



# Decentralization, political competition and corruption<sup>☆</sup>



Facundo Albornoza<sup>a</sup>, Antonio Cabrales<sup>b,c,\*</sup>

<sup>a</sup> University of Birmingham, United Kingdom

<sup>b</sup> Department of Economics, University College London, United Kingdom

<sup>c</sup> CEPR, United Kingdom

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## ABSTRACT

We study the effect of decentralization on corruption in a political agency model from the perspective of a region. In a model where corruption opportunities are lower under centralization at each period of time, decentralization makes it easier for citizens to detect corrupt incumbents. As a consequence, the relationship between fiscal decentralization and corruption is conditional on political competition: decentralization is associated with lower (higher) levels of corruption for sufficiently high (low) levels of political competition. We test this prediction and find that it is empirically supported. Also, we show how the preferences of voters and politicians about fiscal decentralization can diverge in situations where political competition is weak.

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## 1. Introduction

How do fiscal and political decentralization affect the corruption opportunities in a region? Are centralized schemes of government more or less associated with the possibility of electing corrupt politicians? Neither theory nor empirical work provides a univocal response.<sup>1</sup> For example, while [Fisman and Gatti \(2002\)](#), or [Barenstein and de Mello \(2001\)](#) find a positive effect of decentralization in reducing corruption, [Treisman \(2002\)](#) shows evidence of the opposite effect. In this paper, we argue that the effect of decentralization on corruption is conditional on the level of political competition: decentralization is associated with lower levels of corruption provided there is a sufficiently high level of political competition. We also provide evidence that this

is indeed the case. To the main question, we add an additional one: is it possible that the political class preferences over centralization diverge from what the citizens actually prefer? We find that this divorce between politicians and voters may emerge in situations characterized by low levels of political competition.

We begin our analysis by comparing two different fiscal schemes, which differ in who decides the level of public good provision and, thereby, in the payoff consequences of those decisions. In one scheme, a central agency decides the level of public good to be provided in the region, taxes accordingly and delegates the implementation of provision to local politicians. Combining centralized decisions with decentralized execution is a common institutional arrangement in many countries<sup>2</sup> but it has received relatively little attention in the literature. This is specially relevant for developing countries where local politicians administrate the funds received from the central government.<sup>3</sup> This fiscal scheme is a weak form of centralization in the sense that the central government delegates the actual delivery to

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\* Corresponding author at: Universidad Carlos III de Madrid, Spain.

E-mail addresses: [antonio.cabrales@uc3m.es](mailto:antonio.cabrales@uc3m.es), [antonio.cabrales@gmail.com](mailto:antonio.cabrales@gmail.com) (A. Cabrales).

<sup>1</sup> The literature is discussed in [Section 2](#).

<sup>2</sup> Examples include both unitary states, like France, UK and Chile and federal states like Germany, Spain, Argentina, South-Africa and Brazil. See, for example, ([Hueglin and Fenna, 2006](#)).

<sup>3</sup> [Nicolini et al. \(2000\)](#) discuss the case of Argentina. Another example of this system can be found in South-Africa, where the form taken by the post-apartheid federal system is such that centralized decisions are implemented by accountable local governments ([Hueglin and Fenna, 2006](#)).

the local government but it keeps the decision power.<sup>4</sup> For expositional purposes, however, we refer to this fiscal arrangement as centralization.<sup>5</sup>

Importantly, the recognition that the delivery of public goods is often done at the regional level by a politically accountable authority introduces a novel advantage associated with centralization. Given that the delivery of public goods is carried out by regional authorities even when decisions are made by a central government, centralized schemes offer an unexplored advantage. The advantage of a central authority determining the public good provision at sub-central levels is precisely the lack of direct control of the local outcomes. Thus, the center can mandate a level/type of public good that is detached from the potentially biased self-interest of sub-central politicians. This way, the advantage of a central authority does not require any additional assumptions on the different nature of the political class.<sup>6</sup>

As previously identified by the literature, local politicians have (private) better information about the actual cost of delivering the public good (different states of the world would determine different optimal levels of provision). How they use this informational advantage depends on their type, the political process and the level of fiscal autonomy. We consider two types of local politicians, those motivated by ego/pride-rents (and hence honest, in this model) and those materially motivated, which can lead them to behave dishonestly. Since the states of nature in the center and the region may differ, the center may make inappropriate decisions for the region. When her/his signal is that the state of nature is good (costs are low), the center mandates a high level of public good. When the signal is that the state of nature is bad (costs are high), the mandate is to provide a low level of public good. When the signals are mismatched with the true state of the nature, local politicians must either have insufficient funds to meet the central requirements or receive excessive taxation for their needs, which they can pocket (if dishonest) or use as a signal of honesty in order to be re-elected.

Under decentralization, decisions are taken by the local government. In this case, honest local politicians provide the socially optimal amount of the good, at the appropriate cost. The dishonest local politicians always pretend that the public good is expensive, deliver a low amount of the good and personally pocket the difference when it is not expensive. This implies that the relative benefit of decentralization is increasing in the quality of the regional political class. As a consequence, the support to decentralization should be increasing in the level of trust enjoyed by local political parties. We provide evidence consistent with this result at a supra-national level: the public support to the European Union is inversely correlated with the sentiments of trust in the local (national) political system. Importantly, as regional authorities are elected and can potentially be re-elected, voters can read in the provision of the public good the type of the incumbent. This is relevant as they use this information in their decisions on whether to re-elect the incumbent or vote for a challenger. It is in this sense that decentralization allows for a better selection of politicians. To explore this feature, we develop a political agency model with probabilistic voting that elaborates on Besley and Smart (2007).

Exploring how politicians are selected identifies a novel disadvantage associated with centralization. If the provision of public good reveals to some extent the type of the local government, centralization makes it more difficult to detect that type. As a consequence, it facilitates the re-election of potentially corrupt incumbents. Hence a trade-

off may arise, as centralization can reduce temptations to the local politicians at the expense of reducing the capacity of elections to select better politicians. Importantly, we find that the dominant effect is conditional on the level of political competition at the regional level. Thus, our model generates a subtle effect of decentralization on corruption, which adds to an open debate about the effects of decentralization on corruption.<sup>7</sup> Moreover, we provide evidence consistent with this result. We show that the negative relationship between corruption and decentralization, uncovered for example by Treisman (2002), is conditional on the level of political competition. For high levels of political competition, the effect of decentralization is indeed positive.

We conclude our analysis by exploring another source of citizens' disaffection with the political and fiscal system. We show that it is possible to generate situations in which politicians, independently of their type, impose centralization and do not respond to the demand for a change in the direction of decentralization. Interestingly, we show that this divorce between voters and the political class in terms of the organization of the country or the region critically depends on the level of political competition. That political parties respond only partially and slowly to shifts in public opinion is well known in the political science literature (e.g. Adams et al. (2004)) and, as we discuss below, examples of this divorce can be found in the cases of Catalonia and Argentina.<sup>8</sup>

To recapitulate, this paper is organized in the following way. In Section 2, we discuss the related literature. Section 3 presents the model, characterizes the solutions for both centralization and decentralization and shows that the support to decentralization increases in regional divergences and the quality of the local political class. In Section 4.1, we introduce political competition and clarify the effect of decentralization on corruption. We also examine the potential divorce between voters and politicians and show that the citizens' support to decentralization may be unrepresented for low levels of political competition. We conclude in Section 5, we test the main result of our model and provide evidence of the conditional effect of decentralization on corruption. We conclude in Section 6 where we discuss some variations to the model.

## 2. Literature review

Several studies shed light on the costs and benefits associated with fiscal centralization. The traditional trade-off basically goes in this way: a decentralized structure will take better account of the preferences of the people but it will impose coordination costs, when there are externalities or scale advantages in the delivery of the public good (Oates, 1972). More recently, the literature on decentralization and corruption identified some additional interesting trade-offs. An argument favoring decentralization is that it is associated with greater accountability (Seabright, 1996; Tommasi and Weinschelbaum, 2007). This argument is stronger if individuals observe the provision of the public good in other regions and they use this information to evaluate their local politicians (Besley and Case, 1995), and also in the presence of sufficiently strong political competition (Shleifer and Vishny, 1993) or press freedom (Lessmann and Markwardt, 2010). Besides, centralization can generate undesired conflicts of interest between regions if decisions are made by a central legislature which may be reflected in an inefficient and unequal degree of central provision of the public good (Besley and Coate, 2003). These positive features of decentralization may be counterbalanced by a greater danger of corruption and rent seeking associated with the fact that local governments are easier to capture by local elites (Bardhan and Mookherjee, 2000, 2006a, 2006b). Our results complement this literature in providing new

<sup>4</sup> It is stronger than deconcentration, which is considered the weakest form of decentralization (<http://www1.worldbank.org/publicsector/decentralization/admin.htm>)

<sup>5</sup> This type of centralization is of course not unique and stronger forms are common as well. We discuss the implications on our results of complete centralization in Section 5.

<sup>6</sup> As a consequence, we avoid assuming that politicians of the central government are more altruistic (as in Blanchard and Shleifer (2001)) or more talented, as stated by John Stuart Mill more than a century ago in the following way: "the local representative bodies and their officers are almost certain to be of a much lower grade of intelligence and knowledge, that Parliament and the national executive" (quotation taken from Treisman (2002)).

<sup>7</sup> For a review see Besley and Smart (2007).

<sup>8</sup> At the supranational level, the EU provides a good example of conflictive views over integration between mainstream politics and a large mass of the population (Steenbergen, Edwards and de Vries, 2005).

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