Stimulating Local Development through Federal Transfers

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The question of how best to design fiscal policy in order to stimulate aggregate demand and revive a stagnant economy has received considerable attention in recent years, yet without achieving much consensus. Underlying much of this debate is a remarkably poor understanding of the extent to which government spending can foster economic growth. The goal of this research agenda is to estimate the effects of government spending on local employment and income generation using data from Mexico's municipal governments. To overcome the identification concerns that have plagued much of the existing literature, we plan to evaluate a recent development policy that allocates sizeable block grants to local governments based on a well-defined formula.

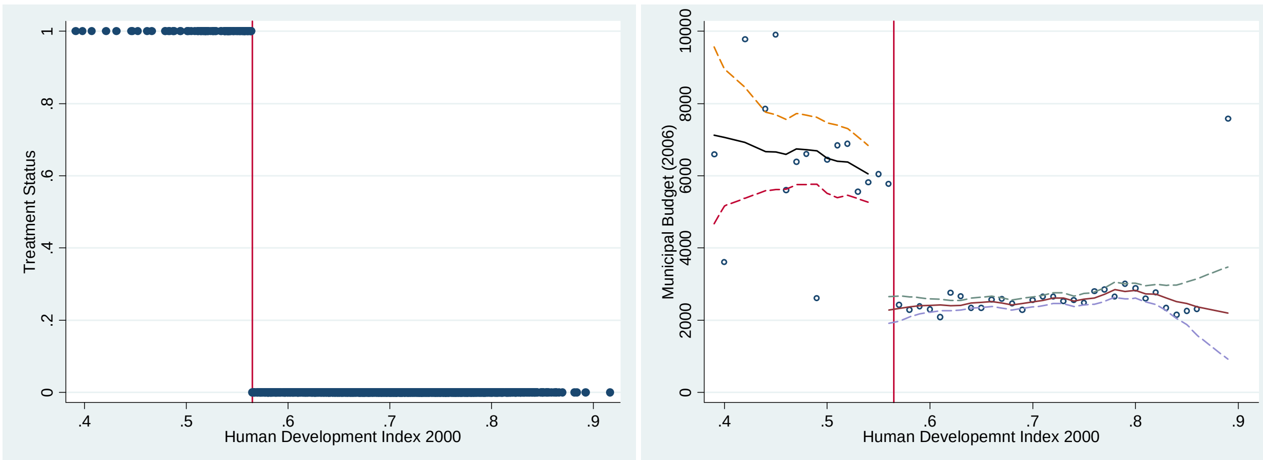
In 2005 the Federal government of Mexico initiated a policy to promote local economic development among its poorest municipalities. To determine which municipalities would participate in the program, the Federal government ranked each municipality according to their 2000 Human Development Index (HDI) score and decided to benefit the bottom 100 municipalities. Beginning in 2006, these municipalities began to receive block grants to fund various large-scale development projects. The block grants are quite large, representing an annual investment of over $450 per capita, which is comparable to the amount invested by the Federal Emergency Relief Act during the Great Depression. However as panel A of Figure 1 depicts, because of the selection criteria, several municipalities with similar HDI scores did not receive these blocks or any other extra funds from the government. Given the sharp and sizeable discontinuity in the municipal budgets that this policy induced between places that received the transfers and those that did not (see panel B of Figure 1), this research proposal will pursue two specific aims:

(1) To examine the extent to which these block grants increased local employment and incomes. Using data from the recent economic and population censuses, our research design will allow us to credibly estimate both employment effects, as well as, the fiscal multiplier effects associated with these federal transfers.

(2) To examine the extent to which these block grants reduced inter-regional economic inequality. Mexico is a highly unequal society, and much of the income inequality is regionally-based. Because this place-based policy targeted Mexico's poorest municipalities, it may have led to significant impacts on the high degree of regional inequality that exists within Mexico.

The results of this research will provide credible empirical evidence on the relationship between federal spending and local employment and income. Understanding whether federal transfers can stimulate aggregate demand is not only important for the Mexican government or other middle-income countries. These findings will also help inform the current debate on whether government spending can be a viable policy instrument for promoting economic growth, particularly during periods of recessions.

FIGURE 1: EFFECTS OF THE BLOCK GRANTS ON MUNICIPAL BUDGETS



Panel A Panel B