NÚMERO 238

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Electoral Competition and the Flypaper Effect in Mexican Local Governments

NOVIEMBRE 2009

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Abstract

In this paper, we present evidence of the flypaper effect of unconditional grants in the Mexican municipalities during the 1990 to 2007 period. Using panel data, we confirm the fiscal replacement asymmetric behavior in different types of expenditures. That is, local governments respond differently when transfers increase than when they decrease. We argue that the response in public expenditure, due to changes in unconditional transfers, is also determined by the increasing electoral competition in the state and municipal levels of government, especially during electoral years.

Resumen

En este trabajo se muestra que el efecto "flypaper" ha estado presente en las transferencias no condicionadas que han recibido los municipios en México durante el periodo de 1990 a 2007. Utilizando datos tipo panel, confirmamos que hay una sustitución fiscal de tipo asimétrico en varios tipos de gasto público. Sostenemos que la respuesta del gasto público municipal también está determinada por el aumento en la competencia electoral a nivel estatal y municipal, especialmente durante los años electorales.

Introduction

As scholars started to study the effects of intergovernmental transfers, they noted that local governments increase their spending in response to a dollar of lump-sum intergovernmental grants more than if the income of the residents in the jurisdiction had increased by an equivalent transfer from the grantor. The public finance literature began to categorize this effect as a "purely empirical phenomenon" named the flypaper effect. The level of unconditional federal transfers to local governments is not always the same. It can increase or decrease according to the availability of the annual federal resources, or due to the economic or demographic changes in the municipalities. In this context, it is interesting to analyze whether the effect of intergovernmental transfers on public spending is the same in the case of either a reduction or an increase in the amount of transfers.

This paper presents an empirical measurement of the effect of unconditional federal transfers on the expenditures of Mexican local governments. We propose that electoral competition and a weak institutional framework can explain the response of public expenditure in the Mexican case. Mexico's municipalities offer important evidence of the flypaper effect as well as of the asymmetric behavior of local governments observed during the 1990-2007 period. We find the presence of a fiscal replacement that confirms Gramlich's (1987) argument for the Mexican case: given the reduction of intergovernmental transfers, municipalities tried to replace it either with their own resources or through higher levels of public debt. We argue that the response in public expenditure due to changes in transfers is also determined by the increasing electoral competition in states and municipalities, especially during electoral years. This is particularly the case of public works expenditure.

The paper is organized as follows. In the first section, we present a literature review, which allows the reader to become familiar with the concept of the flypaper effect. Then, we describe how researchers have recently debated whether or not the flypaper effect is symmetric; that is, if local governments' responses are the same when intergovernmental transfers increase or decrease. The second section is a description of the Mexican revenue share system. Then, we describe the data and variables used in the econometric model in the third section. The fourth section shows the results of the econometric analysis. Finally, the last section offers some conclusions and implications of this study.

The Flypaper Effect

Bradford and Oates (1971) attempted to establish the basis of a theory on intergovernmental transfers. Their model produced a series of hypotheses that have generated a lot of interest for their empirical testing within the scientific community. One of these hypotheses establishes that the observed effect on the allocation of the public budget between private and public goods is the same whether there is a transfer from the federal to the local government or directly to the individuals. Empirical studies have continually rejected this hypothesis. The empirical literature shows that the expenditure on public goods is more responsive to the intergovernmental transfers than to increases in the income of each individual. That is, the free resources granted to local governors have a larger positive effect on public expenditures than what the theory predicts. The constant repetition of this empirical result created a challenge for scholars interested in the issue. At that point, the public finance literature began to categorize this result as an anomaly, a "purely empirical phenomenon", and named it the flypaper effect.[1]

Why do citizens allow the government to have such a behavior? One of the explanations that the literature offers is the so-called "fiscal illusion". The key to answer this question is the asymmetric information permeating the individuals' decision-making process (Oates, 1979). When the local government receives the federal transfers, citizens ignore that the availability of these grants lowers the real price for the provision of public goods. Consequently, locally raised funds through taxes could have been refunded to the community (Snoddon and Wen, 1998).

The Asymmetry of the Flypaper Effect

The unconditional federal transfers to local governments are not always the same. They can increase or decrease according to the availability of annual federal resources or due to the economic or demographic changes in the municipalities. In this context, it is interesting to analyze whether the effect of intergovernmental transfers on public spending is the same in the case of a reduction in the amount of transfers. The empirical analysis of the flypaper effect estimates a coefficient for the impact of unconditional transfers on public spending, whether they increase or decrease (Gamkhar and Oates, 1996). However, one cannot assume that the coefficient by itself reflects the symmetry of the flypaper effect in both directions. In order to test it, one should estimate a different coefficient within the same econometric analysis to capture the exclusive impact of a reduction of federal transfers. A non-significant coefficient would suggest that a reduction and an increase in

[1] Arthur Okun was responsible for the "flypaper effect" tag (Hines and Thaler, 1995: 218). A more accurate description of the flypaper effect in terms of public finance is that "money sticks where it hits".

transfers have the same impact. Conversely, a significant coefficient, regardless of its sign, would point to an asymmetric flypaper effect.

According to Heyndels (Deller and Maher, 2006), a "fiscal replacement" appears when the econometric analysis suggests that the change in public spending due to a reduction in transfers is smaller than the change due to an increase in transfers. That is, a fiscal replacement refers to the transfers that the federal government ceases to send to the municipality and that are replaced by higher levels of taxes or public debt issued by the local government. There are several explanations for this type of asymmetry in the flypaper effect. Gramlich's (1987) explanation, the more widely accepted, proposes that governmental programs take "roots" and generate "clients", making them politically difficult to be cut off or removed when there is a reduction in intergovernmental transfers.

The Empirical Evidence of Asymmetries

The large availability of data at the local level in developed countries allows testing for the presence of the flypaper effect while disaggregating it into the different programs of public spending. Deller and Maher (2006), for instance, conducted a study of the flypaper effect according to the type of expenditure in Wisconsin (United States). They confirmed the presence of the flypaper effect, as well as the fiscal replacement asymmetric behavior of the county governments to unconditional transfers. Pallesen (2006) conducted a comparable analysis for Danish municipalities obtaining similar results, even though the country was in a transition from conditional to unconditional transfers. Shaw (2005) found evidence of the flypaper effect in the Canadian provinces between 1981 and 2000. In addition, he found asymmetries corroborating the argument of fiscal replacement. Other empirical studies that reveal fiscal replacement are Levaggi and Zanola (2003), Deller and Walzer (1995) and Benton (1992). Gramlich (1987) observed that local government spending in the United States when unconditional grants from the central government decreased, fiscal replacement was less than 100% since their own tax revenues replaced them. Heyndels (2001) also confirmed the presence of this type of fiscal replacement on Flemish municipalities. But Stine (1994) found that cuts in federal transfers to Pennsylvania local governments induced them to decrease their own tax revenues.

Among the available studies for Latin American countries, Acosta and Loza (2001) tested the existence of this phenomenon in the provinces of Buenos Aires between 1995 and 1997. Moreover, they found evidence of both, the over proportional increase in local spending and the increase in tax collection when federal transfers increased. For Colombia, Melo (2002) and Trujillo (2006) found evidence that the flypaper effect was present in municipalities that were highly dependent on intergovernmental transfers and confirmed the fiscal replacement asymmetry behavior too.

Nevertheless, the flypaper effect has been scarcely studied for the Mexican case. Ibarra and Varella (2003) employ time-series variables from 1975 to 2000 to conduct a linear and first-difference analysis at the state level. They confirm the flypaper effect and conclude that the results can be explained because during the period of analysis local governments faced a rather lax budget restriction. Furthermore, during the financial crisis of 1995, the federal government granted large amounts of transfers that were allocated in a discretional manner. This considerably increased expenditures as a reaction to the unconditional transfers. We extend their work using data at the municipal level and testing for asymmetric responses of the Mexican local governments.

Unconditional Intergovernmental Transfers in Mexico

Mexico is a federal republic comprising thirty-one states with over 2,400 municipalities and a federal district. In 1980, the law of the *Sistema Nacional de Coordinación Fiscal* (SNCF) was set to allocate the major sources of tax revenues (income tax, excise tax and value-added tax) at the federal level. The revenue share system almost collects the total income in the country. Twenty percent of these resources become unconditional transfers that are allocated between states and municipalities according to a formula linked to the tax effort and the size of the population. These transfers have been labeled to *Fondo General de Participaciones*, *Participaciones* or Branch 28. *Participaciones* have been stable in real terms over time: from 1989 to 2007, they represented between 2 and 3 points of the GDP. However, sub-national governments are dependent of *participaciones*: In 2007, these federal transfers represented 42% of the total state income and 61% at the municipal level.

As opposed to revenue, spending and borrowing decisions have been decentralized in Mexico. According to the Federal Constitution, sub-national governments can borrow only for productive investments, and only if they have the approval of the local congress. In fact, they faced soft budget constraints until 2000, when a change in the regulatory framework for debt management took place. Since then, states and municipalities can borrow from development banks and from commercial banks under market conditions (Giugale, Hernández and Oliveira, 2000). Even though this financial regulation has made it harder for banks to lend to states and local governments with financial solvency, the availability for credit is still open.

Since the appearance of the SNCF, the centralization of tax revenues represented a bargain in which states and municipalities surrendered their taxing authority in exchange of 20% of federal revenues, including oil royalties. This share, for example, represented almost six times local revenues in 1996 (Webb, 2001). Thus, state governors and municipal authorities have relied on the federal government to collect taxes —in order to avoid the political cost of raising local taxes (Díaz and McLure, 2000)— while they have retained plenty of autonomy to spend *participaciones*.

When the SNCF was established, the states were also required to transfer 20% of the *participaciones* to the municipalities —in accordance to the state's own formulas or allocation criteria, which was very similar to the federal formula for distribution among states (Courchene and Díaz, 2000). According to the Mexican Constitution, only states can channel funds directly to municipalities, and unconditional transfers are only to be audited by state congresses. This fact makes difficult for the federal government to judge whether *participaciones* were effectively transferred to municipalities according to the states' formulas (Ortega, 2004).

In Mexico, all public officials are elected with no possibilities for reelection; thus, the weak institutional framework (monitoring problems and cumbersome legal structures) creates a window of opportunity for sub-national government authorities to distribute *participaciones* according to their own criteria. Díaz (2006) argues that governors and local politicians allocate *participaciones* in order to survive in the enhanced political competition at the state and municipal level that started since the hegemonic political party lost the majority in Congress in 1997. In fact, Hernández and Jarillo (2008) show that the conditional transfers for infrastructure spending —the other type of intergovernmental transfers— have been distributed to communities with a larger number of registered voters. We argue that the response in public expenditure due to changes in unconditional transfers is also determined by the increasing electoral competition in sub-national governments, since governors use these resources for political purposes, especially during electoral years.

Data and Methodology

Description of the Sample

We use panel data for all Mexican municipal governments from 1990 to 2007.[2] Mexico is characterized by strong regional disparities. During the period of analysis, the municipalities range from urban cities with millions of inhabitants to small towns with populations under 2,500. This is particularly true in the 2,071 rural municipalities (84.4% of the data). The analysis requires that all variables be expressed in real per capita terms to avoid that the inflationary component of the series affects the outcomes.[3] The municipal

[2] Interactive Data Consult from the National Institute of Statistics and Geography (INEGI). This system provides data of expenditure, income and public debt information for all local governments, except for those in the Federal District which, according to law, are not municipalities.

[3] The variables are measured in logarithms.

population was collected using estimations from the National Council of Population (CONAPO).

Variables

The dependent variable is municipal expenditure. Following Deller and Maher (2006), who concluded that the presence of the flypaper effect vary significantly according to the expenditure category, we analyze the flypaper effect over different allocations of expenditure: (E^1) total gross expenditure, (E^2) public works and social programs; and, (E^3) non-capital.[4]

The independent variables are unconditional federal transfers (*T*), municipal income (*I*), financial resources (*F*), the electoral calendar (*EC*), and the symmetry of the flypaper effect (*S*). Unfortunately, in Mexico, historical municipal data is not available. Thus, we used total municipal income as reported to INEGI to estimate municipal per capita income. Municipalities' own income is composed of taxes, rights, products, and interests. To a certain extent, this income represents individuals' income behavior. Government's income comes from taxpayers, capturing the economic cycle of the population (*I*). In other words, in case of a negative shock on income, municipalities' own income will decrease, reflecting the economic behavior of the agents in the local community.[5]

We include the fact that local governments have access to financial resources to cover their budget deficits (*F*). This funding comes from within or outside the country through credits, loans and other obligations under the subscription or issuance of debt or other documents made payable to term. We also use the municipal voting database from the Center of Research for Developmnent (CIDAC) to build the electoral calendar (*EC*). *EC* is a dichotomous variable that equals 1 when local elections take place, and zero otherwise.

Finally, we construct a variable called symmetry (*S*), which is $D_{it}(logT_{it} - logT_{it-1})$, where D_{it} is a dichotomous variable that equals 1 when the municipality experiences a reduction in unconditional transfers and zero in all other cases. Table 1 shows the basic descriptive statistics of the variables used in the model.

[4] The gross municipal expenditures are composed by the sum of the following: Personal Services; Materials and Supplies; General Services; Acquisition of Furniture and Property; Public Works and Social Programs; Financial Investment; Subsidies, Transfers and Aid; Federal and State Resources to Municipalities; Other Expenditures; Public Debt and Disposability. The Non-Capital Expenditure only includes Personal Services; Materials and Supplies; General Services; and, Acquisition of Furniture and Property.

[5] Even though the unconditional transfers in Mexico are mainly distributed to fill the gap between the expenditures and own resources —and local governments have the possibility to access to public debt— we recognize the underlying empirical problems of this proxy. We leave this limitation as a possible extension for future research due to the lack of information at the municipal level in Mexico.

TABLE 1. BASIC STATISTICS

Variable	Variable Description	Mean	Maximum	Minumum	Standard Deviation	Variance
E^1	Total Gross Expenditure	1,368.1	23,714.3	0.0	1.43E+03	2.04E+06
E^2	Public Works and Social Programs Expenditure	380.5	9,306.2	0.0	5.11E+02	2.61E+05
E^3	Non-Capital Expenditure	641.0	18,128.7	0.0	7.88E+02	6.22E+05
I	Own Income	163.8	9,350.4	0.0	3.00E+02	9.01E+04
T	Unconditional Transfers (Participaciones)	740.7	18,229.8	0.0	9.07E+02	8.23E+05
F	Financial Resources	48.6	5,290.3	0.0	1.44E+02	2.06E+04
EC	Electoral Calendar	0.29	1.0	0.0	0.45	0.21
S	Symmetry	-0.08	0.0	-9.3	0.33	0.11

Source: INEGI, CIDAC. Variables in real per capita terms.

The model to be estimated is the following:

$$\log E_{it}^{k} = \beta_0 + \beta_1 \log T_{it} + \beta_2 \log I_{it} + \beta_3 \log F_{it} + \beta_4 \left[D_{it} \left(\log T_{it} - \log T_{it-1} \right) \right] + \beta_5 EC_{it} + e_{it}$$

where: k= 1,...,3; i=1,...,2347; t=1990,...,2007

There are different models that can be used for panel data. To achieve robust and reliable results, we used a Prais-Winsten regression with Panel Corrected Standard Errors (PCSE).[6] This model allows us to correct for autocorrelation, heteroskedasticity, and temporal effects, but not for fixed effects. However, given that the tests show that the fixed effects are significant for the panel of municipal data, we can construct variables that contain such effects. This is done by calculating for each variable the average per individual during the period under analysis. Formally, the new variables for the PCSE model are calculated in the following manner:

$$\hat{y}_{it} = \left(\log y_{it} - \overline{\log y_i} \right) \qquad i = 1, ..., 2347; \; t = 1990, ..., 2007$$

where $\hat{y}_{it}$ is the variable that takes into account the fixed effects, and $\overline{\log y_i}$ is the average of the logarithm for each individual during the period of analysis.

6 The tests made for choosing the best estimation were: *i)* Breusch-Pagan test for random effects; *ii)* Hausman test for fixed effects; *iii)* Time effect test that rejects that all the time parameters are zero simultaneously; *iv)* Wooldridge test for autocorrelation; and *v)* Wald test for heteroskedasticity.

Results

The estimations are shown in Table 2.

TABLE 2. ECONOMETRIC RESULTS

Independent Variable	Dependent Variable		
	Total Gross Expenditure (E^1)	Public Works and Social Programs Expenditure (E^2)	Non-Capital Expenditure (E^3)
I (Own Income)	**0.132*** **	**0.218*** **	**0.095*** **
	[0.005]	[0.014]	[0.004]
T (Unconditional Transfers- Participaciones)	**0.608*** **	**0.939*** **	**0.494*** **
	[0.012]	[0.034]	[0.012]
F (Financial Resources)	**0.036*** **	**0.067*** **	**0.018*** **
	[0.001]	[0.004]	[0.001]
S (Symmetry)	**-0.419*** **	**-0.632*** **	**-0.331*** **
	[0.016]	[0.046]	[0.015]
EC (Electoral Calendar)	-0.004	**0.041*** **	**-0.041*** **
	[0.003]	[0.015]	[0.004]
Constant	**-0.321*** **	**-0.060* **	**-0.077*** **
	[0.009]	[0.032]	[0.010]
R-squared	**0.79**	**0.40**	**0.68**
Observations	16192	16192	16192
Number of Local Governments	2347	2347	2347

Standard errors in brackets.
* significant at 10%; ** significant at 5%; *** significant at 1%

All regressions show that the flypaper effect is present in the Mexican municipalities since the coefficient for the unconditional federal transfers, *T*, is larger than the coefficient for the municipal income, *I*, at 1% significance level. These results suggest that public expenditure in Mexican municipalities is more stimulated by increases in *participaciones*, than by increases of the same amount in individuals' income. The effect is particularly stronger in public works and social programs.

The symmetry coefficient is also significant in all estimations. This result indicates an asymmetric effect when there is a reduction in the unconditional transfers. Moreover, the negative sign of *S* indicates that there is "fiscal replacement". That is, when *participaciones* decrease, local governments try to replace them with other sources of income, either a more strict tax collection scheme or higher levels of public debt. These results corroborate Gramlich's (1987) hypothesis, which suggests that asymmetries arise because municipal governments use *participaciones* to finance programs that are politically difficult to eliminate when there is a reduction in federal transfers.

The coefficient of financial resources is positive and significant at 1%, but remains small for all types of expenditures. This situation can be explained by the fact that in Mexico local governments had rather lax budget restrictions before 2000, and were subject to market conditions after that. Thus, although local governments are extremely dependent on federal transfers, even when they decrease, officials decide the level of public spending without having to increase their tax related income, for they can issue debt. The public debt market conditions allow municipal governments to widen their budget restrictions.

The coefficient of the electoral calendar is non-significant when the dependent variable is total gross expenditure. However, when we disaggregate the data in different types of expenditure, the coefficient becomes significant. In the case of public works and social programs, the sign is positive, which indicates that, in an electoral year, this type of expenditure is more stimulated than in a non-electoral year. On the other hand, the coefficient for non-capital expenditure is negative, suggesting that local governments are motivated to redirect resources from these areas to others more politically profitable, like public works and social programs. This evidence supports Díaz (2006), who argues that Mexican local politicians allocate *participaciones* in order to survive in the enhanced electoral competition. Moreover, the coefficient of the electoral calendar when public works and social programs is the dependent variable corroborates that local officials use public works spending for political purposes, as suggested in Hernández and Jarillo (2008).

Conclusions

Mexico has recently experienced an important process of fiscal decentralization in which the unconditional transfers have remarkably increased towards municipalities. In this context, this paper conducts an analysis of the impact of unconditional federal transfers on Mexican municipalities during the 1990-2007 period. We find evidence of the flypaper effect; that is, local governments' public spending is more stimulated by an increase in the unconditional federal transfers than by an equivalent increase in the level of income of the members of the community. The evidence indicates a stronger flypaper effect for public works expenditure.

We also find evidence that the asymmetry of the flypaper effect in the Mexican municipalities is in fact "fiscal replacement". In other words, public spending does not respond to the increases in transfers the same way it does in the case of a decrease in transfers. This result corroborates Gramlich's (1987) hypothesis: once a local government is benefited by intergovernmental transfers, it begins to finance a series of public programs that adhere to the public agenda, becoming very difficult to eliminate them, even if the intergovernmental transfers decrease.

Our findings suggest that local authorities replace a reduction in unconditional transfers with public debt in the case of public works and social programs, as opposed to the non-capital expenditure. When there is a reduction in federal transfers, there is fiscal replacement due to the fact that Mexican municipal governments have the option to replace unconditional transfers with public debt.

In addition, the flypaper effect receives an extra stimulus during electoral years. We argue that the response in public expenditure due to changes in unconditional transfers is also determined by political motives. Local authorities, facing increasing electoral competition, especially during electoral years, will find harder to reduce their spending levels, particularly in the case of public works and social programs, as opposed to non-capital expenditure. The weak institutional and legal frameworks allow governors to allocate resources according to the electoral calendar. These results highlight the importance of evaluating the effectiveness of public spending at the local level in future research for the case of Mexico.

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