district levels have been found to be empirically significant in influencing the distribution of national resources, whether as transfers to local governments or through direct spending in national programs: one, the degree to which voters are “core” supporters of the party in power at the center in that they vote largely on ideological grounds; two, the degree to which voters are “swing”, that is, they have weak ideological leaning and are largely influenced by policy actions; and three, the degree to which the electorate participates in elections and is informed about policies. (Schady, 2000; Case, 2001; Johansson, 2003; Besley and Burgess, 2002; Stromberg, 2004).

The extent to which “core supporters” of the ruling national political party receive more or less than voters that are “swing” is a matter of prolific debate in the literature, both theoretically and empirically, with evidence on both sides of the issue, depending upon the local context of electoral competition. Dixit and Londregan (1996, 1998) have stressed the importance of “swing” voters for office-motivated politicians that use spending programs in order to win votes. However, Cox and McCubbins (1986) argue that vote maximizing candidates that are risk averse will over-invest in their closest supporters, while only more risk accepting candidates will pursue “swing” voters. Lindbeck and Weibull (1987) and Snyder (1989) contrast two different objectives—maximizing the votes a party obtains, and maximizing the probability of winning a majority of seats. If the policymaker’s objective is to maximize the number of votes

received more resources should be allocated to those districts where races are tight, or where more voters are likely to be “swing”. On the other hand, if the objective is to maximize the probability of winning a majority of seats in the legislature—as is required to form the executive government in some electoral systems—resources should also be targeted to those core support districts without which the party would be hard pressed to win a majority.

Case (2001) finds that block grants from the federal government in Albania to commune-level governments are higher both to those communes where a higher percentage of voters voted for the President’s party in the past election, and also to those districts where the race was tight, that is where the absolute difference between the commune’s vote for the party and the 50% mark (required to be crossed for victory) was small. Schady (2000) similarly finds that spending under a Presidential poverty alleviation program in Peru was targeted both to provinces that voted in larger numbers for the President, and to those where the election race was tight. Johansson (2003) estimates the number of swing voters directly using election survey data in Sweden, and finds that municipalities with many swing voters receive larger grants than other municipalities.

There is emerging evidence that areas where voters are more likely to participate in elections (by turning out to vote), and are better informed about public policies, receive not only more government resources, but also better government performance in service delivery. Strömberg (2001) finds that between 1933 and 1935 in the United States federal assistance to low-income households was greater in counties where more households had radios and were thus more likely to be informed about government policies and programs. The spread of radio particularly improved information access for rural voters, accounting for as much as 20 percent more in social assistance funds to a rural county than an identical urban county. Besley and Burgess (2003) show that state governments in India respond more to declines in food production and crop flood damage through higher public food distribution and calamity relief spending where newspaper circulation, particularly in local languages, is greater.

Although the impact of politics on transfers may not *necessarily* be regressive, if poor districts are the ones with “swing” voters (or “core” supporters) and informed voters, or if poor regions are the ones politically affiliated with the national government. But more often that not, it is the poor that lack political power, that are less likely to participate in political processes, or more likely to live in areas where the reach of information media is limited, and hence are less critical a constituency for political opportunists at national levels. Boex and Martinez-Vazquez (2004) provide a survey of international evidence on the impact of political and economic factors on the distribution of intergovernmental transfers, and conclude that politically better represented *and* wealthier sub-national jurisdictions are consistently the ones receiving greater transfers.

Can institutional mechanisms curb political influence?

There are two institutional mechanisms that countries have used to curb the impact of political influence—establishing formulae for transfer distribution based on measurable economic characteristics of sub-national jurisdictions, such as local income, population, revenues; and delegating the distribution of transfers to independent agencies, outside the direct line of control of the political executive.¹ However, until recently (Khemani, 2003), there was no evidence in the literature that explicitly tested whether these institutional mechanisms 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 both formula design and delegation to an independent agency because of the existence of two major channels of formula-based, 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.

¹ 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).

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

Although the evidence for the impact of delegation to the independent agency in India is so striking, and so substantially constrains political influence on intergovernmental transfers, the effectiveness of such delegation will depend heavily on the local context. Delegation cannot in general be expected to be successful. For instance, even within India, State Finance Commissions that are supposed to advise state governments on intergovernmental transfers to locally elected village governments, are viewed as largely ineffectual. In South Africa, the Financial and Fiscal Commission, while playing an important role in the initial years of the new democracy, has progressively lost its influence as the country made its transition from conflict years. These examples suggest that the politics that influence the distribution of resources between different tiers of governments may inevitably determine the design and effectiveness of independent commissions aimed at insulating intergovernmental finances from political capture.

Even if institutionalized formulae are effective in determining the distribution of those transfer instruments that they are supposed to govern, national political agents typically have other fiscal instruments at their disposal that they can use to target resources to those regions where they stand to gain political advantage. Khemani (2003) discusses how just as the national political agents in India allowed for the creation of an independent Finance Commission, they almost simultaneously created the Planning Commission which allowed them access to other transfer instruments that would be amenable to political manipulation. Khemani (2004) provides alternate evidence on bypassing transfers that are formula-driven and/or delegated to independent agencies, namely, that of deficit financing—fiscal deficits of affiliated state governments are higher, that is, the center uses both direct (central loans) and indirect financing (guarantees, bail-outs) of deficits as further instruments of resource transfer to state governments since these are not subject to the same institutional constraints as formula-based transfers and deliberation by an independent agency.

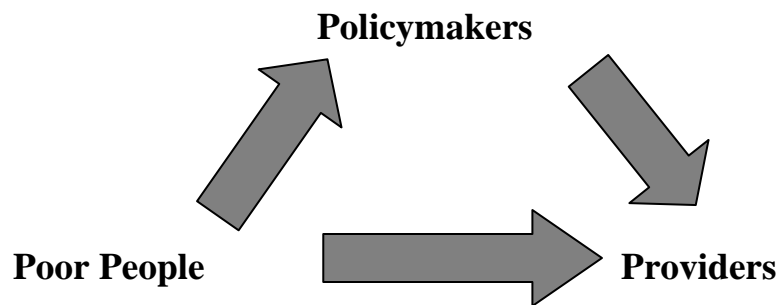
In summary, getting around political considerations is difficult—although institutional mechanisms can change the nature of political bargaining over resources, and even constrain political opportunism to some extent, they cannot hope to entirely do away with it. An important element in trying to equalize access to basic services across regions, conditional on regional needs and own revenue potential, is political representation and participation of sub-national jurisdictions in political processes. The recent empirical evidence suggests that at least as important as technical fiscal design of intergovernmental transfers is the design of political institutions that determine representation and participation. Therefore, perhaps the way to think about equalization policies is not in terms of *getting around* politics, but indeed making politics central to the policy-making process, with a quest for designing political institutions that promote equalization of representation and participation in political processes across sub-national jurisdictions.

3. How does politics impact the use of transfers for service delivery?

An implicit assumption in the literature on intergovernmental transfers is that the recipient sub-national governments would use these transferred resources to serve the interests of their local citizens, and that the design problem is really one of solving the bargaining game between local jurisdictions of who gets what from the national pie, or simply of equalizing fiscal capacities across local jurisdictions. However, the nature of intergovernmental sharing of resources and responsibilities also has implications for local political accountability. In many developing countries that are newly decentralizing, and where local jurisdictions have little own-revenue potential, over-dependence on national transfers undermines the accountability of local governments to their citizens. Rodden (2002) finds that in a large cross-section of countries over time dependence of sub-national governments on transfers is positively associated with higher sub-national fiscal deficits, evidence that is consistent with the idea that greater dependence on transfers creates conditions for reduced accountability of local governments to their local electorate.

The World Development Report 2004 (The World Bank, 2003) and Ahmad et al (2005) discuss more generally how incomplete institutions of decentralization, and poor transfer arrangements, can lead to breakdowns in service delivery by local governments. The essence of their analytical framework is that the delivery of services requires strong relationships of accountability between the actors in the service delivery chain. In contrast to the delivery of goods or services in a private, competitive market, where the service provider is directly accountable to the client or consumer of the service, the delivery of public services involves at least two relationships of accountability. First, clients as citizens have to hold policymakers or politicians accountable for allocating resources towards these services. Second, policymakers in turn need to hold the service providers accountable for delivering the service (Figure 1). Weaknesses in service-delivery outcomes can be attributed to a breakdown in any of these links along the route of accountability.

Figure 1. The framework of accountability

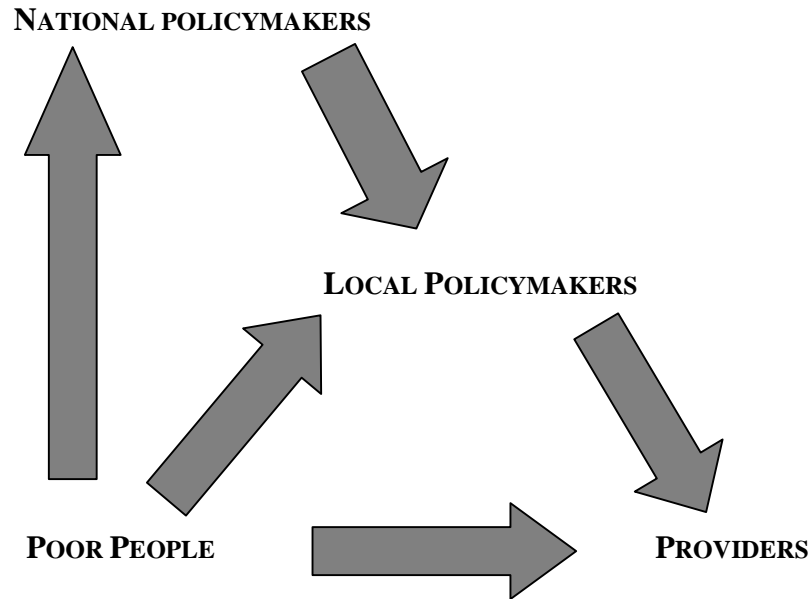


Devolving responsibility for public services to lower tiers of government means that the politician who is responsible is now a locally-elected one. The hope is that this would make him more accountable to the citizens, as they can monitor him more closely and attribute changes in service quality to him more easily. That is, decentralization will strengthen the citizen-local politician relationship of accountability, and thereby the other relationships of accountability for service delivery. However, as shown in Figure 2, decentralization introduces one more relationship of accountability, namely between the central and local policymaker. The rules and practices governing fiscal transfers, regulation and expenditures between central and local policymakers affect service delivery through their effect on the accountability relationship between local policymakers and providers.

Ahmad et al (2005) provide a striking example of this in the area of administrative decentralization, or lack thereof, when fiscal and political decentralization proceeds without being accompanied by explicit staffing strategies or public administration reform—local service providers continue to be full employees of upper-tier government, or local governments have only limited ability to hire and fire providers. Misalignment between the structure of the government bureaucracy and the assignment of service

responsibilities to different tiers confuses incentives, weakens accountability for service delivery, and creates conflicts of interest instead of checks and balances.

Figure 2. The framework of accountability relationships under decentralization.



The problem of over-dependence on intergovernmental transfers for local government accountability for service delivery was mentioned earlier. Micro evidence on how local service delivery might suffer when financed overwhelmingly by transfers from above is available from Nigeria. 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. Bulk of the revenues of local governments (above 90 percent) in Nigeria are obtained from their constitutional entitlement to a share of federal revenues, which in recent years of oil price booms has implied substantial resource flows to local governments, distributed in 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—what factors shape political incentives for service delivery by any tier of government?

But even if resources and responsibilities between the central and local governments can be effectively decentralized, there remains the question whether locally-elected governments will have better incentives for service delivery. This section will seemingly digress from the issue of intergovernmental transfers, and focus seriously on the conditions under which local governments, or any elected government for that matter, will have the right incentives to effectively provide basic services. I argue that this digression is warranted because the extent to which equalizing transfers policies might effectively equalize access to basic services across local jurisdictions depends upon local political incentives. If the true underlying objective of equalization transfers is to ensure access to basic services for all citizens, then transfer design should be considered in the context of political market conditions that determine the incentives of political agents at all tiers of government for service delivery.

It is a common observation across countries, rich and poor alike, that substantial public expenditures are systematically misallocated, for example to wage bills for bulky state administrations, to farm subsidies that impose distortionary costs on the economy and fail to benefit the poor, and to large infrastructure projects that allow political rent extraction without creating sustainable assets, all at the expense of quality public services. These misallocations have a disproportionate impact on the poor, who are known to benefit from increased access to public services. Even resources allocated to broad public services such as basic education and health might be ineffective in actually delivering those services, if, for example, the posts of teachers and doctors are used to extend the patronage of government jobs, rather than being held accountable for actual service delivery.

Misallocation has persisted despite a sea change in the way in which governments are selected and remain in office. From 1990 to 2000, the number of countries governed by officials elected in competitive elections rose from 60 to 100.² Democratization might be expected to benefit most the “median” or average voter, who in most developing countries is “poor”. Yet, public policy in emerging democracies does not seem to have benefited poor voters. Why do policy-makers that depend upon political support from the poor not effectively deliver basic services to the poor?

Keefer and Khemani (2005) argue that imperfections in political markets explain this puzzle. Political market failures in this analysis are reduced to three broad features of electoral competition—one, lack of information among voters about politician performance; two, social and ideological fragmentation among voters that leads to identity based voting and lower weight placed on the quality of public services; and three, lack of credibility of political promises to citizens. Informed voting is costly, and voters may have difficulty in coordinating information to reward (or punish) particular politicians or political parties for specific actions that improve (or worsen) the quality of public services. Similarly, socially and/or ideologically fragmented societies are less able to provide the incentives to their political agents to improve broad public services, because voting is more likely to occur along the dimension of narrowly-defined identities. Even if voters are informed and coordinated in focusing on specific policies, if political competitors cannot make credible promises prior to elections, incumbents are more secure from challenge and have fewer incentives to be responsive to citizens. If politicians are credible only to a few voters, with whom they can maintain clientelist relations, then public resources are allocated to targeted benefits for these “clients”, instead of to broad public services.

A strong conclusion of the analysis here, which is difficult for development policy, is that the most adverse effects of political market imperfections are felt in the area of broad public services, such as health and education. It is especially difficult for voters to assess the quality and efficiency of service provision in these areas and to evaluate the responsibility of specific political actors for service breakdowns or poor outcomes. By the same token, political competitors find it especially difficult to make credible promises about service provision. Voters cannot easily collect information that would verify that politicians have fulfilled their promises.

Moreover, even if they could, politicians in many countries can only make credible promises to narrow groups of voters. For these voters, it may be politically more efficient to promise narrow targetable goods—such as a farm subsidy, a contract for an infrastructure project (especially if it doesn’t need to get built or if the contractor can get away with using poor quality materials), a government job as a teacher or a doctor (especially if they won’t be held accountable to show-up to work in schools and clinics). The large mass of unorganized voters would suffer from the resultant poor quality of services—bankrupt state utilities that bear the subsidy burden, dilapidated roads and undrinkable water, and empty schools and clinics where children don’t learn and the sick don’t get treated—but would find it difficult to coordinate action to improve political

²According to the number of countries reported in the *Database of Political Institutions* (Beck et al, 2001) as having competitive elections for executive and legislative office (*EIEC* and *LIEC* equal to seven).

incentives. Social fragmentation in the electorate exacerbates these problems of voter coordination in determining reward and punishment based upon political actions towards the quality of public services.

Within this framework of analysis, decentralization to locally elected governments will improve political incentives and service delivery outcomes if voters are better informed and likely to use information about local public goods in their voting decisions for electing local governments, if there is greater social homogeneity and coordination of preferences for local public goods, and if political promises are more credible at local levels. Confronting the political economy of service delivery at local levels brings out a dilemma—if local governments in poor areas are also the ones that suffer most from lack of political accountability, because poor voters are more likely to vote in uninformed ways, being susceptible to campaign slogans, or polarized along non-economic, ideological dimensions such as religion or ethnic identity, and political promises are particularly lacking in credibility or prone to clientelism in environments of social inequality, then even if equalization design leads to greater resources being transferred to poor regions, the local governments might not convert these resources into actual services.

In such environments of low political accountability, tinkering with the design of intergovernmental transfers, such as moving from untied transfers to grants conditional upon actual service delivery outcomes can only be a solution if political incentives at the national level are conducive to actually enforcing these conditionalities, and punishing errant local governments. But often, these local governments are locally powerful, and control the local vote bank which is of value to national political leaders, who would therefore be loathe to enforce conditionalities and antagonize local political leaders. Quite apart from the possibility of such a political nexus between national and local governments, there might be simple administrative obstacles to perfect monitoring and control by national governments over local political representatives. Just as national governments can circumvent fiscal rules to target resources to regions where they stand to gain political advantage, local governments also might be able to circumvent transfer conditionalities.

Understanding the nature of political market imperfections can help to optimally design the institutions of decentralization, or to analyze the impact of available and operational institutions. If political markets function better at more centralized levels of government, then decentralization might not need to be political, but rather designed to help central politicians with agency problems, such as gathering information, monitoring performance, and enforcing norms for locally produced and consumed services.

What can policymakers do in the face of political market imperfections?

But what can a policymaker at the national level, with the right political incentives for equalizing access to basic services for all citizens, do when inheriting an existing decentralized system where locally elected governments, with varying degrees of accountability, are responsible for basic services, financed out of intergovernmental transfers? One of the “political market imperfections” that might be particularly tractable to a policy solution is that of information asymmetries. Greater information dissemination about the roles and responsibilities of government, and the outcomes of public resource

allocation might help improve the problem of political accountability. 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.

As mentioned earlier, Besley and Burgess (2003) show that state governments in India are more responsive to declines in food production and crop flood damage via public food distribution and calamity relief expenditure when newspaper circulation, particularly in local languages, is greater. They explain this impact by appealing to the ability of informed citizens to use political institutions such as elections to reward or punish public agents. In Uganda, the national education ministry began publishing information about school grants provided to districts in newspapers and other media, after survey evidence revealed that district governments were not transferring these 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).

Such evidence suggests that when voters have access to the media, and the media publishes information about particular policies, they are able to extract both greater resources and better performance from political agents with regard to these publicized policies. But such evidence does not tell us whether an increase in media access improves government incentives either to target the neediest citizens with transfers or to invest in public goods benefiting large segments of the population. It could be that the mass media make it easier for politicians to take credit for targeted payoffs to particular constituencies, leading them to reduce expenditures on public goods or on broad-based social programs. In countries where the reach of information media is limited and difficult transportation and communications systems divide the electorate, it cannot be relied upon to promote equalization efforts, in the sense of promoting equal access to basic services for all. The information base of poor rural citizens of developing countries might particularly be skewed in a way that diminishes their ability to hold elected officials accountable for the quality of public services.

Therefore, although reforms to solve information problems should include loosening restrictions on the media, including dependency on government advertising, and reducing barriers to entry for media firms, promoting competitive media markets may not be enough to ensure adequate coverage of government performance. Competitive information media might provide inadequate information if the markets they serve consist largely of better-off groups that do not consume public services. External interventions, such as journalist training, subsidized information transmission, or information campaigns by civic society organizations, may be useful in promoting the diffusion of the information needed for political accountability, particularly in poorer countries.

There are numerous examples of successful information campaigns on public services, but no rigorous evidence for what kinds of information dissemination strategies

systematically alter the nature of political accountability.³ 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. Recent work on the psychological underpinnings of social communication indicates that getting information dissemination to have the desired impact on actual outcomes is a particularly difficult mechanism design problem (Lupia, 2003). The problem is as follows—suppose there is a target audience that lacks sufficient information to accomplish certain tasks; what kind of information and dissemination strategy is necessary and sufficient to give the target audience the requisite skill to accomplish those tasks? Lupia (2003) provides a framework for thinking about the content and nature of information dissemination that is likely to make a difference. He identifies three necessary conditions that information dissemination strategies must satisfy in order to be effective—one, it should be brief enough so that citizens actually pay attention and register the information (*the battle for attention and working memory*); two, it should be pertinent enough that people actually retain the information for long enough periods of time as required to evaluate the actions of their agents (*the battle for elaboration and long-term memory*); and finally, the information must make a difference to the choice citizens make, that is, must be actually used by them to evaluate their agents (*the battle at the precipice of choice*).

Keeping these three principles of cognitive science in mind, we may begin to characterize the types of information that are likely to make a difference for political competition. 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 and with local credibility—civic society organizations, NGOs, or even constitutionally created advisory agencies, such as fiscal commissions—might be the implementers of such information campaigns. They would present a latent political challenge to incumbents without in fact having any political

³ A celebrated example is the public service report cards developed by the Public Affairs Centre in Bangalore, India (www.pacindia.org).

mandate or ambitions, other than mobilizing citizens 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.

Similar ideas on the role of evaluating spending programs from the perspective of actual service delivery, and disseminating information about such evaluations have been expressed much earlier (see Shah, 1997; and Picciotto and Weisner, 1998), but rigorous analysis of which basic outcome indicators to use for evaluation, and how to disseminate the information so that it indeed makes a difference for government accountability and performance is still lacking.

To address this gap, experimental studies are planned or underway in a number of countries—Benin, India, Nicaragua, Pakistan, Peru, Uganda—and coordinated by the Development Research Group at the World Bank. These studies focus on outcomes in two sectors—education and health. Survey instruments are developed to measure particular outcomes, that are likely to be the appropriate ones within the individual country context. For example, in India, political economy analysis suggests that information about basic learning outcomes in education service delivery—how many children can actually read and write simple sentences—might be particularly effective in mobilizing citizens to demand better performance along this specified dimension from government agencies. The dissemination strategy is a grassroots campaign at the village level through village meetings and pamphlet distribution by a local NGO. In Peru, the politically salient issue is non-transparent distribution of schooling inputs across public school districts, and the experiment will focus on training school management and communities to use web-based tools to access information about the pattern of distribution of inputs. Each of these strategies will be implemented using a randomized, experimental methodology so that impact on what changed in the process of accountability, and whether it actually improved outcomes can be scientifically evaluated. The overall objective is to develop a set of tools to improve the effectiveness of public spending programs—1) what outcomes, 2) how to measure them, 3) how to disseminate information about them, and 4) what institutional characteristics are needed for an appropriate implementing agency. The results are expected to emerge by 2007, and reported in a compiled volume.

4. Conclusion

This chapter has argued that analyzing intergovernmental transfers from a political economy perspective is essential in order to promote equalization objectives of transfers, interpreted broadly as promoting equal access to basic services for all citizens. Political incentives of government agents impact how transfers are distributed across regions and sub-national jurisdictions, and how these local jurisdictions use the transferred resources to service their citizens.

On the question of distribution, recent evidence suggests that the political characteristics of voters in a region—whether they participate in political processes, whether they are informed about public policies, whether they are core supporters of the national political party or “swing” voters—have a large effect on resources transferred to a region.

Instruments such as formula-based transfers and delegation of distribution criteria to independent agencies can have the power to curb political influence, but cannot undo it, because more flexible fiscal instruments are usually available to national policymakers to bypass the control of formulae and independent agencies. Poor regions are more likely to have voters that are less active in political processes, less informed about public policies, and less critical a constituency for national political leaders, and hence political distortions in intergovernmental resource allocation is more likely than not to be non-equalizing. Given this evidence, moving beyond fiscal design of intergovernmental transfers and investing in understanding what kinds of political institutions promote broad-based representation and participation would therefore be critical for equalization policies to be effective.

On the issue of how transfers are used to service citizens, political economy analysis emphasizes the impact of decentralization institutions in general on political incentives of local governments. The design of transfers, and related institutions of fiscal and administrative decentralization, directly affect accountability of local governments to their citizens. Accountability for actual delivery of basic services is likely to be hampered by three broad “political market imperfections”—one, information constraints amongst citizens about the resources and responsibilities of their local governments, and actual outcomes of public policies; two, social cleavages that prevent citizens from coordinated action to extract good performance from their governments; and three, credibility problems that limit the platform of political competition to patronage policies or clientelism that benefit only a few, politically-connected citizens, at the expense of the many. Again, the dilemma of equalization policies is that local governments representing poor citizens are more likely to suffer from these political market imperfections, so that even if substantial resources were transferred to these jurisdictions, they might not translate into actual services.

This political economy analysis suggests information campaigns as 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, but a start in the direction of moving beyond technocratic solutions based solely on normative fiscal analysis. If the objective of true equalization in the sense of equal access to basic services for all citizens is to be realistically pursued, the technocratic tool-kit would benefit from the development and addition of new tools to assess the nature of political institutions, political market imperfections, and strategies to address these imperfections.

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