



# Blending Top-Down Federalism with Bottom-Up Engagement to Reduce Inequality in Ethiopia

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**Summary.** — Donors increasingly fund interventions to counteract inequality in developing countries, where they fear it can foment instability and undermine nation-building efforts. To succeed, aid relies on the principle of upward accountability to donors. But federalism shifts the accountability of subnational officials downward to regional and local voters. What happens when aid agencies fund anti-inequality programs in federal countries? Does federalism undermine aid? Does aid undermine federalism? Or can the political and fiscal relations that define a federal system resolve the contradiction internally? We explore this paradox via the Promotion of Basic Services program in Ethiopia, the largest donor-financed investment program in the world. Using an original panel database comprising the universe of Ethiopian woredas (districts), the study finds that horizontal (geographic) inequality decreased substantially. Donor-financed block grants to woredas increased the availability of primary education and health care services in the bottom 20% of woredas. Weaker evidence from household surveys suggests that vertical inequality across wealth groups (within woredas) also declined, implying that individuals from the poorest households benefit disproportionately from increasing access to, and utilization of, such services. The evidence suggests that by combining strong upward accountability over public investment with enhanced citizen engagement on local issues, Ethiopia's federal system resolves the instrumental dissonance posed by aid-funded programs to combat inequality in a federation.  
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## 1. INTRODUCTION

Inequality is a large and growing issue in policy debates across both developed and developing nations. One effect of the global financial crisis that began in 2008 was to exacerbate existing levels of inequality across countries as diverse as Brazil, China, France, Greece, India, Mexico, Mozambique, Spain, Uganda, and the United States; another effect was to highlight the issue *per se* as not just an economic concern, but a potent threat to political and social stability in societies poor and rich alike. The United Nations' Sustainable Development Goals recently adopted by the international community commit to reducing inequality through various targets, and inequality is at the heart of SDG16. The debate around such issues in both the academic and non-academic literatures has been rich and often forceful (Boix, 2008, 2015; Galbraith, 2012; Houle, 2009, 2015; Krugman, 2013; Piketty, 2014; Stiglitz, 2012, 2015; Wade 2014a, among many others).

In developed countries, the inequality debate is conducted mainly in terms of taxation, welfare, and wage policy. Anglo-Saxon countries stress *ex-post* redistribution more, meaning taxes, transfers, and public investments that reduce the inequality of market outcomes (Meade, 1964; Mueller, 2003; O'Neill and Williamson, 2012; Pontusson and Clayton, 1998). Some continental European countries, by contrast, focus modestly more on the pre-tax income distribution, which Wade terms "pre-distribution", via tax, labor market, and other regulatory policies that seek to attenuate extreme market outcomes before they occur (Atkinson, 2015; OECD (Organization for Economic Cooperation), 2012; Wade, 2014b). But in both cases the question of inequality has been treated mainly as an issue of incomes policy, with consequences that are important but not fundamental.

The stakes are much higher in developing countries that are poorer and institutionally weaker. Where fiscal resources are

scarce, public services fewer and of lower quality, and poverty far deeper, public investment in infrastructure and primary services takes on a primary role among policy responses to inequality. This is attractive for two strong reasons: (i) There is a broad consensus in the political science and economics literatures about the importance of investing in education, health, and basic infrastructure to accelerate economic growth and human development; and (ii) Expanding primary service and infrastructure networks can not only improve government responsiveness to citizens' needs, but also bolster social cohesion and expand the spatial presence of the state in a country, facilitating citizens' identification with their nation, and decreasing the risk of political instability and violence (Atkinson, 2015; Barro, 1997; Barro, Caselli & Lee, 2013; Landa and Kapstein, 2001; Lipset, 1959; Przeworski, Alvarez, Cheibub, & Limongi, 2000; Przeworski and Limongi, 1997; Sen, 1999; Shorrocks and van der Hoeven, 2004; World Bank, 2004).

Investment programs that extend primary services and infrastructure networks to poorer, underserved areas of developing countries are thus seen as potential "sweet spot" interventions, capable of combating poverty, decreasing inequality, and underpinning young countries' nation-building efforts. Donors and international development agencies, concerned as they are with inequality and stability, are increasingly eager to add such projects to their diverse portfolios of interventions.

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As Blair (2000), Faguet (2012, 2014a), Rodden, Eskeland, and Litvack (2003), Treisman (2007) and many others have noted, decentralization is widely recommended as a reform that can help extend public services to areas previously underserved by centralized government, and make the state more responsive to local demand, thereby increasing both public sector effectiveness and political stability in the highly diverse societies typical of many developing countries. Partly as a result, decentralization has moved from a policy fashion in the 1980s to a broad international movement today, happening in all of the world's regions and most of its countries (Faguet and Pöschl, 2015; Rodden, 2006; World Bank, 1999).

Federal systems can also extend the reach of public services and make the state more responsive to demand, as Rodden (2006) and Pöschl and Weingast (2015, chap. 7) point out, although through subtly different legal and fiscal means in a non-unitary context. For this reason, the policy literature often treats decentralization and federalism as functional substitutes. But it is important to note that the two are different concepts with quite different origins. Decentralized systems typically locate more power at the local level (3rd tier), while federal systems tend to concentrate power at the regional level (2nd tier), which often have significant authority over 3rd-tier administrations. Different levels imply different economies of scale and scope, and hence different distributions of subnational powers and responsibilities between federal vs. decentralized systems. But both federalism and decentralization denote highly diverse sets of systems, and it is important not to exaggerate the differences.

Decentralization is a policy process and popular reform in (often but not necessarily) unitary constitutional systems. It typically involves devolving power and resources from the central state to elected local administrations, which thereby inherit responsibility for the provision of specific public services. Federalism, by contrast, is a constitutional and fiscal arrangement typically dating to the founding of a nation and/or the design of the state. Examples include the USA, West Germany (inherited by united Germany), Canada, and Australia. It typically involves a decision by pre-existing (soon-to-be-regional) units to come together to form a nation with strong retained subnational (i.e., federal) political and fiscal powers and responsibilities. For this reason, "federalization" is a much more difficult policy choice than decentralization, and accordingly less common.

The necessary implication of these two trends is that a number of externally funded programs to reduce inequality are being undertaken in federal or decentralizing countries. This raises the worrying but interesting prospect of instrumental dissonance, as fiscal theory strongly suggests that greater *centralization* is required if the sorts of tax-and-transfer policies necessary for equalization are to succeed. Much the same is true of most externally funded interventions, in which donors hold host governments to account for the use of aid funds. The sorts of upward accountability that connects the ultimate uses of funds to the foreign source of those funds is facilitated not by a decentralized or federal structure, with functional and political independence at multiple levels of government, but rather by centralization.

What we see across many countries thus amounts to a mostly unnoticed, probably unplanned, and as far as we know unexplored natural experiment in institutions and incentives. If theory is correct, either federalism will undermine aid programs focusing on inequality, or anti-inequality aid programs will undermine developing countries' fiscal federal relations. Either way, the mismatch between intervention and federal structure will prevent such programs from achieving the

impacts that might otherwise have been expected. But it is also possible that aid programs have taken this into account, and are designed to overcome this contradiction. Some donors, for example, focus explicitly on building institutions, rather than attaining results, and have proved tolerant of the long lags involved in strengthening developing countries' capacity. Or perhaps federal institutions somehow resolve this tension internally. Alternatively, the theory could simply be wrong. These are intriguing empirical questions with important implications for institutional theory and development policy, about which much evidence is available from a broad range of countries, but which as far as we know are unexplored in the academic literature.

This paper asks: Can an aid-funded program succeed in reducing inequality in a federation? This is an empirically subtle question with interesting implications not just for inequality, but for development more broadly. We seek to answer it with evidence from Ethiopia's Promotion of Basic Services (PBS) program. Jointly financed by the Ethiopian government (50%), and donors (50%) led by the World Bank and the UK Department for International Development, PBS finances basic services in education, health, agriculture, water supply, and rural roads. As primary responsibility for such services lies with the country's regional, city and *woreda* (district) governments, PBS funds are channeled through Ethiopia's inter-governmental fiscal transfer mechanism to subnational governments, where they are invested. Its main effect is to pump about \$1 billion per year, mostly through *woredas*, into social investment in Ethiopia, making it the largest donor-supported program in the world.

In addition to hosting PBS, Ethiopia is a particularly good empirical context in which to study issues of accountability and inequality for three reasons. First, the country's size and recent development experience give it a natural prominence. Ethiopia has achieved significant improvements in basic service delivery indicators in recent years. The latest survey data show child mortality falling from 123 per thousand in 2005 to 88 in 2010, and primary net enrollment rates rising from 68% in 2004–05 to 82% in 2009–10. And economic growth has averaged 11% per year during 2004/05–2009/10, becoming more broad-based, with rising contributions from mining, services and manufacturing. As a result, the population in absolute poverty fell from 38.7% in 2004–05 to 29.6% in 2011. Second, Ethiopia's geographic and socio-cultural diversity are among the highest in the world, providing natural sources of variation that we can exploit analytically. Ethiopia's vast system of mountains and highland plateaus is bisected by the Great Rift Valley, itself surrounded by lowland steppes and semi-deserts. In the east are remote deserts containing some of the hottest human settlements on earth, while to the south there are tropical forests. With 93 officially recognized mother tongues and 98 ethnicities counted by the Ethiopian census, the country is also one of the most ethno-culturally diverse societies on earth. Third, the country's recent political history features dramatic changes in institutional structure and accountability, including the adoption of a unique federal system, which provide additional dimensions of interesting variation.

The rest of this paper is organized as follows. Section 2 discusses theories of accountability in the federalism and aid literatures, focusing on their implications for anti-inequality policies, before turning to empirical evidence on the same. Section 3 presents Ethiopia's fiscal context, our data, and methods used in this study. Section 4 discusses recent trends in horizontal and vertical equity in service delivery, and then analyzes the effects of aid-supported block grants to *woredas*

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