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Decentralization and electoral accountability: Incentives, separation and voter welfare

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ABSTRACT

This paper provides a systematic analysis of fiscal decentralization on the quality of government by studying jointly its effects on electoral discipline and selection, in a setting where, realistically, voters only have limited information about fiscal policy in other jurisdictions, ruling out yardstick competition. Fiscal centralization reduces the *extent* of electoral discipline, as a corrupt (rent-seeking) incumbent can target good behavior only at a "minimum winning coalition" of regions (selective rent-diversion) in order to retain office, but thus makes it more profitable for bad incumbents to pool with good ones, thus increasing the *probability* of electoral discipline occurring at all. Voters tend to prefer centralization when politicians are low quality i.e. more likely to be corruptible. Centralization with uniform taxes can dominate both unconstrained centralization and decentralization, explaining why uniform taxes are so widely observed.

1. Introduction

The link between fiscal decentralization and political accountability has so far received relatively little attention from economists. This may be in part because in the standard theory[1] of fiscal decentralization, a basic premise is that policy-makers are benevolent. According to this perspective, the cost of decentralization is that spillovers are not internalized, and the benefit is that there is better preference-matching: that is, public goods provided by decentralized governments will be better matched to local preferences.[2]

This paper addresses the question of what effect fiscal (de)-centralization will have on electoral accountability in an environment where politicians can be non-benevolent i.e. rent-seeking. To make the argument as clear as possible, we assume an otherwise "level playing field"; that is, we work with a model where the traditional arguments in favour of either fiscal regime do not apply i.e. there are no inter-districtal spillovers or differences in voter preferences across districts.[3] So, the difference in outcome between

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[1] Theoretical work following this approach includes Alesina and Spolare (1997), Besley and Coate (2003), Bolton and Roland (1997) and Cremer and Palfrey (1996), Ellingsen (1998), Lockwood (2002), Oberholzer-Gee and Strumpf (2002).

[2] Oates (1972), and many subsequent contributions, have modelled the preference-matching benefit by the assumption of policy uniformity, namely that, under centralization, local public goods are provided at the same level across localities, irrespective of local preferences. Some more recent contributions (Lockwood, 2002; Besley and Coate, 2003), have relaxed this assumption, modelling preference-matching in a more sophisticated way.

[3] The implications of introducing spillovers are discussed in Section 8.1.

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centralization and decentralization is *entirely* due to the difference in the extent to which the voters can control, or hold accountable, the incumbent, in the two cases.

We feel that this topic is of interest for several reasons. First, there is a general belief among donor governments and multilateral institutions, and those advising them, that political, as well as administrative, decentralization is a key part of any decentralization reform, because it increases the accountability of politicians to local voters. For example, the UK government's aid donor Ministry, DFID, says "Donors generally support decentralization. Decentralized cooperation, circumventing ineffectual central governments, has become a core part of development assistance." (DFID, 2002). Or, according to Bahl and Martinez-Vasquez (2006), "Accountability to local voters is perhaps the most crucial part of a decentralized system, and one that ties together all the other components of decentralization design."

Second, the aspect of "political failure" that we focus on, i.e. dishonesty of politicians, is a very important one in practice. There is a great deal of variation across countries in perceived corruption of government officials and politicians, even within Europe.[4] Ultimately, the probability that a politician will be corruptible i.e. willing to take rent if the opportunity arises, depends on such factors as the level of trust in society, levels of public sector pay, etc. We take this probability as given in our modelling and ask which is the best fiscal arrangement, centralization or decentralization, for minimizing the amount of actual corruption that occurs.[5]

Third, this paper aims to fill a gap in the theoretical literature that we think is quite sizeable. Specifically, as we argue in more detail in Section 2, we believe that there is no existing work that *both* (a) explicitly compares outcomes under both centralization and decentralization in a political economy setting, *and* (b) allows for elections to hold corrupt incumbents accountable via both discipline and selection effects, to use the terminology of Besley and Smart (2006). Moreover, the literature that comes closest to achieving both of these, the yardstick competition literature, makes, in our view, unrealistic assumptions about what voters can observe outside their own district.

Our model has two periods and n districts. In the first period, the type of the incumbent policy-maker is determined by a random draw: the incumbent may be benevolent or rent-seeking. We refer to the probability of benevolence as the quality of the (pool of) politicians. The cost of public good provision is random and only observed by the incumbent. This cost is uncorrelated over time, but – as in the yardstick competition literature – may be correlated across districts.

With decentralization, the policy-maker in district i, knowing his type, then chooses a tax and a level of public good provision in their district. With centralization, the single incumbent chooses these variables in all districts. In either case, voters observe the tax and public good in their own district only (see Section 2 below for a justification for this), and then vote for the incumbent or the challenger; the type of the challenger is also determined by random draw. In the second period, the winner again chooses a tax and a level of public good provision in their district.

Our main results are as follows. First, in the simpler case where costs are perfectly correlated across districts (spatially correlated), centralization unambiguously gives rise to a weaker selection effect i.e. the probability that the bad incumbent is de-selected is lower. The intuition is simple; with centralization, the option of *selective rent-diversion* makes pooling cheaper, and thus more attractive, for the bad incumbent. Specifically, as voters do not observe fiscal policy outside their own jurisdiction, then with centralization, if the incumbent wishes to win the election and stay in office, he can do so by only imitating the good incumbent in a "minimum winning coalition" of $m=(n+1)/2$ districts, and can take unconstrained rent in the other districts.[6]

Thus, centralization has two effects on voters. First, other things equal, if the incumbent diverts rent selectively, this makes voters worse off; with probability $1-\frac{m}{n}$, any district will be outside the minimum willing coalition and thus suffer maximum rent-diversion. But, things are *not* equal, because the lower cost of pooling under centralization causes the incumbent to pool more often, increasing the probability of fiscal restraint. So we have the subtle effect that centralization raises the *probability* of fiscal restraint by bad politicians but limits the *extent* of this fiscal restraint to a bare majority of districts. So, if voters ever prefer centralization, they will do so when the quality of politicians is relatively low i.e. they are likely to be corrupt. This is because under centralization, bad politicians are more likely to retain office, but this has a relatively low cost to the voters if the challenger is also likely to be bad.

With less than perfect spatial cost correlation, an additional effect comes into play, i.e. that the statistical distribution of costs the incumbent will face changes with the size of the relevant jurisdiction (either the district or the nation). This *cost distribution* effect implies that the selection effect can be stronger under centralization. This changes the conditions under which voters prefer centralization; voters may now possibly prefer centralization when the quality of politicians is relatively high.

Finally, we show that ex ante, at a constitutional stage, voters may unanimously prefer to impose full uniformity across districts on both per capita public good provision and tax rates, or just on tax rates (Section 7). We focus on the case of perfect cost correlation[7] to obtain clean analytical results. Then, the advantage of uniformity is that it reduces or eliminates the possibility of selective rent-diversion by bad incumbent. The possible cost is that this can trigger a decision to separate by the bad incumbent, in which case voters are fully expropriated in the first period. We show that full uniformity is in fact equivalent to decentralization

[4] For example, the well-known Transparency International Index (http://www.transparency.org) shows that Italy and Greece have values of the index that are statistically significantly lower than the Nordic countries or even the UK, and below some countries in Africa and Asia.

[5] For empirical studies of the link between corruption and decentralization, see Fissman and Gatti (2002) and Treisman (2000).

[6] Of course, ultimately, the reason why selective rent-diversion is possible only with centralization in our model is that public goods are regional, so expenditure can be targeted at specific groups within the electorate *only* with centralization. But, all we require for our qualitative results to go through is that targeting should be easier with centralization: as long as regional goods are not purely public at the national level, this will be the case.

[7] When costs can vary across regions, expenditure uniformity has the additional cost that it prevents good incumbents from adapting public good supply to variations in regional costs (*loss of flexibility*), which considerably complicates things. This case is studied by Hindriks and Lockwood (2005).