The political economy of fiscal transfers: corruption, political alignment, and subnational economic performance in Nigeria

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1 Introduction and Motivation

Spatial inequality remains a central concern in development economics. Even in economies that experience sustained aggregate growth, economic activity is often unevenly distributed across regions, with production concentrated in a limited number of urban centres while peripheral areas lag behind (Henderson *et al.*, 2001; World Bank, 2009). Such disparities have implications not only for welfare but also for economic efficiency and political stability.

Nigeria presents a particularly striking case of this phenomenon. Despite its large economic size and substantial resource endowment, economic activity remains concentrated in a few states, while many others exhibit weak industrialisation and low internally generated revenue. This pattern persists within a federal system designed, in principle, to promote balanced regional development.

A defining feature of Nigeria's fiscal architecture is the system of intergovernmental transfers administered through the Federation Account Allocation Committee (FAAC). These transfers, comprising statutory allocations, VAT distributions, and other federally collected revenues, constitute the primary source of income for most states, reflecting a pronounced vertical fiscal imbalance (Taiwo, 2022). Standard fiscal federalism theory emphasises the role of transfers in correcting mismatches between revenue-raising capacity and expenditure responsibilities, as well as in equalising fiscal capacity across regions (Musgrave, 1959; Oates, 1972). In principle, fiscal transfers should enable subnational governments to finance public goods provision, support infrastructure development, and stimulate economic activity. However, empirical evidence shows that transfers do not automatically translate into improved economic outcomes (Martinez-Vazquez and McNab, 2003; Rodden, 2002).

These outcomes suggest that institutional and political factors condition the effectiveness of fiscal transfers. On the one hand, corruption represents a key institutional constraint on the productivity of public spending. A substantial body of evidence shows that corruption distorts resource allocation, reduces investment efficiency, and undermines economic growth (Mauro, 1996, 1995, 1998; Rajkumar and Swaroop, 2008; Tanzi and Davoodi, 1997). In particular, Rajkumar and Swaroop (2008) show that the effectiveness of public spending depends critically on governance quality, with similar levels of expenditure producing markedly different outcomes across institutional environments.

On the other hand, partisan alignment between subnational and national governments may influence both the allocation and implementation of fiscal resources. Empirical studies from different contexts

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show that aligned jurisdictions may receive preferential treatment in the distribution of discretionary transfers or benefit from improved coordination with central authorities (e.g., Arulampalam *et al.*, 2009; Brollo and Nannicini, 2012; Solé-Ollé and Sorribas-Navarro, 2008). At the same time, alignment may weaken accountability mechanisms by reducing political competition and oversight (Ferraz and Finan, 2011; Stoecker, 2022). In the African context, Ejobowah (2015) notes that intergovernmental transfers often operate within environments characterised by weak fiscal capacity and institutional constraints, potentially limiting their effectiveness in promoting local development.

Taken together, these mechanisms suggest that the economic impact of fiscal transfers depends not only on their magnitude but also on governance quality and political incentives. Despite these insights, limited attention has been paid to how corruption and political alignment shape the economic efficiency of fiscal transfers at the subnational level. This gap is particularly evident in Nigeria, where large fiscal transfers coexist with substantial variation in economic performance across states.

In light of these, this study pursues three objectives:

i. To evaluate the economic efficiency of federal fiscal transfers across Nigerian states.

ii. To examine whether corruption influences the economic productivity of fiscal transfers in Nigerian states.

iii. To assess whether political alignment between state federal governments conditions both the effectiveness of fiscal transfers and the economic impact of corruption.

2 Positioning within the Literature

This study draws on and contributes to three strands of literature: fiscal federalism, corruption and public expenditure, and the political economy of partisan alignment.

The fiscal federalism literature provides the theoretical foundation for intergovernmental transfers. Early contributions by Musgrave (1959) and Oates (1972) establish the efficiency rationale for decentralisation, emphasising the benefits of aligning public service provision with local preferences. However, subsequent work highlights important limitations in developing country contexts characterised by weak institutions and persistent fiscal imbalances (Prud'homme, 1995; Rodden, 2002). Empirical evidence shows that transfers do not automatically translate into improved outcomes. For example, Martinez-Vazquez and McNab (2003) and Faguet (2008) document considerable heterogeneity in the effectiveness of decentralisation reforms, while Lyytikäinen *et al.* (2024) provide recent evidence that intergovernmental transfers can generate weak or even adverse incentives depending on institutional conditions. Despite these advances, relatively little attention has been paid to the productivity of transfers in generating economic activity at the subnational level, particularly in developing federations.

A second strand examines the relationship between corruption and the efficiency of public expenditure. Theoretical contributions by Shleifer and Vishny (1993) and Tanzi and Davoodi (1997) identify mechanisms through which corruption distorts resource allocation and reduces the returns to public investment. Empirical evidence supports these predictions. Mauro (1996, 1995, 1998) and Gupta *et al.* (2000) show that corruption lowers growth and investment efficiency, while Treisman (2007) provides broader cross-country evidence on its adverse institutional effects. In the Nigerian context, recent studies also find that corruption undermines investment efficiency and fiscal performance (e.g.,

Abu *et al.*, 2022). More importantly, Rajkumar and Swaroop (2008) demonstrate that the effectiveness of public spending depends critically on governance quality, with similar levels of expenditure yielding different outcomes across institutional environments. However, this insight has not been systematically applied to the analysis of intergovernmental fiscal transfers within a single-country subnational framework.

A third strand focuses on the political economy of fiscal transfers, particularly the role of partisan alignment. Studies from both developed and emerging economies show that political alignment between different tiers of government influences the allocation of fiscal transfers. For instance, Arulampalam *et al.* (2009) find that politically aligned states in India receive preferential treatment in discretionary transfers, while Brollo and Nannicini (2012) document similar patterns in Brazil. Solé-Ollé and Sorribas-Navarro (2008) also provide evidence from Spain that partisan alignment affects grant allocation through political channels. However, its implications for governance are ambiguous. While alignment may improve policy coordination, it may also weaken electoral accountability and oversight, thereby facilitating corruption (Ferraz and Finan, 2011; Stoecker, 2022).

Despite these advances, three gaps remain. First, there is limited evidence on whether fiscal transfers enhance economic activity at the subnational level in developing federations, particularly in Africa. Second, the role of corruption in shaping the productivity of fiscal transfers remains underexplored. Third, the influence of political alignment between state federal governments in shaping both the efficiency of fiscal transfers and the economic impact of corruption has received little empirical attention. This study addresses these gaps by examining how corruption and political alignment condition the impact of federal fiscal transfers on economic activity across Nigerian states.

3 Data and Methodology

3.1 Data

The empirical analysis will employ a panel dataset covering the 36 Nigerian states over the period 1999-2025. Fiscal transfers comprise statutory allocations from the Federation Account, VAT distributions, and other federally allocated revenues, subject to data availability. Economic activity is proxied using satellite-based night-time light intensity, which has been widely validated as a reliable measure of subnational economic performance (Chen and Nordhaus, 2011; Henderson *et al.*, 2012). State-level corruption is measured using the subnational corruption index developed by Crombach and Smits (2024). Political alignment is constructed from electoral data on the party affiliation of state governors relative to that of the federal executive. Control variables include subnational demographic and economic characteristics. Data are obtained from the World Bank, IMF, Nigeria's National Bureau of Statistics, Nigeria's Independent National Electoral Commission (INEC), and other relevant sources.

3.2 Empirical Strategy

The empirical analysis proceeds using a set of complementary panel specifications designed to isolate the effects of fiscal transfers, corruption, and political alignment while mitigating multicollinearity concerns.

The baseline model evaluates the economic efficiency of fiscal transfers:

$$Y_{it} = \beta_0 + \beta_1 Transfers_{it} + X_{it}\Gamma + \mu_i + \lambda_t + \epsilon_{it} \tag{1}$$

where Y_{it} denotes economic activity in state i at time t, $Transfers_{it}$ represents federal fiscal transfers, X_{it} is a vector of control variables, μ_i captures state fixed effects, and λ_t captures time effects.
To assess whether corruption conditions the effectiveness of fiscal transfers, the following specification is estimated:

$$Y_{it} = \beta_0 + \beta_1 Transfers_{it} + \beta_2 Corruption_{it} + \beta_3 (Transfers_{it} \times Corruption_{it}) + X_{it}\Gamma + \mu_i + \lambda_t + \epsilon_{it} \quad (2)$$

The role of political alignment is examined using:

$$Y_{it} = \beta_0 + \beta_1 Transfers_{it} + \beta_2 Alignment_{it} + \beta_3 (Transfers_{it} \times Alignment_{it}) + X_{it}\Gamma + \mu_i + \lambda_t + \epsilon_{it} \quad (3)$$

where $Alignment_{it}$ is a binary indicator equal to one if the state governor is politically aligned with the federal executive.
To examine whether political alignment conditions the economic impact of corruption, the following specification is estimated:

$$Y_{it} = \beta_0 + \beta_1 Corruption_{it} + \beta_2 Alignment_{it} + \beta_3 (Corruption_{it} \times Alignment_{it}) + X_{it}\Gamma + \mu_i + \lambda_t + \epsilon_{it} \quad (4)$$

The interaction terms capture whether corruption and political alignment condition the effectiveness of fiscal transfers and their broader economic consequences.

3.3 Estimation Approach

All models will be estimated using fixed effects to control for unobserved state-specific heterogeneity and common time shocks. Standard errors are clustered at the state level to account for heteroskedasticity and serial correlation. Potential endogeneity concerns are addressed through the use of lagged explanatory variables and alternative model specifications. Where appropriate, dynamic panel estimators, including system GMM and cross-sectional autoregressive distributed lag (CS-ARDL), are employed depending on the time-series and cross-sectional properties of the data. Robustness checks include the use of alternative corruption measures, different definitions of fiscal transfers, and sensitivity to sample periods and model specifications.

4 Expected Contribution

This study contributes in three main ways. First, it provides new empirical evidence on whether fiscal transfers translate into economic activity at the subnational level in Nigeria. Second, it shows how governance quality and political alignment condition the effectiveness of fiscal policy. Third, it offers policy-relevant insights for improving the design and implementation of intergovernmental fiscal systems in developing federations.

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