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Letter from the President

American Imperialism in Comparative Politics

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Comparative politics is under assault. Scholars armed with quantitative technologies and schooled in the research tradition dominant in American politics have invaded our turf. Signs of the onslaught abound. Comparativists complain that the American Political Science Review only publishes the type of comparative article that an Americanist would write. World Politics, long the bastion of traditional scholarship in comparative politics and international relations, increasingly publishes articles containing tables of regression coefficients. Young scholars must traverse a minefield to get tenure. The best scholars using non-quantitative methods are vulnerable to the sort of tenure letter that says so-and-so is very good at he does, but what he does is not "cutting edge work." At the same time, the best young scholars using quantitative methods are vulnerable to the sort of tenure letter that says so-and-so may know something about game theory, but she doesn't know anything about Argentine (or French or Chinese) politics. In a divided discipline, no one can please all sides.

Comparative politics has been invaded before. In the early postwar period, the behavioral revolution in American politics spawned a generation of comparativists who ap-

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plied the new technology of public opinion research around the globe. The introduction of survey research in comparative politics had a longlasting impact. Today, public opinion research is well-established in every rich and middle income democracy. Nevertheless, the first invasion was largely resisted and survey researchers in comparative politics were marginalized. Twenty years ago, young comparativists were captivated by the sweeping historical-comparative analyses of Barrington Moore, Karl Polanyi, Immanuel Wallerstein or Joseph Schumpeter. For a while, it was the Americanists turn to be invaded as the comparative-historical approach was applied to the study of politics in the United States by Walter Dean Burnham, Theda Skocpol, Stephen Skowronek and others.

The current generation of invaders differs from the survey researchers in fundamental ways. Economics, rather than social psychology, is now the dominant source of imported theories and methods. While the standards of statistical work have grown over time, many of the new quantitative scholars are more concerned with deductive theory-building than with data analysis. Most importantly, the new generation of quantitative comparativists are generally concerned with impact of political institutions as opposed to the earlier concern with individual attitudes or class conflict.

So what should the response of comparativists be to the new generation of scholars who insist on studying "our" countries in the same way that Americanists study the US Congress. The first response should be to celebrate that central fact that makes such an invasion possible, that is the spread of democracy. However one evaluates the functioning of democracy in the US, it is surely a great advance that politics in much of the world is much more similar today to politics in the US than it was twenty five years ago.

The second response to the invaders should be to incorporate the new technologies that the invaders have introduced. When theory becomes sufficiently complex, mathematical language becomes indispensable for ascertaining what conclusions follow from a given set of assumption. When our data can be put in quantitative form without losing essential information, quantitative techniques are the only way to determine with precision what can and cannot be inferred from the evidence. I hasten to say that I am not advocating the abandonment of traditional methods of research in comparative politics. My argument is that the more varied the research tools in our toolbox, the likelier we are to have access to the best tool for the particular task we face.

New research tools lead to new research questions. Until recently, no one in comparative politics paid much attention to Duverger's law. Suddenly, the impact of the rules whereby votes are turned into seats in parliament is a thriving area of research. The institutional details of how parliaments, or the courts, are organized may have important consequences that have been largely neglected until recently. The new emphasis on the potentially large effects of small differences in political institutions has added an important dimension to the study of comparative politics.

Yet, if comparative politics abandoned its traditional questions in the rush to embrace a new research agenda, the loss would exceed the gain. The problems studied by most Americanists are narrowly political from the perspective of traditional comparativists. In part, it is inevitable that single-country specialists will engage in a more extensive division of labor than comparative scholars. In part, the narrowness of the research topics reflects the stability of American political institutions and the small range of differences with regard to policy choices from one administration or Congress to another.

The connections between political institutions and economic outcomes have greater salience in a comparative context where the variation of both political and economic outcomes is many times greater. Similarly, democratic politics is neither so widespread nor so stable where it exists that comparativists can take the existence of democratic institutions for granted. Why regimes change from authoritarian to democratic and back again remains one of the fundamental questions that comparativists will continue to address. Nor, in a world in which ethnic and religious conflict is not diminishing, can comparativists neglect the study of the political causes of inter-group violence.

Thus, the third and final response of comparativists to the invaders should be to adapt the new research tools in order to gain fresh insights regarding the big questions of institutional change and of the relationship between political institutions and the economy or the patterns of social interaction that have defined comparative politics but are seldom asked in American politics. In the long run, the migration of ideas from one field to another strengthens both, especially if the field that imports the new ideas is not afraid to modify and adapt them for its own ends.

Symposium

The New Political Economy of Decentralization and Federalism

Introduction

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Political and fiscal decentralization have hit the headlines in recent years. At the turn of the 21st century, it is hard to find a corner of the globe where there are not at least two or three projects underway to devolve political or economic authority down to regional or local governments. Responding to these events, research on decentralization and federalism has undergone a remarkable renaissance. For this issue, we asked a number of political scientists and economists to share their thoughts on what recent experience has taught us.

The contributions that follow are both varied and surprisingly consistent in suggesting the fascinating research that remains to be done in this area. Barry Weingast opens the symposium, proposing a comparative theory of federalisms – good and bad – that builds on his well-known work on "market-preserving" federalism. Robert Inman, fresh from the trenches, reports on his experience applying theory to the design of institutions in post-apartheid South Africa. Susan Rose-Ackerman explores some differences and similarities in the ways political scientists and economists think about decentralization, and raises some provocative doubts about the "states as laboratories" argument often traced to Justice Brandeis. Jenna Bednar reviews several decades of thought in economics and political science about modeling federal states. Jennie Litvack and Jonathan Rodden discuss the evolving approach to decentralization of the World Bank – a major institutional contributor to these debates – and describe an ambitious, ongoing research project to explain the hardness or softness of subnational budget constraints. Finally, Karen Remmer and Erik Wibbels explore ways in which the fiscal federalism literature must develop if it is to illuminate the particular problems of decentralization in Latin America.

If one impression dominates others in reading this collection, it is of the towering shadow still cast more than four decades later by Charles Tiebout's nine-page note in the *Journal of Political Economy*. Tiebout has become synonymous with the idea that free competition between local or regional governments to attract capital or residents will lead to efficient provision of local public goods and efficient sorting of residents by taste. His name comes up in five out of the six articles. A more recent article in the *JPE* chose a question for its title: "Tiebout or Not Tiebout?" The answer must clearly be... "Tiebout."

Still, what *is* Tiebout's role in current debates? Running through the new literature on decentralization is a focus on the ways in which Tiebout's vision of efficient competition fails to reflect observable reality. Even Weingast, whose theory of market preserving federalism owes much to the Tiebout way of thinking, looks in his contribution to this issue at the ways in which many *de jure* federal states fall short of the desirable qualities that subnational competition is thought to bring.

Consider a parallel. The Coase Theorem is arguably the most celebrated economic result of the second half of the 20th century. Yet, it stimulated economic thought ultimately by provoking scholars to think systematically about why in practice it does *not* hold. Is the new political economy of decentralization about to develop into something comparable to transaction cost economics? We will have to wait and see. But the contributions that follow suggest a vigorous intellectual move in this direction.

A Comparative Theory of Federal Economic Performance

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Introduction

Why do federal systems perform so differently? Consider: For the last three centuries, the richest nation in the world has always been federal. The Dutch Republic from the late sixteenth through mid-seventeenth centuries, England from the late seventeenth or early eighteenth until the mid-nineteenth century, and the United States from the late nineteenth and throughout the twentieth century. Similarly, modern China, a de facto federal state, has also experienced sustained growth. In contrast, India, the large Latin America federal states of Argentina, Brazil, and Mexico, and modern Russia have all fared much more poorly. How do we account for such large differences in economic performance?

The first observation to make is that federalism is not a single system with one type of tendency. Federalism is instead a category of systems whose political and economic properties vary widely. It therefore seems inappropriate to speak of the tendencies or properties of federalism per se, as so often occurs in the literature. Some federal systems may promote economic growth or macroeconomic stability while others do not.

In this article, I present a theory that allows us to explain and predict differential federal economic performance. The theory provides an explanation of why some federal systems grow so rich, sustaining the richest economy in the world, while others remain poor and exhibit low growth.

The next section discusses various conditions characterizing different federal systems. The third section applies the framework to a range of countries around the world. My conclusions follow.

A Comparative Theory of Federalism

To understand the comparative theory of federal performance, I develop a set of conditions that help differentiate among federal systems. All federal systems decentralize political authority, so a clear necessary condition for federalism is:

> (F1) there exist a *hierarchy* of governments with a *delineated scope of authority*.

Yet federal systems differ enormously in how they allocate power. The following conditions characterize how federal states allocate power among national and subnational governments.

> (F2) Subnational autonomy. Do the subnational governments have primary *authority over the local economy*?

> (F3) Common market. Does the national government have the authority to police the *common market*?

> (F4) Hard budget constraints. Do all governments, especially subnational ones, face *hard budget constraints*?

(F5) Institutionalized authority. Is the allocation of political authority *institutionalized*?

To make this discussion manageable, I will ignore many subtleties and simply assume that each condition either holds or not. We can thus characterize different federal systems as to which conditions they satisfy, ranging from F1 alone to F1 and some of the others, to F1-F5.

I first consider an ideal type of federalism that satisfies all five conditions called *market-preserving federalism* (see Weingast, 1995). In combination, these conditions help foster and preserve markets. The logic is as follows. Conditions F2-F5 limit national power to the task of policing subgovernmental encroachment on the common market and to providing national public goods, such as defense and a stable macroeconomic regime. Power to regulate markets is reserved for the subnational governments (F2). Competition among lower governments for factors of production and tax revenue limits the discretionary authority of these governments. Jurisdictions that fail to foster markets risk losing capital and labor and hence valuable tax revenue. A necessary condition for this competition to be beneficial is the absence of trade barriers. Without F3, each subnational government would become a *de facto* "national government" in its jurisdiction, short-circuiting federalism's limits on lower governments.

A hard budget constraint (F4) concerns fiscal transfers among levels of governments and government borrowing (see McKinnon, 1997, and Wildasin, 1997). Under this condition, the federal government cannot bail out states that go into deficit due to fiscal imprudence; and it prevents states from endlessly bailing out failing enterprises. A hard budget constraint does not limit fiscal transfers to poorer regions, however; but it does constrain how and under what circumstances fiscal transfers are made.

Condition F5 provides for credible commitment to the federal system. This condition requires that, beyond simple decentralization, the federal structure must not be under the discretionary control of the national government. The absence of this condition allows the national government to compromise subnational government autonomy and hence the benefits from competition among them.

A critical feature of market-preserving federalism is that it limits the exercise of arbitrary authority by all levels of government. Federalism limits the central government directly by placing particular realms of public policy beyond that government's reach. For lower governments, constraints are imposed in two ways. First, the central government polices state abuses of the hierarchy, such as encroachments on the common market (F3). Second, the induced competition among lower jurisdictions places self-enforcing limits on these governments' ability to act arbitrarily (Tiebout, 1956, and Rubinfeld, 1987).

No government has a monopoly of regulatory authority over the entire economy, so no government can create monopolies, massive state owned enterprises solely to provide jobs or patronage, and other forms of inefficient economic intervention that plague developing countries. A subnational government that seeks to create monopolies or a favored position for an interest group places firms in its jurisdiction at a disadvantage relative to competing firms from less restrictive jurisdictions.

Competition also induces subnational governments to provide a hospitable environment for factors of production, typically through the provision of local public goods, such as establishment of a basis for secure rights of factor owners, provision of infrastructure, utilities, access to markets, safety nets, and so on. Jurisdictions that fail to provide these goods find that factors move to other jurisdictions.

Third, under a hard budget constraint (F4), local governments can go bankrupt. This provides subnational governments with the incentives for proper fiscal management. Local enterprises, politicians, and citizens hardly want their government to spend more money than is prudent. Bankruptcy would greatly hinder the ability of local governments to finance necessary public goods, such as those needed to attract foreign capital and lower business costs.

The set of conditions goes beyond market-preserving federalism to form a comparative theory of federalism. The economic and political performance of federal systems vary systematically when one or more of the conditions fail to hold.

Consider a federal system that satisfies all conditions but the common market axiom (F3). The absence of a common market allows lower jurisdictions to erect trade barriers. This implies that some areas, particularly those whose economies are not likely to perform well under open competition, are likely to erect trade barriers to firms and products from other areas. A federalism of this sort (one which is only incompletely market-preserving) will produce seemingly contradictory results. Some areas will be observed to promote markets while others will closely control their economy, especially to prevent influence from outside the jurisdiction. The absence of a common market also implies far less pressure against political corruption. Corruption is likely to be higher in those jurisdictions that raise high trade barriers.

A second type of federal system satisfies all the axioms except F4. Several problems are likely to emerge in federal systems that fail condition F4, especially systems that decentralize authority over credit so that it remains at least in part at the discretion of subnational governments. The most obvious effect is inflation as each government "overgrazes the commons," causing too much growth in the money supply. China in the late 1980s and early 90s experienced modest inflation as a result while Brazil in the 1990s experienced hyperinflation Decentralized access to credit softens the hard budget constraint. Governments can finance massive rent-seeking, unremunerative public works projects, or corruption and then borrow more to cover their deficits. Decentralized access to credit also allows lower jurisdictions to bail out ailing enterprises, compromising economic incentives imposed by market discipline. The absence of condition F4 thus diminishes a federal system's political incentives for fiscal prudence and to limit political rent-seeking and corruption.

A final type of federalism fails condition F5; for example, a system in which the federal government can compromise subnational government autonomy, perhaps by declaring an emergency and legally taking over the state. This power compromises the value of political decentralization since it allows the federal government to threaten states that seek to deviate from federally desired policies.

Explaining Differential Economic Performance

The payoff from the approach is that it differentiates the economic performance of various federal systems. My approach shows that whether a nation calls itself federal "de jure federalism" is irrelevant.[1] What matters for federal performance is the combination of conditions that hold.

The following table summarizes the effects of the conditions on federal performance. Federal states that have met all or nearly all five conditions – that is, those characterized by market-preserving federalism – have experienced sustained long-term growth. Federal states failing to meet these conditions have experienced meager or no growth. Throughout its history, the United States has been a market-preserving federal system. Except for a brief period under the Articles of Confederation, the common market condition, F3, has always held, as has the hard budget constraints, F4 (the national government does not bail out states). Until the 1960s, states retained the lion's share of authority over economic regulation. As I argue (Weingast, 1995), the conditions contribute significantly to this country's economic prosperity and growth.

Similarly, England during the 18th century and thus the industrial revolution had a market-preserving federal structure, though not a de jure one. Constitutional changes following the Glorious Revolution of 1689 limited the national government's role in the economy and improved local government autonomy. This proved especially important during the industrial revolution, which took place not in the established commercial centers but in more remote northern England (Weingast, 1995).

Similarly, many de jure federalism systems are nothing like market-preserving federalism. For example, in Argentina, Brazil, and Mexico, conditions F2 and F5 fail, and often F4. In most Latin American federalisms, the lion's share of state revenue comes from the national government. This creates several problems. First, it breaks the link between local economic prosperity and fiscal health. Second and perhaps more importantly, along with that much revenue come restrictions, rules, and regulations of the center. Argentina in the 1980s and Brazil in the 1990s both experienced hyperinflation due in part to profligate behavior of the lower governments, which forced the federal government to bail them out. Until recently, the long-dominant PRI used its central power, including the power to fire governors (compromising F5) to limit lower government autonomy. Lower governments in these systems have neither the incentive nor the ability to differentiate themselves from their neighbors. More broadly, the failure of F2 and F5 implies that the political discretion and authority retained by the central government in these systems greatly compromise their market-preserving qualities.[2]

The de jure federalism of the former Soviet Union provides another contrast between market-preserving federalism and other forms of decentralization.[3] In that system all conditions but F1

Types of Federalism and Economic Growth		
	Sustained Growth	Meager Growth
Market-Preserving Federalism	Dutch Republic, 16-17 c Great Britain during the industrial revolution US, 1787 - present Modern China	
Other Federal Systems		Modern Russia Post-WWII: Argentina Brazil India Mexico

failed. The Soviet Union was characterized by the nearly complete absence of subnational government policy discretion. Lower governments were administrative units of the central government having little power over their local economies. The center also carefully controlled factor mobility. As a consequence, federalism provided no positive incentives toward economic growth. The absence of a hard budget constraint (F4) allowed the state to bail out ailing state-owned enterprises, removing all incentives for these firms to produce efficiently.

Next, consider modern China. Although it does not call itself federal, China has instituted serious decentralization of political decision-making, particularly over the economy. China now satisfies all the conditions except F3, though there was a modest problem with soft-budget constraints leading to modest inflation in the 1980s. The failure of F3 implies that many interior provinces have created trade barriers and "dukedom economies." Because many of the coastal provinces seek to earn rents on the competitive market, the lack of a domestic common market provides only a modest constraint on their behavior. These provinces' political autonomy over economic regulation has allowed them to provide a remarkably hospitable environment for markets and hence sustained economic growth (Montinola, Qian, and Weingast, 1995). Indeed, Guangdong's famous "one step ahead" allowed it to use its new discretion over the economy that attracted an unprecedented level of investment and economic growth.

Conclusions

This article sketches a comparative theory of federal performance. I propose four conditions that differentiate among federal systems. The conditions relate to the different ways in which federal systems allocate political and economic power among the levels of government. The theory demonstrates that different allocations of power yield different patterns of economic performance. A specific subset of systems satisfying all four conditions, called market-preserving federalism, have experienced sustained economic growth. Other types of federal systems satisfy fewer or none of the conditions and have much poorer economic performance.

Market-preserving federalism holds the potential for fostering markets, in part because it limits the interventionist tendencies that plague all levels of government in developing countries. This ideal type of federalism satisfies four conditions: it limits the authority of the national government over the economy; it fosters competition among lower governments in part through the common market; it limits the ability of the national government to bail out fiscally imprudent behavior; and it limits the ability of the national government to compromise lower government autonomy. Federal systems that fail to satisfy one or more of these conditions only incompletely foster markets, if they do so at all.

The discussion in section 3 shows that this framework helps explain why federal systems exhibit such divergent economic performance. Federal states characterized by market-preserving federalism experience sustained growth, including the United States, Modern China, the Dutch Republic in the seventeenth century, and England during the eighteenth century. Federal states not characterized by market-preserving federalism fail to exhibit sustained growth, including modern Russia, the former Soviet Union, India, and the large federal states in Latin America, such as Argentina, Brazil, and Mexico.

Obviously, this approach only covers certain aspects of federalism, particularly the relationship between political authority and economic performance. This focus omits a range of important aspects of federal performance, such as ethnic or regional harmony, and the mechanisms providing for political stability, notably the party system.

Let me conclude by making an important observation about this approach to federalism: it makes no mention of democracy. Perhaps democracy—particularly certain types of competition among parties—provides a major mechanism that helps sustain federalism (see Riker, 1964). This is not a condition for federalism, however, but for federal stability. Further, most discussions of this point at best argue that certain forms of party competition are a sufficient condition for federal stability, not a necessary condition. Our discussion of federalism in China (Montinola, Qian, and Weingast, 1995) suggests that stable federalism can occur without democracy. Nonetheless, a major open question concerns the mechanisms by which federalism becomes self-enforcing.

Notes

1. Williamson (1996).
2. On India's problematic brand of federalism, see Parikh and Weingast (1997).
3. In contrast, 18th century England was characterized by market-preserving federalism, although the English did not call their system federal (Weingast, 1995).

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Fiscal Federalism in Developing Economies: Lessons Learned From Working in South Africa

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In May, 1994, I had the special opportunity to visit South Africa as part of a World Bank mission led by Dr. Junaid Ahmad to assist the new ANC-led government on the design and implementation of its fiscal constitution. The mission included Dr. Charles McLure as an advisor on tax policy and Professor Richard Bird as an advisor on the public administration of fiscal policy. My job, with considerable help from Junaid, Charles, and Richard, was to assist the Department of Finance, the new Department of Provincial Affairs and Constitutional Development, and the constitutionally created Financial and Fiscal Commission in thinking through a financing structure for the nine new Provinces and the country's major urban centers. The interim Constitution, the result of 18 months of difficult negotiations between the African National Congress (ANC) and the old apartheid regime, was quite explicit in its commitment to a decentralized structure of government responsibility, though never officially called "federal" because of the link of that word to apartheid's homeland policies and the National Party's and the Inkata Freedom Party's demands for protected minority rule governments. "Devolution" – the preferred code word – was to be an important component of the new democracy. In the interim Constitution, the nine new provinces – boundaries were based on earlier economic development regions – and the national government were given shared responsibility for elementary and secondary education, environment, housing, economic development, health care, public transit, and welfare. Cities and smaller local jurisdictions were given responsibility for providing childcare, electricity and gas, sanitation services and waste removal, local public transit, firefighting, and water. Local governments retained their right to tax property and to levy service fees. In contrast, and for reasons which will soon become apparent, the new provinces were granted only limited own taxing powers, which have not yet amounted to more than seven percent of total provincial revenues. Provincial revenues were to come from the national government, through a constitutionally guaranteed share of nationally collected tax revenues. Local governments were also guaranteed a share of all nationally collected tax revenues. The official Constitution, adopted in May of 1996, has largely followed the decentralized fiscal structure outlined in the original, interim Constitution.

Since that initial visit, I have continued to advise the government on a design for funding a system of decentralized governments. Whatever my contribution, the experience has given me a far clearer understanding of the potential role for decentralized fiscal institutions in developing economies. In sharing these lessons learned, I hope you will forgive my naïveté on matters political. If my lessons strike you as obvious, then treat them as confirming but still valuable data points, tightening your confidence intervals. The usual disclaimer applies: These are my own views and do not represent an official position of the World Bank or the views of Drs. Ahmad, Bird, or McLure.

Lesson No. 1: *Whatever their economic virtues, politically independent provinces and cities are created by constitutions primarily for political, not economic, reasons.* The economic theory of federalist institutions, so nicely summarized by Wallace Oates (1972), offers a persuasive economic argument for fiscal decentralization. With the appropriate assignment of spending and taxing responsibilities, provincial and local governments can provide public goods efficiently. There is good evidence now that at least in developed economies such efficiencies result. All of this analysis and evidence, however, seems to have very little to do with why actual federations form. William Riker's (1964) treatise on federalism argues that political unions form because one dominant party to the federal bargain wants to expand its political control and the other parties to the bargain sacrifice some political independence for the protection such a union provides. This seems an accurate description of the motives that lay behind the provincial structure of South Africa's interim, and final, Constitution.

By 1990, it was clear to the National Party (NP) leadership that the economic, and perhaps personal, survival of the white residents of South Africa required sharing power with the country's African majority, represented by the ANC. The original NP position was to demand fiscally independent provincial governments and de facto unanimity rule for central government decisions. In these demands, the NP found a ready ally in the leader of the Inkatha Freedom Party (IFP), Chief Mangosuthu Buthelezi, seeking to protect his privileged position from the old homeland structure. The ANC rejected these demands for a confederal form of government and made clear that majority rule was a non-negotiable requirement for any new constitution. The final bargain among these three important parties, a compromise which allowed for a peaceful all-race election in April, 1994, established nine provinces, three of which were likely to be controlled by the minority parties to the agreement: KwaZulu-Natal (IFP), Western Cape (NP), and Northern Cape (NP). The central government was to be run by a nationally elected majority (ANC), with shared ministerial leadership with the NP and IFP. Under the interim Constitution, important public services responsibilities would be shared between the national and provincial governments, satisfying the NP and IFP. In return, police and military powers would remain solely the responsibility of the national government, and as noted, provincial revenues were to come almost exclusively from the national government. With these constitutional assignments, provinces would control the bureaucracy for the deliver of public services while the national government would control funding. In principle, both tiers of governments, and thus each tier's ruling political party, would need each other. To ensure provinces would receive sufficient monies, the interim and final Constitutions explicitly required that national tax revenues be shared "equitably" with provincial and local governments. The last link in the constitutional bargain left the definition of "equitable" to an expert commission of lawyers, accountants, and economists, none of whom could hold elected office while serving on the Commission. Commission members would be appointed by the newly elected national and provincial governments. Named the Financial and Fiscal Commission (FFC), the Commission finished its work in May, 1996, and the "equitable share" formula was approved by Parliament as recommended. While sound economic thinking guided the Commission's proposals, the provinces in South Africa, their spending responsibilities, and their revenues exist for political reasons only.

Lesson No. 2: *In designing decentralized fiscal structures for developing economies, Tiebout is irrelevant*. This lesson took about one day to learn. Remember what the Tiebout theorem says: *If* 1) the goods being provided by government are congestible (not pure) public goods; 2) there is a perfectly elastic supply of new communities; 3) households are fully informed about the fiscal attributes of each community; 4) households are mobile between communities; and 5) there are no spillovers across communities, *then* government services will be efficiently supplied to the residents of each community. This is an important result. There are good reasons to think that the conditions of the theorem hold in many metropolitan areas of the United States and that the valued outcome of economic efficiency results. While approvingly cited by most advocates for fiscal decentralization of governmental institutions, the theorem's five conditions are very demanding and only likely to hold in large metropolitan areas with many governments, sophisticated land markets, and efficient resident-based financing. Conditions (1) and (5) are technological facts and hold for many important public services both in developed and developing economies: education, health care, sanitation, recreation, police and fire protection, and secondary roads are good examples. Condition (4) depends on the private economy and cultural preferences for location, but it is certainly met in South Africa – just witness the transformation of Johannesburg since the fall of apartheid. Condition (3) is also likely to hold in South Africa, certainly in the major urban centers where citizens actively discuss local politics and a free press covers political misdeeds.

The problem is condition (2). An elastic supply of new communities really means an elastic supply of public or private entrepreneurs. Tiebout's original vision relies upon private real estate developers, chartered by a provincial or national government, to build new communities to provide those public services in scarce supply. New suppliers arise whenever entrepreneurial profits can be earned. In the Tiebout model profits are earned through the selling of locations. That process requires a well-functioning property market, however; yet in major sections of the urban townships of South Africa property markets do not exist. Even when such property markets do exist to efficiently allocate citizens across communities, user fees will still be needed to efficiently ration congestible services within communities. In Tiebout's world, residents pay for their public services through a per resident fee, administered as a property tax, a resident-based income tax, or simply as a head tax. This works fine if you have a sophisticated land market, formal labor markets with employee records, or ways of counting residents who use the public service. Right now, however, all three are largely missing in the townships that surround South Africa's major cities. Public sector entrepreneurs, called new town "managers", will face the same obstacles in running a Tiebout-style local government as their private sector counterparts.

Even if Tiebout's five conditions hold, I doubt that the theorem's primary accomplishment of ensuring static economic efficiency stands very high on the list of pressing national objectives in most new democracies or developing economies. Certainly this is true in South Africa. The central objective of national domestic policies as outlined in the national government's Growth, Employment, and Redistribution, or GEAR, agenda is to correct decades of economic inequities by stressing the twin goals of more equal access to public services and stronger economic growth. Tiebout's model of decentralized public finance, when it works, undermines the equity objective and is noticeably silent on how to achieve economic growth. Using Tiebout's arguments as a sole, even a primary, basis for institutional decentralization in developing economies does not make much sense.

Lesson No. 3: *We know surprisingly (and distressingly) little about the effects of decentralized fiscal institutions on economic growth*. While I felt comfortable discussing the effect of decentralized fiscal systems on fiscal equity – its bad, and gets worse the more you decentralize – I hesitated to make a case for, or against, independent provincial and local governments as contributors to economic growth. Plausible arguments can be made either way, and the empirical evidence is mixed at best (Davoodi and Zou, 1998). Allocating significant fiscal powers to lower tier governments has at least three potentially adverse effects on economic growth. First, to the extent monitoring and motivating locally elected officials is more expensive than monitoring and motivating centrally appointed administrators, corruption and rent-seeking will be greater with independent local governments (Treisman, 1997); such rent-seeking has been shown to have strong negative effects on investment and growth (Alesina, 1998). Second, *honest* locally elected officials will pursue policies that are best for their local constituents, but when local services and taxes have significant spatial spillovers then local services will be underprovided and local taxes overused. Third, local officials, again seeking to maximize local support, will seek to shift local costs onto the national fisc through excessive intergovernmental aid and debt bailouts. To the extent these strategies are successful, government distributive expenditures and public debt will increase and economic growth will suffer (Alesina, 1998).

None of these three flaws of institutional decentralization need be fatal to the growth objective, however; each has an effective remedy. First, a strong national stance against local corruption coupled with official oversight and well publicized firings or prosecutions can help check local corruption. The ANC has signaled its intentions to pursue this strategy in its firm handling of a recent public corruption case involving a local mayor. Second, the constitutional assignment of local public goods and resident-based taxation to provinces and cities and pure public goods and non-resident (VAT, natural resource, and capital) taxation to the national government avoids fiscal inefficiencies from local spillovers. The new South African Constitution has adopted an appropriate assignment of spending and tax responsibilities. Third, balanced budget, no bailout rules enforced by an independent judiciary can check the moral hazard of excessive local borrowing (Inman, 1997), while formal and informal institutions strengthening the hands of central government political parties and executives can control the moral hazard of excessive intergovernmental aid (Inman, 1988). At the moment, South African provinces and municipal governments are not allowed to borrow from international lenders. Larger cities have been informally "cleared" by the Finance Department to borrow from the domestic markets; the new provinces have not. For the future, the Finance Department is developing detailed guidelines to supervise local borrowing powers and financial market oversight with explicit court-enforced "no-bailout" provisions within the regulations. Presently, central government aid to provincial and local governments is allocated by an exogenously specified needs-based formula and is budgeted to ensure that aggregate grants spending stays within the country's overall budget constraint. While minor adjustments to the original equitable share aid formula are now being proposed, the agenda-setter is the Department of Finance, and the Department is committed to the Commission's formula-driven, balanced-budget approach to intergovernmental transfers. The strong party structure of the ANC minimizes the risk that any new provincial grants will become part of a larger, distributive budget logroll. Further, recent attempts by the provinces of KwaZulu-Natal (an Inkata majority province) and the Eastern Cape (an ANC majority province) to leverage their large welfare case backlog into increased general assistance for provincial spending resulted in Finance Department oversight of provincial spending, a "tax" on future aid to repay current overspending, and the dismissal of the ANC Eastern Cape official responsible for administering welfare services.

If there is a case for decentralized fiscal institutions as contributors to economic growth it will have to rest on their ability to train a skilled and motivated labor force, provide public infrastructure to meet local business needs, encourage private capital accumulation, and protect property rights. There are good reasons to think that well run and independent local and provincial governments might have comparative advantages over a central government in doing each of these activities. Beyond basic education (centrally funded), labor training is most effective when it meets the needs of local industry. Beyond primary roads and central communication networks (centrally provided), public infrastructure, best financed through local borrowing, is most productive when designed to complement local private capital. Beyond the enforcement of contracts (centrally guaranteed), low capital taxation and minimal business regulations to foster private capital accumulation are most likely to result from, or to be credibly promised by, competitive provincial and local governments (Weingast, 1995). In these directions, South Africa is moving more slowly. Educational policy and school budgets are still centrally decided. Teacher salaries, as well as salaries of all public employees, are decided through national negotiations. Public infrastructure investment is largely directed by the central government, though regulations for a local municipal credit market permitting borrowing by South Africa's major cities will be in place soon. Capital taxation is still centrally controlled.

Lesson No. 4: *From the bottom and from the top, the constitutionally allocated powers to decentralized fiscal institutions are constantly under challenge*. Weak, ineffective local leaders will look to the national government for policy leadership and financial bailouts. Strong, effective local leaders pose a future political threat to current national leaders. Either way the central government will be tempted to override the constitutionally assigned powers of provincial or city governments. Signs of both pressures to re-centralize are evident in South Africa. The abuses of the provincial welfare budget in KwaZulu-Natal and Eastern Cape and their demands for central government bailouts is a case in point; the central government is now *de facto* administering those welfare systems. For those provinces that have managed their public monies effectively (Gauteng, Western Cape), the nationally elected ANC-dominated Parliamentary Assembly has found it convenient to add new unfunded mandates to provincial agendas. Provincial governments appear in danger of becoming simply administrative arms of the central government.

If the principle of fiscally independent provinces (and cities) is to survive in practice, protection will have to come from the two institutions created by the Constitution for that purpose: the Financial and Fiscal Commission (FFC) and the second house of Parliament, the National Council of Provinces (NCOP), composed of the provincial premiers and provincially elected representatives. The FFC has only weak agenda-setting and gate-keeping powers; its influence lies in the quality of its ideas and its present track record for impartiality. An analogy to the Congressional Budget Office seems appropriate. The FFC has recently proposed that provinces be given their own power to tax residential income, up to an initial maximum rate of 5.0 percent. NCOP too has recently become a more assertive voice on behalf of provincial interests, but NCOP members still serve two masters: the ANC national party and their provinces.

South African provinces and cities will survive as independent governments only if important national constituencies benefit from what provincial and local governments do. Riker (1964) identified national political parties based on coalitions of local interests as the most important guardian, at least historically, of the federal constitutional bargain. This is *not* the ANC. I suspect the best hope that South African provincial and city governments have for the long run is to be more efficient providers of public services in the short-run than their national bureaucratic counterparts. The political pressures today are to provide public services to the poor, to make some headway in controlling crime, and to hold down taxes on the middle class and rich. At the moment, what the ANC leadership needs, and respects, most are talented public managers. If those managers work for provinces and cities and exploit the comparative advantage of lower tier governments as service providers – today, Gauteng and Western Cape, Johannesburg and Cape Town are examples – then those provinces and cities will continue to survive as independent governments.

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The Economics and Politics of Federalism: Tensions and Complementarities

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The political and economic benefits of federalism and decentralization can be inconsistent. None of these benefits is illusory, but they cannot all be true in any particular case. Worse, features of federalism that are a benefit under one theory become a cost under another. Scholars approaching the problem from one perspective often proceed as if other ways of looking at the issue simply did not exist. This is unfortunate, and the task for the next generation of scholars is to bridge these gaps in theory and empirical work.

Political scientists often see federalism as a realistic response to governing a geographically fractured society. The nation stays together at the top only by granting considerable autonomy to regional groupings. The most common examples are ethnically, racially, and religiously divided societies where the groups are geographically concentrated. The national government provides some minimal protection for minorities in particular states, but the bulk of public spending and regulation is carried out by the states. Crucial to this view is a fairly static notion of individual interest. People are identified by membership in a group – an unchanging feature – and the task for government is to prevent inter-group hostility from escalating into violence. The only migration that is expected, and perhaps encouraged, is of minorities in one state leaving to become residents of a state dominated by their group.

Interestingly, economists have developed a very similar model of federalism. Unlike political scientists who focus on stability and the prevention of violence, economists model the supply of public goods and services. Governments are essentially productive bodies that act to overcome market failures. Reluctant to use terms like race and ethnicity, economists concentrate on differences in tastes for public services. Federalism allows lower-level governments to make choices that satisfy their residents and can produce variable levels and mixtures of public services. Citizens can cluster in governments that satisfy their own preferences. In such models, the tradeoff facing a constitutional designer is between economies of scale in the production of public services and a structure that satisfies the heterogeneity of tastes.

To bring the two models together consider a religiously divided society where parents want to give their children a religious education. Suppose that there are cost savings in providing a standardized curriculum. If the Catholics live in the south of the country and the Protestants in the north, however, the country might be organized into two states each with authority to organize its own schools. The state would sacrifice some cost savings in the production of education in order to produce the variety in educational services demanded by residents. Families could migrate to the state of their choice. This example illustrates why there is often an awkward fit between economic and political models. Economists are agnostic about tastes. In the educational area, they tend to talk about such things as preferences for sports versus the arts or preschools versus after-school programs. In many countries, however, the differences in tastes have a decidedly exclusionary cast. Catholic parents want not only a Catholic education for their children but also an educational environment devoid of Protestants, and vice versa for Protestant parents. Those who focus on violence and the preservation of a fragile state accept these consequences. In fact, these scholars have an unexpected affinity for the economic approach in that both accept the existing distribution of preferences and group loyalties.

In contrast, in both political science and economics other scholars worry about state and local exclusionary policies. Those political scientists who emphasize state-building and democratic citizenship are uncomfortable with a federalism that exacerbates and even encourages interpersonal and inter-group differences. Similarly, some economists worry about the external costs of exclusionary policies. Sorting by preferences for public services seems fine to them, but they balk at local government efforts that permit people to exclude the poor and disadvantaged based on land use zoning and other restrictive practices.

So far, I have considered models of federalism that start from the premise of interpersonal differences in preferences. Another set of models emphasizes the way a multiple government system encourages the efficient production of public services, stimulates innovation, and avoids self-seeking by politicians. These models function best if citizens' preferences are homogeneous. Then governments are modeled like firms that try to get and retain business. Under the simplest models, state politics is irrelevant. Governments are controlled by politicians who are self-seeking, but they cannot survive in office unless they satisfy mobile interests. Citizens canvass the range of tax \service combinations and move to the community they prefer. Although public goods are consumed in common by residents of a particular community, the production function for services experiences diminishing returns as the population rises. The service becomes congested; to maintain service levels spending must increase. Beyond some minimum efficient scale, marginal costs rise with respect to population. This is a fundamental assumption of Charles Tiebout's seminal model on intergovernment competition, and it is necessary to produce an equilibrium result with a large number of local governments. Otherwise if there is no congestion or, even worse, if network effects and scale economies mean that marginal costs fall with population, a single government is most efficient. Only differences in tastes for public services or location could then explain why everyone does not cluster in a single jurisdiction. Even if congestion sets in for large population agglomerations, people will benefit from locating close together in urban areas until the costs of congestion outweigh the benefits of living near others. When network effects are important, the forces of interjurisdictional competition will be weakened. Governments that benefit from scale economies can be inefficient and corrupt without driving away their citizens.

Another type of interstate competition involves mobile businesses seeking hospitable investment environments. Once again, state politicians are not to be trusted. According to these models, the best government structure is a federal system where business uses its threat of exit at the state and local level to keep taxes and regulatory costs low. The central government limits protectionist activity by the states and maintains a national legal environment favorable to business but is otherwise lacking in power.

Part of this defense of federalism is the claim that competitive state governments will innovate to keep costs down and improve service quality. These innovations may show the way to the states and to the federal government. This is a widely accepted argument, but it does not have much credence on either logical or empirical grounds. Of course, states and localities do sometimes experiment with innovative ideas – although many of the examples in the United States arose as a result of federal programs. Nevertheless, as a general argument for decentralization, the innovation claim is weak and in conflict with other claims. Thus if a nation is very deeply divided along ethnic or religious lines, it seem unlikely that new programs in one community will have much to teach those in other communities with very different values. A successful experiment in bilingual education in Texas will not be of much interest in Montana. A new way of teaching girls in a community of Islamic fundamentalists will be of no interest to a neighboring Christian community. Even for less ideological issues, such as trash collection or fire prevention, local communities will be unlikely sources of new ideas in all but the most technically unsophisticated areas. A state or local government will not sponsor much research since other communities will free ride on their innovations. Furthermore, even if they do try something new, they will have no incentive to carry out a controlled experiment that will permit outsiders to evaluate their efforts in a scientifically valid manner. Thus although any system with multiple sources of power is likely to produce some variation in outcomes, one should not rely heavily on the "states as laboratories" argument as a defense of federalism.

As a normative matter, some view the mobility of citizens and firms as a way to limit the opportunistic behavior of politicians. The goal is to make internal politics irrelevant. Governments are constrained by exit threats, not political threats. This vision of federalism is directly opposed to the defense of decentralization that sees lower-level governments as more democratic and participatory than other levels of government. Under this latter view, governments of small jurisdictions can be more accountable to their citizens than larger jurisdictions. This is partly because the services they provide are visible and of immediate concern to people – local roads, schools, water, trash collection. It is also because the behavior of politicians themselves can be monitored and more people can be induced to participate actively. The countervailing concern is capture. In small groups an economically powerful local individual or family may be able to dominate political life especially in rural areas with feudal histories. The debate over the value of decentralization in this context is a classic example of Albert Hirschman's distinction between exit and voice. One set of models stresses the control exercised by exit; another set stresses voice, but as Hirschman argues, ease of exit can undermine the role of voice. In any particular federal system political leaders who respond to exit threats may find themselves in conflict with those constituents who take the time and trouble to monitor their behavior. Such tensions, of course, are not inevitable. Some cases may be overdetermined with both citizens and mobile capitalists in favor of growth enhancing policies.

To conclude, models of decentralized political systems that emphasize sorting by preferences and group identities are in conflict with models where interjurisdictional mobility is a response to differences in governmental efficiency. So long as preference groupings are lumpy (e.g. people are either Christians or Muslims, not a little of each), or so long as the production functions for public goods exhibit economies of scale with respect to population, mobility of people and businesses will not necessarily produce efficient sorting. The central government will need to take an active role both to prevent self-dealing by state and local politicians and to prevent some regions from becoming backwaters inhabited only by the poor and disadvantaged.

Formal Theory and Federalism

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The recent onrush of formal models of federalism was prompted by political science's renewed interest in the operation of federal systems. Formal theory is a microfoundational approach to comparative theoretical research, where political phenomena are explained in terms of strategic agents responding to an incentive environment. When appropriately written, formal (mathematical) structure lays bare the logical flow from assumption to result (and empirical prediction). The construction of a model provides a template for future scholarship, allowing manipulation of the functional form to match specific case parameters. It offers a useful tool to complement our comparative skills as we search for an understanding of how federalism works.

Comparative political study of federalism had its heyday in the 1960s, at a time when academics considered constitutional design to be a pressing policy interest, and the management of fractured, heterogeneous populations was foremost on their list of prescriptive objectives. Studies by Duchacek, Franck, Friedrich, MacKinnon, MacMahon, McWhinney, Riker, Sawer, and Wheare,[1] among others, searched for common trends across federations, to understand how this constitutional form might perform in the newly emerging countries of the developing world. Studying the United States, Grodzins (1966) and Elazar (1962) were among the first to recognize that federalism implies a sharing of authority, Grodzins classically likening federalism to a marble cake, and Elazar emphasizing the long history of cooperation between U.S. state and federal governments. But the field never produced generalized theories; for the most part, these works were collections of case studies followed by insights, built inductively. Even Riker, who, concurrent with his work on federalism, was most responsible for introducing the rational choice paradigm to political science, never married his two interests to generate a rigorously derived theory of federalism's origin and maintenance. Interest in developing a general theory fizzled as the field – perhaps impatient to convert the insights gleaned from the work of the 1960s into specific policy recommendations – turned its attention to single-country or single-region studies of federalism, and only scattered contributions to general theory-building (e.g. Elazar, Hicks, Lemco) appeared for the next two decades.

Politics of the early 1990s promoted a resurgence in federal theory, with public debates about the merits of decentralization and subsidiarity in the United States, Europe, and elsewhere, and global events which alternately made us despondent about and hopeful for the prospect of a federal solution to the governance of diverse populations. Positive political theory offers a new approach to general theory-building that returns us to the origins of federal theory, to Publius, and an examination of the microfoundations of politics working within a federal structure. Formal analysis focuses our attention on how institutions manipulate political behavior by creating incentive environments that structure interaction between strategic agents. I divide the literature roughly into two categories: (1) federalism and policy evaluation, where federalism is an independent variable – an institutional context – that helps to determine the success of policies chosen, or how they are chosen, and (2) federalism and stability, where federalism becomes the dependent variable as scholars investigate its feasibility and ways to maintain or improve its operation.

Federalism and Policy Evaluation

As recently as five years ago, when I would announce to friends in economics that I study federalism, the reply invariably would be, "oh, fiscal federalism?" While formal theory may be new to political studies of federalism, at least since the 1950s economists have been untangling the knotty problems of taxation and redistribution posed by decentralization. Much of the work can be lumped together under the classification of "Tiebout" models, named for Charles Tiebout, whose seminal 1956 contribution demonstrated how mobile taxpayers might "vote with their feet" by choosing a jurisdiction that best suits their preferences.[2]

Naturally, the fiscal federalism literature spawned the earliest formal political analysis of federalism, and its derivatives continue to be the most active area of formal federalism research. The Tiebout literature teaches us about the importance of spillovers and mobility; works tying these challenges together with electoral politics and intergovernmental competition include Epple and Zelenitz (1981), Gordon (1983), Caplan (1996a, 1996b), and Dixit & Londregan (1995, 1998). Several theorists have pointed out the advantages of interstate competition to promote economic health; on the other hand, other theorists point out the inefficiency created (rather than stemmed) by intergovernmental (state to state only) competition. Aranson (1995) shows how the number of units in a federation affects policy choice and economic efficiency.

Formal theory is a good choice of theoretical tool when making comparisons of the policy generated in federal versus unitary states. Riker (1975) and Rose-Ackerman (1981) explicitly compare federal and unitary systems; Kollman, Miller and Page (1999) show that if there are negative externalities within the district, then decentralized policy provision is optimal, but if positive externalities exist, it can be beneficial to have a unitary system.[3] In other work, the comparison is only implied: for example, Crémer and Palfrey (1999b) show how the federal system can contribute to over-regulation, in light of the preference of the national median voter.

Between-system policy comparisons need not be confined to federal v. unitary states: federalism does not prescribe a specific degree of centralization, but may be more or less centralized (or, in the spirit of Grodzins and Elazar, have jurisdictional overlap). Kollman, Miller, and Page (forthcoming) show that as problems get more difficult to solve, the benefits of decentralization initially increase – exploiting states as policy laboratories – and then decrease, due to the center's greater efficiency at problem-solving. Panizza (1999), probing the effect of heterogeneous regional median voters, models (and tests) conditions, such as lower per capita income and less ethnic factionalization, under which voters would support greater fiscal centralization. Crémer and Palfrey (1999a) show how the expressed preferences of voters on degree of centralization and the voting rule depends upon the size of the subunit, the number of subunits, and the degree of heterogeneity within and between units. Volden (1999) most explicitly ties the problem of optimal level of public good provision to politics by arguing that politicians at different levels game one another, understanding that the public holds them responsible for success or failure.

We can also consider different preference aggregation mechanisms. Kollman, Miller, and Page (1997) compare voting rules to see which encourages more optimal sorting of citizens and therefore more satisfactory locally-provided policy. Persson and Tabellini (1996a, 1996b) evaluate the optimality and efficiency of policy generated under alternative federal constitutional schemes.

Another literature examines the pattern of diffusion and state government adoption of policy innovations in federal systems. See, for example, Walker (1969), Gray (1973), and Case, Rosen, and Hines (1993).

One particularly interesting example of the partnership between economics and political science is federalism as resolution to the economic problem of revenue-generation. Weingast and collaborators have introduced the notion of "market-preserving" federalism, where the decentralized system serves as a commitment mechanism to help the center keep promises it makes regarding repayment of debt and accountability for action. Montinola, Qian, and Weingast show how federalism ("Chinese-style:" decentralization) has contributed to the economic success of China; Qian and Roland (1998) expand the study of China to examine the political costs and benefits of bailouts; McKinnon (1994) warns that the European Union must design market-protecting federalist institutions into its design of monetary union; Weingast (1993) investigates how federalism contributed to growth in the antebellum United States; and Dick (1998) demonstrates the same in pre-Confederation Canada.

Federalism and Stability

While the political literature (including my own work) almost always thinks in terms of federal stability, stability is an elusive dependent variable. For example, is Canada stable? What about the antebellum U.S.? The U.S. during reconstruction? Better is to model feasibility, even while writing of stability. Generally, the problem is, given a set of rules (a constitutional bargain), how do you get the member governments to behave?

We begin with the puzzle of federalism's vulnerability. While it is easy to recognize the motivation to burden-shift and shirk, given the sacrifices demanded by all federal unions, such behavior is destructive to the union; therefore, the question becomes: if a participating government (regional or central) could profit by the union, why would it ever jeopardize the union by cheating? In general, opportunistic behavior requires some information deficiency; for example, Bednar (1998a) motivates central government encroachment on regional jurisdictions by highlighting the problem of credit assignment in multi-layered governments. De Figueiredo and Weingast (1998) and Gibbons and Rutten (1997) model "self-enforcing" federalism, where the center can resolve burden-shifting tendencies between regions, and its own tendencies to encroach are kept in line by the collective effort of the regional governments; Solnick (1998) probes regional collective action more deeply, discussing the conditions that support coordination versus self-interested behavior and collusion with the center to produce asymmetric treatment of regions. Bednar (1999) shows that full-compliance equilibria exist only under highly stylized situations; generally, all federations will exhibit moderate tension, creating pressure for institutions to redefine their roles to be managers of inherent tension, rather than trying to eliminate opportunism altogether.

As we identify the source of federal instability, our attention turns naturally to an investigation of the types of institutions that might effectively manage the problems that all federations face. Cain and Dougherty (1997) and Dougherty (forthcoming) use a collective action model to show how the faults of the Articles of Confederation meant that cooperation could not be sustained. Tsebelis (1995) and Persson, Roland, and Tabellini (1997) model the importance of separation of powers and other veto mechanisms to introduce stability through stagnation; Bednar, Eskridge, and Ferejohn (1995) discuss two necessary conditions for the maintenance of federalism: fragmentation and adjudication. Inman and Rubinfeld (1997) compare two alternative constitutional objectives, showing a trade-off between economic efficiency and democratic values. Likewise Dougherty (1999) compares several constitutional options available to the American founders and shows that the U.S. Constitution was not optimal in terms of economic efficiency or protection of state sovereignty, suggesting that the Constitution was adopted with other, perhaps strategic, goals in mind. Bednar (1998b) considers the effectiveness of imperfect institutions at constraining intergovernmental opportunism. Ordeshook and Shvetsova (1995) and Ordeshook (1996) argue that a strong, decentralized party system is critical for establishing incentives for central and regional governments to cooperate with one another; they find that the party system in Russia lacks the necessary ingredients to support federal stability.

Some theorists have translated the mobile citizen of the Tiebout models to the question of federal stability. If citizens can sort themselves and exit, then so can jurisdictions. A natural combination of the policy and stability literatures considers the motivation for secession. Buchanan and Faith (1987) model the political-structural consequences of taxation policy that might cause some units to secede. Alesina and Spolaore (1997) find equilibrium size and number of units in a union, arguing that the equilibrium number of units increases in the degree of economic integration; Piketty (1996) and Bolton and Roland (1997) model the tradeoff between the efficiency gain of unification and the loss of autonomy. Chen and Ordeshook (1994) show that secession clauses are more than a "parchment barrier" and can influence behavior.

True to the spirit of

Hirschman, if federal units can leave, then they have power. Treisman (1999a) models the bargaining power of recalcitrant regions in demanding asymmetric (and favorable) arrangements with the center; Treisman (1999b) pairs regional bargaining and tax-evasion with the classic Tiebout analysis of the power of mobile interests. Fearon and Van Houten (1998) model the electoral connection to regional autonomy movements, and Van Houten (1998) searches for the causes of regional ambivalence toward fiscal autonomy. As the theory of regional autonomy movements develops, we should look for research that expands the traditional two-level conception of federalism to three levels. We generally assume that it is sufficient to model two levels of interaction; however, our assumption is challenged by the dynamics of the European Union, where centralization and decentralization evolve concurrently, as subnational units are empowered by developmental fiscal transfers and the principle of subsidiarity.

Both policy-related studies and stability studies contribute to questions of constitutional design. What is efficient – or even optimal – from an economic viewpoint might not always be sustainable politically. I believe one of the greatest challenges ahead of us as formal scholars of federalism is to synthesize the two branches of the literature, to consider how policy efficiency and political feasibility are related. Works that include an examination of an exit option come closest to the synthesis; I encourage their pursuit. Questions of when to decentralize, how, and to whom – questions regularly raised by the policy literature – might not be best answered by examining policy efficiency, but instead ought to be informed by work on political feasibility. In the future, I look forward to more work that bridges the two trends in this growing literature.

Notes

1. A bibliography of the works cited in this article is available at the *Newsletter's* website. The works selected are meant to be indicative of trends in the field rather than to serve as an exhaustive survey.
2. I urge the interested reader to consult Oates (1999) and Inman and Rubinfeld (1996) for a review of the economic literature and especially to consult the bibliography maintained at the World Bank's website: http://www1.worldbank.org/wbiep/decentralization/Readings.htm.
3. Their methodology allows for parameter manipulation to weight the relative degree of decentralization, but to simplify, they interpret their results in a federal v. unitary context.

Decentralization and Hard Budget Constraints

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The issue of decentralization has been on the World Bank's radar screen for decades, but it has become particularly pressing during the past decade. Countries throughout the developing world are increasingly devolving fiscal, political and administrative responsibilities to lower levels of government and to the private sector. In most parts of the world, decentralization is being led by political reform and democratization. Nevertheless, it may have strong implications for most aspects of the development agenda, including delivery of social services, building of infrastructure, provision of social safety nets, governance, privatization, financial sector development and macroeconomic stability.

In the 1980s and early 90s, the World Bank and IMF focused mainly on the fiscal aspect of decentralization, and discussed intergovernmental fiscal relations from a normative perspective. What should be the appropriate assignment of expenditures and revenues, how should intergovernmental transfers be designed, and what should be the regime for subnational borrowing? How would decentralization affect important development objectives? While there was general agreement that decentralization could improve allocative efficiency (i.e. provide services that respond more closely to local needs and preferences), there was considerable debate on the implications of decentralization for equity and macroeconomic stability.[1]

An Evolving Approach to Decentralization

In the past few years, the Bank's approach to decentralization has evolved considerably. Much of the literature – and underlying assumptions – of decentralization draws from the experience of industrialized countries, particularly the United States, whereas the Bank's client countries operate in a very different institutional environment. Fiscal transparency, political accountability, and factor mobility are often very limited in developing countries, so "voice" and "exit" mechanisms (key to successful decentralization) are often very weak.[2] There is a growing realization that the institutional environment that affects the underpinnings of decentralization should be examined in each county, and policies designed accordingly.

The implications of the new approach can be seen in (1) a renewed research agenda focusing on careful case studies as well as econometric analysis, (2) a greater emphasis on consistent, comprehensive approaches to decentralization rather than on sector driven projects, and (3) a keen focus on the political environment for decentralization including the institutions that can support accountability.

An Example: Hard Budget Constraints

During the past year, the Bank has undertaken a cross-country study of particular concern to many macroeconomists at the Bank and the Fund – institutional arrangements for hard budget constraints. Whereas the debate of the early 1990s focused on "decentralization: good or bad for macroeconomic stability?" the current path of enquiry is "under what conditions can decentralization be dangerous for efficiency and macro stability?" An examination of this question points clearly to the importance of a hard budget constraint for subnational governments. Our study uses theory and evidence from around the world (case studies from 4 industrialized and 6 developing countries) to explain why sub-national budget constraints are often "soft," and to explore the mechanisms through which they might be "hardened" in practice.[3]

When an entity such as a subnational government faces a soft budget constraint, it means that it can explicitly or implicitly pass on its liabilities to other entities such as higher-level governments. This leads to a situation of moral hazard in that it provides incentives for subnational governments to, inter alia, overspend, undertax, overborrow, underprovide services, and accumulate arrears through state enterprises, in the hope that local public expenditures will ultimately be subsidized by taxpayers in other jurisdictions. Consider the case of an unexpected, adverse fiscal shock at the state or local level. Instead of implementing politically painful expenditure cuts, local politicians might choose not to adjust, even if this leads to a debt crisis, especially if their key constituents – voters, creditors, and asset owners – believe that local debt is ultimately the responsibility of the central government.

One of the key goals of our study is to explain why the beliefs and payoffs of these actors vary from one country to another, and how they might be changed over time. For example, neither voters nor creditors expect discretionary bailouts in the Canadian provinces and U.S. states, even when they face serious unexpected shocks. This has the beneficial effect that lenders as well as the jurisdictions themselves keep debt to sound levels. On the other hand, voters and creditors in some of the German Laender, Argentine provinces, and Brazilian states have recently expected (and received) bailouts when subnational governments faced hard times. In Brazil, the intergovernmental moral hazard problem has been especially severe – expectations of bailouts have repeatedly been confirmed throughout the last decade, with serious implications for macroeconomic stability.

Institutions and Accountability: A Dilemma

What explains these differences, and perhaps more importantly, how can "soft" budget constraints be "hardened"? Our approach focuses on institutions and accountability. In particular, we look at institutions in two rather contradictory ways. On the one hand, fiscal and political institutions should send the clearest possible signal to creditors, voters, and asset owners that the central government will *not interfere* in the affairs of the subnational governments. On the other hand, we find that in many countries, the best way to harden budget constraints in the short term is for the central government to get *more involved* in the regulation of subnational governments. The remainder of this article draws from our study to explain and then resolve this dilemma.

Hard Budget Constraint Mechanisms

The first and most basic "hard budget constraint mechanism" is a set of fiscal and political institutions that sends a clear message to local governments that they alone will bear the costs and benefits of their fiscal decisions. When this is the case, other actors – namely creditors, voters, and asset owners – will get the message as well, and three additional hard budget constraint mechanisms will come into play. First, the capital market will place firm constraints on local fiscal decisions. Local governments will realize that their access to credit will be limited if they don't make sound fiscal decisions. Second, local voters will face incentives to use electoral sanctions against profligate local officials. Third, markets for land and other assets will supplement the market for votes. Knowing that local fiscal decisions directly affect their property values and rents, landowners are likely to use "voice" to lobby against imprudent debt levels. Moreover, owners of more mobile assets might threaten to use the "exit" option.

The problem with these market-like mechanisms, however, is that they appear to work well only when (1) the subnational governments have a very high degree of fiscal autonomy, and (2) the central government has clearly established the credibility of its commitment not to provide bailouts. In our sample of subnational government sectors, only the U.S. states and Canadian provinces clearly meet these conditions. For most of the cases, however, important aspects of basic fiscal and political institutions undermine local accountability and market discipline. First, consider the intergovernmental fiscal structure. When faced with a negative revenue shock, it is relatively easy for local governments to convince voters and creditors that the costs of adjustment should fall on the central government if 70 or

80% of local government revenue comes from grants or shared revenue. In all of our developing country cases, and many of our developed country cases as well, state and local governments are heavily reliant on revenue raised by or regulated by higher levels of government. Furthermore, intergovernmental grants are often distributed through processes that are highly discretionary, political, and unpredictable, as in Brazil or Ukraine.

In some countries, like Brazil and India, hard budget constraints are undermined by the role of the central government and its agencies as lenders to the states. In India, for example, the central government has on occasion arbitrarily forgiven the debts of the states. In some countries, like Brazil, Argentina, and to some extent even Germany, states borrow from locally owned banks and public enterprises. This arrangement undermines the independence of lenders. In Brazil, this led to the perception that some states were "too big to fail," because default would threaten key state banks, whose "assets" consisted primarily of bad debt of state governments.

Consider also the organization of the central government's political institutions in shaping the beliefs and strategies of the key actors. Actors are much more likely to expect bailouts in systems with decentralized, fragmented legislatures and weak party discipline. In such systems, the construction of legislative coalitions can be difficult, and vote-trading is a common strategy. Such logrolling helps explain why a central government would opt to provide bailouts to certain states, even though the policy is socially inefficient for the federation as a whole.

In short, when fiscal and political institutions allow for the *perception* that bailouts are possible, local accountability relationships and capital markets are unlikely to provide adequate constraints on the behavior of subnational officials. Voters and asset owners face few incentives to carefully oversee local fiscal decisions, and creditors are more likely to evaluate the creditworthiness of the public sector as a whole, rather than that of individual local governments.

Obviously some of the issues mentioned thus far can and should be targets for reform. Indeed, some have already been addressed. For example, state banks in Brazil and Argentina are being privatized. Incentives for credit market oversight may be improving in Germany and India, and voters appear to be gaining greater control over fiscal outcomes in some of the Brazilian states.

An important lesson of the case studies, however, is that when local governments do not have broad autonomy to set and raise their own taxes, and the central government cannot fully commit to a no-bailout policy, local accountability and market discipline are insufficient. This is usually the case in new democracies and developing countries embarking on decentralization programs. In such cases, additional hierarchical mechanisms might be necessary for hard budget constraints. For instance, the central government might put numerical limitations on local deficits and debts, require that all or a subset of debt issues be centrally approved, or stipulate that local governments only issue debt for investment purposes. Such mechanisms have been used successfully at the local/municipal level in Norway, Hungary, and Canada. In fact, these were the only cases of highly transfer-dependent local public sectors that were *not* characterized by serious local fiscal crises and bailouts. It appears that transfer-dependence and local borrowing autonomy might be a dangerous combination.[4]

This returns us to our institutional dilemma. Recall our first argument about institutions—they should send a clear signal that the central government will stay out of local affairs. Clearly this is not compatible with blunt, centrally imposed borrowing restrictions. Nor are such restrictions compatible with most of the efficiency and accountability advantages of decentralization.

Some of our case studies demonstrate, however, that rules and administrative structures governing local spending and borrowing need not be blunt, and they need not rely on the discretion of the central government. In fact, it may be possible to implement rules that limit local autonomy and create disincentives for opportunistic behavior, while making it clear that ultimately the costs and benefits of local fiscal decisions will be borne locally. For example, Hungary has recently implemented local bankruptcy legislation that largely removes the process from the political realm, relying instead on courts and independent arbitrators. Even in cases where bailouts are unavoidable, it may be possible to structure the bailout in a way that encourages improved local oversight and accountability in the future. In fact, the Argentine case shows that intergovernmental debt renegotiation can be an opportunity for major structural reform. In Argentina, the central government was able to make debt renegotiation conditional on the promulgation of key reforms. Importantly, in that case, the central government had access to an enforcement mechanism – it was able to subtract debt repayments from intergovernmental grants.

In sum, we find that local government accountability to voters, creditors, and asset holders might be sufficient to enforce hard budget constraints in stable, mature decentralized public sectors. In many new democracies and developing countries that are rapidly decentralizing, however, hard budget constraints – for the time being – may require rules and incentives that restrain local borrowing in the short term, but in the long term, send the message to local voters and creditors that local obligations are indeed local. As countries' experience with decentralization evolves, subnational governments can gain greater tax-raising autonomy and establish credible track records of no bailouts. This will allow them to move along a continuum between hierarchical and market enforcement mechanisms, gradually increasing their reliance on the latter.

Conclusion

This article has outlined an evolution in the World Bank's approach to decentralization, and discussed a project that reflects these changes. Decentralization is neither good nor bad for allocative efficiency, macro-stability, or growth. The costs and benefits of decentralization in practice depend on politics, the institutions of accountability, and specific policy decisions. Although we cannot alter countries' political institutions, we can provide advice with our eyes open; certain political systems are more likely to engender soft budget constraints and macroeconomic instability than others unless certain regulatory mechanisms are adopted. Evidence from comparative case studies and cross-national quantitative analysis can help us gain a better understanding of the determinants of soft budget constraints in order to assess the policies that affect them. Such studies also help create a useful set of comparative data about the political and institutional conditions under which reform might be most likely.

Finally, our discussion underscores a key theme of this *Newsletter*. Decentralization is a topic that demonstrates the importance of collaboration between comparative political scientists and economists. Our study of hard budget constraints demonstrates that political institutions and economic outcomes are intimately related, and important lessons run in both directions between the two fields. Microeconomics contains some extremely useful tools for the systematic study of comparative politics. At the same time, political institutions and incentives are critical determinates of macroeconomic outcomes.

Notes

1. See Remy Prud homme (1995), "The Dangers of Decentralization," *The World Bank Research Observer* 10 (2), pp. 201-20; Charles E. McLure Jr. (1995), "Comment on Prud homme," *The World Bank Research Observer* 10 (2), pp. 221-26.
2. Jennie Litvack, Junaid Ahmad, and Richard Bird (1998), *Rethinking Decentralization in Developing Countries*, Sector Studies Series, World Bank.
3. Jonathan Rodden, Gunnar Eskeland, and Jennie Litvack, eds. (forthcoming), *Decentralization and Hard Budget Constraints*. Cases and authors include Argentina (Steven Webb), Brazil (Jonathan Rodden), Canada (Richard Bird and Almos Tassonyi), China (Jing Jin and Feng-fu Zou), Germany (Jonathan Rodden), Hungary (Deborah Wetzel and Anita Papp), India (William McCarten), Norway (Jorn Rattso), Ukraine (Sean O Connell and Deborah Wetzel), and the United States (Robert Inman).
4. See also Jonathan Rodden, "Federalism and Soft Budget Constraints," Ph. D. dissertation, Yale University, 1999.

The Political Economy of Decentralization in Latin America

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During the 1980s, scholarly research on Latin American politics revolved around two major topics: democratic transitions and the political economy of stabilization and adjustment. The projection of both these research concerns into the 1990s has led to an explosion of literature on decentralization. For those converging on the topic from the study of democratization, central emphasis has been placed on the expansion of democratic legitimacy and participation to subnational levels of government. Students of stabilization and adjustment, on the other hand, have been analyzing decentralization in relationship to the drive to shrink the state and increase economic efficiency. Both strands of research reflect the growing strength of state and local governments in Latin America – a trend that has been fuelled in new and old democracies alike by constitutional reforms extending elections to lower levels of government as well as by policies of fiscal decentralization.

Like the literature on democratization and economic adjustment before it, the first wave of research on decentralization in Latin America focused on patterns of causation, largely bracketing questions about consequences. The underlying presumption was that policies of decentralization would achieve their intended effects, simultaneously strengthening democratic governance and the efficient delivery of public services. The similarities with earlier bodies of literature are marked in other respects as well: the initial studies of decentralization were descriptive, heavily reliant upon case study or small-*n* analysis, and constructed around path-dependent accounts of political change. Their central insights revolve around institutionalist understandings of the ways in which decentralized political agents and the party systems through which they function have shaped the dynamics and extent of the decentralization process. Where state and local politicians are politically powerful, decentralization is expected to be more extensive than elsewhere because national political leaders find it more difficult to resist subnational demands for resources and political autonomy. Such explanations may be less useful in understanding decentralization in nations traditionally characterized by strong national political authority, such as Chile, but they have successfully underlined the importance of focusing upon the subnational or demand side of the decentralization process.

With the passage of time and the development of a more extensive body of knowledge about state and local governments in the region, research has begun shifting to the study of the consequences of decentralization. The dramatic, destructive, and repeated collision of state and national political logics in Brazil, in particular, has fostered a widening recognition that decentralization is considerably more complicated than its proponents have suggested. Numerous researchers have begun to observe that decentralization can undermine economic reform policies, exacerbate regional inequalities, empower local traditional elites, foster clientelism, and undermine the delivery of public services. Nevertheless, because most scholarly research on decentralization in the Latin American context has taken its bearings from the economic literature on fiscal federalism, these negative outcomes tend to be dismissed as anomalies arising out of particular contextual conditions and/or deficient institutional engineering rather than as expressions of tensions inherent in the decentralization process.

Beginning with the work of Tiebout (1956) and Oates (1972, 1977), the fiscal federalism literature is suffused with normative assumptions about the capacity of decentralization to enhance democratic accountability and foster public sector efficiency. First, decentralization supposedly helps to overcome aggregation problems by bringing policy decisions more closely into line with citizen preferences, which may vary across regions or parts of the country. Second, decentralization is assumed to offer solutions to agency problems by providing the electorate with mechanisms for disciplining local officials. The third major argument is that decentralization allows individuals and firms to "vote with their feet" and move to jurisdictions that offer the most attractive package of taxes and services. The resulting competition among jurisdictions is expected to constrain the growth of the public sector and advance economic efficiency. The final outcome is presumed to be a more responsive and efficient public sector – something desired by analysts with widely varying intellectual and normative concerns. For what remains of the Latin American Left, for example, decentralization is seen as a way of removing power from historically repressive and unresponsive central governments, creating new opportunities for deepening democracy. For conservative forces, its attractions revolve around the possibilities for constraining the growth of traditionally bloated public sectors in favor of the consolidation of orthodox models of economic development.

Across Latin America, however, decentralization has failed to live up to its advance billing. The reason has less to do with regional peculiarities than with the fundamental contradictions between the democratic and economic logics of decentralization. A growing body of evidence from the Brazilian and Argentine contexts, in particular, suggests that democratically elected subnational politicians operate in accordance with incentives that defeat the economic logic of decentralization. Lacking electoral responsibility for national macroeconomic performance and insulated from international economic pressures, subnational politicians have every incentive to spend beyond their means and export the resulting costs to other jurisdictions, thereby undermining national efforts at economic stabilization and adjustment. These consequences have generated a growth of interest in institutional mechanisms that can harden budget constraints. Yet many of the suggested ways of limiting state or provincial spending impose serious constraints on the choices of subnational governments. To the extent that the purported democratic benefits of decentralization depend upon the responsiveness of subnational politicians to local electorates, strong national controls on subnational policy choice represent an obvious problem for democratic accountability. The implication is that increased political responsiveness and more efficient resource allocation do not necessarily go hand in hand. The failure of decentralization researchers to address these theoretical issues suggests that researchers need to move beyond the biases of the fiscal federalism literature to explore the political and institutional variables shaping the behavior of politicians and conditioning the degree of conflict between local and national political interests.

The neglect of institutional issues is reflected in the ongoing conflation of decentralization and federalism. By taking their bearings from the economic literature on fiscal federalism, students of decentralization in Latin America have ignored the crucial distinction between nations constituted on the basis of unitary and federal structures. Federalism is an institutional arrangement that establishes autonomous bases of political power for subnational officials by constitutionally allocating policy responsibilities, seats in the national legislature, and rights of self-rule to constituent territorial units. Decentralization is a process that involves the devolution of administrative functions to lower levels of government. Hence while federal and unitary states may both evince high levels of administrative decentralization, subnational officials in the latter cannot draw upon autonomous bases of power to advance their careers. Decentralization may thus be expected to yield very different results in federal and nonfederal systems in accordance with the institutional incentives and opportunities for subnational officials to pursue their political self-interest at the expense of national goals. Certainly, the most serious collisions between subnational and national interests in Latin America have occurred in countries with federal systems. The failure of the literature to focus upon these and related sets of institutional issues is not peculiar to the study of Latin America, but it does speak to the limitations of scholarship constructed around economistic understandings of political outcomes, including recent efforts to develop a new positive theory of federalism (or is it decentralization?).

An additional theoretical difficulty associated with the foundation of most Latin America research in the literature on fiscal federalism is the lack of systematic interest in a pivotal question, *qui bono*? The fiscal federalism literature would have us believe that everyone gains through decentralization, but as E.E. Schattschneider (1960, p. 12) observed four decades ago, "Everywhere the trends toward the privatization and socialization of conflict have been disguised as tendencies toward the centralization or decentralization, localization or nationalization of politics." The initiation of the drive towards decentralization in authoritarian Chile and the "smoke and mirrors" character of decentralization in Argentina offer some clues to decentralization's winners and losers. In both cases, the devolution of responsibilities to provincial and local governments has benefited central governments by reducing their spending responsibilities and decentralizing political conflicts with powerful public sector unions. These advantages have been achieved at the expense of growing geographical inequalities, declining social services, and significant subnational financial fragilities.

These broad theoretical shortcomings of the existing literature on decentralization in Latin America are reflected in the limited empirical reach of available research. First, the bulk of existing literature explores national patterns of decentralization on the basis of case study or small-n research. Without a common theoretical framework, however, individual case studies are unlikely to add much to our current understanding of decentralization. Far more promising are research designs emphasizing systematic subnational comparisons, which would be capable of addressing, rather than assuming away, pivotal questions regarding institutional sources of variation in service delivery and political accountability.

Second, although we have learned a fair amount about issues of intergovernmental economic relations and other issues of interest to economists affiliated with international financial institutions, we know very little about the politics of decentralization. How do intergovernmental politics, party structures, political career patterns, clientelistic networks, and interest group pressures shape the causes and consequences of decentralization? Answers to this question would not only shed new light on the conditions under which decentralization may be expected to yield its theorized benefits, but also help to advance ongoing but increasingly sterile debates about the quality of democracy in the region.

Third, we lack the micro-level empirical data necessary to assess the consequences of decentralization for democratic accountability. The traditional literature on fiscal federalism presumes an informed and mobile electorate. Voters are supposed to be knowledgeable about the relative costs and benefits of the local package of taxes and services and to act accordingly, either by exercising the exit or voice option. In the first instance, voters move to jurisdictions offering tax and service bundles that more closely reflect their preferences. In the second, voters exercise the voice option and transmit their preferences to politicians. In either case, however, the benefits of decentralization can only be achieved if citizens are informed about the relative costs and benefits of services and can assign responsibility to the appropriate level of government. To what extent are these assumptions met in contemporary Latin America? The question is of central importance for addressing the impact of decentralization on democratic accountability in a political context characterized by far lower levels of mobility and information than in the U. S.

Finally, empirical research has yet to address the assumption that transferring new responsibilities to subnational politicians in Latin America will yield policies that more closely reflect citizen demands and interests. Given strong traditions of local clientelism across the region, there is ample reason to presume just the opposite. Indeed, until some systematic body of evidence is collected to suggest that subnational politicians in Latin America are any more informed about or responsive to citizen demands than their counterparts at the national level, the most appropriate approach to traditional arguments in favor of decentralization would seen to be extreme skepticism. Decentralization has become the *última moda* in the study of Latin American politics, but the rate of policy change has far outstripped our understanding of either the determinants of the process or its implications for democratic rule, economic performance, or the distribution of political costs and benefits across society.

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