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PROJECT TITLE

Political Economy of Conditional transfers: Evidence from an emerging democracy.

THEMATIC AREA: The Reform Process including Public Finance, Fiscal Burden, and Taxation

Principal Investigator: Elvina Merkaj

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ABSTRACT

Decentralization is still a new reality in most of emerging democracies. Financial dependence from the central government has been decreasing; however local governments are still highly depended on central government grants.

This study focuses on conditional transfers in Albania, which are state funds allocated to LGUs for specific purposes, to achieve national objectives and to perform functions that central government delegates to local government. This study aims to analyze the factors impacting the funds distribution from the central government to the local government units, with a special focus on the political influence.

Results highlight the fact that in Albania although the central government follows some principles of equity and efficiency, politics and electoral objectives of the incumbents do influence the allocation of intergovernmental transfers as conditional grants are tactically distributed towards supporters of the central government. However the central government changes its strategy during election years, since it turns its attention towards jurisdictions with weak party preferences when the electoral competition is strong.

Keywords: intergovernmental transfers, conditional grants, political economy, emerging democracy , Albania

JEL classification: H77, P48, P26

1. Introduction

Decentralization is still a new reality in Albania. Financial dependence from the central government has been decreasing; however local governments still encounter a number of challenges in providing public goods and maintain accountability towards their citizens. Local governments are still highly depended on central government grants. More than 50% of the local government budgets in Albania rely on intergovernmental transfers. The high dependency from the central government is also based on limited resources since the local government revenues represent approximately 10% of the government revenues and no more than 3% of the country's GDP. Under these conditions fiscal equalization is an important tool for making the local government functioning, especially in the early decentralization phase, where countries are burdened by the inefficiencies in the local governments' fiscal governance.

The central government has applied only in 2002 for the first time a scheme for the distribution of intergovernmental grants, which was to a large extent conditional[1], and later on was complemented by an increasing proportion of unconditional grants. The Albanian government goal consists on providing elastic expenditures in order to insure that the efforts for a balanced territorial growth would properly meet the budgetary requirements of the central government (Levitas, 2011; Schroeder, 2007; Shehu, 2006).

Conditional grants have been changing since 2002, where the grant dismantled into two components the one for operational expenditures and the one for capital investments. Till 2010 the ministries of line had discretion to the grant allocation where capital investment expenditures were based on competitive criteria whereas the operational expenditures on the evaluation criteria judged by the ministries. In 2010 the grant for investments was separately treated as a third type of grant and the authority for the

[1]During the period 1993-2000 almost 95% of the entire revenues of the local units consisted in conditional transfers, called "conditional budget". In this transfer the line ministries had total discretion on the amount, usage and purpose of these grants and the LGU's own revenues were very modest due to the minor fiscal role. Moreover these types of revenues were limited in its use (Banks and Pigey, 1998).

management was centralized under the Regional Development Fund (RDF), an inter-ministerial structure. As for the other component, the operational component of the conditional grant has remained under ministerial jurisdiction.

Despite the institutional changes, there have been a number of reports expressing doubts over the fairness of intergovernmental distribution schemes in Albania (Shehu, 2006; Schläppi et al, 2008, CESPI, 2011, CoPlan, 2012, DLDP, 2014). Attempts to specify formulas of allocation have been sporadic and not transparent to the public which leaves room for further changes on subjective terms.

To the present date, fiscal equalization represents an essential issue, also in most Western Balkan countries (Dabla-Norris, 2006; Basta and Byrne, 2006). World Bank reports (2006 and 2007) show a weak public payment system in several countries in the Western Balkans far from European principles. Wide empirical evidence, in both developed and developing countries argues that the distribution of grants across local governance units is heavily influenced by political clientelism among other factors (Khemani, 2008; Sato, 2007). Authors have shown that the level of funds being allocated to the local government units still risks being non-transparent and unpredictable, thus influencing negatively the equity and efficiency criteria of decentralization (UNDP, 2005; Dafflon, 2006; CoPlan, 2012; DLDP, 2014).

Clientelist behavior is not an unusual phenomenon in Albania. Case (2001) finds that economic aid distributed to poor households from the central government are higher both to core support and swing communes. Alderman (1998), Henderson (2008) as well as Mangiavacchi and Verme (2009) have observed that grants allocation for poor and disabled/unemployed people is also unequally distributed. Imami and Lami (2008) observe manipulation of fiscal instruments (increase in public investments and other forms of public expenditures) during both local and parliamentary elections. Patronage and clientelistic behaviors are revealed also in other studies. For instance, Gërxhani and Schram (2009) find that Albania stands for a particular case of clientelistic behavior which is deeply related to the regional and cultural polarization that has existed for centuries and is stronger than the usual representation of interests observed in most democracies. A 2011 report finds that for influencing political decision-making in their favor, mayors and heads of communes still apply direct and personal links to central power holders (CESPI, 2011). CoPlan (2012) carried descriptive analyses of grants and surveyed a sample of local government representatives. Results signalized the existence of political influence on conditional grants and the use of patronage relations on the competing grants (RDF).

However, despite frequent reports and studies focusing on intergovernmental grants allocation, there are no in-depth and scientifically rigorous studies in Albania to empirically show whether the central government allocates those funds in an objective manner in the second decade of transition. Except some earlier studies that focused entirely on the social aid (Alderman, 1998: Case, 2001; Mangiavacchi and Verme, 2009) studies investigating other type of transfers have been based on descriptive analysis. Being a study on a later phase of transition it contributes also to the literature of post-socialists economies. It generates expanded knowledge on the process of transition in a post-structural transformation period. Moreover the study uses a much longer period of time compared with the previous authors. It covers approximately the second decade of the transition, taking as a reference period the first year of the implementation of intergovernmental scheme in Albania.

This study is focused on investigating whether there is political influence in the allocation of the conditional grants by analyzing secondary data available. This study aims to analyze the factors impacting the funds distribution from the central government to the local government units, with a special focus on the political influence within the framework of improved transparency and institutional accountability. The study will assess to what extent the allocation system is affected by political influence. The research questions of this study are:

1. What kind of factors explains the horizontal allocation of grants?

2. Does the conditional grant allocation system in Albania meet the normative theory requirements of equity and efficiency principles?
3. Does the Albanian grants allocation system of transfers eliminate possible politically motivated allocations of transfers?
4. Is the allocation of grants influenced by election periods?
5. If signs of political influence are found, what are the main tactics used by the incumbent to influence the voters?

The overall hypothesis is that the distribution of conditional transfers towards units of local governance, controlling for normative variables, is influenced by political interests of the incumbent. Thus local government units aligned with the same political coalition leading the central government will receive more grants than the others.

This study will focus on conditional transfers, which are state funds allocated to LGUs for specific purposes, to achieve national objectives and to perform functions that central government delegates to local government. LGUs do not have discretion in using conditional transfer, as it can be allocated for the purpose, in the amount and according to the rules set by the central government[2].

During the years the conditional transfers system has changed considerably in 2006 and 2010. In 2006[3] a new type of conditional grant for investment was introduced: the competitive grant. This type of grant was further, in 2010, reorganized in the Regional Development Fund.

Conditional grants are part of the structural budgets of the line ministries, which have the discretion on allocating the grants across LGUs according to few guidelines and criteria given by law. LGUs do not have discretion in using conditional transfers, as it can be allocated for the purpose, in the amount and

[2]Law nr.8652,2002, "On the organization and functioning of local government",
[3] Law nr 9464, 2005, "On the state budget of year 2006"

according to the rules set by the central government[4]. The grants are decided annually during the state budget preparation stage, where the Ministry of Finance based on the requirements from each line ministry determines the funds to be allocated to the local government. The individual allocation to local governments is carried out by the line ministries directly.

2. Literature review

In the last three decades, a wide array of theories analyzing intergovernmental transfers has evolved from the normative approach, to a public choice approach and later on to a political economy approach. In their early stages normative theories focused on the use of intergovernmental transfers to provide basic public services across the regions as noted from Buchanan (1950). During the period 1970-1980 normative theories of decentralization as referred by various authors (Oates, 1972; Gramlich, 1977; Musgrave, 1983), emphasized the role the government, as provider of welfare, in being guided by principles of efficiency and equity while distributing financial resources to the regions using intergovernmental transfers.

The seminal papers of Oates (1972) and Musgrave (1983) explain that a part of local government units suffer from an unequal access to resources and therefore have limited capacity to offer local public goods and services. Therefore equity principles are promoted in order to balance the horizontal fiscal imbalances arising between local government units.

The second principle guiding this theory, namely the economic efficiency principle, aims to smooth or compensate for externalities arising from the provision of essential public services. For example, the larger the expenditures for education and health, the lower are the possibilities for a local government unit to generate revenues from providing such services. These fiscal shortcomings needs to be corrected

[4]Law nr.8652,2002, “On the organization and functioning of local government”,

by the central government which should allocate larger grants to those local government units having a larger number of service users (e.g. pupils in schools, patients in health care centers, elders, unemployed heads of households or poor households in need of social assistance) or lower capacity to support these services by own revenues collected (e.g. weak tax base due to low number of businesses and high geographic marginalization).

However, evidences from a large number of studies have found that fiscal capacity of regions and the budgetary needs for fulfilling public services are not the only statistically important factors in determining the allocation of grants (Lindbeck, 1976; Dahlby and Wilson, 1994; Inman and Rubinfeld, 1996; Kessler and Lessmann, 2009; Dafflon, 2007; Sato, 2007). They find evidence that political factors influence on the horizontal allocation of grants (see the review made by Veiga and Pinho, 2007; Caldeira, 2011; Grau et al. 2012).

Normative economics promotes the horizontal allocation of grants through a formula using social (population and poverty), geographical (marginalization and size) or economic factors (tax collection and economic dynamism) of each local government units, in order to achieve an equitable distribution. The formula allocation has been rarely studied by scholars (Worthington and Dollery, 1998; Banful, 2010; Allers and Ishemoi, 2011).

On the other hand, the public choice literature argues that the central government's objective is not to maximize social welfare, but rather it promotes policies to maximize its own interests and become reelected. The literature is divided into two branches: the opportunistic political business cycles and tactical redistribution theory[5].

Opportunistic political business cycles were firstly discussed in the1970's by two seminal papers of Nordhaus (1975) and Lindbeck (1976), and later on with the study exploring the rationality of pre-

[5]Other authors such as Caldeira (2012) divides the tactical distribution from the patronage where the first aims to increase the probability of being reelected and the later reward the political supporters.

electoral manipulation of Rogoff and Sibert (1988). This group of scholars present models reflecting an opportunistic central government that aims to be reelected by using fiscal stimulus before elections. Such stimulus is applied under information asymmetry and low voters education. This seems proper for a developing country where voters' education and their adaptive expectations on budgetary manipulation are still fragile (Brender and Drazen, 2005).

The theory of tactical redistribution is a theory developed during the 1980s. Scholars of this theoretical approach (Cox and McCubbins, 1986; Lindbeck and Weibull, 1987; Dixit and Londregan, 1995) describe how transfers emerge as a consequence of the political decisions and interactions among political actors at central and local level. The theory considers a central state behaving as an "opportunistic planner" aiming to maximize the electoral support in order to prolong its governing period.

There exist two branches of this theory: the one developed by Cox and McCubbins (1986) which show that a risk adverse incumbent transfers more grants for increasing the welfare of their core voters. The second developed by Lindbeck and Weibull (1987, 1993) and the later one by Dixit and Londregan (1996) who emphasized that a more risk acceptant incumbent will support voters with uncertain preferences, namely "swing" voters, who may react much quicker to any stimulus (the allocation of larger transfers). Dixit and Londregan (1996) argued that attracting swing voters is a proper approach in case the incumbent cannot separate the core voters on any attempt for fiscal manipulations. Authors establish a model that identifies a critical value (cut-off point) that divides voters into those voting for one party and those voting for the other party. Central governments use grants to influence the cut-off point and increase the shares of partisan votes. Overall the idea of these scholars is that core voters, being ideologically bound to the ruling party, may not risk the seats of the incumbent in case the incumbent does not grant [distributive] rewards. Therefore the incumbent chooses to utilize better their fund by persuading the voters with weak party preferences.

As Grau et al. (2012) and Rodden and Wilkinson (2004) emphasize, the theory of tactical distribution does not clearly define the core versus the swing voters. There are two types of *swing* definitions that are used in various papers. The first type defines as *swing* the voters who are more prone to change their preferences because not politically bound to either party. The second definition defines *swing* the jurisdictions, where the distance of vote shares between the largest competing parties or coalitions is very tight[6] (Grau et al, 2012).

Empirical evidences has tested these two seminal papers of tactical redistribution in both developed (see Worthington and Dollery, 1998; Meyer and Naka. 1999; Jameson Boex and Jorge Martinez-Vazquez, 2005; Veiga and Pinho, 2007; Solé-Ollé and Navarro 2008, Johanson, 2003; Grauet al. 2012) and developing countries (Case, 2001, Khemani, 2004; Caldeira, 2012).

Empirical evidences are also divided according to the two different classes of tactical distributive theories:

(i) a risk adverse central government supporting mainly the "core supporters" such as the case of developed countries- the US (Ansolabehere and Snyder, 2006) or Spain(Solé-Ollé and Navaro2008; Grauet al. 2012) - or a developing country such as in the case of the Russian Federation (Treisman, 1996), Argentina (Porto and Sanguinetti (2001), Mexico (Díaz-Cayeros et al. (2007) India (Dasgupta et al. 2004; Khemani, 2004) orGhana (Miguel and Zaidi (2003).

(ii) a less risk adverse government supporting more "swing" voters with the purpose of creating voting diversion on their side. This model is evidenced in developed countries such as Sweden (Dahlberg and Johansson, 2002), Portugal (Veiga & Pinho, 2007) and developing countries such as Ghana (Banful, 2010), India (Cole, 2009) or Senegal (Caldeira, 2012). There are also "mixed" cases where

[6] We will use the definition of swing jurisdiction in our analysis.

authors such as Arulampalam et al. (2009) find evidence that incumbents provide grants to both core and swing voters.

In this study we shed additional light for the case of Albania, earlier signalized by the papers of Case (2001), Alderman (2002) and Mangiavacchi and Verme (2009) as well as the recent study of Coplan (2012). The first group of authors covers only one type of conditional transfer (economic aid). This study covers all the other components of the conditional transfers except the economic aid. Our study is the first one, according to the authors' knowledge that carries out an empirical analysis at the multi-period (2004-2011) and multidistrict (373 Albanian LGUs) level.

3. ALBANIAN POLITICAL FRAMEWORK

The study time span covers the second decade of the decentralization history in Albania which initiates in the beginning of the 2000s where major reforms took place. According to the hypothesis the election objectives are the primary factor influencing the grant allocation. Therefore it is important to illustrate the political framework underlining this period. During the period 2002-2011 three local government elections (2003, 2007 and 2011) and three parliamentary elections (2001, 2005, and 2009) took place.

The central election is a process of electing 140 members of parliament. Two approaches are used during the period covered by our study. During the years 2001 and 2005 the system was based on a mixed method. A hundred from the 140 members of parliament were directly elected from the electorate and 40 from a defined list of the party. In the year 2009 the system switched to a proportional voting system. The party or coalition ranked a closed list of all the candidates for each of the 12 regions. Seats in the parliament are defined by a proportional representation system that allocates seats to each party in proportion to the number of votes won in each region.

Local elections in Albania serve to elect heads of LGUs and the members of the councils of the 373 LGUs, which are directly elected. Citizens during local elections are required to vote for the candidates that run as mayors and for the different parties presented in the election. The candidate for LGU leadership that receives more votes than any other wins the position. The number of votes received by the different parties defines how many members from a closed list determined by the party (based on a proportional system upon a publicized candidate lists) will be part of the LGU council. Thus higher number of votes from a party or a coalition would result in a larger number of council members representing that party or coalition. However, the total number of the members of the council is determined by the population size of the LGU, ranging from 13 members in the smallest communes to 45 members in cities between 100,000 and 200,000 inhabitants.

Table 1: Central elections during the period 2001-2012

Dates of general election	Winning party	Share in parliament	Form of government
21-Jun-01	SP	73/140=52.1%	One party
12-Oct-05	DP	56/140=40.0%	One party
28-Jun-09	DP	72/140=51.4% (68 DP + 4 LSI)	Coalition

Source: Central Election Commission[7]

The beginning of the period targeted by this study was governed by the Socialist Party (SP) till 2005 (1998-2005) and from 2005 till the end of this period (till 2013) the Democratic Party (DP) where in 2005-2009 it was leading alone and in 2009-2013 in a coalition[8]. The same trend has been witnessed in the local government elections were after the year 2003 slightly more than half of the LGUs were

[7]http://www2.cec.org.al/en-us/Elections/Parliamentary

[8] In 2001 the SP won 73 of the 140 seats whereas in 2005 the victory of the DP was witnessed allying with the Republican Party (RP). In 2009 the 33 existing parties were organized in four alliances (Alliance of Change by DP, Union for Change leaded by SP, Socialist Alliance for Integration leaded by Socialist Movement for Integration (SMI) and the Pole of Freedom). No alliance achieved 71 deputies on its own, needed to form a parliamentary majority; hence DP and SMI joined their forces and ruled the country till 2013.

represented by Socialist Party coalitions whereas in the 2007 local elections 60% of local government units were represented by Democratic Party coalitions.

Table 2: Local elections during the period 2001-2012

Dates of local election	Number of LGUs voting right wing (DP)	Number of LGUs voting left wing (SP)	Number of LGUs voting other coalitions
12-Oct-03	139	192	42
18-Feb-07	224	116	33
8-May-11	210	142	21

Source: Own authors' contribution

The number of the elections and the switching rounds in the governing party is a peculiar and interesting laboratory for exploring and comparing the propensity of the governing parties of both wings to influence the grants allocation. The structure of the political parties and the control of the parties on the list of parliamentary members based on the proportional system established a peculiar environment for patronage relations between the incumbent and the voter.

4. METHODOLOGY

4.1. Data and key variables

In this study we empirically investigate the factors influencing the allocation of conditional transfers in Albania. Panel data covering all the LGUs during the period 2004[9]-2011 are used. We followed the general empirical framework used in the literature, that regress per capita amounts of transfers on different categories of independent variables that follow the theoretical framework (e.g. Veiga & Pinho,

[9] The conditional transfer system has firstly begun in 2002, but in order to analyze political influence in its distribution, local election data is needed. We could found data on the local elections held in 2003, 2007 and 2011, but could not find results of the elections held in 2000. That is the reason we excluded from our analysis the conditional transfers distributed in the years 2002 and 2003 and the start of our analysis in the year 2004.

2007; Caldeira 2012, Treisman 1996, Boex & Martinez, 2005; Dahlberg & Johansson, 2002).The first category of dependent variables controls for normative theories that attribute to the central government the role of a benevolent planner whose interest is to maximize social welfare. The second group of variables captures the opportunistic interest of the central government to be reelected, as indicated by public choice scholars. This group includes variables to test for tactical distribution and opportunistic political budgetary cycles of conditional transfers in Albania (see Table 3).

Our dependent variable is the annual conditional transfer per capita, expressed in natural logarithms, allocated to all 373 Albanian LGUs during the period 2004-2011.

Following decentralization and normative theories these transfers should depend on economic and demographic variables to ensure efficiency and equity therefore improve social welfare. According to these scholars more transfers should be allocated in favor of LGUs which have more need for expenditure which are those who are poor or have low taxable income. To control for the equity and efficiency criteria we use different indicators widely used in literature (Boex and Marinez-Vaquez, 2004).

Table 3: Descriptive statistics of key variables for the analysis of conditional grants

Variable	Number of observation	Mean	Standard deviation	Min	Max	Source
Per capita Conditional Transfers without the social sector	2984	886.7	1595.2	0	23421.6	MoF
Normative variables						
Population	2984	11426.8	35426.4	731	618288	MoF
Density	2984	442.8	1343.9	4.2	15457.2	Instat
Total own source revenue per capita	2984	1477.9	2083.5	0	39208.4	MoF
Poverty headcount 2001	2984	34.8	13.5	0.26	80.4	WB
Poverty headcount 2005	2984	0.24	0.16	0	84	WB
Growth of Regional GDP	2984	6306.7	7493.4	793	45066	Instat
Trend	2984	4.5	2.2	1	8	
Trend squared	2984	25.5	21.1	1	64	
Political variables						
Governing	2984	0.5	0.4	0	1	CEC
Difference in votes	2972	0.2	0.1	0	0.9	CEC
Percent vote governing	2972	0.4	0.1	0	0.9	CEC

National election years	2984	0.25	0.4	0	1	CEC
Local election years	2984	0.25	0.4	0	1	CEC

Source: Ministry of Finance, Instat, Central Election Center, World Bank

Firstly, to determine whether conditional transfers in Albania are allocated in accordance with efficiency principles we considered the POPULATION and DENSITY to capture the LGUs' need for expenditure. LGUs with high population face more expenditure to maintain the same standard of local public goods as smaller LGUs. On the other hand, LGUs with high density encounter economies of scale compared to less dense local units. However Pereira (2005) has criticized this argument arguing that central governments tend to allocate to smaller jurisdictions because of the need to have broader support and because of the recognized lobbing power of small groups.

Secondly, to test whether allocation of conditional transfers has targeted the equity criterion and has been pro-poor oriented we included the headcount index and the per capita tax income collected by the LGU. The first variable, headcount index, is calculated by the World Bank and proposes to measure the number or people living below the poverty line in each LGU in the year 2001 and in 2005. The indexes however are calculated based on different methodologies therefore are not comparable and cannot be used simultaneously in the analysis of the panel data. Therefore we used them separately as robustness check of our results. The second control variable for equity used is the per capita tax income collected by the LGUs in the previous year. LGUs with low fiscal capacity should be targeted by the transfers' allocation of a benevolent planner.

Moreover in the first category of variables we included the growth of regional GDP as a proxy for the macroeconomic situation of a country. While to capture time changes of the transfers that do not depend on the specific LGUs but rather on the specific year, we considered the trend and the trend squared. These variables capture also economic conjectures or various shocks that affect equally all LGUs (Veiga & Pinho, 2007).

All the normative variables except the trend are lagged one year for two reasons. Firstly it takes time for these data to be released by the institutions and therefore considered by policy makers in the allocation process and secondly by lagging we exclude to a certain extent endogeneity and reverse causality of the variables.

The second vector of variables is composed by political and electoral variables which allow us to investigate whether the central government pursues tactical political objectives through transfers' allocation to the local government. We test the *supporter model* of Cox and McCubbins (1986), the *swing model* of Lindbeck and Weibull (1987) and the Rogoff and Sibert (1988) model of *politically budgetary cycles*.

The variable used to test the model of Cox and McCubbins is the GOVERNING[10] variable. It is a dummy that takes the value of one if the LGU mayor has the same affiliation as the central government. If the government allocates the transfers to support the core voters who have voted the incumbent party in the last electoral election[11]then the coefficient is expected to be positive. As an alternative of the GOVERNING variable to check the robustness of the supporter model we also use PERCENT VOTE GOVERNING, which is the share of votes the incumbent party has gathered in the local elections in each LGU. In case the Cox and McCubbins model finds support this variable is expected to be positive.

The second model we test is the swing model of Lindbeck and Weibull (1987) using the variable DIFFERENCE IN VOTES. It is constructed as the absolute value of the difference in vote's share between the incumbent party and its main opponent during the last local election in each LGU. This variable is used as a proxy for swing LGUs (Case, 2001; Dahlberg and Johansson, 2002; Johansson, 2003; Veiga and Pinho, 2007; Caldeira, 2013). The rationale behind it is that if the share of votes for the incumbent party in an LGU is close to the share of votes of the second candidate belonging to the opposition party means

[10]Refer to Note 1 in the Appendix for a detailed explanation of the construction of the GOVERNING variable
[11] Past election results are good predictors for future elections outcomes (Gschwend and Nordpoth, 2005).

that a majority of voters in that specific LGU have different party preferences, making that LGU a potential swing LGU. DIFFERENCE IN VOTES captures the inclination of a risk taker central government who might use transfers to persuade voters belonging in LGUs with weak party preferences and attempt to change their preferences toward the party in power.

Finally we test the opportunistic budgetary cycles in transfers' allocation theory. Following the literature we use dummies for local and general elections during 2004-2011. The coefficient is expected to be positive in case the central government increases the transfers in the electoral year to convince the voters.

4.2. Empirical Model

We have a panel data on conditional transfers of all 373 LGUs in the 8 years from 2004-2011. In order to account for LGU specific effects we could apply a fixed effects (FE) model[12]. However, the FE model does not estimate time-invariant variables and yields inefficient results in the case of variables that have little within-variance[13] (Wooldridge, 2002). Moreover, conditional transfers are supposed to depend on the amount of transfers given in the previews years. In fact if an LGU in one particular year is financed by the Ministry for the construction of a road, it is less likely for the same LGU to receive funds the following year for another road. This means that the lagged value of the transfer should be included as independent variable. The lagged value of the dependent variable included in the regression would be correlated with the error term leading to inconsistent parameter estimates (Cameron &Trivedi, 2005; Green, 2003). These drawbacks make the FE estimator not appropriate for the analysis of our data.

[12]A fixed effect model is not appropriate for time invariant and rarely changing variables (Plümper & Troeger 2007). A random effects model can be used with these types of variables but it is ruled out in our case by the Hausman test.

[13] Most of our interest variables, are the results of elections, which makes them rarely changing in time. For instance GOVERNING and PERCENT VOTE GOVERNING variables change every 2 years, DIFFERENCE IN VOTE changes every 4 years.

The model developed to solve these problems leading to consistent estimates is the Generalized Method of Moments (GMM)[14], a dynamic estimation technique for panel data. Rodman (2009) stated that GMM is designed for panel data that follow the assumptions: (i) generated by a dynamic process, meaning that the dependent variable is influenced by past values;(ii) data that have fixed individual effects; (iii)some regressions may be endogenous; (iv)the disturbances may have individual specific heteroskedasticity and serial correlation; (v) some regressors can not be strictly exogenous; (vi) data should have a large N and a small T.

We analyze 373 LGUs in an eight year period, making GMM appropriate for our data. By using the lagged values of the regressors as instrumental variables the GMM produces consistent estimates when the lag of the dependent variable is introduced in the regression. It controls also for the LGU specific effect. GMM solves also two other issues the serial correlation and heteroskedasticity present in our data.

There are two types of GMM: the difference GMM (developed by Arellano and Bond in 1991) and the system GMM (developed by Blundell and Bond, 1998). We use for our analysis system GMM, because it results in an increase in efficiency compared to the difference GMM (Blundell and Bond, 1998). Moreover, differently from Difference GMM, System GMM is also appropriate to model time invariant and rarely time changing regressors, which is the case for our political and electoral variables (Rodman, 2009).

Windmeijer (2005) found that the two step GMM estimator is superior to the one step estimator if corrected for the finite sample. Therefore, we use the two-step system GMM with the Windmeijer corrected standard errors in order to have a more accurate and efficient estimate of the conditional transfers.

[14] Please refer to Rodman (2009) for a detailed technical explanation of GMM methods.

The baseline empirical model, widely used in literature, is described below, where *t* represents the year (t=1….8) and *I* represent the LGUs (i=1…373).$CON\_TRANFER_{i,t-1}$ is the lag of the conditional transfers allocated to the i-th LGU. NORMATIVE and POLITICAL includes the vector of variables controlling for normative and political economy theories respectively, whileβ and γ are the vectors of estimated parameters associated with them. The individual effect of LGUs is captured by $\vartheta_i$and $\varepsilon_{i,t}$ is the error term as indicated in the following equation:

$$CON\_TRANFER_{i,t} = \alpha CON\_TRANFER_{i,t-1} + \beta NORMATIVE_{i,t} + \gamma POLITICAL_{i,t} + \vartheta_i + \varepsilon_{i,t}$$

5. Results

We empirically investigate influences and tactics of the central government on the allocation of per capita conditional transfers from 2004 to 2011 using a system-GMM for linear dynamic panel data models. To avoid endogeneity of the variables we included the lag of all the normative variables (except for the trend). We used as instruments the lags of the dependent variable.

The results shown in the Table 4 reveal a statistically significant negative influence of the lagged transfers, showing signs of predictability in the distribution scheme. This is expected as conditional transfers are granted also for investments which do last in time. Probably there is a long term planning on conditional grants, thus the government takes into consideration the previously transferred funds, especially for investment grants.

The significance of the political and electoral variables shows that the allocation of conditional transfers is statistically influenced by the central government. The positive highly significant coefficient of the GOVERNING dummy founds support for the Cox and McCubbin's (1986) core model. It seems that Albanian central government favors supporters. The model highlights the fact that LGUs leaded by mayors that belong to the ruling party receive higher per capita conditional transfers.

To test the robustness of this result we substituted the dummy GOVERNING with the variable PERCENT VOTE GOVERNING[15] (model 2) that measures the percent of votes given to the ruling party by the LGU electorate in the last local elections. The result provides further support for the Cox and McCubbins model, as more transfers are allocated to LGUs with higher preferences for the ruling party. This is in line with the results of studies previously carried out in developing countries such as the early period of the Russian Federation (Treisman, 1996), Argentina (Porto and Sanguinetti, 2001), Mexico (Díaz-Cayeros et al.2007) India (Dasgupta et al. 2004; Khemani, 2004)) and Ghana (Miguel and Zaidi, 2003).

Table 4: GMM analysis of conditional transfers during the period 2004-2011

CONDITIONAL TRANSFERS PER CAPITA	(1)	(2)	(3)	(4)	(5)
CONDITIONAL TRANSFERS PER CAPITA (t -1)	-0.734***	-0.722***	-0.527**	-0.773**	-0.725**
	(0.258)	(0.267)	(0.218)	(0.340)	(0.309)
NORMATIVE VARIABLES					
POP (t-1)	5.011***	4.673*	4.081***	2.711	4.619***
	(1.242)	(0.704)	(0.826)	(1.698)	(1.335)
POVERTY HEADCOUNT 2005		-3.983			
		(32.244)			
Δ REGIONAL GDP (t-1)	0.667	0.777	-0.430	0.768	1.182
	(0.971)	(1.211)	(0.957)	(1.278)	(0.934)
TAX REVENUES PER CAPITA(t-1)	-4.071***	-4.039***	-4.153***	-4.354***	-4.326***
	(0.762)	(0.771)	(0.622)	(1.439)	(0.796)
TREND	3.880**	3.807**	5.016***	4.313*	4.632***
	(1.590)	(1.774)	(1.206)	(2.236)	(1.494)
TREND SQUARE	-0.411***	-0.404***	-0.518***	-0.446**	-0.466***
	(0.138)	(0.156)	(0.107)	(0.195)	(0.132)
POLITICAL AND ELECTORAL VARIABLES					
GOVERNING	11.083**	10.983**		10.131***	7.804*
	(4.503)	(4.660)		(3.411)	(4.125)
PERCENT VOTE GOVERNING			30.577***		
			(9.375)		
DIFFERENCE IN VOTES	-26.862*	-26.137	-21.827*	-20.203	-6.785
	(15.420)	(16.768)	(11.496)	(13.446)	(16.086)
NATIONAL ELECTION YEARS	0.684***	0.704**	0.632***		4.017**
	(0.252)	(0.275)	(0.236)		(1.916)
LOCAL ELECTION YEARS	-1.757	-1.664	-1.791*		1.447
	(1.265)	(1.386)	(1.038)		(3.791)

[15] As in Veiga and Pinho (2007)

LOC.ELECTION YEARS*GOVERNING				-1.352	
				(3.288)	
LOC.ELECT. YEARS*NONGOVERNING				-2.257	
				(2.339)	
NAT.ELECT.YEARS*GOVERNING				-0.194	
				(0.902)	
NAT.ELECT.YEARS*NONGOVERNING				1.796**	
				(0.809)	
LOC.ELECT. YEARS *DIFFERENCE IN VOTES					-13.122
					(14.452)
NAT.ELECT. YEARS *DIFFERENCE IN VOTES					-15.407*
					(8.693)
Nr. Observations	2,591	2591	2,591	2,591	2,591
Nr. LGUs	373	373	373	373	373
AR (1)	0.003	0.003	0.01	0.001	0.02
AR (2)	0.07	0.08	0.09	0.10	0.55
Hansen J test (p-values)	0.19	0.14	0.12	0.31	0.52
Nr. instruments	22	22	22	21	22

Notes of the regression table:

- The model is a two-step system-GMM linear model for panel data with Windmeijer correction. Robust standard errors are in parentheses, *** p<0.01, ** p<0.05, * p<0.1
- The dependent variable does not include the social assistance transfers allocated by the Ministry of Work
- All the normative variables (except for the trend), the independent variable and his lag are expressed in natural logarithms.
- (t-1) means lagged one period
- AR(1) and AR(2) are the first order and second order serial correlation of the residuals under the null of no serial correlation.

Evidence is found also in support of Nordhaus (1975) and Lindbeck (1976) as well as Rogoff and Sibert's (1988) model of opportunistic political budgetary cycles. As predicted by the literature grants increase during election periods. The fact that the total amount of grants the central government allocates to local governments is not tied to any state budget or macroeconomic indicator, but can be changed at the discretion of the central government makes it possible for the later to increase and decrease it on its discretion, even under budget constraints. In fact conditional transfers increase during the years of national elections. However the coefficient of the local election years dummy is not statistically significant, meaning that the central government does not use tactically conditional transfers during local election years[16].

To deeper investigate whether conditional funds flow towards supporters of the ruling party or towards swing jurisdictions with weak party preference, we interacted the elections years' dummies with the GOVERNING and NONGOVERNING dummy (model4) and with the DIFFERENCE IN VOTEs (model 5), similar to Veiga and Pinho (2007). The results show very interesting patterns of the tactical distribution of the conditional grants. It seems that with the increases in transfers during national election years the Albanian central government favors non-governing LGUs. Veiga and Pinho (2007) too found that during central election years, the central government in Portugal allocated more to jurisdictions led by mayors associated to the opposition rather than to the governing jurisdictions. This is also in line with the logic of Grau et al. (2012) who underlines the motivation that may push a government to support unaligned voters. Grau et al. (2012) explain that under incomplete information of voters, government has not much to claim as a grantor to those LGUs which are aligned, losing so the opportunity to gain credit. Therefore, they may give more to opposing voters since at least they may perceive the benefit from the vote.

Model 5 shows that the strategy of the central government changes during election years compared to other years. The results suggest that central governments allocate more transfers to swing LGUs during national election years. Bringing together model 4 and 5, probably the central government during central elections concentrate more on swing non-governing LGUs in order to change their preferences and votes towards the ruling party. This is in line with the Lindbeck and Weibull (1987, 1993) model and the findings of studies carried out in developing countries such as Ghana (Banful, 2010) and India (Cole, 2009).

[16] Interestingly the Albanian Central government seems to use the conditional transfers as a mean to improve the likelihood of being reelected during national elections and do not use them to enhance the likelihood of reelection of the local leaders.

Regarding the variables controlling for the normative literature the results indicate that more transfers are allocated to LGUs with a higher number of population. This may be due to the fact that highly populated areas do have more expenditure needs. To check the robustness of this result we estimated the same regression substituting POP with the DENSITY (Table 5 in the Appendix). Results are essentially the same. On the other hand other scholars (Wright, 1974; Ansolabehere et al. 2003; Porto and Sanguinetti, 2001; Khemani, 2007) argue that the central government allocates more to the biggest jurisdiction because they have more voters. This way, it may be the case that the central government tries to persuade the biggest number of voters. Our result however, does not support the work of Pereira (2006) that smaller jurisdictions are allocated more per capita conditional transfers by the central government because of powerful interest groups with potentially higher lobbying power.

Results indicate that LGUs with more fiscal capacity are allocated less per capita transfers. The coefficient of TAX REVENUES PER CAPITA is negative and highly significant in all specifications. It seems that the central government has followed the equity criteria distributing more conditional transfers to those LGUs with a low revenue base.

On the other hand, the poverty headcount index[17] that measures the number of population living under the poverty line is not significant. This is contrary to the arguments of Lindbeck and Weibull (1987,1993) and Dixit and Londregan (1996) as well as the findings of Calvo and Murillo (2004)where a higher number of poor is translated into a higher number of "easily persuaded voters" since they have a "higher marginal utility of income".

The regional GDP growth used to capture the macroeconomic performance of the country, although having the expected sign is surprisingly not significant. Conditional transfers per capita have grown over time, but their growth rate is decreasing.

[17] Both headcount indices of 2001 and 2005 were used and results were substantially the same.

6. DISCUSSION OF MAIN FINDINGS

This study finds evidence for political influence on the distribution of conditional transfers to local governments. We use a dynamic GMM estimator for the 373 LGUs in Albania during the period of 2004-2011. The model allows us to test normative theories as well as political economy theories of intergovernmental transfers.

Findings indicate political and electoral manipulation on conditional grants. Partisan distribution of the conditional grants is verified by the fact that the "core supporters LGUs" are allocated larger grants during the entire period covered by the study. GMM results suggest that LGUs led by mayors affiliated with the central government have received more per capita conditional transfers. It seems that the central government rewards its supporters.

Opportunistic budgetary cycle behavior of the central government is also witnessed in the case of conditional transfers. The central government uses conditional transfers to acquire political capital by increasing them during national elections. In fact conditional transfers represent a direct impact of the central government on citizens without passing through the intermediation of the local government.

Tactics of targeting the voters do also change along the observed period. Indeed, the model suggest that during national elections the tactic of central government in the allocation of conditional grants changes. The increase in conditional transfers during national election years flows towards non-governing and swing jurisdictions. During national election years the central government turns its attention towards jurisdictions with weak party preferences when the electoral competition is strong.

Results from this study highlight the fact that in Albania although the central government follows some principles of equity and efficiency, politics and electoral objectives of the incumbents do influence the allocation of intergovernmental transfers as conditional grants are tactically distributed.

These findings call for policy fine-tuning related to the budgetary decision-making. Line ministries responsible for the conditional funds are required to stick to budgeting best practices. Criteria for funding distribution have to be made public. Special regulations on regards to budgetary plans have to be enacted before election years. A rigorous application of the Law on the Right for Information on Official Data is a key element for establishing transparency and accountability from the government side.

Proper orientation is required in terms of Civil Society engagement in order to compel the government to become more accountable to the people and promote transparency. Watchdog organizations, focused on monitoring budgetary plans amendments, are necessary to be oriented toward budgetary advocacy. LGU associations also are necessary to enhance their potentials too, in order to succeed at presenting their issues to decision-makers. This implies a better preparation to bureaucratic advocacy type, targeting line ministries responsible to conditional grants provision.

7. APPENDIX

Note1 : Explanation on the variable GOVERNING for the analysis of conditional transfers.

In order to analyze the distribution of conditional and unconditional transfers, local units were classified into 2 categories: “governing” and “non-governing”. The governing group of local units was composed by all local units whose chief or mayor represented the governing coalition ruling the country the specific year taken into consideration, while the non-governing group was composed by all the rest.

The classification into governing and non-governing was straightforward for the years no election took place: such as 2004, 2006, 2008 and 2010.

Since political rotation happened at the end of 2005, we assumed that the pre-election government decided the distribution of grants during 2005 and not the new one. In this year we classified as “governing” LGUs the ones with the mayors belonging to the left coalition.

In the budget law the total amount of conditional transfers of each line ministry is defined, but the exact conditional transfer amount to be allocated to a specific LGU by the line ministry is decided during the year. In this way the line ministry has the time and opportunity during the year to adapt the allocation of transfers taking into consideration the new results and to use the conditional transfers as a “reward” for just-elected local representatives. Thus in the years of local elections (2007 and 2011) in order to classify LGUs as governing or not, the new local election results were considered. Experts[18] also do agree with this decision.

The change brought by the central elections of 2009 was the fact that a new party entered the governing coalition: the SMI (Socialist Movement for Integration). This made a change for only three LGU’s with mayors representing this party which shifted from “non-governing” to “governing” LGUs.

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[18] Experts interviewed for this research.

Table 5: GMM analysis of conditional transfers during 2004-2011: Robustness check

VARIABLES	(6)	(7)	(8)	(9)
CONDITIONAL TRANSFERS PER CAPITA(t-1)	-0.707***	-0.497**	-0.712**	-0.636**
	(0.246)	(0.211)	(0.294)	(0.305)
NORMATIVE VARIABLES				
DENSITY (t-1)	3.252***	2.473***	2.197**	2.753***
	(0.869)	(0.553)	(0.912)	(0.745)
ΔREGIONAL GDP (t-1)	0.572	-0.196	1.710**	1.321
	(0.985)	(0.950)	(0.737)	(0.824)
LOCAL PER CAPITA REVENUES (t-1)	-3.911***	-3.918***	-3.514***	-4.124***
	(0.701)	(0.588)	(0.752)	(0.664)
TREND	4.409***	5.368***	4.250**	5.062***
	(1.494)	(1.206)	(2.007)	(1.219)
TREND SQUARE	-0.458***	-0.548***	-0.443**	-0.503***
	(0.130)	(0.107)	(0.178)	(0.109)
POLITICAL AND ELECTORAL VARIABLES				
GOVERNING	10.240**		8.627***	5.977
	(4.128)		(2.898)	(3.754)
PERCENT VOTE GOVERNING		27.469***		
		(9.121)		
DIFFERENCE IN VOTES	-28.194*	-23.399**	-21.609	-4.655
	(14.662)	(10.915)	(13.392)	(14.072)
NATIONAL ELECTION YEARS	0.683***	0.673***		3.846**
	(0.241)	(0.230)		(1.721)
LOCAL ELECTION YEARS	-1.640	-1.473		2.672
	(1.198)	(1.008)		(3.636)
LOC.ELECT.YEARS*GOVERNING			-0.587	
			(2.793)	
LOC.ELECT.YEARS*NONGOVERNING			-1.476	
			(2.097)	
NAT.ELECT.YEARS*GOVERNING			0.166	
			(0.617)	
NAT.ELECT.YEARS*NONGOVERNING			1.914***	
			(0.695)	
LOC.ELECT.YEARS*DIFFERENCE IN VOTES				-16.804
				(13.404)
NAT.ELECT.YEARS*DIFFERENCE IN VOTES				-14.457*
				(7.746)
Nr. observations	2,591	2,591	2,591	2,591
Nr. LGUs	373	373	373	373
AR (1)	0.002	0.021	0.001	0.03
AR (2)	0.06	0.09	0.07	0.38
Hansen J test (p values)	0.10	0.07	0.15	0.26
Nr. instruments	22	22	21	22

Source: Author’s elaboration

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